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Collier on Bankruptcy Taxation

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CHAPTER TX1 Policies and History

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CHAPTER TX1 Policies and History

I History and Development of Tax Treatment in Bankruptcy

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P TX1.01 Introduction

Advising financially troubled taxpayers that are either insolvent or are considering filing a title 11 case, or are debtors in a pending case, links the complicated, and normally distinct, legal practices of taxation and bankruptcy. Further, the subject of federal taxation in relation to a title 11 case reflects a delicate commingling and balancing of conflicting public policy objectives.

Collecting taxes is the keystone for the operation of governmental entities. The system of taxation and the imposition and collection of taxes were designed by Congress and the U.S. Treasury to maximize the dollar return to the government, by such means as: priority in payment of taxes over the debts of other creditors; easily created lien rights in favor of the collector to secure past due taxes; simplified attachment of wages and receivables; simplified securing of delinquent taxes through the IRS administrative process; interest assessed and collectible on past due taxes; penalties assessable and collectible for unpaid taxes; and imposition of third party liability for failure to collect and pay over taxes.

The Internal Revenue Code seeks the full, complete and prompt payment of taxes. n1 All taxes due to the government must be collected, and it is the IRS's duty and responsibility to do so promptly and efficiently. n2

Title 11 was designed by Congress in 1978 to provide debtors with a "fresh start" by granting them a discharge from certain obligations, to distribute assets and pay claims in a predetermined scheme with a statutory system of priorities, and to provide debtors with an opportunity to reorganize, rehabilitate, or liquidate. n3

It may be argued that if all tax liabilities were excused and discharged, and all debtors reorganized and rehabilitated, the new debt free entities created could theoretically generate greater business revenue and larger tax collections. However, in practice, the legislative policies of the Bankruptcy Code and the Internal Revenue Code tend to conflict with each other. How is the conflict between the policy of promptly and efficiently collecting all taxes due balanced against the orderly administration of the objectives of the Bankruptcy Code, the concept of "fresh start" and rehabilitation? Is the conflict irreconcilable? Congress addressed this issue when the Bankruptcy Code was initially enacted in 1978 and acknowledged that a tension exists among the interests of creditors, debtors, and the government; interests which are susceptible to a balance in treatment in the bankruptcy process. n4

The Bankruptcy Code seeks equality of distribution, financial rehabilitation and a fresh start. Although there are many points of divergence in the operation of the two legislative schemes, it is possible that the overall objectives of the Bankruptcy Code and the Internal Revenue Code do not conflict because "successful reorganization satisfies the goals of bankruptcy and tax." n5

On the other hand, there will always be tension between the debtor, creditors, and the Internal Revenue Service in every bankruptcy case where the debtor has not paid prepetition taxes and this tax liability is carried forward to the bankruptcy estate. n6

FOOTNOTES:

(n1)Footnote 1. See *Bull v. United States*, 295 U.S. 247, 259, 55 S. Ct. 695 (1935) ("taxes are the lifeblood of government and their prompt and certain availability an imperious need.").

(n2)Footnote 2. See *Bob Jones University v. Simon*, 416 U.S. 725, 94 S. Ct. 2038, 40 L. Ed. 2d 496 (1975) , modified on other grounds by *South Carolina v. Regan*, 465 U.S. 367, 104 S. Ct. 1107, 79 L. Ed. 2d 372 (1984) ; *United States v. A & B Heating and Air Conditioning, Inc.*, 823 F.2d 462, 17 C.B.C.2d 1409 (11th Cir. 1987) ; see generally Bancroft, *Postpetition Interest on Tax Liens in Bankruptcy Proceedings*, 62 Am. Bankr. L.J. 327 (1988).

(n3)Footnote 3. For a philosophical discussion of the elements of the Bankruptcy Act and its goals, see The Report of the Commission on the Bankruptcy Laws of the United States, Chapter 3, H.R. Doc. No. 93-137, 93d Cong., 1st Sess. (1973), reprinted in Vol. B Collier on Bankruptcy, App. Pt. 4(c) (Matthew Bender 15th Ed. Revised); see also Trost and King, *Congress and Bankruptcy Reform Circa 1977*, 33 Bus. Lawyer 2 (1978); *Hanover National Bank v. Moyses*, 186 U.S. 181, 22 S. Ct. 857, 46 L. Ed. 1113 (1902) ; *Kuehner v. Irving Trust Co.*, 299 U.S. 445, 57 S. Ct. 298, 81 L. Ed. 340 (1937) ; *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 103 S. Ct. 2309, 76 L. Ed. 2d 515, 8 C.B.C.2d 710 (1983) .

(n4)Footnote 4. Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 1978 U.S. Code Cong. & Admin. News 5787, 5799-5800 (reprinted in Vol. A Collier on Bankruptcy, App. Pt. 4 (Matthew Bender 15th Ed. Revised):

In a broad sense, the goals of rehabilitating debtors and giving equal treatment to private voluntary creditors must be balanced with the interests of governmental tax authorities who, if unpaid taxes exist, are also creditors in the proceeding.

A three way tension thus exists among (1) general creditors, who should not have the funds available for payment of debts exhausted by an excessive accumulation of taxes for past years; (2) the debtor, whose "fresh start" should likewise not be burdened with such an accumulation; and (3) the tax collector, who should not lose taxes which he has not had reasonable time to collect or which the law restrained him from collecting. See also *Local Loan Co. v. Hunt*, 292 U.S. 234, 54 S. Ct. 695 (1934) for the Supreme Court's concepts of the purposes of the Bankruptcy Act of 1898, the predecessor to the Bankruptcy Code.

(n5)Footnote 5. Rothman, *Responsible Persons and Irresponsible Doctrine: The Allocation of the Bankrupt's Postpetition Payments on Unpaid Prepetition Federal Taxes*, 95 Comm. L.J. 24, 36 (1990) . The author makes the point that viable reorganization provides more money to creditors than liquidation and preserves the economic life of the business entity, thus allowing the government to receive partial payments with interest for many years for tax obligations as a part of the reorganization plan; so that over a six-year period the government theoretically receives interest and all revenue owed or, at least, maximizes the funds it collects.

(n6)Footnote 6. See Jenks, "The Tax Collector in Bankruptcy Court: The Government's Uneasy Role as Creditor in Bankruptcy," 71 Taxes 847 (1993).



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CHAPTER TX1 Policies and History

I History and Development of Tax Treatment in Bankruptcy

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P TX1.02 History of Tax Treatment in Bankruptcy

An important element of income tax planning for a debtor corporation about to file for bankruptcy relief is adjustment of debt without further federal income tax liability, loss of favorable tax attributes or net operating loss carryovers. n1

The Bankruptcy Act of 1898 ("Bankruptcy Act") contained some provisions which affected the bankruptcy court's right to determine taxes owed by the trustee of the bankrupt's estate to the Internal Revenue Service. n2 The bankrupt had the ability to ask the bankruptcy court to take jurisdiction over tax issues. If the bankruptcy court made a ruling on prepetition income taxes, this ruling may not have been binding on the IRS. Frequently, even though a bankruptcy court had ruled on the amount of nondischargeable tax claims exclusive of those paid out of the administration of the bankrupt's estate, the IRS could relitigate the tax questions and liability in a nonbankruptcy court.

The bankruptcy court and the Tax Court had concurrent jurisdiction to determine tax liability. A decision of the Tax Court was not binding on the bankrupt's estate unless the bankruptcy trustee intervened and participated in the litigation before the Tax Court. On the other hand, the bankruptcy court's decision would not have had binding effect on the individual bankrupt unless the bankrupt had invoked the bankruptcy court's jurisdiction. The bankruptcy court had no jurisdiction over refund suits. If a bankruptcy trustee sought a refund from the IRS, suit was required to be filed in the Tax Court, the United States District Court, or the Court of Claims. n3

There was no jurisdiction in the bankruptcy court to force the IRS to audit and approve tax returns filed, to determine and calculate net operating losses, or to enter judgments or orders which determined the tax consequences of plans of arrangement or reorganization. n4

Once a bankruptcy case was filed, there was no automatic stay, and the IRS had the power to assess income tax liabilities against the bankrupt. This concept of immediate assessment was detrimental to the bankrupt taxpayer because it took away the power of the Tax Court to pass on tax issues. After immediate assessment the Tax Court had no jurisdiction over the bankrupt's tax liabilities. The bankrupt's right to invoke the jurisdiction of the bankruptcy court was available after immediate assessment of tax by the IRS, but the ruling of the bankruptcy court had a limited effect on the IRS. The IRS could proceed after the immediate assessment of the tax to collect the tax by levy on the bankrupt's property and could seize and sell assets in which the bankrupt had an interest. The bankrupt had limited effective remedies. One remedy was to pay the tax assessed and sue for a refund of the tax paid in the United States District

Court. This court could order the IRS to refund the erroneous tax collected with interest. The bankrupt could also elect to sue the IRS in the Court of Claims after the tax had been paid. The bankruptcy court had no jurisdiction to order the IRS to refund the taxes collected even though the IRS had filed a proof of claim with that court.

Because the bankruptcy court had limited jurisdiction in tax matters, very little interest had been generated with respect to the tax aspects of bankruptcy and reorganization prior to the Report of the Commission on the Bankruptcy Laws of the United States (the "Commission"). n5 The Commission was created by Congress to study the Bankruptcy Act existing at that time. n6 The Commission Report and its recommended legislation were introduced in the House as H.R. 10792 and in the Senate as S. 2565. At that time, many practitioners recognized that tax reform was sorely needed in the bankruptcy area with regard to tax benefits derived from debt cancellation and net operating loss ("NOL") carryovers. n7 A distinguished tax expert had previously recognized that the cancellation of indebtedness in the tax area was a problem of "creeping confusion." He urged comprehensive statutory treatment. n8 It might be noted that both of these areas continue to be of major concern today and were and have been addressed in tax legislation subsequent to the Bankruptcy Tax Act of 1980. n9

Similarly, the Commission Report recommended and suggested numerous amendments to the Bankruptcy Act and to the Internal Revenue Code. n10 The Commission proposed the reduction of NOL carryovers to the extent that indebtedness that was cancelled or reduced had contributed to those losses. The Commission adhered to the view that the mere filing of a reorganization petition should not bar the carryforward of tax attributes or generate tax consequences apart from the specific tax rules applicable to the transaction itself. n11

For example, a series of amendments to *I.R.C. sections 371, 381 and 382* were recommended. n12 As the law stood, an *I.R.C. section 371* bankruptcy reorganization was not apparently within the scope of *I.R.C. section 381*; therefore, the NOL carryover of the reorganized corporation was lost. The Commission recommended that *I.R.C. section 381* be made applicable to a bankruptcy reorganization so that the reorganized entity or its successor could succeed to and use the NOL carryforward as provided in *I.R.C. section 381(a)*. All NOL carryforwards would have been made available to a successor corporation following reorganization in bankruptcy or outside of bankruptcy pursuant to the Internal Revenue Code provisions. This objective would have been reached by an amendment to *I.R.C. section 382*, which would have provided that an increase in the amount of stock owned by creditors in cancellation of their indebtedness would not be treated as a "purchase" of the debtor corporation's stock. n13

The Commission proposed an adjustment of the basis of property in a reorganization case by the amount of the debt reduction if the reduction would otherwise have been taxable as income from the discharge of indebtedness. The extent of the proposed basis reduction would not have exceeded the amount by which the reorganized debtor was solvent after the cancellation or reduction of debt. The Commission's recommendation with regard to stock given to creditors in exchange for debt, whether partially or fully in satisfaction of creditors' claims, was based on the premise that such a transaction was not an act requiring a reduction of corporate indebtedness, a basis reduction, or a reduction in NOL carryforwards. The Commission reasoned that creditors exchanging debt for stock had a financial interest in the reorganized debtor and, therefore, should not be responsible for making the debtor successful or bear the burden of future financial success. n14

Prior to the Commission's consideration, the tax consequences of a Bankruptcy Act Chapter X reorganization, Chapter XI arrangement, or Chapter XII real property arrangement were determined by specific mandatory provisions dealing with taxes, contained within the Bankruptcy Act itself. No taxable income resulted from the reduction of indebtedness when debts were discharged by agreement among the creditors if the debtor was insolvent immediately after the agreement took effect. n15 Income was realized only if the discharge of debt rendered the debtor solvent, and only to the extent of the solvency. If the reorganization or arrangement did not involve the transfer of assets, the basis of assets remaining in the debtor's hands was reduced by the amount of debt forgiven by the creditors. n16 Forgiveness of debt usually resulted from a plan of reorganization or plan of arrangement, depending on the applicable chapter within which the proceeding fell.

There was a limitation to the amount of basis reduction, however. Generally, a bankrupt's basis in its assets could not be reduced below the fair market value of the assets at the date of confirmation of the corporate reorganization or arrangement plan. n17 Any excess debt discharged which did not reduce basis because of the limitation was excluded from income.

A significant dispute existed concerning the interrelationship of losses, carrybacks, and carryforwards in reorganizations or arrangements under the Bankruptcy Act. In brief, there was no unanimity on the extent to which an NOL carryover of a reorganized debtor remained available after reorganization had taken place. This depended on whether the reorganization was internal, or was accomplished by a transfer of assets or by a successor corporation acquiring the debtor corporation's stock. n18

Subsequent to the Commission's Report and recommendations, the Commission introduced a number of bills containing substantive tax provisions. n19 The National Conference of Bankruptcy Judges proposed a revised Bankruptcy Act as a counterproposal to the Commission's bill. n20 This bankruptcy bill did not change the Commission's bill with regard to the special tax provisions and the tax consequences of liquidation and reorganization. From 1974 to 1977, a number of proposed bankruptcy bills were introduced in the House and Senate. n21

As a result of the Commission's tax recommendations, the modernization of tax treatment in bankruptcy generated continuing interest by governmental entities in an effort to strengthen their position in bankruptcy. The tax provisions in the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") n22 brought together ideas and concepts from the Department of Justice, the Internal Revenue Service and the National Association of Attorneys General. n23 The tax provisions of BAPCPA were designed to simplify tax collection and give more strength and power to federal, state and local tax collectors in a bankruptcy case.

The historical evolution of the Bankruptcy Code, the Bankruptcy Tax Act of 1980 and BAPCPA is discussed later in this introductory material. n24 The foregoing discussion brings the chronological development of tax treatment and problems to 1978, before the enactment of the Bankruptcy Code.

FOOTNOTES:

(n1)Footnote 1. Asofsky, *Reorganizing Insolvent Corporations Today*, 47 *Inst. on Fed. Tax'n* 40-3 (1989). The author discusses debt adjustment objectives from a tax standpoint. He concludes that the tax consequences can play a significant role in determining whether a plan of reorganization is feasible and whether the debtor corporation can survive, successfully reorganize and have its plan confirmed. Asofsky points out that attaining the goals of both the policies of the Internal Revenue Code and the Bankruptcy Code should not be regarded as "tax avoidance" because the bankruptcy tax rules reflect congressional tax policies which were designed to integrate rehabilitative policies and tax collection objectives. He complains that the 1980s ushered in a new tax policy attitude: "In the guise of reform and equity many of them [tax breaks] have been swept aside without regard to the economic consequences." Asofsky, *Reorganizing Insolvent Corporations Today*, 47 *Inst. on Fed. Tax'n* 40-4 (1989). He concludes that "tax relief once afforded to struggling companies is being slowly withdrawn. Practitioners in the bankruptcy field must learn the new rules to take advantage of the tax benefits that still exist." Asofsky, *Reorganizing Insolvent Corporations Today*, 47 *Inst. on Fed. Tax'n* 40-4 (1989).

(n2)Footnote 2. Bankruptcy Act § 2(a)(2)(A), *reprinted in* Vol. A Collier on Bankruptcy, App. Pt. 3(a) (Matthew Bender 15th Ed. Revised); *City of Amarillo v. Eakens*, 399 F.2d 541 (5th Cir. 1968), *cert. denied*, 393 U.S. 1051, 89 S. Ct. 688, 21 L. Ed. 2d 692 (1969).

(n3)Footnote 3. *Danning v. United States*, 259 F.2d 305 (9th Cir. 1958), *cert. denied*, 359 U.S. 911, 79 S. Ct.

587, 3 L. Ed. 2d 574 (1959) ; Bankruptcy Act, § 23(b).

(n4)Footnote 4. *In re Wingreen Company*, 412 F.2d 1045 (5th Cir. 1969) ; *In re Inland Gas Corp.*, 241 F.2d 374 (6th Cir. 1957) , *cert. denied sub nom. Allen v. Williamson*, 355 U.S. 838, 78 S. Ct. 35, 2 L. Ed. 2d 50 (1957) . Plans of arrangement were proposed and approved by the bankruptcy court in Chapter XI, and affected and modified unsecured debt only if approved by 51 percent of the creditors affected in number and amount.

(n5)Footnote 5. The Report of the Commission on Bankruptcy Laws of the United States was issued in two parts, Part I and Part II, H.R. Doc. No. 93-137, 93d Cong., 1st Sess. (1973), *reprinted in* Vol. B Collier on Bankruptcy, App. Pt. 4(c) (Matthew Bender 15th Ed. Revised). Part I of the Commission Report was a survey in narrative form and contained recommendations, authorities and reasoning. Part II was the proposed Bankruptcy Act of 1973 introduced in the House as H.R. 10792 and in the Senate as S. 2565.

(n6)Footnote 6. The Commission was established by Pub. L. No. 91-354, 84 Stat. 468, effective July 24, 1970. The Commission Chairmen, Harold Marsh, Esq., Professor Charles Seligson, and J. Wilson Newman, were appointed by the President. Two United States District Judges were appointed by the Chief Justice of the Supreme Court, two Senators were appointed by the President of the Senate, and two Representatives were appointed by the Speaker of the House. The Commission became operational on June 1, 1971, and utilized a full-time staff, research associates and assistants, and a number of consultants.

(n7)Footnote 7. *See* Blum, *Ramifications of Bankruptcy in Federal Tax Matters*, 29 *Inst. on Fed. Tax'n* 937 (1971); Glancy, *Carrying Losses Through Chapters X and XI Reorganizations*, 28 *Tax L. Rev.* 27 (1974); Horwich, *The Taxation of Appreciation Income in the Course of Bankruptcy*, 73 *Com. L.J.* 448 (1968); Kay, *Federal Taxes, Bankruptcy and Assignments for the Benefit of Creditors--A Comparison*, 73 *Com. L.J.* 78 (1968); Kingsmill, *Bankruptcy and the Tax Law*, 18 *Tul. Tax Inst.* 633 (1969); Mansfield, Coogan, Scheffer, and Stuetzer, *Practical Techniques for Handling Tax Problems in Bankruptcy: A Panel Discussion*, 27 *Inst. on Fed. Tax'n* 1115 (1969); Newton, *Tax Planning Factors to be Considered by Debtors and Creditors in and Out of Court*, 83 *Com. L.J.* 513 (1978); Paul, *Debt and Basis Reduction Under the Chandler Act*, 15 *Tul. L. Rev.* 1 (1940); Plumb, *Tax Recommendations of the Commission on the Bankruptcy Laws--Income Tax Liabilities of the Estate and the Debtor*, 72 *Mich. L. Rev.* 937 (1974); *Tax Recommendations of the Commission on the Bankruptcy Laws--Priority and Dischargeability of Tax Claims*, 59 *Cornell L. Rev.* 991 (1974); *Tax Recommendations of the Commission on the Bankruptcy Laws--Reorganizations, Carryovers, and the Effects of Debt Reduction*, 29 *Tax L. Rev.* 229 (1974); *Tax Recommendations of the Commission on the Bankruptcy Laws--Tax Procedures*, 88 *Harv. L. Rev.* 1360 (1975); Sheinfeld and Parkins, *Tax Problems of a Business in Reorganization and Arrangement*, 13 *Hous. L. Rev.* 480 (1976); and Tillinghast and Gardner, *Acquisitive Reorganizations and Chapters X and XI of the Bankruptcy Act*, 26 *Tax L. Rev.* 663 (1971).

(n8)Footnote 8. *See* Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 *Tax L. Rev.* 225, 288 (1959), in which Professor Eustice stated:

[I]t would seem sufficient experience has been accumulated in the cancellation of indebtedness field, both among members of the tax bar and the Legislature, to sustain the intelligent drafting of a uniform and comprehensive statutory treatment of this problem. There is a crying need for some adequate guideposts to taxpayers and the Government in this exceedingly complex field. Reason and necessity can demand no less.

(n9)Footnote 9. The Tax Reform Act of 1984, Pub. L. No. 98-369 (1984) and the Tax Reform Act of 1986, Pub. L. No. 99-514 (1986). *See also* The Tax Simplification Act of 1991 (proposed and introduced as S. 1394 in the 102d Congress, 1991). *See* discussion at P TX8.04[2] *infra*.

(n10)Footnote 10. The Commission Report (Part I, Chapter 11, pp. 227-297) sets forth the recommendation of amendments to bankruptcy and tax statutes to eliminate inequities that the Commission felt existed from the interaction

of bankruptcy and tax. Part I and Part II, H.R. Doc. No. 93-137, 93d Cong., 1st Sess. (1973), *reprinted in* Vol. B Collier on Bankruptcy, App. Pt. 4(c) (Matthew Bender 15th Ed. Revised).

(n11)Footnote 11. This position was articulated in the Commission Report with the recommendation that *I.R.C. § 381*, which provides that the acquiring corporation in a tax-free reorganization under *I.R.C. § 368* succeeds to loss carryovers and specified tax attributes of the acquired corporation, should be applicable to a nonjudicial insolvency reorganization under *I.R.C. § 371*. In other words, the Commission recommendations provided for carryforward of losses and tax attributes after a reorganization regardless of whether the general requirements of a tax-free reorganization pursuant to provisions of *I.R.C. § 368* were met.

(n12)Footnote 12. *I.R.C. § 371* provided for tax-free treatment of reorganization of a corporation in Chapter X of the Bankruptcy Act or in a receivership, foreclosure, or similar proceeding. The provisions of *I.R.C. § 371* did not apply to Chapter XI of the Bankruptcy Act when transfers of assets occurred from a debtor corporation to a new corporation pursuant to an arrangement. *I.R.C. § 381* permitted loss carryovers and other tax attributes of the transferor corporation to be acquired by the transferee corporation if the reorganization qualified under *I.R.C. § 368(a)* as a tax-free corporate reorganization. This was not applicable to insolvency reorganizations. *I.R.C. § 382(b)* limited the use of net operating loss carryovers by an acquiring corporation under *I.R.C. § 381* where shareholders immediately after the reorganization owned less than 20 percent of the fair market value of the stock of the acquiring corporations.

(n13)Footnote 13. Specifically, it was proposed that *I.R.C. § 382(a)(1)* be amended to assure that an increase in stock ownership resulting from a creditor's exchange of stock for debt in a bankruptcy reorganization or a nonjudicial insolvency reorganization under *I.R.C. § 371* would not be considered an increase resulting from a "purchase" of stock. It proposed a restriction if the creditor's claim had been obtained for the purpose of acquiring the stock in either a bankruptcy reorganization or insolvency reorganization. In such event, the transaction would be tainted and result in a stock purchase.

(n14)Footnote 14. The Commission's recommendations, according to one interpretation, appear consistent with a policy favorable to rehabilitation. One could conclude that the Commission felt that an exchange of stock for debt would be a favorable reorganization device.

(n15)Footnote 15. Bankruptcy Act §§ 268 (Chapter X), 395 (Chapter XI), and 520 (Chapter XII).

(n16)Footnote 16. Bankruptcy Act §§ 270 (Chapter X), 396 (Chapter XI), and 522 (Chapter XII).

(n17)Footnote 17. Bankruptcy Act §§ 270 (Chapter X), 396 (Chapter XI), and 522 (Chapter XII).

(n18)Footnote 18. *See* Plumb, Report on Loss Carryovers and Debt Reduction in Proceedings Under Chapters X, XI, and XII, H.R. Doc. No. 93-137, 93d Cong., 1st Sess. 1-178 (1973).

(n19)Footnote 19. The Commission's proposed bill, H.R. 10792, was introduced by Congressmen Edwards and Wiggins in 1973.

(n20)Footnote 20. H.R. 16643 was introduced by Congressmen Edwards and Wiggins in 1973.

(n21)Footnote 21. For a thorough and comprehensive legislative history of the making of the Bankruptcy Code, *see* Vol. B Collier on Bankruptcy, App. Pt. 4 (Matthew Bender 15th Ed. Revised).

(n22)Footnote 22. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n23)Footnote 23. Report of the ABA Tax Section Task Force on the Tax recommendations of the National Bankruptcy Review Commission, Asofsky and McKenzie, 97 TNT 90-22 (May 9, 1997), hereafter the ABA Tax

Section Task Force Report.

(n24)Footnote 24. *See P TX1.03 and P TX1.05 infra* .



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CHAPTER TX1 Policies and History

I History and Development of Tax Treatment in Bankruptcy

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P TX1.03 Legislative History of Tax Treatment in Modern Bankruptcy Practice

In 1977, the Bankruptcy Reform Act of 1978, with tax provisions, was introduced in the House. n1 Because H.R. 8200 contained tax provisions that were within the jurisdiction of the Committee on Ways and Means, a dispute between the Judiciary and Ways and Means Committees ensued. An accord was reached. The Judiciary Committee removed the federal tax provisions in the Bankruptcy Code and reported the bill. Certain substantive tax provisions remained in H.R. 8200 but those provisions operated only with respect to state and local taxes. n2 As a consequence, when H.R. 8200 was signed into law on November 6, 1978 (effective on and after October 1, 1979), it was, from a tax practitioner's point of view, incomplete.

On November 3, 1977, H.R. 9973, a bankruptcy tax bill, was introduced specifically to cover federal taxes that had been omitted from H.R. 8200. The Subcommittee on Civil and Constitutional Rights of the House Judiciary Committee proposed H.R. 9973 as a special bankruptcy tax bill designed to modify and modernize the tax treatment of insolvency proceedings and title 11 cases. H.R. 9973 was referred to the Committee on Ways and Means, which commenced hearings on February 22, 1978. The bill was designed to deal with certain tax aspects of title 11 and, in particular, the tax treatment of discharge of indebtedness income, the reorganization of debtor corporations, the jurisdiction of various courts over tax deficiency and refund litigation, priority rights of the taxing entity, and questions of tax liability and collection of taxes arising during a title 11 case. Hearings of the Committee on Ways and Means on H.R. 9973 were concluded in 1978 but no action was taken on the bill.

H.R. 5043, the Bankruptcy Tax Act of 1979, was introduced on August 1, 1979. This bill was heralded by the announcement that it had been developed by the congressional staffs based on extensive studies, commentaries, and recommendations for changes in bankruptcy tax rules made over the previous six years. On September 27, 1979, the Ways and Means Subcommittee on Select Revenue Measures held hearings on H.R. 5043. H.R. 5043 was approved by the Subcommittee on November 1, 1979, subject to further commentary on certain aspects.

On December 13, 1980, the House was asked to concur in certain Senate amendments to H.R. 5043, which was called the Bankruptcy Tax Act of 1980. n3 The Senate amendments were read into the Congressional Record. n4 The bill was described as an amendment to the Internal Revenue Code of 1954 to provide for the tax treatment of title 11, insolvency, and similar proceedings. The Bankruptcy Tax Act of 1980 was characterized by the Chairman of the Committee on Ways and Means, Representative Ullman, as an important bill which had been carefully developed over

the past two years. n5 Representative Ullman advised his colleagues that unless the Bankruptcy Tax Act of 1980 was enacted, there would be confusion and controversy regarding the statutory rules governing the tax treatment of debt discharged and other tax aspects of title 11 cases. n6 On December 24, 1980, the Bankruptcy Tax Act of 1980, as passed by the Senate and House, was signed by President Carter. The Bankruptcy Tax Act was very controversial insofar as it permitted special tax treatment for bankruptcy transactions. Many opposed relaxation of traditional tax rules in bankruptcy reorganization situations and preferred to keep out-of-court reorganizations and bankruptcy reorganizations on equal footing. These critics argued that the debtors in a title 11 case received an advantage, or "head start" over other taxpayers. n7

The Bankruptcy Tax Act has been affected by subsequent amendments to the Internal Revenue Code. Of particular importance are revisions made as part of the sweeping tax simplification and reform program passed by the 99th Congress. The Tax Reform Act of 1986, n8 embodying these reforms, was signed into law on October 22, 1986. This was the culmination of much debate. n9 The 1986 Act included amendments in areas that have historically been of concern to bankruptcy practitioners. It addressed and substantially restricted the ability of a debtor corporation to continue to use net operating loss and other carryovers following a change of stock ownership. It also limited the application of the stock for debt exchange rules. n10

The Bankruptcy Judges, United States Trustees, and Family Farmer Bankruptcy Act of 1986 n11 became effective on November 26, 1986. Chapter 12--"Adjustment of Debts of a Family Farmer With Regular Annual Income"--was added to the Bankruptcy Code. n12 No specific tax provisions were added to address the ramifications and federal tax consequences of Chapter 12. Special tax provisions applicable only to state and local taxes n13 are provided which require the trustee to file state and local tax returns. The taxable period for those taxes terminates on the date the order for relief is entered. n14 Chapter 12 has been permanent reenacted by BAPCPA.

The Bankruptcy Code grants the bankruptcy court jurisdiction to determine tax questions unless the tax issue has previously been adjudicated by a court of competent jurisdiction before the bankruptcy case began. This jurisdiction is constantly expanding by court decision. n15

Some doubt existed as to the authority of the bankruptcy court to declare the federal tax consequences of a plan. n16 There existed controversy over the scope of section 1146(d)(2) on the grounds that it limits the bankruptcy court's authority to declare tax consequences only with regard to state and local taxes and not to federal. n17

The Bankruptcy Reform Act of 1994 n18 amended *section 106 of the Bankruptcy Code* to "effectively overrule" the Supreme Court's decisions in *Hoffman v. Connecticut Department of Income Maintenance* n19 and *United States v. Nordic Village*. n20 Section 106 now expressly provides for a waiver of sovereign immunity by governmental units with respect to monetary relief as well as declaratory and injunctive relief. n21 The purpose of the sovereign immunity waiver of both Federal and State governments is to permit the recovery of money judgments. Additionally, a compulsory counterclaim may be asserted against the governmental unit where that unit has filed a proof of claim in the bankruptcy case. n22

Recent activity by the IRS and Treasury continues to demonstrate their "concern" with the use of title 11 as a tax advantage vehicle. The IRS is taking an activist position in the areas of tax-free exchanges, n23 tax avoidance by ownership change through the filing of a title 11 case, n24 and restricting stock for debt exchanges qualifying for the exception from the realization of discharge of indebtedness income. n25 These areas have and will continue to receive attention.

FOOTNOTES:

(n1)Footnote 1. H.R. 8200, 95th Cong., 1st Sess., was reported by the House Committee on the Judiciary on September

8, 1977. The bill was then debated on the floor of the House of Representatives on October 27-28, 1977 and on February 1, 1978. This bill was passed by the House and sent to the Senate along with House Judiciary Report 95-895. The Senate Bill S. 2266, substantially identical to H.R. 8200, was considered by the Senate Judiciary Committee and reported favorably on July 14, 1978. The Senate considered and acted on S. 2266 on September 7, 1978. H.R. 8200 was amended by the Senate by striking out all the text after the enacting clause and substituting the text of S. 2266. This is the manner in which the Senate approved S. 2266 and blended H.R. 8200 into the compromise bill that became Pub. L. No. 95-598, the Bankruptcy Reform Act of 1978.

(n2)Footnote 2. The special tax provisions of H.R. 8200 (§§ 346, 728, 1146, and 1331), as originally written, were applicable to state, local, and federal taxes. The Ways and Means Committee and Judiciary Committee agreement allowed H.R. 8200 to be immediately considered by the Judiciary Committee. The special tax provisions remained in H.R. 8200, but an amendment was adopted limiting the scope of such special tax provisions to state and local tax rules. *See 3 Collier on Bankruptcy, P 346.01* (Matthew Bender 15th Ed. Revised); it was hoped that the void would be filled by H.R. 9973.

(n3)Footnote 3. The House passed H.R. 5043 on March 24, 1980 by a vote of 324-0 after it was considered by the Subcommittee on Select Revenue Measures of the House Committee on Ways and Means. H.R. 5043 was considered by the Subcommittee on Taxation and Debt Management of the Senate Committee on Finance on May 30, 1980. Throughout this chapter, the compromise legislation, Pub. L. No. 96-589, passed by Congress and signed by President Carter, will be referred to as the Bankruptcy Tax Act of 1980.

(n4)Footnote 4. A full statement of the Senate proposed amendments may be found in 126 Cong. Rec. S. 16489-16492 (daily ed. Dec. 13, 1980). The proposed Senate amendments were read into 126 Cong. Rec. H. 12419-12422 (daily ed. Dec. 13, 1980).

(n5)Footnote 5. Representative Ullman's full statement is found at 126 Cong. Rec. H. 12461-12464 (daily ed. Dec. 13, 1980).

(n6)Footnote 6. Representative Ullman characterized the "stock-for-debt" rule proposed by the Senate amendment as a favorable tax treatment that encouraged reorganization rather than liquidation of financially distressed companies. He also expressed the view that the proposed Senate amendments represented a fairly balanced approach between the policy of the tax collector and the Bankruptcy Code concept of a "fresh start." Final Senate and House Debate, 126 Cong. Rec. S16489-16493 and H. 12439-12464 at H. 12461-12462.

(n7)Footnote 7. Hearings on H.R. 9973 before the House Committee on Ways and Means, 95th Cong., 2d Sess. (1978) (statements of Daniel I. Halperin, Tax Legislation Counsel, Office of Assistant Secretary for Tax Policy, Department of Treasury, and M. Carr Ferguson, Assistant Attorney General, Tax Division, Department of Justice); Hearings on H.R. 5043 before Subcommittee on Select Revenue Measures of the House Committee on Ways and Means, 95th Cong., 1st Sess. (1979) (statement of Daniel I. Halperin, Deputy Assistant Secretary for Tax Policy, Department of Treasury).

(n8)Footnote 8. Pub. L. No. 99-514.

(n9)Footnote 9. The House bill, H.R. 3838, was passed in December 1985, the Senate bill in May 1986, and the Conference bill in September 1986.

(n10)Footnote 10. The stock for debt exception has been repealed by the Omnibus Budget Reconciliation Act of 1993 (Pub. L. No. 103-66). The repeal of this exception took place in two stages, becoming fully effective for stock transfers after January 1, 1995. *See* chapter TX8 *infra*. For a full discussion of discharge of indebtedness and *I.R.C.* § 108 relief, the stock for debt exception, the special title 11 tax-free reorganization provisions and the net operating loss rules, *see* chapters TX8, TX10 and TX11, *infra*, respectively.

(n11)Footnote 11. Pub. L. No. 99-554 (1986), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 7(a) (Matthew Bender 15th Ed. Revised).

(n12)Footnote 12. Chapter 12 was later permanently reenacted, effective July 1, 2005, and amended to include family fishermen by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n13)Footnote 13. 11 U.S.C. § 1231. *See* 8 Collier on Bankruptcy, P 1231.01 (Matthew Bender 15th Ed. Revised).

(n14)Footnote 14. 11 U.S.C. § 1231(a) and (b).

(n15)Footnote 15. 11 U.S.C. § 505(a). *See* chapter TX5 *infra*, for a full analysis of the bankruptcy court's jurisdiction to determine tax questions.

(n16)Footnote 16. 11 U.S.C. § 1146(d)(2).

(n17)Footnote 17. *In re Goldblatt Brothers, Inc.*, 106 B.R. 522 (Bankr. N.D. Ill. 1989) ; *see also* *U.S. v. Nordic Village, Inc.*, 503 U.S. 30, 112 S. Ct. 1011, 117 L. Ed. 2d 181, 26 C.B.C.2d 9 (1992) ; *Holywell Corp. v. Smith*, 503 U.S. 47, 112 S. Ct. 1021, 117 L. Ed. 2d 196, 26 C.B.C.2d 1 (1992) (regarding the availability of declaratory relief as a vehicle for determining the obligation to file tax returns, pay taxes, and the amount and dischargeability of any tax); *see also* *In re Thomas Vinson Blanton, Jr.*, 105 B.R. 321 (Bankr. E.D. Va. 1989) (in which a creditor was allowed to seek declaratory relief from the bankruptcy court with regard to the determination of the debtor's taxes).

(n18)Footnote 18. Pub. L. No. 103-394, signed into law and effective (as to most amendments) on October 22, 1994, is *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 7(a) (Matthew Bender 15th Ed. Revised).

(n19)Footnote 19. 492 U.S. 96, 109 S. Ct. 2818, 106 L. Ed. 2d 76, 20 C.B.C.2d 1204 (1989) .

(n20)Footnote 20. 503 U.S. 30, 112 S. Ct. 1011, 117 L. Ed. 2d 181, 26 C.B.C.2d 9 (1993) .

(n21)Footnote 21. *See* § 106, as amended. *See also* House Report Part II, "Bankruptcy Reform Act of 1994, A Section-by-Section Description," *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(b) (Matthew Bender 15th Ed. Revised).

(n22)Footnote 22. *In re Town & Country Nursing Home Services, Inc.*, 963 F.2d 1146 (9th Cir. 1992) ; *In re Gribben*, 158 B.R. 920 (S.D.N.Y. 1993) ; and *In re The Craftsman, Inc.*, 163 B.R. 88 (Bankr. W.D. Tex. 1994) are effectively overruled by the amendment to section 106(b).

The 1996 decision of the Supreme Court in *Seminole Tribe of Florida v. Florida*, 517 U.S. 44, 116 S. Ct. 1114, 134 L. Ed. 2d 252, 34 C.B.C.2d 1199 (1996) raised serious questions concerning the constitutionality of section 106. In that case the Court held, in a 5-4 decision, that Congress lacks the power under the Indian *Commerce Clause* in Article I of the U.S. Constitution to override the *Eleventh Amendment* and subject unconsenting states to suits in federal court for violations of federally created rights. In so holding, the Court overruled *Pennsylvania v. Union Gas Co.*, 491 U.S. 1, 109 S. Ct. 2273, 105 L. Ed.2d 1 (1989) , a plurality decision finding that the *Interstate Commerce Clause* granted Congress the power to abrogate state sovereign immunity. The Court did recognize, however, that Congress does have the power to abrogate state sovereign immunity under *Section 5 of the 14th Amendment*. *Seminole Tribe of Florida v. Florida*, 517 U.S. 44, 59, 116 S. Ct. 1114, 1125, 134 L. Ed. 2d 252, 268, 34 C.B.C.2d 1199 . Although the ruling in *Seminole* did not directly address Congress' power under the Bankruptcy Clause in *Article I, Section 8, Clause 4 of the Constitution*, the decision held that state sovereignty under the *Eleventh Amendment* overrides Congressional power under Article I of the Constitution, signaling that section 106 may be unconstitutional as it relates to suits to recover money judgments against states. Unfortunately, the majority opinion in *Seminole* did not give clear guidance as to the

applicability of the decision to the Bankruptcy Code.

In another case sustaining the state's claim to sovereign immunity and the invalidity of section 106, the Massachusetts Department of Revenue prevailed. In *IRS v. Gosselin*, 252 B.R. 854 (D. Mass. 2000) the district court reversed the bankruptcy court decision discharging the debtor's tax liability in chapter 7. In this case, the IRS did not file a proof of claim or participate in the case and the debtor filed a complaint seeking to discharge the income tax due. The bankruptcy court granted a discharge and the motion to dismiss the complaint was denied. The district court held that the bankruptcy court did not have subject matter jurisdiction to hear the complaint seeking discharge of tax due because of the *Eleventh Amendment*.

(n23)Footnote 23. In the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, Congress enacted *I.R.C. § 108(e)(11)*, redesignated § 108(e)(10) by the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66. This new section was designed to ensure recognition of discharge of indebtedness income with respect to the issuance of a debt instrument in satisfaction of indebtedness and to incorporate fully the original issue discount rules.

(n24)Footnote 24. See *Treas. Reg. § 1.269-3(d)*. For a discussion, see chapter TX11 *infra*. For an analysis of whether a transactional acquisition in a title 11 case was for the purpose of avoidance of federal income tax, see *In the Matter of Federated Department Stores, Inc.*, 1992 LEXIS 392 (Bankr. S.D. Ohio 1992) and cases cited therein.

(n25)Footnote 25. The stock for debt exception has been repealed by the Omnibus Budget Reconciliation Act of 1993 (Pub. L. No. 103-66). The repeal of this exception took place in two stages. The repeal is effective in chapter 11 cases commenced after 1993 and exchanges effected after 1994. See chapter TX8 *infra*.



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Collier on Bankruptcy Taxation

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CHAPTER TX1 Policies and History

I History and Development of Tax Treatment in Bankruptcy

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P TX1.04 Tax Issues Considered by the National Bankruptcy Review Commission

The nine-member National Bankruptcy Review Commission (the "NBRC") was created by Congress pursuant to the Bankruptcy Reform Act of 1994. The purpose of the NBRC, which held its first meeting in October 1995, was to study the bankruptcy laws and make recommendations for reform. To accomplish this task, the broad topic of "bankruptcy" was divided into eight subcategories, including a "government issues" category which included bankruptcy tax matters. Three Commissioners were assigned to each of the eight subgroups, which were termed "Working Groups" by the NBRC. In addition to these eight subgroups, the NBRC created a discussion dialogue with the interested public. n1

The Government Working Group compiled a list of proposed tax reform measures, some of which were developed into formal proposals. Some of these proposals included review of the burden of proof on tax claims and matters pursuant to *11 U.S.C. section 505*; repeal of *18 U.S.C. section 1231(b)*; requiring mandatory filing of tax returns by trustees; barring tax-related setoffs under *11 U.S.C. section 362(a)*; requiring notice of federal tax audit to state tax authority; tightening requirements for seeking contempt sanctions against the Internal Revenue Service; and specific notice requirements for taxpayers seeking expedited audits.

In addition to the dialogue within the Government Working Group and at numerous publicly held meetings, the NBRC created an advisory committee of expert private and government tax individuals to assist it on tax-related issues. The Tax Advisory Committee, formed in late February 1997, was charged with proposing and discussing all issues related to federal, state, and local tax collection compliance and reporting related to the bankruptcy process and the administration of the bankruptcy estate. The Tax Advisory Committee identified a number of controversial issues for discussion and consideration. These issues include: strengthening notice requirements with respect to expedited audits under *18 U.S.C. section 505(b)*; selection of one applicable interest rate for deferred tax claims under *11 U.S.C. section 1129(a)(9)*; selection of one applicable interest rate for secured priority claims under *11 U.S.C. section 1322(a)(5)*; conforming *11 U.S.C. section 346* to *Internal Revenue Code section 1398(d)(2)*; excepting from discharge those taxes that were fraudulently unpaid by business entities in compliance with applicable tax laws; amending *11 U.S.C. section 1141(d)(3)* to clarify federal tax liability of bankruptcy estates for both alternative minimum tax and capital gains tax; clarification of when an individual voluntary bankruptcy case commences for tax purposes; when tax creditors must file proof of priority claims in chapter 7; whether individual chapter 11 debtors may be treated as employees of the bankruptcy estate; whether the time period specified in *11 U.S.C. section 507* should be tolled in successive bankruptcy filings; consider amending *11 U.S.C. section 507(a)(8)* to provide that any pending offer in compromise will toll the 240-day

pre- and postpetition assessment period; amendment of *11 U.S.C. section 362(a)(8)* so that no automatic stay is in effect to bar commencement or continuation of proceedings before the U.S. Tax Court if the taxpayer files bankruptcy; amendment of *11 U.S.C. section 545(2)* to overrule reported cases that penalize the government due to certain *bona fide* purchases provided for and lien provisions of the Internal Revenue Code; and amendment of *11 U.S.C. section 503* and *28 U.S.C. section 960* to eliminate the need for requests by governmental tax entities to debtors to pay taxes which have administrative priority.

Additionally, the Tax Advisory Committee suggested that the Bankruptcy Code be amended to provide more realistic and effective notice to governmental units in connection with income taxes, trust fund taxes, and postpetition ad valorem taxes.

Further issues suggested by the Tax Advisory Committee for consideration by the NBRC include amendments of *I.R.C. section 108* to identify when a discharge is entered; defining the term "assessed"; and setting specific standards for tax disclosure in chapter 11. An additional proposal was added to clarify possible inconsistencies in *11 U.S.C. section 346* and *I.R.C. section 1398* with regard to carryover of tax attributes.

The Tax Advisory Committee furnished a final report in August 1997. The final report contains three sections. One section lists and discusses 27 consensus items, of which 23 were adopted unanimously by the NBRC. Another section contains a listing and discussion of six consensus items which were forwarded to the NBRC without prior vote of the federal participants on the Committee. The third portion of the report lists and discusses 32 proposals that are classified by the Committee as very important, highly controversial, or controversial. There is no consensus on these items.

The Tax Section of the American Bar Association ("ABA") created a task force to monitor the work of the government working group, the tax advisory committee of the NBRC and the NBRC. In April 1997, the task force submitted an extensive memorandum to the NBRC on its recommendations relating to tax issues that the working groups had been discussing.

The ABA opposed the amendment of section 505 to limit bankruptcy court jurisdiction in connection with issuance of declaratory judgments on tax consequences of plans of reorganization.

The ABA opposed the repeal of *U.S. v. Energy Resources* ⁿ² and sought to confirm the fact that the bankruptcy court has jurisdiction under section 105 and section 1123(b)(5) to order the Internal Revenue Service to apply plan-allocated tax payments to trust fund debts first and then to nontrust fund tax debts where this is necessary to the success of the reorganization plan.

The ABA further recommended that the Bankruptcy Code and the I.R.C. be amended to provide an automatic stay applicable upon filing a chapter 11 petition, and a permanent injunction on plan confirmation against collection of trust fund taxes from the debtor's employees.

The ABA opposed any modification of the chapter 13 discharge to restrict dischargeability of a tax if all criteria for discharge are met.

The ABA opposed any repeal of section 724(b), which would require subordination of valid tax liens to the cost of administration and other unsecured priority claims occurring when a case is converted from chapter 11 to chapter 7.

The ABA recommended amending *I.R.C. section 1398(f)(2)* to provide that on abandonment of an asset administered by a bankruptcy trustee when the asset is subject to a debt in excess of the basis, the asset is deemed to have been disposed of immediately before the filing of the bankruptcy, and the liability for tax on disposition is a nondischargeable debt of the estate. This position is supportive of *In re A. J. Lane & Company*. ⁿ³

The ABA attempts to deal with tax liability of a corporation for the year of filing of a bankruptcy petition. Presently, the tax liability of a corporation for the year of filing is divided into a prepetition claim prior to the filing and an administrative claim subsequent. The competing position issues are: whether corporate income tax liability for the tax year that straddles the petition date should be an administrative expense for the entire year; or whether it is appropriate to bifurcate the tax liability for the year of filing, with the portion of liability attributable to the prepetition period having a priority status and the portion attributable to the postpetition period having an administrative priority status. n4

The ABA is concerned with the definition of "willfulness" as used in section 523(a)(1)(C). It believes that willfulness should be defined in the manner consistent with the criminal case interpretation of willfulness under *I.R.C. section 721*. There should be a sufficient conduct standard to support a finding of willfulness in connection with section 523.

The ABA believed that section 505 should be amended to broaden the jurisdiction of the bankruptcy court to determine tax liability for all members of a consolidated group in a proceeding to determine the tax liability of the parent, and to determine that payment provisions applicable to the parent should be applied equally to the members of the consolidated group.

The ABA recommended that subordination of tax penalties be restored in chapter 11 cases and that section 507(a)(8) be amended to exclude subsection (G), which affords priority status to a penalty related to a tax.

The ABA endorsed a reversal of the repeal of the stock-for-debt exception, so corporations undergoing reorganization may take advantage of the fresh start election.

A number of other organizations became active, some supporting the Commission's Tax Advisory Committee and others supporting the ABA Task Force or advocating positions of their own. Some of these organizations are the National Association of Attorneys General, the Department of Justice, the National Association of County Treasurers & Finance Officers, the American College of Bankruptcy, the Commercial Law League of America and the National Bankruptcy Conference.

The Tax Advisory Committee held a further meeting in May 1997 and presented a reported 24 committee consensus tax matters to the NBRC at that time. The same month the NBRC acted on the consensus tax issues, characterized as recommendations. The NBRC approved 23 of the 24 recommendations which would do the following: strengthen the notice requirements on expedited audits under section 505(b); require one applicable statutory interest rate for those tax claims presently entitled to receive interest; recommend the amendment of section 1141(d)(3) to except from discharge those taxes that were unpaid by a business debtor as a result of fraud; subject income of a bankruptcy estate to alternate minimum tax and capital gain tax treatment; require a taxing authority to file a claim for priority tax before the final order approving a trustee's report is entered in chapter 7 cases; recommend the amendment of *11 U.S.C. sections 362(b)(9) and 507(a)(8)* to clarify the definition of the terms "assessed" or "assessment" to mean "that time in which the taxing authority may commence an action to collect the tax"; amend section 545(2) to overrule those cases that penalize the government due to certain benefits for *bona fide* purchasers provided for in the lien provisions of the Internal Revenue Code; and amend section 1125(b) to establish standards for tax disclosures in a chapter 11 disclosure statement.

Additionally, the NBRC agreed that in the event of successive filings of bankruptcy, the time period specified in *11 U.S.C. sections 507(a)(8) and 523(a)(1)* should be tolled during the pendency of the previous bankruptcy; section 507(a)(8)(A) should be amended to toll the 240-day assessment period for both pre- and postpetition assessment offers to compromise; and section 503 and *28 U.S.C. section 960* should also be amended to eliminate the need for a governmental unit to make a request to the debtor to pay tax liabilities that have administrative priority.

The NBRC favorably determined that section 362(a)(8) should be amended to overrule the decision in *Halpern v. Commissioner*, n5 which held that section 362(a)(8) stays the commencement or continuation of a proceeding involving

the individual debtor's postpetition tax liabilities. The NBRC also recommended that appeals from tax court decisions should be permitted without violating the automatic stay of 11 U.S.C. section 362.

A number of suggestions for amending the Bankruptcy Code to conform the treatment of state and local taxes to federal taxes were also adopted by the NBRC. These included: recommending an amendment of section 346 to conform state and local tax attributes to the federal attributes in *I.R.C. section 1398*; and repealing 11 U.S.C. sections 728, 1146, and 1231, which amended section 346 and *I.R.C. section 1398* to provide that making an election to close a debtor's tax year commences on the date the order for relief is entered in the bankruptcy case.

A number of proposals by the Tax Advisory Committee were controversial and unanimous approval was not forthcoming. The Tax Advisory Committee reported a possible consensus on the following additional items: provide for a method where a trustee may obtain safe harbor and certainty regarding the nature, amount and consequences of a debt discharged; n6 amend *I.R.C. section 1398(e)(3)* to provide that payment of estate assets to the debtor for services performed is ordinary income such that the estate has a deduction; n7 allow a bankruptcy estate a one-time exclusion of \$125,000 for capital gain on the sale of a residence; n8 if personal residence exemptions remain nonuniform, adopt a *pro rata* share standard for the tax treatment of gain on the sale of a debtor's homestead by the estate; n9 amend *I.R.C. sections 108* and *382* to provide that a corporation in reorganization be permitted to make a fresh start election with respect to the issuance of stock in satisfaction of debt; n10 and amend *I.R.C. section 1001* to provide for parallel tax treatment of recourse and nonrecourse debt. n11

In June 1997, the NBRC met and approved three additional controversial tax proposals. The first proposal suggests an amendment or repeal of section 724(b) to exempt from subordination properly perfected non-avoidable ad valorem tax liens on real or personal property of the estate. This proposal would require a marshaling of encumbered assets of a bankruptcy estate and a surcharge against secured claims under section 506(c) before any subordination of tax liens could take place. The proposal was supported by a majority of the Tax Advisory Committee of the NBRC and was suggested by the Government Working Group. This recommendation changes existing priorities which permit a trustee to subordinate valid tax liens to the cost of administration and other priority claims. The proposal is highly controversial and essentially exempts any lien on real or personal property created by an ad valorem tax from subordination.

In June 1997, the NBRC approved a second proposal which affects the application of the burden of proof rules in bankruptcy. This proposal enables nonbankruptcy law rules to be applicable to bankruptcy court rulings in sections 502 and 505. The purpose of this proposal is to treat tax claims uniformly by permitting nonbankruptcy law burdens of proof to be applicable to claims in bankruptcy disputes under the Bankruptcy Code. At the present time, taxing authorities in nonbankruptcy matters do not have the burden of proof; that burden falls on the taxpayer. If this provision is ultimately adopted by Congress, the burden of proof for tax claims in a bankruptcy court, in connection with tax disputes, would be on the debtor.

The third proposal recommended by the NBRC suggests that section 362(b) be amended to permit governmental units the right of set-off. An income tax refund that arose prior to the commencement of a bankruptcy case in chapter 7 or chapter 13 could be setoff against a prepetition undisputed income tax liability of an individual debtor. The automatic stay of section 362(a) would be inapplicable and an exception under section 362(b) would be provided to permit setoff of prepetition tax refunds against prepetition tax claims.

In the last NBRC meeting, in August 1997, the Commission adopted a proposal to subordinate prepetition tax penalties in chapter 11, 12, and 13 cases to the payment of unsecured claims without a requirement of a finding of governmental misconduct. Additionally, NBRC supported the authority of bankruptcy courts to grant declaratory judgments on prospective tax issues on chapter 11 plans of reorganization. This is novel because, traditionally, declaratory judgments have not been allowed in controversies regarding federal taxes (28 U.S.C. section 2201). This controversial proposal is advanced thinking and benefits creditors who must understand the tax consequences of a plan of reorganization when they vote in order to make an informed decision.

FOOTNOTES:

(n1)Footnote 1. In accordance with statute, the National Bankruptcy Review Commission submitted a final report with recommendations to Congress, the President, and the Chief Justice on October 20, 1997. This final report contained detailed statements of findings and conclusions with recommendations for legislative action. Some of these suggestions are discussed *infra*.

(n2)Footnote 2. *United State v. Energy Resources*, 495 U.S. 545, 110 S. Ct. 2139, 109 L. Ed. 2d 580, 22 C.B.C.2d 1093 (1990) .

(n3)Footnote 3. 133 B.R. 264 (Bankr. Mass. 1991) .

In August 1997, the NBRC voted to clarify the tax treatment of property of the estate that is abandoned to the debtor. Abandonment would be treated as a disposition by the debtor immediately prior to bankruptcy. To the extent the tax is not satisfied out of the bankruptcy estate, the debtor will be responsible.

(n4)Footnote 4. In August 1997, the NBRC adopted a proposal for the bifurcated treatment of a corporate tax year that straddles the petition date. This proposal would allow a bifurcation by election.

(n5)Footnote 5. 90 C. T. C. 895 (1991) .

(n6)Footnote 6. This proposal was adopted by the NBRC in August 1997.

(n7)Footnote 7. This proposal was adopted by the NBRC in August 1997.

(n8)Footnote 8. This proposal was adopted by the NBRC in August 1997.

(n9)Footnote 9. This proposal was adopted by the NBRC in August 1997.

(n10)Footnote 10. This proposal was adopted by the NBRC in August 1997, with an ABA proposal to be annexed to the recommendations.

(n11)Footnote 11. This proposal was adopted by the NBRC in August 1997.



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CHAPTER TX1 Policies and History

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P TX1.05 The Tax Provisions of BAPCPA

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") was signed by the President on April 20, 2005. n1 Many Bankruptcy Code sections were affected by the BAPCPA which generally becomes effective and applicable for cases filed on or after October 17, 2005.

Many of the existing Bankruptcy Code sections have been re-written. For example, section 346, which originally was designed to determine the substantive and procedural uniformity of state and local taxes in bankruptcy tax matters, proved to be a source of confusion. BAPCPA rewrote the entire section to seek conformity of state and local tax practice to Internal Revenue Code provisions.

The following paragraphs will discuss the specific changes in the Bankruptcy Code provision effected by BAPCPA.

[1] *Ad Valorem* Taxes and Liens

[a] Subordination of *Ad Valorem* Taxes

The general rule in Chapter 7 liquidations is that, when property is sold, the claims of secured creditors must be satisfied before any payment is made to priority or general unsecured creditors. Under BAPCPA, subordination will not apply to liens securing claims for *ad valorem* real and personal property taxes, but these taxes would still be paid after certain wage and employee benefit plan claims. New rules governing payment priorities, expense recoveries, and the trustee's duty to exhaust the estate's unencumbered assets are mandated in cases where the downgrading rule continues to apply. n2 The policy behind subordination is the belief that the taxing authorities should not recover until administrative and other priority claims have been paid. The changes made by the 2005 Act to section 724 reverse that result, and will in some cases have a dramatic and negative impact on the recoveries obtained by holders of administrative and other priority claims (other than those wage and employee benefit plan claims that will retain their superiority to tax liens under the new law). State and local taxing jurisdictions, which have long argued (uniformly in vain) that section 724(b) was an unconstitutional violation of their *Tenth Amendment* rights, have finally prevailed by statutory amendment.

[2] Jurisdiction to Determine *Ad Valorem* Taxes

Section 505(a) of the Bankruptcy Code confers extremely broad authority on the bankruptcy court to determine any

unpaid tax liability of the debtor that has not been contested before or adjudicated by a judicial or administrative tribunal before the debtor filed for bankruptcy. n3 In particular, there is nothing in section 505(a) that expressly prohibits debtors from contesting in bankruptcy court tax liabilities (especially real property or *ad valorem* tax claims) that arose many years ago and with respect to which the debtor never filed timely objection. n4 The state and local taxing jurisdictions have occasionally argued that there is an unwritten, equitable time limitation on debtor actions to contest stale property tax claims under section 505(a), but the bankruptcy courts have generally been unreceptive to these arguments. n5 The effect of the BAPCPA is to reverse this result, but only with respect to *ad valorem* taxes. Under the 2005 Act, if the liability became fixed and the debtor's time to contest it outside of bankruptcy court had expired by the time of the filing, the debtor may not contest the liability in bankruptcy. n6

[3] Creation of Property Tax Liens

Under present law, the automatic stay does not prevent the creation of property tax liens for taxes becoming due after the filing of the petition. n7 BAPCPA will extend this principle to a "special tax or special assessment." n8

[4] Avoidance of Statutory Liens Prohibited

Under present law, the trustee is given lien avoidance rights of a hypothetical bona fide purchaser, whether or not such a purchaser exists. n9 BAPCPA will make this provision inapplicable to federal tax liens arising under *Section 6321 of the Internal Revenue Code* ("I.R.C."). n10 This provision arguably does no more than codify existing law. n11

[5] Priority and Subordination of Taxes

[a] Priority Status of Straddle--Year Tax Claims

Several U.S. Court of Appeals panels have held that the income tax liability of a corporate debtor for the year of bankruptcy filing (the "Straddle Year") must be bifurcated into a pre-petition component and an administrative expense component, notwithstanding that the filing of a petition does not terminate the corporate debtor's taxable year. BAPCPA amends section 507(a)(8) governing the priority of taxes to provide that income and gross receipts taxes for Straddle Years are post-petition administrative expense claims that must be paid in full in the ordinary course, rather than pre-petition priority claims that are not payable until emergence (and may at that point be subject to the deferred payment rules of section 1129(a)(9)(C)).

[b] Priority Status of Stale Tax Claims

Under present law, a claim for income taxes of a debtor receives priority status if the return in respect of such tax is due, including extensions, after three years before the date of the filing of the petition. n12 Under BAPCPA, the three-year period is tolled during the stay period of the prior case plus 90 days. In addition, under present law, a claim for income taxes of a debtor receives priority status if it was assessed within 240 days before the filing of the petition. n13 That 240-day period is also tolled during the period an offer in compromise was pending plus 30 days, if made within 240 days after the assessment. n14 Under BAPCPA, the tolling will apply to the period when an offer in compromise is actually in effect plus 30 days, and during the time a prior bankruptcy case is in effect plus 90 days. Finally, under present law, the 240-day assessment safe harbor is not tolled during other periods during which a taxing authority is precluded from taking action. Under BAPCPA, tolling will apply during any period when a taxing authority is prohibited from collecting a tax as a result of a request by a debtor for a hearing and an appeal of any collection action taken or proposed against the debtor.

[c] Priority Status of Property Taxes

Under present law, priority status applies to property taxes "assessed" before the commencement of the case and last payable without penalty after one year before the date of the filing of the petition. n15 Confusion arises because the

term "assess" has a different meaning under state and local *ad valorem* real property tax laws than under other tax laws. BAPCPA substitutes the word "incurred" for the word "assessed" in the case of such taxes. n16

[d] Tardily Filed Priority Tax Claims

Under present law, priority claims are entitled to distribution in chapter 7 even if tardily filed, provided they are filed before the trustee commences distribution. n17 Under BAPCPA, if the trustee mails to creditors a summary of his final report prior to commencing distribution, a late-filed priority claim must be filed within ten days after the mailing of the summary. n18

[6] Determination and Payment of Taxes

[a] Request for Determination of Taxes

Under *section 505(b) of the Bankruptcy Code*, a trustee or debtor in possession may seek a prompt determination of the debtor's liability for administrative expense taxes. In order to invoke the procedure, the debtor submits a tax return and a request for determination of tax to the governmental unit charged with responsibility for collecting the tax in question. If the governmental unit does not notify the debtor within 60 days that the return has been selected for examination, or complete such an examination within 180 days of the request, the debtor is generally discharged from liability for that tax. n19 It has not always been clear to debtors seeking to invoke section 505(b) what procedures should be followed in notifying the taxing authority. Under BAPCPA, taxing authorities may register with the clerk of the bankruptcy court an address for service of requests and describe where further information concerning additional requirements may be found. If a taxing authority fails to do so, the trustee may serve the request at the address for filing a tax return or protest with the applicable taxing authority. n20

[b] Rate of Interest on Tax Claims

Present law is silent on the applicable rate of interest on tax claims when such interest is allowed. Under section 1129(a)(9)(C), if a chapter 11 debtor avails itself of the privilege of deferring payment of tax claims, the payments must have a present value equal to the allowed amount of the claim. BAPCPA has established a new section 511 which provides that the interest rate paid on pre-petition and administrative period tax claims (as well as the interest rate applied to deferred payments made under section 1129(a)(9)(C)) shall be the applicable rate under non-bankruptcy law. In the case of a confirmed plan, the interest rate in effect as of confirmation may be used, rather than the variable rate called for by some state tax laws. n21 This provision will generally increase the rate of interest that debtors pay on oversecured pre-petition tax claims or deferred tax payments made after emergence. Note also that the enactment of new section 511 would appear to circumscribe the impact of the U.S. Supreme Court's decision in *Till v. SCS Credit Corp.*, n22 where at least the Court plurality suggested in *dictum* that the so-called prime-plus method (pursuant to which the national prime rate is treated as the starting spot and is augmented as necessary to account for the nonpayment risk posed by the debtor's particular financial position) should be applied to deferred payments under section 1129(a)(9)(C).

[c] No Discharge of Fraudulent Taxes in Chapter 13

Under present law, individuals who file under chapter 7 face a different set of rules with respect to the discharge of taxes than individuals who file under chapter 13. First, in order for income taxes to be discharged in a chapter 7 case, the individual must have filed returns with respect to the taxes whose discharge is being sought and must have done so in timely fashion to the extent that the taxes in question arose in the last two years prior to bankruptcy. n23 By contrast, in a chapter 13 case taxes can be discharged without any return being filed after all. n24 Second, a taxpayer who files a fraudulent return or willfully attempts to evade or defeat a tax cannot discharge that tax in a chapter 7 case, n25 but the same is not the case in chapter 13. n26 Under BAPCPA, the chapter 13 rules will be largely conformed to those in chapter 7, with the consequence that this "superdischarge" result will no longer be applicable to taxes owed by chapter

13 debtors who fail to file, file late, or file fraudulently. n27

[d] No Discharge of Fraudulent Taxes in Chapter 11

Under present law, confirmation of a plan of reorganization discharges a corporate debtor from all debts, except when the plan is a liquidating plan. n28 Under BAPCPA, a corporation will not be discharged from a tax or a customs duty with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat the tax or duty. n29

[e] Stay of Tax Court Proceedings

Under present law, the filing of a petition operates as a stay against the commencement or continuation of a proceeding before the United States Tax Court concerning the debtor. n30 Literally read, this stay would apply even to a post-petition year over which the bankruptcy court has no jurisdiction. n31 Under BAPCPA, the stay will apply to a corporate debtor's tax liability for any period that is subject to the bankruptcy court's jurisdiction and to an individual debtor's pre-petition tax liability. n32

[f] Deferred Payment of Priority Taxes

Under present law, a chapter 11 debtor's pre-petition liability for unsecured priority taxes may be spread over a period ending not later than six years from the date of assessment of the tax, provided that the taxing authority receives payments having a value not less than the allowed amount of the claim. n33 Under BAPCPA, the deferred amounts must consist of "regular" installment payments in cash, must not extend beyond five years from the date of the order for relief (i.e., normally the petition date), and the taxing authority must be treated not less favorably than the most favored non-priority unsecured claimant other than a convenience class. These provisions will also apply with respect to secured tax claims. n34 The change to the period over which deferred tax payments can be made will drastically shorten the actual deferral period in many major corporate bankruptcies. Under prior law (where the six-year time period began to run on the date of assessment), it was very common for reorganized debtors to have a full six years *from the date of emergence* to pay pre-petition taxes, because the date of assessment would typically have been delayed throughout the case. Once the provisions of section 1129(a)(9) become effective, however, the new five-year period will begin on the petition date. This will mean that, in major cases in which the debtor is in bankruptcy for several years, the deferral benefit conferred by section 1129(a)(9) will dwindle or even disappear entirely.

[g] Payment of Taxes in the Conduct of Business

Under present law, it is not clear that all post-petition taxes must be paid when due. BAPCPA makes a number of changes in existing law in an effort to make it clear that current payment is required. First, language in section 960 of Title 28 provides that any taxes that must be paid pursuant to section 960 are due "on or before the due date of the tax under applicable nonbankruptcy law," unless (a) the tax is a property tax secured by a lien against property that is abandoned promptly after the lien attaches, (b) payment of the tax is excused by an express provision of title 11, or (c) in a chapter 7 case the tax was either not incurred by the trustee or the bankruptcy court issues an order prior to the due date of the tax finding that the estate is probably administratively insolvent. BAPCPA amends *section 503(b)(1)(B)(i) of the Bankruptcy Code* to clarify that post-petition *ad valorem* taxes qualify as administrative expenses. BAPCPA also makes it unnecessary for taxing authorities to file a request for payment before a post-petition tax qualifies as an allowed administrative expense. BAPCPA also clarifies that state taxes, including *ad valorem* property taxes, can qualify for treatment as secured claims under section 506, even though they do not arise from any agreement. n35

[h] Discharge of the Estate's Liability for Unpaid Taxes

Under present law, following a request for a prompt assessment of taxes made by the trustee and upon payment of the tax shown on the return, if a taxing authority does not timely respond or audit the return, the trustee, the debtor, and any

successor to the debtor are discharged from any tax liability in excess of the tax paid. n36 Some cases have held that this discharge does not apply to the "estate" so that a taxing authority may participate in the distribution in respect of late-claimed taxes. Under BAPCPA, the estate will also receive the benefit of the discharge when the taxing authority does not comply with section 505(b) procedures. n37

[7] Filing of Tax Returns

[a] Income Tax Returns Prepared by Tax Authorities

Under present law, an individual may not receive a discharge in chapter 7 in respect of a tax for which a return, if required, has not been filed. n38 Under BAPCPA, a return will include a written stipulation to a judgment or a final order entered by a non-bankruptcy tribunal and a return based upon information supplied by the taxpayer and signed by him, but prepared by a taxing authority pursuant to *section 6020(a) of the Internal Revenue Code* or similar state or local law. It will not include a substitute return under section 6020(b) of the Code, which is not a full return, but merely a predicate for assessment. n39

[b] Requirement to File Tax Returns to Confirm Chapter 13 Plans

Under present law, a debtor is entitled to the benefits of chapter 13 notwithstanding that he has unfilled returns outstanding. Under BAPCPA, the debtor will be required to have filed tax returns for the four taxable years immediately preceding the filing of the petition. Limited extensions will be permitted, during which the trustee will hold open the first meeting of creditors. Conversion or dismissal will result from failure to file within the extended periods. n40

[c] Dismissal for Failure to Timely File Tax Returns

Under present law, a debtor may continue to exercise the right to reorganize under bankruptcy protection notwithstanding the failure to file post-petition tax returns. Under BAPCPA, a debtor who fails to file post-petition returns may, on request of a taxing authority, have his case converted or dismissed. n41

[d] Providing Requested Tax Documents to the Court

Under BAPCPA, the court may not grant an individual a chapter 7 discharge or confirm the chapter 11 or chapter 13 plan of an individual unless requested tax documents have been filed with the court. The court must retain such documents for three years, subject to extension in the event of an audit enforcement action. n42

[e] Providing Tax Returns to Trustee or Requesting Creditor

Under BAPCPA, the debtor is required to provide federal income tax returns to the Chapter 7 or 13 trustee not later than 7 days before the date set for the first meeting of creditors. n43 The federal income tax return required is for the most recent tax year ending before the filing of the bankruptcy case. In the event the debtor has a transcript of the tax return that may be provided instead of the tax return itself. n44 Any creditor who timely requests a copy of the tax return or transcript must also be furnished copies. n45 If the debtor fails to comply with these requirements the bankruptcy court shall dismiss the case, unless the debtor can demonstrate that the failure to comply is due to circumstances beyond the debtor's control. n46

[8] Miscellaneous Tax Provisions

[a] Standards for Tax Disclosure

Under present law, prior to solicitation of acceptances for a chapter 11 plan, a proponent must submit and have approved by the court a disclosure statement containing adequate information. n47 The Bankruptcy Code does not

specify what constitutes adequate information as to the tax consequences of the plan. Under BAPCPA, the disclosure statement will be required to contain a discussion of the potential material federal tax consequences to the debtor and a hypothetical investor typical of the holders of claims or interests in the case. n48 It has been the better practice to include an adequate statement of federal tax consequences in most disclosure statements, usually in a section of the disclosure statement entitled "tax consequences."

[b] Setoff of Tax Refunds

Outside of bankruptcy, the IRS is generally permitted to set off refunds owed to a taxpayer against unpaid taxes owed by that taxpayer. n49 Current bankruptcy law preserves the government's right of setoff with respect to pre-petition taxes but prevents the taxing authority from exercising that right while the automatic stay is in place. n50 Under BAPCPA, setoffs will generally be permitted if setoff would have been permitted outside bankruptcy and if the taxable periods giving rise to both the overpayment and the deficiency are pre-petition. If setoff is not permitted under non-bankruptcy law because of a contest over the amount or legality of the deficiency, the taxing authority will be permitted to hold the refund pending resolution of the contest, unless the court grants adequate protection. n51 This provision will eliminate the existing procedural requirement that taxing authorities seek bankruptcy court approval before pre-petition setoffs can take place, even though outside bankruptcy such setoffs are generally permitted.

[c] Special Provisions Related to the Treatment of State and Local Taxes

Present *section 346 of the Bankruptcy Code* contains a series of detailed provisions that mandate a uniform outcome at the state and local level with respect to a variety of bankruptcy tax matters, both substantive and procedural. Under BAPCPA, section 346 is completely rewritten, and the provisions previously housed in section 728 and sections 1146(a) and (b) are largely transferred to section 346. Among other things, the new rules require uniformity among federal, state, and local tax administrative rules by (a) preventing a bankruptcy filing from resulting in the creation of a new taxable estate (or the termination of the debtor's taxable year) for federal purposes but not for state and local purposes (or vice versa), (b) conforming the federal, state, and local tax consequences of property transfers from the debtor to the estate (or vice versa), (c) preventing state or local tax from being imposed on discharge of indebtedness income unless that income is also subject to tax under the Internal Revenue Code, and (d) generally requiring states and localities to reduce tax attributes to reflect untaxed discharge of indebtedness income following the same rules applicable for federal purposes. n52 New section 346 is both simpler and more effective than its predecessor. Instead of laying out detailed tax rules for the states and localities to follow, it relies on simpler cross-references to federal law that should help keep the two more closely in sync. Although the validity and enforceability of section 346 itself may be thought to be open to some question in light of the sovereign immunity issues raised by several recent Supreme Court decisions, n53 the new version of section 346 is a significant improvement over the old one.

[d] Treatment of Fuel Tax Claims

The Bankruptcy Code is amended to provide that a claim arising from the liability of a debtor for fuel use tax may be filed by the base jurisdiction designated pursuant to the International Fuel Tax Agreement and, if so filed, shall be allowed as a single claim. n54 Nevertheless, standing orders or local rules in some bankruptcy courts permit setoffs of tax deficiencies and overpayments without court order in certain circumstances.

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n2)Footnote 2. 11 U.S.C. § 724.

(n3)Footnote 3. 11 U.S.C. § 505(a).

(n4)Footnote 4. *See generally* 15 *Collier on Bankruptcy P TX5.04[2][a]* (15th Ed. Revised).

(n5)Footnote 5. *See, e.g., Custom Distrib. Servs., Inc. v. City of Perth Amboy (In re Custom Distrib. Servs., Inc.), 216 B.R. 136 (Bankr. D.N.J. 1997) .*

(n6)Footnote 6. 11 U.S.C. § 505(a)(2)(C).

(n7)Footnote 7. *See generally* 3 *Collier on Bankruptcy P 362.05[17]* (15th Ed. Revised).

(n8)Footnote 8. 11 U.S.C. § 362(b)(18).

(n9)Footnote 9. 11U.S.C. § 545(2).

(n10)Footnote 10. 11 U.S.C. § 545(2).

(n11)Footnote 11. *I.R.C. § 6321* provides that, "[i]f any person liable to pay any tax neglects or refuses to pay the same after demand, the amount [of that tax plus various enumerated costs associated with it] ... shall be a lien in favor of the United States upon all property and rights to property... belonging to such person." *I.R.C. § 6323* limits the reach of this lien by making it invalid against any "purchaser". *I.R.C. § 6323(h)(6)* then defines "purchaser" to mean "a person who, for adequate and full consideration in money or money's worth, acquires an interest (other than a lien or security interest) in property which is valid under local law against subsequent purchasers without actual notice." The lien avoidance power given to the trustee by section 545(2) is that of "a bona fide purchaser that purchases such property at the time of the commencement of the case, whether or not such a purchaser exists." The courts have generally held that the lien avoidance right given to the trustee does *not* allow a trustee to avoid a tax lien by invoking *I.R.C. § 6323*. *See, e.g., United States v. Hunter (In re Walter), 45 F. 3d 1023 (6th Cir. 1995)* (since "bona fide purchaser" standard lower than "adequate and full consideration in money or money's worth" standard, trustee cannot avoid liens under *I.R.C. § 6323*).

(n12)Footnote 12. 11 U.S.C. § 507(a)(8)(A)(i).

(n13)Footnote 13. 11 U.S.C. § 507(a)(8)(A)(ii).

(n14)Footnote 14. *Id.*

(n15)Footnote 15. 11 U.S.C. § 507(a)(8)(B).

(n16)Footnote 16. 11 U.S.C. § 507(a)(8)(B).

(n17)Footnote 17. *See* 6 *Collier on Bankruptcy P 726.02[1]* (15th Ed. Revised).

(n18)Footnote 18. 11 U.S.C. § 726(a)(1)(A).

(n19)Footnote 19. 11 U.S.C. § 505(b). *See generally* 15 *Collier on Bankruptcy P TX5.04[3][b]* (15th Ed. Revised).

(n20)Footnote 20. 11 U.S.C. § 505(b).

(n21)Footnote 21. 11 U.S.C. § 511.

(n22)Footnote 22. 541 U.S. 465, 124 S. Ct. 1951 (2004) .

(n23)Footnote 23. *See* 11 U.S.C. § 523(a)(1)(B).

(n24)Footnote 24. *See* 11 U.S.C. §§ 1322(a)(2) and 1328(a).

(n25)Footnote 25. *See* 11 U.S.C. § 523(a)(1)(C).

(n26)Footnote 26. *See* 11 U.S.C. § 1322(a)(2).

(n27)Footnote 27. 11 U.S.C. § 1328(a).

(n28)Footnote 28. *See* 15 Collier on Bankruptcy, P TX1.07[10] (15th Ed. Revised).

(n29)Footnote 29. 11 U.S.C. § 1141(d)(b).

(n30)Footnote 30. 11 U.S.C. § 362(a)(8).

(n31)Footnote 31. *See generally* 15 Collier on Bankruptcy, P TX1.04 (15th Ed. Revised).

(n32)Footnote 32. 11 U.S.C. § 362(a)(8).

(n33)Footnote 33. 11 U.S.C. § 1129(a)(9)(C).

(n34)Footnote 34. 11 U.S.C. § 1129(a)(9).

(n35)Footnote 35. 28 U.S.C. § 960; 11 U.S.C. § 503(b).

(n36)Footnote 36. 11 U.S.C. § 505(b).

(n37)Footnote 37. 11 U.S.C. § 505(b).

(n38)Footnote 38. *See* 15 Collier on Bankruptcy, P TX4.02[2] (15th Ed. Revised).

(n39)Footnote 39. 11 U.S.C. § 523(a).

(n40)Footnote 40. 11 U.S.C. § 1308.

(n41)Footnote 41. 11 U.S.C. §§ 1112(b)(4)(i) and 521(j)(1) and (2); *see In re Cushing*, 2009 Bankr. LEXIS 276 (B.A.P. 1st Cir. 2009) which overturned a Bankruptcy Court decision denying dismissal of the Debtor's Chapter 13 case for failure to file tax return by the first day of the Section 341 meeting. The appeals panel indicated that even though a Debtor, before filing bankruptcy, had received an extension of time to file a tax return, the failure to file the tax return on the first date of the Section 341 meeting was grounds for dismissal of the Chapter 13.

(n42)Footnote 42. Pub. L. No. 109-8, § 1228 (2005), effective in cases commenced on or after October 17, 2005, reprinted in Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n43)Footnote 43. 11 U.S.C. § 521(e)(2)(A)(i).

(n44)Footnote 44. *Id.*

(n45)Footnote 45. 11 U.S.C. § 521(e)(2)(A)(ii); *see In re Fontaine*, 2008 Bankr. LEXIS 3046 (Bankr. D. Mass. 2008) where a creditor's motion for dismissal of the Chapter 7 bankruptcy case was denied when the creditor received a copy of the Chapter 7 Debtor's tax return the day after delivery of the tax return to the Chapter 7 Trustee and not on the same day.

(n46)Footnote 46. 11 U.S.C. § 521(e)(2)(B) and (C). *See In re Ring*, 2006 Bankr. LEXIS 787 (Bankr. D. Me. 2006) for a case where dismissal was denied when the debtor demonstrated that the failure to comply with the delivery of copies of the tax returns to the trustee was due to circumstances beyond the debtor's control.

(n47)Footnote 47. *11 U.S.C. § 1125(b)*.

(n48)Footnote 48. *11 U.S.C. § 1125(a)*.

(n49)Footnote 49. *See I.R.C. §§ 6402(a) & 6411(b)*.

(n50)Footnote 50. *See 11 U.S.C. §§ 553 and 362(a)(7)*. *In re Gould, 2009 Bankr. LEXIS 351 (B.A.P. 9th Cir. 2009)* , held under pre-BAPCPA rules that it was an abuse of the Bankruptcy Court's discretion to deny the IRS motion for relief from stay to allow setoff rights, pursuant to *Bankruptcy Code Section 553(a)*, and to permit the IRS relief to setoff the prepetition tax payments received against prepetition unpaid tax liabilities.

(n51)Footnote 51. *11 U.S.C. § 362(b)(26)*.

(n52)Footnote 52. *11 U.S.C. § 346*.

(n53)Footnote 53. *See e.g., Seminole Tribe v. Florida, 517 U.S. 44 (1996) ; Zadvydas v. Davis, 533 U.S. 678 (2002) .*

(n54)Footnote 54. *11 U.S.C. § 501*.



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CHAPTER TX1 Policies and History

I History and Development of Tax Treatment in Bankruptcy

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P TX1.06 Selected Tax Issues Common to Title 11 Cases

Many tax issues are created and arise prior to filing a title 11 case, during the administration of the title 11 estate, and subsequent to the entry of discharge or confirmation of a plan of reorganization. The following is intended as a summary of the significant tax issues that can be encountered.

[1] Tax Issues Prior to Filing

A number of issues deal with prebankruptcy income tax considerations. Some of these issues are: (1) Is there a difference in tax treatment if there is a taxable event generated by a transfer of collateral to the lender (whether in a foreclosure or by deed in lieu of foreclosure) before the title 11 filing?; (2) Is the debtor an individual, a corporation, or a pass-through tax entity such as a partnership or S corporation?; (3) What is the tax effect of a transfer of property from one entity to another entity or a change in the tax status of the debtor?; and (4) Is taxable income generated by the "restructuring" of a debt where the amount of outstanding debt is reduced, and, if so, how much taxable income is recognized, for whom is the income a liability, and how is the tax to be paid? n1 Generally, different types of prepetition taxes arise in bankruptcy cases: (1) the ad valorem property tax is common in bankruptcy cases; (2) employment taxes or trust fund taxes becomes a usual issue in bankruptcy cases; and (3) numerous other state taxes, for example, sales or use taxes, unemployment taxes and franchise taxes are sometimes involved.

[2] Tax Issues Common in Title 11 Cases

Frequently, the filing of a title 11 case creates numerous tax issues and questions of tax claims treatment. The first issue is whether a transfer of assets from the debtor to the estate on the filing of a title 11 case is a separate taxable event. Once a title 11 case is commenced and an order for relief is entered, tax questions primarily revolve around issues of dischargeability, priority of tax payment, amount of the tax claim, responsibility for filing tax returns, termination of tax years, and whether the tax claim includes post or prepetition interest or post or prepetition penalties. During the course of the administration of a case, issues may be presented such as the determination of tax, payment responsibilities for taxes, jurisdiction to enjoin or recover assets seized by taxing authorities, and the operation of the automatic stay on tax authorities exercising collection procedures, assessment, and third party nondebtor collection. Additionally, sometime during the case, the estate often disposes of assets by sale, transfer, or abandonment under *Bankruptcy Code sections 363 and 554*. These actions generate issues of who is liable for the taxable gain, does basis carry over and if so, how much, to whom is the gain allocated, and what tax attributes, if any, are available to offset the gain. Issues involving

collection and payment of withholding tax, responsible officer liability, and allocation of tax payments to withholding, income, interest, or penalty are generated during the administration of a case. n2

[3] Post-Filing Issues Generated by Actions Taken or Orders Entered During the Administration of a Title 11 Case

Postpetition tax issues are commonly generated because of an abandonment of an asset during the title 11 case, the setting aside of exempt property, the denial or nondischargeability of tax claims, the setoff rights of the Internal Revenue Service against a debtor's tax refund, the validity of a prior recorded tax assessment and lien on post-petition property, the sales and disposition of property by the bankruptcy estate, franchise, sales and use tax liability, the tax treatment of creditor trusts in plans of reorganization, and the right to collect nondischargeable taxes out of postpetition assets acquired by the former debtor-taxpayer. Some postpetition issues may arise because of the failure to make tax payments provided in the Bankruptcy Code, required payments in a confirmed plan, the attempt to enforce tax liens on postpetition property, and collection activity against transferees of assets or responsible nondebtor parties. n3

Since the form of the debtor entity in a title 11 case determines the type of tax liability, caution must be exercised in dealing with partnerships, S corporations, and individuals throughout the commencement and administration of a case and until its termination. Issues of solvency are important and the key to recognition of income from discharge of indebtedness for these debts discharged prior to the commencement of a title 11 case. n4 Serious concern should also be given to the issue of which tax attributes may survive a reorganization. Is the net operating loss available to the reorganized entity and, if so, to what extent will tax attribute reduction for discharge of indebtedness income excluded under *I.R.C. section 108* offset the amount of such attributes? n5

FOOTNOTES:

(n1)Footnote 1. For discussion of federal tax reporting requirements, *see* chapter TX3 *infra*. *See also* P TX12.03 *infra* for state and local reporting requirements; P TX5.04 *infra* for the jurisdiction of the bankruptcy court to determine tax liability.

(n2)Footnote 2. For a detailed discussion of many tax issues frequently encountered in a title 11 case, *see* chapter TX4, *infra*, for an analysis of priority and dischargeability of tax claims and treatment of interest and penalties; chapter TX6, *infra*, for discharge of indebtedness; chapter TX7, *infra*, for a discussion of the tax treatment of creditors; chapter TX13, *infra*, for a discussion of the treatment of debtor partnerships; and chapter TX5, *infra*, for a discussion of the jurisdiction of the bankruptcy court in tax issues and disputes with tax collecting entities.

(n3)Footnote 3. For a comprehensive discussion of post-petition tax compliance under the Bankruptcy Code, *see* Gargotta, *Post-petition Tax Compliance Under the Bankruptcy Code: Can the IRS Enforce Collection After Bankruptcy Is Filed?*, 11 *Am. Bankr. Inst. L. Rev.* 1, page 113 (Spring 2003).

(n4)Footnote 4. A taxpayer who is not a debtor in a title 11 case can exclude cancellation of indebtedness from income under *I.R.C. § 108(a)(1)(B)* only if the income is realized at a time when the taxpayer is insolvent.

(n5)Footnote 5. The law is not clear on the timing of the realization of cancellation of indebtedness income in title 11 cases. Realization of income may occur when a debtor receives a discharge from debts. In chapter 7 this is easily determined because it is based on the date of the entry of the order of discharge. In chapter 11 the timing is not easily calculated. The provisions of the chapter 11 plan would govern when realization of cancellation of indebtedness income occurs.



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CHAPTER TX1 Policies and History
II Survey of Bankruptcy Code Provisions Affecting Tax Law Issues

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P TX1.07 Introduction

The tax policy of maximum collection and protection of the Treasury through an aggressive network of voluntary tax returns, assessment, collection, litigation and pursuit of all potential responsible taxpayers clashes irrevocably with the policy of a "fresh start" for the bankruptcy debtor through the use of the bankruptcy process. The conflict between bankruptcy policy and tax policy is sometimes overwhelming. Tax disputes generate litigation and affect tax practitioners and litigators. When the taxpayer, the subject of the tax dispute and a party to the litigation becomes a debtor in a title 11 case, the elements of bankruptcy law become inextricably involved in the tax dispute process. Tax disputes in title 11 cases involve the determination of the amount of tax liability, questions of priority in tax payments as they relate to other claims against the bankruptcy estate, dischargeability of tax liability, setoff of tax refund against tax claims, and turnover of assets seized by the Internal Revenue Service prior to commencement of the case.

The bankruptcy court is the contemporary litigation forum for sophisticated and complicated business disputes involving billions of dollars. Because title 11 filings have increased dramatically, the bankruptcy court will be called upon more frequently to hear, determine and dispose of tax disputes between the debtor and all taxing authorities. It has been characterized as the "tax forum of the 90s." n1

The Bankruptcy Code provides for the orderly distribution of a debtor's assets in accordance with a scheme which determines priorities for payment and discharge of obligations. The bankruptcy process is designed to provide the debtor with a fresh start. The fresh start is achieved because the debtor is discharged from obligations. A tax debt is among the obligations included in the discharge, providing it meets certain tests.

The reorganization and debt adjustment provisions of chapter 11 of the Bankruptcy Code are designed to rehabilitate a debtor, whether partnership, corporation or individual, by providing for the reorganization of the debtor through a plan which is filed with a disclosure statement. The plan is brought on for voting and approval by various classes of creditors and heard by a court as part of the confirmation process. Once a plan is confirmed, in the case of individuals and business entities which continue as reorganized debtors, discharge of debts is ultimately accomplished by the performance of those payment undertakings proposed in the plan. Discharge is the ultimate objective of the debtor.

Once a title 11 case is commenced, a bankruptcy estate is created and the administration of the estate is accomplished through the bankruptcy process. A number of parties are significant players in a chapter 11 case, for example, the

debtor, the United States trustee, creditors and creditors' committees, equity owners and equity committees. Some of the creditors may have priority rights to payment before other classes of creditors. Some examples of priority creditors with priority right to payment are employees and taxing authorities. Once the title 11 case is filed an automatic stay comes into place protecting and insulating the debtor, the bankruptcy estate and its assets from all acts or proceedings to collect, assess, perfect, enforce or recover any claim which arose before the filing of the case. The automatic stay significantly affects taxing authorities and their actions to collect taxes or enforce tax liens, as is the case with other creditors.

Counsel who specialize in taxation and the resolution of tax disputes or tax planning should be aware of the significance of bankruptcy law and the importance of the bankruptcy court as a forum in which to resolve tax disputes. Bankruptcy counsel should be aware of the interaction of the Internal Revenue Code and the Bankruptcy Code, and the affect of tax law on the bankruptcy process. This publication is designed to furnish counsel with an overview of the interrelation of tax law and bankruptcy law and concentrates on the impact of the Bankruptcy Code on all aspects of taxation.

Generally, this publication discusses jurisdiction of the bankruptcy courts, the claims process and particularly the dischargeability of tax liabilities and their priority in payment, n2 procedures for filing a tax claim, tax authority rights of setoff, subordination of tax claims and the concept of estimation of tax claims for voting purposes in the reorganization plan confirmation process. Additionally, a full discussion is provided of bankruptcy court authority and jurisdiction in determining prepetition and postpetition tax liability.

The plan of reorganization process as it affects tax liability is examined along with the automatic stay and its effect on tax authorities. Collection of taxes, interest and penalties, determination of tax liability administratively, and negotiation of tax settlement are also considered. Specific tax issues such as the tax consequences of exchange of debt for debt, survival of net operating losses, exchange of corporate stock for debt n3 and bankruptcy implications of tax reorganization of debtor corporations are discussed. Tax reporting requirements, tax treatment of creditors and the treatment of debtor partnerships is featured in this text. Tax consequences of disputed claims reserves and the taxation of noncorporate entities in a title 11 case are further areas of study. Additionally, the treatment of state and local taxes and their relationship to the title 11 case are discussed. Litigating with the Internal Revenue Service in the bankruptcy court and the description of tax consequences to various parties in the reorganization process and the plan of reorganization are other significant areas treated in the text. A discussion of tax claims includes postpetition interest and penalties, deductibility of expenses of reorganization and the liability of responsible parties.

This chapter surveys the provisions of the Bankruptcy Code that affect tax disputes, the tax claim process and tax transactions. This chapter also contains a brief discussion of specific provisions of the Bankruptcy Code which are directly related to tax law issues. n4 Many provisions of the Bankruptcy Code affect property and claims resolution. To the extent that there are specific provisions of the Bankruptcy Code which relate to the tax collection process, resolution of taxability and payment of tax claims liability, those provisions are explained. n5

FOOTNOTES:

(n1)Footnote 1. This description of the bankruptcy court as the "Tax Forum For The 90's" was first used by Allegra in an article which appeared in 31 Fed. Bar News & J 338 (1991); *see also* Sheinfeld, "Litigating With The Internal Revenue Service In Bankruptcy: Bankruptcy Courts--The Tax Forum For The 90's," Great Plains Federal Tax Institute, Lincoln, Nebraska (1991).

(n2)Footnote 2. For example, in *Henkel v. Florida Dept. of Revenue (In re Clark)*, (Bankr. M.D. Fla. 2000), the court held that the IRS lien had priority over liens created by state tax warrants. A federal tax lien arises on the date the tax is assessed. In this case, the IRS lien was filed four days before the state tax warrant was filed.

(n3)Footnote 3. The stock for debt exception was repealed by the Omnibus Budget Reconciliation Act of 1993 (Pub. L. No. 103-66). The repeal of this exception was prospective and affects stock transfers after December 31, 1994. If the title 11 case is filed after December 31, 1993, the stock transfer must have been completed before January 1, 1995 to qualify for the stock for debt exception. *See* chapter TX8 *infra*.

(n4)Footnote 4. For a specific listing of those provisions of the Bankruptcy Code which directly deal with taxes, *see* P TX1.05 *supra*.

(n5)Footnote 5. There are staggering amounts of tax claims pending in the bankruptcy courts. In 1991, nine of the largest tax claims pending resolution before the bankruptcy courts involved a cumulative amount of \$9.6 billion. Sheinfeld, *Litigating With The Internal Revenue Service In Bankruptcy: Bankruptcy Courts--The Tax Forum For The 90's*, Great Plains Federal Tax Institute, Lincoln, Nebraska (1991).



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CHAPTER TX1 Policies and History
II Survey of Bankruptcy Code Provisions Affecting Tax Law Issues

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P TX1.08 Bankruptcy Law Concepts

[1] Structure and Jurisdiction of the Bankruptcy Courts

The Bankruptcy Reform Act of 1978 (the "Reform Act") was enacted on November 6, 1978. n1 All existing bankruptcy laws became subject to the Reform Act on its effective date, October 1, 1979. Title I of the Reform Act is known as the Bankruptcy Code. n2 This is codified as title 11 of the United States Code. Not too long after the enactment of the Reform Act the jurisdiction of the bankruptcy court was challenged in *Northern Pipeline Construction Co. v. Marathon Pipe Line Co.* n3 The Supreme Court held that the grant of jurisdiction to non-Article III bankruptcy judges to rule on common and state law claims of the trustee against third parties was unconstitutional as a violation of Article III.

After the *Marathon* decision, it was the responsibility of Congress to react and design a modification of the Reform Act. The Bankruptcy Amendments and Federal Judgeship Act of 1984 (the "BAFJA") was passed on July 10, 1984. n4 BAFJA established bankruptcy judges as a unit of the United States district court. It repealed jurisdictional sections of title 28 of the United States Code which were stricken down in *Marathon*. BAFJA essentially provided that bankruptcy judges were to be appointed to fourteen year terms by the United States Court of Appeals and that they are judicial officers of the district court. n5 The district court is granted original and exclusive jurisdiction of all bankruptcy cases, and original but not exclusive jurisdiction of all civil proceedings arising in or related to bankruptcy cases. n6

Every bankruptcy case is referred initially by the district court to the bankruptcy court. The "reference" may be revoked for "cause" and is revoked on timely motion if a case requires consideration of both title 11 matters and other laws of the United States regulating organizations or activities affecting interstate commerce. n7

BAFJA set up the distinction between "core proceedings" and "noncore proceedings." Bankruptcy courts are empowered to issue final judgments and orders only in core proceedings. In noncore proceedings, the bankruptcy court may issue a final judgment and order only with consent of the parties. In noncore proceedings, in which the parties do not consent, the bankruptcy court may hear the matter and submit proposed findings of fact and conclusions of law to the district court. n8 It is the district court which enters a final judgment or order in the proceeding after considering the bankruptcy court's findings and conclusions and reviewing *de novo* any matters timely and specifically objected to by a party. n9

BAFJA defines "core proceedings" to include, without limitation, administrative matters, claims estimation, allowance and disallowance (other than estimation and liquidation of personal injury, tort or wrongful death claims for the purposes of a distribution in a title 11 case), counterclaims by the estate against persons filing claims against the estate, financing orders, turnover orders, voidable preferences, motions to terminate, annul or modify the automatic stay, fraudulent conveyance matters, dischargeability matters, determinations of the validity, extent or priority of liens, plan confirmation, orders approving sale, use or lease of property (including use of cash collateral) and "other proceedings affecting the liquidation of the assets of the estate or the adjustment of the debtor-creditor or equity security holder relationship, except personal injury tort or wrongful death claims." n10

A serious qualification was placed upon the jurisdiction of district courts in *Seminole Tribe of Florida v. Florida*. n11 In that case, the Supreme Court held that Congress cannot use its powers under Article I of the Constitution to infringe upon the states' rights under the *Eleventh Amendment* to be immune from Federal court litigation. Although *Seminole* did not involve the bankruptcy court power contained in Article I of the Constitution, the decision indicates that a state's sovereign immunity privilege may preclude a bankruptcy court's jurisdiction. The *Seminole* doctrine qualifying Congress right to infringe states rights, and limiting the bankruptcy court's jurisdiction, has essentially been repudiated and modified. In *Central Virginia Community College v. Katz*, n12 the Supreme Court, in 2006, held that a bankruptcy trustee can sue a state entity and can affirmatively recover from that state entity funds received as a preference. The *Katz* decision repudiates the dicta in *Seminole* and is consistent with the Supreme Court decision in *Tennessee Student Assistance Corp v. Hood*. n13 *Hood* held that a debtor's discharge is not a suit against a state but is an *in rem* proceedings under the bankruptcy code. The state claim for immunity from suit in the federal courts, and the bankruptcy court, did not exist but has been surrendered by the provisions of the constitution. n14

The Bankruptcy Code contains substantive bankruptcy law. The Federal Rules of Bankruptcy Procedure and local court rules of bankruptcy procedure govern practice and procedure under the Bankruptcy Code. n15 The Rules are to be read along with the substantive provisions of the Bankruptcy Code. The Bankruptcy Rules also contain Official Forms which are prescribed by the Judicial Conference of the United States. The Federal Rules of Civil Procedure (the "FRCP") are sometimes referenced or incorporated in the Bankruptcy Rules. The local bankruptcy court rules are adopted in many judicial districts and govern specific items of bankruptcy practice and local procedure.

The Bankruptcy Code consists of five types of debtor relief chapters:

- (1) Chapter 7: liquidation cases, including liquidation of corporations, partnerships, individuals, stockbrokers and commodity brokers. n16
- (2) Chapter 9: adjustment of debts of a municipality, including political subdivisions and public agencies.
- (3) Chapter 11: reorganization cases, including reorganization of corporations, partnerships, individuals and railroads. n17
- (4) Chapter 12: adjustment of debts of a family farmer with regular annual income.
- (5) Chapter 13: adjustment of debts of an individual with regular income.

Individuals may file petitions under chapter 7, 11, 12 or 13. n18 Partnerships and corporations may use chapters 7, 11 and 12. n19

[2] Bankruptcy Judges and United States Trustees

Bankruptcy judges are appointed to fourteen year terms by the United States Courts of Appeals n20 and are judicial officers of the district court. A bankruptcy judge's term which has expired may be extended for a period of up to 180

days or until the appointment of a successor, whichever comes first. n21 Bankruptcy judgeship appointments are based upon consideration of recommendations by the judicial council for each circuit. n22 Bankruptcy judges constitute a unit of the district court known as the bankruptcy court for each district.

The bankruptcy court has specific authority on its own motion or on request of a party in interest to hold a status conference regarding any case or a proceeding. It is assumed that parties will receive notice when the court sets a status conference. The bankruptcy court may issue an order at any status conference which prescribes limitations and conditions, as the court deems appropriate, to ensure that the case is handled expeditiously and economically. There are certain specific areas where the court may act in connection with chapter 11. n23

The United States Trustee program is administered by a United States Trustee agency within the Department of Justice. The executive office of the United States Trustee is the location of the United States Trustee. Additionally, Trustees are appointed in twenty-one regions by the Attorney General of the United States for a term of five years, subject to removal without cause. n24 Alabama and North Carolina function under the Bankruptcy Administrator program under the judicial branch. These districts are not in the United States Trustee program. The United States trustee is assigned a catalog of responsibilities and duties including monitoring fee applications, reviewing disclosure statements in chapter 11 cases, appointing and monitoring creditors' committees, notifying the United States attorneys of criminal acts and assisting in prosecutions when requested by the United States attorney. n25 The United States trustee may raise and may appear and be heard on any issue in any case or proceeding under the Bankruptcy Code, but may not file a plan of reorganization. n26 The single most used power of the United States trustee in reorganization cases is the responsibility to appoint committees of creditors holding unsecured claims and additional committees of creditors or equity security holders as is deemed appropriate. n27 The United States trustee may seek dismissal of a chapter 11 case because of the debtor's failure to file timely schedules and financial statements. n28

The National Bankruptcy Review Commission has discussed the United States Trustee program and has recommended certain reforms to Congress in a portion of their report. These reforms suggest the elevation of the United States Trustee to a position of Assistant Attorney General, increase centralization of authority in the United States Trustee, reduce the number of United States trustee regions to make them consistent with the number of federal circuit courts.

[3] Who May Be a Debtor

The Bankruptcy Code establishes who may be a debtor under the Bankruptcy Code generally and under each of the operative chapters. n29 The eligibility requirements for being a debtor indicate that only a person that resides or is domiciled, or has a place of business or property in the United States, or a municipality, may be a debtor. n30 "Person" includes an individual, partnership, and corporation, but does not include a governmental unit. n31 The eligibility requirements for being a debtor in chapter 7 are tied into the definition of a person. A domestic insurance company, bank, savings bank, cooperative bank, savings and loan association, building and loan association, homestead association, New Markets Venture Capital company, small business investment company, credit union or industrial bank or similar institution which is insured by the Federal Deposit Insurance Act is not eligible as a debtor in chapter 7 or any other chapter. n32 A railroad is not eligible as a debtor in chapter 7. n33 Neither is a foreign insurance company, bank, savings bank, cooperative bank, savings and loan bank, building and loan association, homestead association or credit union engaged in business in the United States eligible as a debtor in chapter 7. n34 A small business investment company licensed by the Small Business Administration may not be a debtor. n35 All debtors eligible to file a chapter 7 petition are eligible to file a chapter 11 petition except stockbrokers and commodity brokers. A railroad may be a debtor in chapter 11. n36

[4] Voluntary and Involuntary Petitions

A voluntary case is commenced by a person eligible to be a debtor by filing a petition with the bankruptcy court. n37 The filing of the petition constitutes an "order for relief." n38 No allegation of insolvency is required for filing a petition

under the Bankruptcy Code. The issue of whether a voluntary petition may be filed on behalf of a partnership by one or more general partners if all general partners consent to the petition is a matter of nonbankruptcy law. n39 If such consent is required, a voluntary petition may be filed by only one general partner, but there must be evidence that the remaining general partners consent to the filing.

Involuntary cases may be commenced only under chapter 7 and 11 and only against a person who is otherwise qualified to be a debtor. n40 Involuntary petitions may not be filed against a farmer or a corporation that is not a "monied, business, or commercial corporation." n41

If a debtor has twelve or more unsecured creditors that hold claims "that [are] not contingent as to liability or the subject of a *bona fide* dispute," three or more creditors whose "claims aggregate at least \$10,000 more than the value of any lien on property of the debtor securing such claims" must join together to file an involuntary petition against the debtor. n42 If there are fewer than twelve creditors, excluding creditors who are employees, "insiders" and holders of certain avoidable transfers, one or more creditors may file the involuntary petition "if the holders of the claim hold in the aggregate at least \$10,000 of such claims." n43 Once an involuntary petition is filed, the clerk of the court issues a summons for service on the debtor. Service of the summons is governed by the Bankruptcy Rules. n44

An involuntary petition may be controverted. n45 An order for relief is entered by the court if the debtor is generally not paying its debts as they become due unless such debts are the subject of a *bona fide* dispute or if within 120 days before the filing of the petition, a custodian was appointed to take charge of substantially all of the debtor's property. n46 The burden is on the party filing the involuntary petition to demonstrate the occurrence of either alternative.

The filing of an involuntary petition may give rise to liability for costs and damages against the petitioners. The bankruptcy court is empowered to impose costs, reasonable attorneys' fees, or damages and to enter a judgment against any petitioner for such costs and attorneys' fees. n47 If an involuntary petition has been filed in bad faith, and a finding is made to this effect, the court may enter a judgment for damages proximately caused by the filing or for punitive damages. n48 There is authority for the court to order petitioners to file an indemnity bond for such amounts or damages as the court may later allow. n49

In an involuntary case, a party in interest may seek the appointment of an interim trustee who will take possession of property of the estate, prior to the entry of an order for relief, to preserve the property, prevent loss, or operate the debtor's business. n50

The Bankruptcy Rules deal with the transfer of claims for the purpose of filing an involuntary petition. n51 A creditor may not qualify as a petitioning creditor if it acquired its claim solely for the purpose of filing an involuntary petition. n52 If the petitioning creditor has acquired a claim prior to the filing of the petition, it must disclose the terms of the transfer to the court and represent that the transfer was not for the purpose of filing the petition. n53

[5] Creation of the Estate

[a] Property of the Estate

Once a title 11 case is commenced an estate is created. n54 The estate is comprised of all assets or property of the debtor, and is administered for the benefit of the debtor's creditors. Some property of the estate is excluded from distribution to creditors. n55 Assets which become property of the estate may be abandoned, surrendered to secured creditors, foreclosed by secured creditors, exempted and released to the debtor or may be unavailable for administration. A good example of an item of property which is unavailable for administration would be a nonresidential lease which has expired before the case is commenced or is terminated either before the case is commenced or during the pendency of the case. n56

Property of the estate is defined broadly to include all legal and equitable interests of the debtor. It includes property owned prior to the filing and certain property acquired by the debtor within certain time periods after the filing. n57

An interest in property that becomes property of the estate is transferred to the estate in spite of provisions which may be contained in an agreement which restrict or condition transfers or terminate ownership because of insolvency or the commencement of a title 11 case. n58 In essence, the Bankruptcy Code strikes down any prenegotiated provisions which effect the transfer by operation of law of any property on the filing of a title 11 case.

[b] Turnover of Property to the Estate

Since the property of the estate is defined broadly and expansively, there must be sufficient powers granted to various parties in the administration of the estate to capture property that was transferred prior to the title 11 filing. These powers are generally described as the avoidance powers. n59 They include the obligation of a receiver or custodian to deliver to the trustee property which had been seized prior to the filing of the title 11 case and following an accounting for the property. Transfers of property of the debtor which may be avoided by a hypothetical *bona fide* purchaser are avoided. Any transfer voidable under state law is also avoided. Additionally, any transfer in violation of the Uniform Fraudulent Conveyance Act, the Uniform Fraudulent Transfer Act or other fraudulent conveyance laws of states is subject to being set aside and avoided. Statutory liens meeting certain criteria are avoidable. Preferential transfers of property, security interests or other acts of preference are subject to being set aside if they meet certain tests and occurred on or within ninety days before the date of the filing of the title 11 case. n60 In the case of an insider the time frame within which preferential transfers are subject to avoidance is extended to one year. n61 The Bankruptcy Code has its own version of a fraudulent conveyance law for transfers occurring within one year before the date of the filing of the title 11 case. n62

The avoidance provisions of the Bankruptcy Code cover postpetition transfers of property as well. n63 In the case of postpetition transfers, if the transferee is a good faith purchaser without knowledge of the filing of the title 11 case and has paid fair equivalent value, an exception is recognized. n64 If the good faith purchaser paid less than fair equivalent value, a lien is granted to such purchaser for the amount of value paid.

[6] The Automatic Stay and Adequate Protection

The automatic stay is universally recognized as one of the most powerful immediate effects of the filing of a title 11 case. Once a title 11 case is filed the stay automatically comes into play. n65

The automatic stay prohibits commencement or continuation of lawsuits against the debtor, enforcement of judgments against the debtor, acts to obtain possession of property of the estate or acts to exercise control over property of the estate. n66 The automatic stay prevents actions which could create, perfect or enforce liens against property of the estate, or property of the debtor if the lien secures a claim arising prepetition. The section 362 stay further prevents collection of a claim or setoff of any debt owing to the debtor that arose before the title 11 case was filed. n67 Commencement or continuation of a tax case concerning the debtor in the Tax Court is stayed. n68

Many exceptions exist to the automatic stay. n69 The most prominent exceptions are: the stay does not affect the commencement or continuation of a criminal action or proceeding against the debtor; it does not affect the collection of alimony, maintenance or support from property that is not property of the estate; it does not affect the commencement or continuation of an action or proceeding by a governmental unit to enforce its police or regulatory power; and it does not bar the issuance to the debtor by a governmental unit of a notice of tax deficiency. If no exception to the automatic stay is specifically set forth in the text of the Bankruptcy Code, it is necessary that a creditor, seeking exception and the right to commence prepetition claim enforcement, obtain an order from the bankruptcy court granting relief from the stay. n70 There are numerous specific exceptions that have been passed by Congress to exclude the operation of the automatic stay from specific situations.

Relief is available from the automatic stay on motion of a party in interest, after notice and a hearing, and upon a showing of cause. n71 Some of the typical reasons for modifying the automatic stay include the lack of adequate protection of an interest in property, that no equity remains to the debtor in the property, and that the property is not necessary to an effective reorganization. n72

In the case of adequate protection, various examples are furnished by the Bankruptcy Code specifying the means by which adequate protection may be provided. n73 The concept of adequate protection of secured creditors is not restricted to the operation of the automatic stay but "weaves" itself around other provisions of the Bankruptcy Code including the use, sale or lease of property, financing, and the assumption of leases and executory contracts. n74

[7] Forum Selection

A title 11 case is commenced by filing a petition with the clerk. n75 The official form may be used to commence a voluntary title 11 case. n76 Only the original petition need be signed and verified and copies can be conformed to the original. n77 The number of copies of the petition to be filed is generally specified by the local rules. For example, sufficient copies must be filed for the court and its files and for the United States Trustee. n78

The title 11 petition may be filed by a debtor or creditor in the district court for the district of the debtor's domicile, residence, principal place of business or location of principal assets for 180 days or longer portion thereof immediately preceding the filing. n79 In the case of a partner, partnership or an affiliate, the case may be commenced in the district in which there is a pending case of an affiliate. n80

If a petition is filed in a proper district, upon motion and after hearing on notice, the case may be transferred to any other district if the bankruptcy court determines that the transfer is in the interest of justice or for the convenience of the parties. If a case is filed in an improper district, transfer may be authorized under the same test. n81

[8] Claims Against the Estate

A claim is a right to payment whether or not the right is reduced to judgment, liquidated, unliquidated, fixed, contingent, matured, unmatured, disputed, undisputed, legal, equitable, secured or unsecured. n82 "Claim" is defined broadly so that the bankruptcy court may deal with as many liabilities of the debtor as possible. A proof of claim may be filed by a creditor in every title 11 case. n83 A proof of interest may be filed by an equity security holder in a title 11 case. n84

A proof of claim or interest in a chapter 11 case is deemed filed if the liability to the creditor or equity security holder is scheduled by the debtor on documents filed with the court and is not listed as disputed, contingent or unliquidated. n85 Claims may be added or deleted as schedules are amended or corrected. A claim may be scheduled as disputed, contingent or unliquidated and may later, on amendment of the schedules, be recharacterized as undisputed, noncontingent or liquidated. The filing of claims may be barred if a claim or equity interest is not filed by a date certain set by the bankruptcy court. n86 The barring of a claim by court order and on notice applies to all types of tax claims.

Once a claim or interest is filed, it is deemed allowed unless objection to that claim or interest is made by a party in interest. n87 A claim for taxes assessed against property of the estate in excess of the value of the estate's interest in the property is not allowable. n88

If a claim is objected to, the procedure for litigating the value of that claim is handled by the bankruptcy court pursuant to the Federal Rules of Bankruptcy Procedure. n89 Certain claims are limited in value as, for example, the claim of a lessor for damages arising from the rejection of a real property lease. n90 Postpetition interest on claims generally is not allowed. n91 Penalties may not be allowed. n92

The priorities of distribution in payment of claims are listed in the Bankruptcy Code. n93 A first priority for administrative expenses is accorded to actual, necessary costs and expenses of preserving the estate, including wages, salary or commissions for services rendered after the case was filed. n94 A first priority administrative expense may include any tax which is incurred by the estate. An eighth priority is accorded to allowed unsecured claims of governmental units for taxes including income, gross receipts, withholding, employment tax, excise tax and property tax. n95 The eighth priority for income or gross receipts taxes is limited to those taxes accruing within three years before the date of the filing of the title 11 petition. n96 There are additional time limits imposed in connection with taxes subject to an offer in compromise and taxes assessable but not assessed before the petition was filed. n97 Unsecured claims based on any commitment by the debtor to a federal depository institution regulatory agency to maintain the capital of that depository institution are granted a ninth priority. n98

Certain claims may be subordinated to payment of other claims pursuant to *section 510 of the Bankruptcy Code*. n99 Subordination agreements that are enforceable under nonbankruptcy law are enforceable in title 11 cases. n100 One claim may be equitably subordinated to another after litigation in the bankruptcy court. n101 The principles of equitable subordination cited in section 510 are a codification of prior case law. n102

[9] Chapter 7 Cases

Chapter 7 is the liquidation chapter of the Bankruptcy Code which provides for the cessation of operation and the distribution of assets to creditors. n103 Once a chapter 7 petition is filed a trustee will be appointed to gather and distribute the assets of the estate. n104 The trustee has the responsibility for collecting property, accounting for property received, investigating the financial affairs of the debtor, examining proofs of claim and contesting them, opposing the debtor's discharge, if appropriate, providing information and reports to parties in interest, and making a final report and final accounting when the estate is fully administered. n105 In some chapter 7 cases, the business of the debtor may continue to operate temporarily and, if so, the trustee is responsible for such operation and will be required to file periodic reports and operational summaries. n106

Property is distributed in chapter 7 in the order specified in the Bankruptcy Code. n107 First, priority claims are paid; n108 second, timely filed allowed unsecured claims; third, allowed unsecured late filed claims; fourth, fines, penalties, forfeiture, exemplary or punitive damages; fifth, interest; and sixth, the remainder to the debtor, if anything remains.

In chapter 7 the debtor seeks a discharge from all debts that arose before the date of the order for relief n109 and the trustee seeks an efficient and orderly administration of the assets and distribution of the funds in the estate. n110

[10] Chapter 11 Cases

Chapter 11 allows individuals, partnerships and corporations to reorganize. n111 In chapter 11, the debtor remains in possession of its business, operates it from the date of the filing of the case and can only be displaced by a court order appointing a trustee. The terms "trustee" and "debtor in possession" are frequently interspersed in the Bankruptcy Code provisions. The term "trustee" includes a debtor in possession. n112

The primary thrust of chapter 11 is to reorganize the debtor so that profitable operations may resume and prepetition claims and obligations may be paid in accordance with a plan of reorganization which has been approved and confirmed. Theoretically, a chapter 11 reorganization should realize more distribution for creditors than a chapter 7 liquidation. On numerous occasions, chapter 11 cases result in liquidation of assets during the administration of the chapter 11 case or after conversion of the chapter 11 case to chapter 7.

Once a chapter 11 petition is filed, the United States trustee appoints a representative committee of creditors generally consisting of the holders of the seven largest unsecured claims, except in "small business" chapter 11 cases. n113 On

request of a party in interest in a case in which the debtor is a small business, the court may order that a committee of creditors not be appointed. n114 "Small business" means a person engaged in commercial business activity whose aggregate, noncontingent, liquidated secured and unsecured debts as of the date of the petition do not exceed \$2 million. A person whose primary activity is the business of owning or operating real property and activities incident thereto is excluded from the definition of "small business." n115 Additional committees may be appointed by the United States trustee if circumstances warrant. n116

A debtor in possession may be displaced, for cause, at any time prior to the confirmation of a plan in chapter 11. The bankruptcy court may order the appointment of a trustee or an examiner. n117 Chapter 11 trustees are to be elected by the creditors in the same manner as in chapter 7 cases, if a party in interest makes such a request within 30 days of a court order directing the appointment of a trustee under *section 1104(a) of the Code*. n118 A trustee is usually appointed when fraud, dishonesty, incompetence or gross mismanagement of the affairs of the debtor takes place by current management. n119 An examiner is usually appointed to conduct an investigation when there have been allegations of fraud, dishonesty, incompetence, misconduct, mismanagement or irregularity in the management of the debtor's affairs. n120

Many chapter 11 cases terminate by conversion to chapter 7. A bankruptcy court may be requested by a party in interest or the United States trustee to convert a chapter 11 case to chapter 7 for cause. n121 Some examples of reasons for conversion are: continuing loss or diminution of the estate and absence of reasonable likelihood of rehabilitation, inability to effectuate a plan, unreasonable delay by the debtor that is prejudicial to creditors, failure to propose a plan within the time fixed by the court, and denial of confirmation of a proposed plan. Many chapter 11 cases have plans which are proposed and confirmed but are not substantially consummated or which have been materially defaulted. A chapter 11 case may be converted to a chapter 7 because substantial consummation of the confirmed plan has failed or a material default has taken place after a plan has been confirmed. n122

The objective of chapter 11 is to propose a plan of reorganization which is accepted by the creditors and confirmed by the court. The debtor has the exclusive right for 120 days after the chapter 11 case is commenced to file a plan of reorganization. n123 This time is called the exclusivity period. In a small business chapter 11 case, the exclusivity period is shortened to 100 days, unless the debtor can show that an increase in time is needed due to "circumstances for which the debtor should not be held accountable." n124 Other parties in interest may file a plan of reorganization if the exclusivity period has terminated and no plan has been filed or a plan that has been filed has not been accepted by the creditors within 180 days following the filing of the chapter 11 case. They may also file a plan if a trustee has been appointed and the debtor in possession has been displaced. n125 It is normal for the debtor in possession to increase the exclusivity period by requesting extensions of time. An extension is not automatic; it may be opposed by parties in interest and is subject to approval by the bankruptcy court. n126 The time period may also be reduced by the court.

A plan of reorganization is usually accompanied by a disclosure statement. n127 The disclosure statement must be approved by the bankruptcy court after notice and a hearing; it must contain adequate information regarding the plan of reorganization and in sufficient detail so that a hypothetical reasonable investor typical of holders of claims or interests in the various classes can make an informed judgment about the plan of reorganization. n128

The plan of reorganization sets forth those classes which are impaired or unimpaired, classifies claims or interests, provides for the treatment of impaired classes and provides for its implementation. n129 A plan of reorganization may provide for the sale of all or substantially all of the estate property and the distribution of the proceeds to holders of claims or interests. n130 Plans of reorganization are creatively written and contain many variations of treatment for claims and interests.

The holder of a claim or interest whose claim or interest is allowed may accept or reject a plan. n131 Those classes of claims that are unimpaired are deemed to have accepted the plan. n132 A class is deemed to have rejected a plan if the plan provides that the members of that class are not entitled to receive or retain any property under the plan. n133

After the vote, the court conducts a confirmation hearing at which all the requirements of the Bankruptcy Code must be examined and a determination must be made to test compliance with the Bankruptcy Code. n134 When a class of claims or interests is impaired, the court must determine at the confirmation hearing that each holder has accepted the plan or will receive or retain under the plan property of a value that is not less than the amount that would be received if the debtor were liquidated under chapter 7. n135 If an impaired class has rejected the plan, in order to confirm it, the court must find that the plan is fair and equitable. n136 A "cramdown" is provided and may be approved by the bankruptcy court if the plan meets certain requirements and is fair and equitable. n137

Once a plan of reorganization is confirmed, the debtor is generally discharged from any debt that arose prior to the date of confirmation which includes debts which arose after the chapter 11 case was commenced. n138 There are exceptions to the chapter 11 discharge. n139 If a debt is nondischargeable under *section 523(a) of the Bankruptcy Code*, an individual debtor may not obtain a discharge from that debt in the chapter 11 case. No discharge is granted if the chapter 11 plan provides for liquidation of all or substantially all of the property and the debtor does not continue in business, if the debtor would be barred from a discharge under *section 727 of the Code*. n140

[11] Chapter 12 Cases

Chapter 12 n141 was added in 1986 to provide special relief for family farmers to ease the financial crisis for family famers. It was expanded in 2005 by the Bankruptcy Abuse Prevention and Consumer Protection Act ("BAPCPA") to include family fishermen. n142 Chapter 12 has been extended several times by Congress since 1986 and was permanently reenacted by BAPCPA, effective July 1, 2005. It is designed to afford bankruptcy relief to family farmers n143 and family fishermen n144 with regular income.

Please note the special tax provisions in section 1231 n145 which authorize a plan proponent to request a determination from any taxing unit of the legal tax effects of a Chapter 12 plan. n146 This provision applies to cases filed on or after April 20, 2005. n147

[12] Chapter 13 Cases

Chapter 13, as well as Chapter 7, have been dramatically changed as a result of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). Consumer lenders are granted significantly more rights and greater protection. Secured lenders with liens on personal property are also granted more protection and will retain their liens until the Chapter 13 plan is completed. n148

Eligibility for relief under the Bankruptcy Code has been revised significantly by BAPCPA. n149 Individuals must have received briefings from a nonprofit budget and credit counseling agency within 180 days prior to filing. The budget and credit counseling agency must have been approved by the United States Trustee. There are standards for approval that are set forth in the Bankruptcy Code. n150 Even after filing, debtors in chapter 13 as well as chapter 7 are mandated to complete instruction in personal financial management, if they desire a debt discharge. n151

Exemptions are affected by the BAPCPA. In most states, other than Texas, there is a limit on the exemption asserted by a resident. Residents of a state who acquired a homestead three and one-half years before the filing of the petition can exempt a maximum of \$125,000 of the homestead equity. In Texas, the debtor must have resided in the state for two years before the filing of the petition. n152

Debtors are required to provide a copy of the most recent tax returns filed with the Internal Revenue Service to the United States Trustee, and to any creditor who timely makes a request. n153 If a debtor fails to provide copies of the tax returns, dismissal of the pending bankruptcy case is provided, unless the debtor can demonstrate failure to comply is beyond the debtor's control. n154 Debtors are also required to prove that tax returns have been filed for the preceding 4

years before the Bankruptcy has been commenced. n155

Debtors in all cases must pay all types of post-petition taxes in the ordinary course of their business. n156 Failure in this regard can result in a dismissal of the bankruptcy case. The amount of a Chapter 13 debtor's tax debt is taken into account in determining the debtor's eligibility for relief. n157 Even though a Chapter 13 debtor disputes the tax liability claimed by Internal Revenue Service, n158 that does not render the tax liability contingent and unliquidated for purposes of Chapter 13 eligibility. If the tax debt is noncontingent and liquidated and exceeds the monetary limit set forth in section 109(e), the debtor is not eligible for Chapter 13. n159

Confirmation hearings on chapter 13 plans are speeded up after the section 341 meeting of creditors.

Discharge rights in chapter 13 cases are limited. The super discharge previously permitted is virtually eliminated. n160 The list of debts which are excepted from discharge is expanded to include debts created by embezzlement, breach of fiduciary duty, and fraud.

The chapter 13 plan may be expanded to as long as 5 years if the debtor has sufficient income. In this situation the plan may provide payment of 100 percent of the unsecured claims. n161

A discharge is granted after completion of all payments provided for by the plan. n162 The type of discharge is much broader than that granted under chapter 7. n163

Plans may be modified after confirmation but before completion to increase or reduce the amount of payments on particular claims or extend or reduce the time for making payment. n164

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 95-598 (1978), *reprinted in* Vol. A Collier on Bankruptcy, App. Pt. 4(a) (Matthew Bender 15th Ed. Revised), as amended by Pub. L. No. 97-35 (1981), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(c)(i) (Matthew Bender 15th Ed. Revised); Pub. L. No. 97-222 (1982), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(d)(i) (Matthew Bender 15th Ed. Revised); Pub. L. No. 98-353 (1984), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 6(a) (Matthew Bender 15th Ed. Revised); Pub. L. No. 99-554 (1986), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 7(a) (Matthew Bender 15th Ed. Revised); Pub. L. No. 100-506 (1988), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(g)(i) (Matthew Bender 15th Ed. Revised); Pub. L. No. 99-509 (1986), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(f)(i) (Matthew Bender 15th Ed. Revised); and Pub. L. No. 100-597 (1988), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(g)(ii) (Matthew Bender 15th Ed. Revised). The Bankruptcy Reform Act of 1978 was further amended by Pub. L. No. 101-311 (1990), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(h)(i) (Matthew Bender 15th Ed. Revised), Pub. L. No. 101-508 (1990), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(h)(ii) (Matthew Bender 15th Ed. Revised), Pub. L. No. 101-581 (1990), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(h)(ii) (Matthew Bender 15th Ed. Revised), and Pub. L. No. 101-647 (1990), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(h)(iv) (Matthew Bender 15th Ed. Revised). It was further amended by the Retiree Benefits Bankruptcy Protection Act of 1988, Pub. L. No. 100-334 (1988), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 8(a) (Matthew Bender 15th Ed. Revised). The bankruptcy code was then significantly changed by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n2)Footnote 2. Title II of the Bankruptcy Reform Act established the United States bankruptcy courts and their administrative systems. Title III amended other bankruptcy litigation, and Title IV set forth the transition system from the Bankruptcy Act of 1898 to the Bankruptcy Reform Act.

(n3)Footnote 3. 458 U.S. 50, 102 S. Ct. 2858, 73 L. Ed. 2d 598, 6 C.B.C.2d 785 (1982) .

(n4)Footnote 4. Pub. L. No. 98-353 (1984), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 6(a) (Matthew Bender 15th Ed. Revised).

(n5)Footnote 5. 28 U.S.C. § 152(a)(1).

(n6)Footnote 6. 28 U.S.C. § 1334.

(n7)Footnote 7. 28 U.S.C. § 157(a), (d).

(n8)Footnote 8. 28 U.S.C. § 157(b), (c).

(n9)Footnote 9. 28 U.S.C. § 157(c)(1).

(n10)Footnote 10. 28 U.S.C. § 157(b)(2)(O).

(n11)Footnote 11. Seminole Tribe of Florida v. Florida, 517 U.S. 44, 116 S. Ct. 1114, 134 L. Ed. 2d 252, 34 C.B.C.2d 1199 (1996) .

(n12)Footnote 12. 126 S. Ct. 990, 163 L. Ed. 2d 945, 54 C.B.C.2d. 1233 (2006) .

(n13)Footnote 13. *In re Hood*, 541 U.S. 114, 124, S. Ct. 990, 163 L. Ed. 2d 945, 51 C.B.C.2d 627 (2004).

(n14)Footnote 14. *Constitution art 1, § 8 Clause 4* granted Congress the power to establish "uniform laws on the subject of Bankruptcies throughout the United States."

(n15)Footnote 15. Bankruptcy Rules are promulgated pursuant to 28 U.S.C. § 2075, amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised). The 1991 Amendments to the Bankruptcy Rules and Official Forms amended *Bankruptcy Rule 1001* by changing the citation form of the Bankruptcy Rules to the "Federal Rules of Bankruptcy Procedure." Subsequent references to the "Bankruptcy Rules" or the "Rules" in this chapter refer to the Federal Rules of Bankruptcy Procedure.

(n16)Footnote 16. Subchapters III and IV of chapter 7 govern stockbroker liquidations and commodity broker liquidations respectively.

(n17)Footnote 17. Subchapter IV of chapter 11 governs railroad reorganizations.

(n18)Footnote 18. 11 U.S.C. § 109; *see also* 11 U.S.C. § 101 for the definitions of "debtor," "corporation," "family farmer" and "person."

(n19)Footnote 19. 11 U.S.C. § 109.

(n20)Footnote 20. 28 U.S.C. § 152(a)(1). Bankruptcy judges are appointed under Article I of the Constitution and are not Article III judges who have tenure for life.

(n21)Footnote 21. Added by the Judicial Improvements Act of 1990, Pub. L. No. 101-650, § 304 (1990), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 42(b)(i)(D) (Matthew Bender 15th Ed. Revised).

(n22)Footnote 22. 28 U.S.C. § 152(a)(1) and (b)(1).

(n23)Footnote 23. 11 U.S.C. § 105(d)(2)(B) provides specific authority for the court to act on specific items applicable to chapter 11 by use of a status conference. This specific authority is designed to speed up the chapter 11 process.

(n24)Footnote 24. 28 U.S.C. § 581.

(n25)Footnote 25. 28 U.S.C. § 586.

(n26)Footnote 26. 28 U.S.C. § 307; 11 U.S.C. § 1121.

(n27)Footnote 27. 11 U.S.C. § 1102(a)(1).

(n28)Footnote 28. 11 U.S.C. § 1112(e).

(n29)Footnote 29. 11 U.S.C. § 109.

(n30)Footnote 30. 11 U.S.C. § 109(a).

(n31)Footnote 31. 11 U.S.C. § 101. *In re C-TC 9th Avenue Partnership*, 113 F.3d 1304 (2nd Cir. 1997) determined that a partnership in dissolution is not a person eligible to file for chapter 11 relief under 11 U.S.C. § 109(d). See *In re Winshall Settlor's Trust*, 758 F.2d 1136 (6th Cir. 1985) .

(n32)Footnote 32. 11 U.S.C. § 109(b)(2). Pub. L. No. 106-554, the Consolidated Appropriations Act, 2001, effective December 21, 2000, *reprinted in* Vol. F Collier on Bankruptcy, App. Pt 41(q)(iii) (Matthew Bender 15th Ed. Revised), amended section 109(b) to exclude New Markets Venture Capital companies, as defined in section 351 of the Small Business Investment Act of 1958, from being a debtor under chapter 7, and to except uninsured State member banks, and "corporations organized under section 25A of the Federal Reserve Act, which operates, or operates as, a multilateral clearing organization pursuant to section 409 of the Federal Deposit Insurance Corporation Improvement Act of 1991," from the list of impermissible debtors under chapter 7. The Act amended section 101 to add a definition for "uninsured State member bank."

(n33)Footnote 33. 11 U.S.C. § 109(b)(1).

(n34)Footnote 34. 11 U.S.C. § 109(b)(3).

(n35)Footnote 35. 11 U.S.C. § 109(b)(2).

(n36)Footnote 36. 11 U.S.C. § 109(d). See Subchapter IV of chapter 11. Pub. L. No. 106-554, the Consolidated Appropriations Act, 2001, effective December 21, 2000, *reprinted in* Vol. F Collier on Bankruptcy, App. Pt 41(q)(iii) (Matthew Bender 15th Ed. Revised), amended section 109(d) to include an uninsured State member bank, and a "corporation organized under section 25A of the Federal Reserve Act, which operates, or operates as, a multilateral clearing organization pursuant to section 409 of the Federal Deposit Insurance Corporation Improvement Act of 1991," as permissible debtors under chapter 11.

(n37)Footnote 37. 11 U.S.C. § 301.

(n38)Footnote 38. 11 U.S.C. § 301.

(n39)Footnote 39. *Fed. R. Bankr. P. 1004*. The 2002 Amendment to *Fed. R. Bankr. P. 1004*, effective December 1, 2002, deleted subdivision (a) (concerning voluntary petitions) of the rule so the rule could not be construed as requiring the consent of all of the general partners to the filing of a voluntary petition, even if fewer than all of the general partners would have the authority under applicable nonbankruptcy law to commence a bankruptcy case for the partnership. The amendment also retitled the rule to reflect that it applies only to involuntary petitions filed against partnerships. The Supreme Court has held in the corporate context that applicable nonbankruptcy law determines whether authority exists for a particular debtor to commence a bankruptcy case. See 2002 Advisory Committee Note to *Fed. R. Bankr. P. 1004*.

(n40)Footnote 40. 11 U.S.C. § 303(a).

(n41)Footnote 41. 11 U.S.C. § 303(a).

(n42)Footnote 42. 11 U.S.C. § 303(b)(1).

(n43)Footnote 43. 11 U.S.C. § 303(b)(2).

(n44)Footnote 44. *Fed. R. Bankr. P. 1010*.

(n45)Footnote 45. 11 U.S.C. § 303(h).

(n46)Footnote 46. 11 U.S.C. § 303(h)(1) and (2); see *McCoid II, The Occasion for Involuntary Bankruptcy*, 61 *Am. Bankr. L.J.* 195 (1987).

(n47)Footnote 47. 11 U.S.C. § 303(i)(1)(A) and (B).

(n48)Footnote 48. 11 U.S.C. § 303(i)(2)(A) and (B).

(n49)Footnote 49. 11 U.S.C. § 303(e).

(n50)Footnote 50. 11 U.S.C. § 303(g).

(n51)Footnote 51. *Fed. R. Bankr. P. 1003*.

(n52)Footnote 52. *Fed. R. Bankr. P. 1003(a)*.

(n53)Footnote 53. *Fed. R. Bankr. P. 1003(a)*.

(n54)Footnote 54. 11 U.S.C. § 541(a).

(n55)Footnote 55. 11 U.S.C. § 541(b) sets forth a few specific exclusions. Generally, all legal or equitable interests of the debtor in property are deemed property of the estate. In *In re Bakersfield Westar, Inc.*, 40 *C.B.C2d* 1439, 226 *B.R.* 227 (*B.A.P. 9th Cir.* 1998), the trustee sought to avoid the revocation of a Subchapter S election as a fraudulent transfer under section 548. The court found that the right to revoke a Subchapter S election was a property right and the issue of revocation in a Subchapter S election, a property interest. The court relied on *In re Russell*, 927 *F.2d* 413 (*8th Cir.* 1991), which held that a net operating loss election was a property interest. The court also found no distinction between an NOL election and a Subchapter S election and concluded that the Subchapter S election and its revocation were property interests. The IRS position that there is no basis to permit avoidance or revocation of the election was rejected.

(n56)Footnote 56. 11 U.S.C. § 541(b)(2).

(n57)Footnote 57. See 5 *Collier on Bankruptcy*, P 541.05 (Matthew Bender 15th Ed. Revised) for a discussion of the kinds of property encompassed within the broad definition of property of the estate, *i.e.*, life estates, equity of redemption, dower and curtesy.

(n58)Footnote 58. 11 U.S.C. § 541(c)(1). See also *In re Mciver*, 2000 *U.S. Dist. LEXIS* 12358 (*D. Md.* 2000), a case of first impression in connection with the IRS continuing enforceability of tax liens securing a tax claim against postpetition annuity payments. This is a case of first impression in connection with the question of whether annuities are property of the estate and, if property of the estate, whether the IRS secured tax lien attaches to the present value of the future stream of income. The district court reversed the bankruptcy court and concluded that an interest in a trust, while not property of the estate, is still subject to the secured claim of the IRS on a postpetition basis. The debtor had annuity

contracts from pensions and claimed that they were not property of the estate. The IRS filed a claim and sought enforcement of the claim against the debtor's monthly annuity payments. The IRS asserted that its tax liens attached to the annuity payments whether or not they were property of the estate. The bankruptcy court ruled against the IRS; the district court reversed and determined that, even though there were transfer restrictions in the annuity contract, these restrictions were unenforceable and ineffective against federal tax liens. The court concluded that the debtor's right in the annuities were not excluded from the estate, as property of the estate, and if property of the estate under § 541(c)(2) they were subject to the IRS secured claim to the extent of the annuity's value in the estate. That value is the present value of the future stream of payments to be received by the debtor and this can be reached by the IRS.

(n59)Footnote 59. 11 U.S.C. § 542 (turnover of property to the estate); 11 U.S.C. § 543 (turnover of property by a custodian); 11 U.S.C. § 544 (trustee avoidance powers as a lien creditor and as successor to certain creditors and purchasers); 11 U.S.C. § 545 (avoidance of statutory liens); 11 U.S.C. § 547 (avoidance of preferences); and 11 U.S.C. § 548 (avoidance of fraudulent transfers).

(n60)Footnote 60. 11 U.S.C. § 547(b)(4)(A).

(n61)Footnote 61. 11 U.S.C. § 547(b)(4)(B).

(n62)Footnote 62. 11 U.S.C. § 548. See *BFP v. Resolution Trust Corp.*, 511 U.S. 531, 114 S. Ct. 1757, 128 L. Ed. 2d 556, 30 C.B.C.2d 345 (1994), in which the court held that when a real estate mortgage foreclosure sale is conducted in compliance with applicable state law, the fair and proper price, or a "reasonably equivalent value," is the price that is in fact received at such sale, and no determination need be made as to whether the sale price was the equivalent of the "fair market value" or "fair foreclosure price." See also 5 *Collier on Bankruptcy*, P 548.05[2] (Matthew Bender 15th Ed. Revised).

(n63)Footnote 63. 11 U.S.C. § 549.

(n64)Footnote 64. 11 U.S.C. § 549(c).

(n65)Footnote 65. 11 U.S.C. § 362(a).

(n66)Footnote 66. 11 U.S.C. § 362(a)(1), (a)(2) and (a)(3). See the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, effective October 22, 1994.

(n67)Footnote 67. 11 U.S.C. § 362(a)(4); (a)(6)-(a)(7). The Omnibus Consolidated Emergency Supplemental Appropriations Act, 1999, Pub. L. No. 105-277, effective October 21, 1998, deleted sections 362(b)(4) and (b)(5) (the exceptions to the automatic stay for exercises of the police and regulatory power) and supplied a new section 362(b)(4). The 1998 amendment to subsection (b)(4) expands the breadth of the exception by its introductory reference to paragraphs (3) and (6) of section 362(a), but the expansion appears limited by the history of the provision. See discussion in *Collier on Bankruptcy*, P 362.05 (Matthew Bender 15th Ed. Revised).

(n68)Footnote 68. 11 U.S.C. § 362(a)(8).

(n69)Footnote 69. 11 U.S.C. § 362(b) contains a list of exceptions. The section 362 list of exceptions has been increased by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394.

(n70)Footnote 70. 11 U.S.C. § 362(b)(9). The automatic stay does not apply to tax audits, issuance of a notice of tax deficiency, demand for tax returns or the making of an assessment. 11 U.S.C. § 362(b)(9). In *U.S. v. Holden*, 2000 U.S. Dist. LEXIS 12825 (D. Vt. 2000), the court held that the IRS's imposing of an indefinite "V-freeze" on debtors' postpetition income tax refund, because of a prepetition tax debt, violated the automatic stay in bankruptcy and was in contempt of debtors' plan confirmation order.

(n71)Footnote 71. 11 U.S.C. § 362(d). Section 362(d) makes an exception to the automatic stay for single asset real estate cases. The automatic stay is lifted after 90 days unless the debtor filed a plan with a reasonable possibility of being confirmed or is making monthly payments to the consensual lienor equal to the current fair market rate of interest on the value of the mortgagee's interest in the property. For a case illustrating the necessity of a debtor to respond to IRS action in connection with their seeking relief from the automatic stay in connection with a setoff claim of a refund against a tax debt, see *In re Hand, 2000 Bankr. LEXIS 839 (Bankr. S.D. Iowa 2000)*. The court granted the IRS relief from the stay when the debtor failed to file any response.

(n72)Footnote 72. 11 U.S.C. § 362(d)(1) or (d)(2)(A) and (B).

(n73)Footnote 73. 11 U.S.C. § 361.

(n74)Footnote 74. See 11 U.S.C. §§ 361, 362, 363, 364 and 365.

(n75)Footnote 75. *Fed. R. Bankr. P. 1002*. A number of jurisdictions have recently allowed electronic filing as a substitute for paper filings. This trend will continue and makes document filing contemporary with trends to electronic business communication. The Rule will provide for electronic filing.

(n76)Footnote 76. *Fed. R. Bankr. P. 9009*.

(n77)Footnote 77. *Fed. R. Bankr. P. 1002*.

(n78)Footnote 78. *Fed. R. Bankr. P. 1002*.

(n79)Footnote 79. 28 U.S.C. § 1408.

(n80)Footnote 80. 28 U.S.C. § 1408. The term of "affiliate" is defined at 11 U.S.C. § 101.

(n81)Footnote 81. *Fed. R. Bankr. P. 1014(a)*.

(n82)Footnote 82. 11 U.S.C. § 101.

(n83)Footnote 83. 11 U.S.C. § 501(a).

(n84)Footnote 84. 11 U.S.C. § 501(a).

(n85)Footnote 85. 11 U.S.C. § 1111(a).

(n86)Footnote 86. *Fed. R. Bankr. P. 3002(c)* for chapter 7, 12 and 13 cases and *Fed. R. Bankr. P. 3003(c)(3)* for chapter 11 cases.

(n87)Footnote 87. 11 U.S.C. § 502(a).

(n88)Footnote 88. 11 U.S.C. § 502(b)(3).

(n89)Footnote 89. *Fed. R. Bankr. P. 3007*; see also *Fed. R. Bankr. P. 9014* governing the contested matter which is initiated by the filing of an objection to a claim.

(n90)Footnote 90. 11 U.S.C. § 502(b)(6).

(n91)Footnote 91. 11 U.S.C. § 502(b)(2).

(n92)Footnote 92. 11 U.S.C. § 507(a)(8). Section 507(a)(7) was renumbered by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, reprinted in Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed.

Revised). The new seventh priority concerns paternity proceedings, establishment or modification of alimony and support orders and collection of such payment from non-estate property.

(n93)Footnote 93. 11 U.S.C. § 507(a).

(n94)Footnote 94. 11 U.S.C. § 507(a)(1).

(n95)Footnote 95. 11 U.S.C. § 507(a)(8); see *In re NVF Co., 2008 Bankr. LEXIS 2396 (Bankr. D. Del. 2008)* where prepetition city utility charges and property taxes were claimed and allowed, over the Chapter 11 Debtor's objection, pursuant to section 502(a), against abandoned property that had been administered in the estate.

(n96)Footnote 96. 11 U.S.C. § 507(a)(8).

(n97)Footnote 97. 11 U.S.C. § 507(a)(8).

(n98)Footnote 98. 11 U.S.C. § 507(a)(9).

(n99)Footnote 99. 11 U.S.C. § 510(a).

(n100)Footnote 100. 11 U.S.C. § 510(a).

(n101)Footnote 101. 11 U.S.C. § 510(c).

(n102)Footnote 102. H.R. Rep. No. 595, 95th Cong., 1st Sess. (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n103)Footnote 103. 11 U.S.C. § 701 *et seq.*

(n104)Footnote 104. 11 U.S.C. §§ 701, 702, 703 and 704.

(n105)Footnote 105. 11 U.S.C. § 704 sets forth a list of the trustee's duties. *Bankruptcy Rules 2001* (appointment of an interim trustee before an order for relief is entered); 2002 (notice requirements); 2015 (requirements to keep records, furnish reports and give notices); and 3007 (objection to claims) are illustrations of significant Bankruptcy Rules applicable to a trustee's duties.

(n106)Footnote 106. 11 U.S.C. §§ 721 and 704(8).

(n107)Footnote 107. 11 U.S.C. § 726(a).

(n108)Footnote 108. 11 U.S.C. § 726(a)(1) incorporates § 507 to determine which claims are paid as priority and which claims are paid in order. The priority provisions of § 507, incorporated in § 726, also incorporate other provisions, for example § 503(b) (which lists administrative expenses by category) and § 502(f) (which describes the "gap" claim as an administrative claim; gap claims are those which arise after an involuntary petition is filed but before an order for relief is entered). Section 726(a) and section 503 permit a late filed priority claim to be paid if distribution has not commenced.

(n109)Footnote 109. 11 U.S.C. § 727. Under 11 U.S.C. § 727(a)(1), only an individual may receive a discharge under chapter 7.

(n110)Footnote 110. 11 U.S.C. § 704(1).

(n111)Footnote 111. 11 U.S.C. § 1101 *et seq.*

(n112)Footnote 112. 11 U.S.C. § 1107(a).

(n113)Footnote 113. 11 U.S.C. § 1102(a)(1) and (b).

(n114)Footnote 114. Section 1102 permits an expedited and less expensive procedure for reorganizing a small business.

(n115)Footnote 115. See the definition of "small business" in 11 U.S.C. § 101.

(n116)Footnote 116. 11 U.S.C. § 1102(a)(2).

(n117)Footnote 117. 11 U.S.C. § 1104(a).

(n118)Footnote 118. 11 U.S.C. § 1104(a).

(n119)Footnote 119. 11 U.S.C. § 1104(a)(1) and (2).

(n120)Footnote 120. 11 U.S.C. § 1104(c)(1) and (2).

(n121)Footnote 121. 11 U.S.C. § 1112 sets forth the guidelines for conversion of a case or its dismissal.

(n122)Footnote 122. 11 U.S.C. § 1112(b)(7), (8).

(n123)Footnote 123. 11 U.S.C. § 1121.

(n124)Footnote 124. Section 1121(e), as added by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, *reprinted in* Vol. E. Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n125)Footnote 125. 11 U.S.C. § 1121(c)(1), (2) and (3).

(n126)Footnote 126. 11 U.S.C. § 1112(d) provides for increasing the exclusivity period on motions timely filed and upon a hearing by the court after appropriate notice. The standard is "for cause." Parties in interest may file a motion to shorten exclusivity or terminate it at any time during the exclusivity period. The standard for shortening or terminating exclusivity is also "for cause."

(n127)Footnote 127. 11 U.S.C. § 1125 requires a debtor to file a disclosure statement. Section 1125(f) allows acceptances or rejections of a plan to be solicited based on a conditionally approved disclosure statement. *Bankruptcy Rule 3016* requires the disclosure statement to be filed with the plan or to be filed within the time fixed by the court.

(n128)Footnote 128. 11 U.S.C. § 1125(a)(1) and (2).

(n129)Footnote 129. 11 U.S.C. § 1122 (classification of claims or interests) and § 1124 (defines impairment of claims or interests).

(n130)Footnote 130. 11 U.S.C. § 1123(b)(4).

(n131)Footnote 131. 11 U.S.C. § 1126(a).

(n132)Footnote 132. 11 U.S.C. § 1126(f).

(n133)Footnote 133. 11 U.S.C. § 1126(g).

(n134)Footnote 134. 11 U.S.C. § 1128(a). The requirements of confirmation which must be found by the bankruptcy court are located at 11 U.S.C. § 1129(a)(1)-(13).

(n135)Footnote 135. 11 U.S.C. § 1129(a)(7)(A) and (B).

(n136)Footnote 136. 11 U.S.C. § 1129(b)(2)(A), (B) and (C).

(n137)Footnote 137. The plan must meet the requirements of 11 U.S.C. § 1129(a) (except paragraph (8)) and must be fair and equitable, which is defined in 11 U.S.C. § 1129(b).

(n138)Footnote 138. 11 U.S.C. § 1141(d)(1)(A) and (B).

(n139)Footnote 139. 11 U.S.C. § 1141(d)(2) and (3).

(n140)Footnote 140. 11 U.S.C. § 1141(d)(2).

(n141)Footnote 141. 11 U.S.C. §§ 1201 *et seq.* For a complete discussion of chapter 12, see 8 Collier on Bankruptcy, chapters 1201- 1231 (Matthew Bender 15th Ed. Revised).

(n142)Footnote 142. Pub. L. No. 109-8, §§ 1001-1007) (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n143)Footnote 143. 11 U.S.C. § 101 defines "family farmer," and "family farmer with regular annual income." 11 U.S.C. § 101(18), as amended by Pub. L. No. 109-8 (2005), defines family farmers to include individual or individuals and spouses engaged in a farming operation whose aggregate debts do not exceed 3,237,000 in connection with other requirements. "Family farmer" may include a corporation or partnership where 50 percent of the outstanding stock or equity is held by one family or relatives of such a family which conducts the farming operation. 11 U.S.C. § 101(19), (20), and (21) defines a farming operation and a farmer. The family farmer must have annual income which is sufficiently stable and regular to enable payments under a chapter 12 plan to be made.

(n144)Footnote 144. 11 U.S.C. § 101 defines "family fishermen," and "family fishermen with regular annual income." 11 U.S.C. § 101(19A) defines family fishermen to include individual or individuals and spouses engaged in a commercial fishing operation whose aggregate debts do not exceed 1.5 million in connection with other requirements. "Family fisherman" may include a corporation or partnership where 50 percent of the outstanding stock or equity is held by one family or relatives of such a family which conducts the fishing operation. The family fishermen must have annual income which is sufficiently stable and regular to enable payments under a chapter 12 plan to be made.

(n145)Footnote 145. 11 U.S.C. § 1231, as amended by Pub. L. No. 109-8, §§ 719(b)(4) and 1003(b) (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n146)Footnote 146. 11 U.S.C. § 346.

(n147)Footnote 147. Pub. L. No. 109-8, § 1003(c) (2005).

(n148)Footnote 148. 11 U.S.C. § 506(a)(2).

(n149)Footnote 149. 11 U.S.C. § 109(h).

(n150)Footnote 150. 11 U.S.C. § 111.

(n151)Footnote 151. 11 U.S.C. § 727(a)(11) and 1328(g); see *In re Ring*, 2006 Bankr. LEXIS 787 (Bankr. D. Me. 2006) .

(n152)Footnote 152. 11 U.S.C. § 522(a)(3).

(n153)Footnote 153. 11 U.S.C. § 521(e)(2)(A). When neither the Trustee nor a creditor requested a copy of the Debtor's tax return, no automatic dismissal of the bankruptcy case for noncompliance with Section 521(e)(2)(A) will

occur. *In re Watson*, 2008 Bankr. LEXIS 2920 (Bankr. N.D.N.C. 2008) .

(n154)Footnote 154. 11 U.S.C. § 521(e)(2) and 1308(b); see *In re Ring*, 2006 Bankr. LEXIS 787 (Bankr. D. Me. 2006) .

(n155)Footnote 155. 11 U.S.C. § 1308(a).

(n156)Footnote 156. 11 U.S.C. § 521(j)(1).

(n157)Footnote 157. Section 109(e) sets forth the monetary limitations on unsecured and secured debts in determining eligibility of a debtor for Chapter 13 relief.

(n158)Footnote 158. Determination of tax liability is begun by filing an adversary complaint against Internal Revenue Service, in accordance with Section 505(a)(1).

(n159)Footnote 159. *In re Tucker*, 345 B.R. 373 (Bankr. M.D. Ala. 2006) is a case where the debtor disputed a large tax claim which was in excess of the jurisdictional amount of unsecured debt set forth in Section 109(e). The liquidated within the meaning of Section 109(e). See also *In re Verdunn*, 89 F.3d 799 (11th Cir. 1996) regarding Section 109(e) interpretation of tax liability as a liquidated debt.

(n160)Footnote 160. 11 U.S.C. § 1328.

(n161)Footnote 161. 11 U.S.C. § 1322 and 1325.

(n162)Footnote 162. 11 U.S.C. § 1328.

(n163)Footnote 163. 11 U.S.C. §§ 1328(a)(1), (2) and (3) and 1328(c).

(n164)Footnote 164. 11 U.S.C. § 1329(a)(1), (2) and (3). See also *Fed. R. Bankr. P. 3015*.



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Collier on Bankruptcy Taxation

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CHAPTER TX1 Policies and History
II Survey of Bankruptcy Code Provisions Affecting Tax Law Issues

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P TX1.09 Bankruptcy Law Provisions with Significant Impact on Tax Law Issues

[1] Jurisdiction of the Bankruptcy Courts

Bankruptcy court jurisdiction springs from the jurisdiction of the United States district court. n1 The type of jurisdiction can be divided into three areas: jurisdiction over property, jurisdiction over persons, and jurisdiction over subject matter.

In rem jurisdiction of the bankruptcy court, derived from the district court, is exclusive. n2 Exclusive jurisdiction of all the property of the debtor, wherever located, at the time of the commencement of the case and of all property of the estate is axiomatic. n3

Jurisdiction of the bankruptcy court over persons is extremely broad. Bankruptcy process is nationwide. Because issues in title 11 cases are federal questions, n4 broad jurisdiction over persons is necessary to resolve those issues.

The district court has original and exclusive jurisdiction of all title 11 cases. The bankruptcy court receives its jurisdiction as a unit of the district court and by reference from it. n5 The district court also has original, but not exclusive, subject matter jurisdiction over civil proceedings which arise under the Bankruptcy Code. These are commonly called "core" matters. The district court has original, but not exclusive, subject matter jurisdiction over civil proceedings which arise in, or are related to a case under the Bankruptcy Code. These are commonly called "noncore" matters. n6 The United States Code provides that all cases under title 11 and any and all proceedings which arise under title 11 n7 or which arise in or are related to a case under title 11 are referred by the district court to the bankruptcy judges for the district. n8 Bankruptcy courts may hear and enter final orders in all core matters and may hear all noncore matters referred to them by the district court. The bankruptcy court cannot enter final orders in noncore matters unless all parties consent. n9 The Bankruptcy Reform Act of 1994 responded to the numerous courts of appeals which held that bankruptcy courts were not authorized under the Code to conduct jury trials. Title 28, section 157(e) permits jury trials if the parties expressly consent and the district court specifically designates that the bankruptcy courts may exercise such jurisdiction. n10

Some examples of core matters are: matters concerning administration of the estate; proceedings affecting liquidation of assets and the adjustment of debtor-creditor relationships; turnover orders; orders determining preferences and

fraudulent conveyances; motions concerning terminating, modifying or annulling the automatic stay; discharge and dischargeability actions; determinations of the validity, priority and extent of liens; confirmation of plans; orders approving the use, lease or sale of property, including cash collateral; and allowance or disallowance of claims. n11 This representative list of core matters contains many areas which affect taxability, tax liens, tax claims, dischargeability of taxes, tax collection and turnover of property previously seized by the IRS.

The bankruptcy court will exercise jurisdiction unless a motion for abstention is filed. n12 The district court may review the bankruptcy court's decision on abstention. n13 There are two types of abstention, discretionary and mandatory. n14 A court may abstain from hearing a particular proceeding in the interest of justice or comity with other courts. n15 For example, the bankruptcy court may abstain in favor of the Tax Court in connection with a tax dispute pending in that court. n16 With regard to mandatory abstention, the district court must abstain from hearing a proceeding which has already been commenced but can be timely adjudicated in a state court. n17 The bankruptcy court must abstain if the noncore proceeding was pending at the time the title 11 case was filed and the proceeding can be speedily concluded in a state forum of appropriate jurisdiction. n18

Jurisdiction of the bankruptcy court in connection with affirmative actions against governmental entities has been restricted by the Supreme Court. n19 Certain exceptions have taken place. A governmental entity filing a proof of claim constitutes a waiver of sovereign immunity which would permit a debtor to bring an action against that entity for matters involving the same transaction or occurrence, or actions which violate such things as the automatic stay or discharge. n20

[2] Injunctive and Equitable Power of the Bankruptcy Court

The bankruptcy court is often described as a court of equity. Bankruptcy fosters equitable distribution of a troubled company's assets. Title 11 cases create a scenario in which creditors of equal rank share burdens equitably, n21 and the bankruptcy court applies equitable principles in determining claims of creditors, applies equitable tests of fairness in confirmation of a reorganization plan, and uses equity in its jurisdiction. The title 11 process affords the debtor an opportunity to rehabilitate or liquidate with a "fresh start."

The bankruptcy court may issue any order, process, or judgment that is necessary or appropriate to carry out the provisions of title 11. n22 This comprehensive power permits great latitude in the issuance of orders which may be designed to enhance the purposes of rehabilitation and the debtor's "fresh start."

The bankruptcy court has authority to issue injunctions and restraining orders. n23 Injunctive relief is generally granted by the bankruptcy court to prevent actions or activity which will seriously interfere with the reorganization of a debtor. n24 It is in this context that the bankruptcy court has taken action to enjoin tax collection against the debtor's officers and directors and, on occasion, its responsible officers. n25

[3] Automatic Stay

Filing a title 11 petition automatically invokes the stay. n26 The automatic stay is an injunction of all actions which may be brought against the debtor that could directly or indirectly interfere with the administration of the title 11 case. n27

The automatic stay operates to the advantage of the debtor and provides the necessary "breathing spell" n28 to attempt reorganization in a chapter 11 case. The automatic stay provides protection to the title 11 estate because the race to the courthouse stops and all creditors are treated equally in the orderly liquidation or reorganization of debtor's assets. n29

The automatic stay provisions set forth a list of those actions which are specifically stayed. n30 The IRS is barred, during the operation of the stay, from the following actions: it may not assess or collect taxes; n31 it may not levy or execute on the debtor's property; n32 it may not issue a Notice of Intent to Levy; n33 and it may not set off tax refunds

owed to the debtor against the debtor's tax liability owed to the IRS. n34

Certain actions by the IRS are not barred by the automatic stay. The IRS may continue examinations or investigations which may lead to the determination of an assessable tax n35 and may issue a statutory notice of deficiency. n36 The automatic stay will not apply to tax audits, issuance of notice of tax deficiency, demand for tax returns, and the making of an assessment, but a lien will not attach unless the debt is nondischargeable and the property is transferred out of the estate. n37

The continuation or commencement of a proceeding concerning a debtor before the United States Tax Court is specifically stayed. n38

The stay may be modified, terminated or annulled if a party in interest appropriately files pleadings and seeks a hearing before the bankruptcy court. n39 The reasons for terminating, annulling or modifying a stay are set forth in the Bankruptcy Code. n40

The consequences of violating the automatic stay can be severe. n41 Damages, including costs and attorneys' fees and, in appropriate instances, punitive damages, are recoverable.

Intentional and inadvertent stay violations by the IRS may precipitate sanction awards and some damages. n42 A significant issue is whether or not the IRS is chargeable with actual and punitive damages, attorneys' fees and costs if it violates the automatic stay. The issue had centered on the defense of sovereign immunity. n43

[4] Property of the Estate

Property of the estate is defined in the Bankruptcy Code n44 and includes any legal or equitable interest of the debtor in property. n45

When property is held by the debtor in trust for another, such as withholding tax proceeds held for the IRS, this asset is not deemed property of the estate. n46

Property seized by the IRS immediately prior to the filing of the title 11 case is property of the estate. n47 If the debtor retains an ownership interest in the property even though it may be physically out of the debtor's possession, it is still property of the estate.

Illustrative of the extent to which property of the estate has been defined is the net operating loss carryforward. A net operating loss carryforward attributable to a chapter 11 corporate debtor is property of the estate and belongs to that debtor's estate. n48 In one case, a parent corporation, which owned all of the stock of its subsidiary, a chapter 11 debtor, and had filed a consolidated tax return with the chapter 11 debtor, claimed the net operating loss carryforward. This claim was denied because the net operating loss carryforward is property of the estate and belongs to the chapter 11 debtor subsidiary. n49

Estimated tax payments made by the debtor prior to the filing of a title 11 case have been deemed not to be property of the estate. n50 Tax refunds have been characterized as property of the estate. n51 Even though tax refunds are for a prepetition taxable year and are received after the title 11 case has been filed, they are considered property of the estate and are not available to the debtor free of section 541. Once a tax refund or tax refund claim becomes property of the estate, and the refunded amount or refund claim is not abandoned, the bankruptcy court retains jurisdiction to determine to whom the refund claim or refund amount is payable or distributed. n52

In many instances where there has been a tax refund, attributable to prepetition taxes and the refund has been received by a Debtor after the bankruptcy petition has been filed, a dispute arises on how the refund should be applied, that is,

whether it belongs as property of the estate and therefore to the Bankruptcy Trustee or whether it is to be applied post-petition and belongs to the Debtor. Where there has been a tax refund of both state and federal income taxes, and there is no evidence that the refunds arose as a result of post-petition events, the methodology used by one court was to apply the refund calculation on a pro rata basis by days methodology. n52a In another situation where the prepetition tax refund was used by the Debtor to apply as a pre-payment of a subsequent year's tax liability, the Bankruptcy Court held that the tax refund was not subject to turnover to a bankruptcy trustee, even if the pre-payment of tax constituted property of the estate as a reversionary interest. The Bankruptcy Appellate Panel affirmed the Bankruptcy Court ruling but specifically observed that it did not decide the estate's interest in the pre-payment or whether the Bankruptcy Trustee had a claim against the IRS for return of the funds. n52b

On the other hand, if the debtor had validly assigned the tax refund as security for a law firm's pre and postpetition legal services, and the assignment was made prepetition, the tax refund claim or proceeds are no longer property of the estate, and not reachable by the debtor's trustee. n53

[5] Turnover of Property to the Estate

Property of the estate must be turned over to the trustee or debtor in possession. This includes property that a debtor may later be entitled to as exempt. n54 Usually property of the estate is held by the debtor; it is sometimes also held by a custodian or a noncustodian. n55 Any entity which holds property of the estate must turn that property over to the estate or it is subject to turnover proceedings. Conceptually, property of the estate may be used, sold or leased by the trustee or debtor during the course of the title 11 case. n56

Property which the IRS has levied on or seized prior to the filing of the title 11 case must be turned over to the estate. n57

Other elements involving turnover of property to the estate are set forth in the Bankruptcy Code. Avoidance authority is granted to the trustee or debtor. Preferences may be avoided, fraudulent transfers may be set aside, postpetition transfers may be recovered, statutory liens may be avoided and property seized prior to the commencement of the title 11 case may be recovered. n58

[6] Claims Objection Process

The Bankruptcy Code contains provisions to determine the validity of creditors' claims. These provisions first presume that timely filed and properly scheduled claims are valid. n59 Any tax claim must be listed. The tax claim should be listed and characterized as contingent or disputed or liquidated or unliquidated, or undisputed. Listing a tax claim as unknown is not deemed as filed and property scheduled. n60

After a claim is filed, the party filing an objection to the claim has the burden to produce evidence to show facts to defeat the claim. The evidence must be of a probative force equal to that of the allegations of the proof of claim. The ultimate burden of proof is always on the claimant. n61 The debtor or trustee bears the burden of going forward to meet, overcome or at least equalize the *prima facie* claim validity presumption which operates in favor of the creditor. n62

The burden of proof in bankruptcy tax disputes is a significant issue. Some courts have allocated the burden of proof based on whether the tax liability was assessed or asserted before or after the filing of the title 11 case. n63 The IRS has disagreed on the issue of burden of proof. This issue in the claims process becomes particularly significant because in many instances the debtor's records have been destroyed or lost and the IRS's claim is estimated. n64 There has been a well settled rule in Tax Court determinations and district and Claims Court litigation that the Commissioner's determinations or assessments carry a presumption of correctness and the taxpayer bears the burden of proof in litigation. n65 A natural dispute has developed in the claims objection process in the bankruptcy courts. n66 Most bankruptcy courts have applied the general rule for all creditors regarding the presumption of the validity of claims to

claims of the IRS. n67 Through the claims objection process, it is possible that once an IRS claim is scheduled as undisputed, it is deemed filed and *prima facie* valid, with the objecting party then being required to produce evidence rebutting the claim; the burden then shifts to the IRS to produce evidence sustaining the validity of the claim. n68

The Supreme Court has now had an opportunity to pass on the issue of whether or not state substantive law, which creates a tax obligation, and establishes the burden of proof will supercede the burden of proof on a tax claim in bankruptcy. n69

If a state law establishes the burden of proof, the bankruptcy claim process must give deference to state law. State law will govern the substance of the tax claim. Since the Bankruptcy Code has made no specific provision for altering the burden of proof on a tax claim, the Supreme Court reasoned that no change was intended. Prior to the ruling in *Raleigh*, Courts of Appeals were divided on the issue of whether or not the taxpayer or the tax collector has the burden of proof on a claim filed in a bankruptcy estate. The conflicts in the Courts of Appeals in connection with the burden of proof on a tax claim is now resolved. n70

If tax litigation is pending at the time the bankruptcy case is commenced, the taxpayer, as a debtor, would have the continued burden of proof. Assuming the automatic stay was in place because of the filing of the bankruptcy case, and assuming it was lifted, and the tax litigation was to continue, the burden of proof remains on the taxpayers, and a determination of tax in that litigation is final.

[7] Determination of Tax Liability

The power to determine tax liability is provided in the Bankruptcy Code. n71 This power enables the bankruptcy court to resolve any unpaid tax liability that has not been contested before an administrative or judicial court of competent jurisdiction prior to the filing of a title 11 case. n72

The bankruptcy court has jurisdiction to determine a tax liability of a debtor notwithstanding the fact that no claim has been filed by the IRS. n73 The bankruptcy court can determine the debtor's tax liability even if the IRS has not calculated that liability. n74 Additionally, all administrative remedies required by state or federal law need not be completed or even attempted prior to the filing of a request by a debtor in a title 11 case for the bankruptcy court to determine tax liability. n75

There are limitations on the bankruptcy court's jurisdiction. The bankruptcy court may not determine a tax liability that has already been adjudicated by a tribunal of competent jurisdiction before the title 11 case is filed. This is pursuant to the *res judicata* rule. n76

Another limitation is called the refund suit rule. n77 If the bankruptcy estate is a taxpayer separate from the debtor, the estate cannot file a refund suit until the later of 120 days after the filing of the claim or disallowance of the claim. The full payment of the tax assessed or the tax owed is a jurisdictional prerequisite to such a claim for refund. n78 If the bankruptcy estate is not a taxpayer, the debtor can file for tax determination regardless of the payment of tax liability. Recommendations by the ABA Tax Section task force to the National Bankruptcy Review Commission relate to expanded jurisdiction to allow the bankruptcy court to determine the tax liability for all members of a consolidated group when the bankruptcy court has jurisdiction over the parent. This proposal, not yet adopted, would permit the bankruptcy court to determine that payment provisions applicable to the parent may apply equally to the members of the affiliated group. This proposal for expansion of jurisdiction will likely be raised in the future.

The Bankruptcy Court cannot determine and rule on tax liability in an action brought by a receiver whose receivership included debtor corporations administered under the Bankruptcy Code. The jurisdiction under section 505 was not broad enough to override the provisions of the Declaratory Judgment Act. n79

The Bankruptcy Code authorizes a trustee or debtor to request a determination of any unpaid liability of the Title 11 estate for any tax incurred during the administration of the case by submitting tax returns and requesting determination. n80

In any discussion of determination of tax liability, the important issue is the debtor's discharge. If the taxes are not discharged, the debtor's "fresh start" may be significantly impaired.

The Bankruptcy Code has an elaborate set of rules which pertain to exceptions to an individual debtor's discharge. n81 Taxes are included in those rules. n82 Certain taxes are not discharged if they are entitled to priority, are reported on delinquent returns filed within two years of bankruptcy, are obligations which were required to be reported on a tax return but no return was filed, are tax obligations which the debtor willfully attempted to evade or are taxes represented by a fraudulently filed return. n83

Certain taxes are entitled to a priority in payment. n84 If the Bankruptcy Code has classified a tax as priority, it is generally nondischargeable. n85

In the past the proper procedure for invoking section 505(b) has been somewhat unclear n86 The BAPCPA permits various taxing authorities to register an address with the Clerk of the Bankruptcy Court for service of requests and describe where further information and requirements may be found. This is extremely helpful and should alleviate disputes over the propriety of service in connection with requests under the Bankruptcy Code for determination of taxes. If the taxing authority fails to register an address the bankruptcy trustee or other party in interest may serve the request for determination of taxes at the address for filing a tax return or a tax protest with the appropriate taxing authority.

[8] Waiver of Sovereign Immunity

Section 106 provides for a waiver of sovereign immunity. In tax cases section 106 does not establish a basis for asserting a claim against the Internal Revenue Service. In *In re New Century TRS Holdings, Inc.*, n87 the Debtor filed appropriate documents with the IRS seeking a tax refund based on net operating losses and sought an order from the bankruptcy court against IRS to release the tax refund. The debtor argued that the bankruptcy court had jurisdiction to enter such an order for relief. n88 The bankruptcy court determined that section 106(b) did not grant it jurisdiction to order the IRS to release the fund. No independent basis is provided in section 106 to assert a claim against the government.

In interpreting section 106, the Second Circuit determined that this section did not have priority nor did it override the provisions of section 553 in connection with offsetting a NOL carry back tax refund for a postpetition year against prepetition taxes. In *Wade Cook Finance*, n89 the IRS refusal to refund taxes because it asserted a set off right under section 553 was sustained. In interpreting section 106(a)(4) and 106(c) the court indicated that these sections must be read to be consistent with other provisions of the Bankruptcy Code, and they did not override section 553, but only operate to waive sovereign immunity to permit a bankruptcy estate to offset claims against a governmental unit and not to change the requirements of set off in bankruptcy.

In a situation where the IRS and the Debtor agreed to an amount as a tax settlement, the settlement was approved by the bankruptcy Trustee, the settlement was entered into the court record, and payment was accepted by the IRS, the IRS could not later assert a priority claim in the bankruptcy estate for the balance of the taxes not covered by the settlement agreement. section 106, as well as section 726 were both applicable and binding on the IRS. n90

[9] The Confirmation Process for Plans of Reorganization

As a part of the reorganization process in a chapter 11 case, a written plan is proposed to provide the manner and means by which the proponent will satisfy various creditor claims and by which the debtor will reorganize or liquidate. n91 As

part of the process, it is necessary to submit a disclosure statement. n92 The disclosure statement, in addition to other significant matters, must set forth the tax effects of the plan and be as informative as possible on the tax consequences to the various parties who would be affected by the treatment afforded in the plan. n93

As a part of the confirmation process, it is necessary for the court, after a plan has been approved by the requisite number and amount of creditors, to conduct a confirmation hearing. n94 The court must find that the plan complies with title 11, has been proposed in good faith, is in the best interest of creditors, and, among other things, can be performed and will not result in the debtor's demise. n95

As part of the confirmation process, there is a provision which permits the bankruptcy court to declare the tax effects of a plan. n96 This provision, as written, applies to state and local taxes but is not broad enough to authorize the bankruptcy court to declare the federal tax effects of a plan. n97 Two significant issues have arisen, which must be determined in the future: may the bankruptcy court declare by judgment tax effects of the plan which bind taxing authorities; and, is the scope of inquiry limited to state and local taxes? n98

Because many tax claims are nondischargeable and are entitled to priority payment, the plan must provide for the satisfaction of these tax claims. n99 Since some tax claims are entitled to administrative priority, provision for their payment in full must be made in the plan. n100 The plan may provide for the payment of other priority tax claims in deferred cash installments not exceeding six years after the date of assessment so that the payments provide the tax authority an amount equal to the present value of the claim. n101 Frequently, transactions in connection with the reorganization scheme create postpetition tax liabilities which must also be paid. n102 Tax planning and good tax advice are prerequisites to a successful reorganized debtor. In addition, the Bankruptcy Reform Act of 1994 now states that if loans are used to pay taxes, including the use of credit cards, the lender or card issuer has a nondischargeable claim to the extent that the government's claim would have been nondischargeable. n103

FOOTNOTES:

(n1)Footnote 1. 28 U.S.C. § 1334.

(n2)Footnote 2. 28 U.S.C. § 1334(d); see *United States v. Nordic Village*, 503 U.S. 30, 112 S. Ct. 1011, 117 L. Ed. 2d 181, 26 C.B.C.2d 9 (1992), in which the United States' sovereign immunity was held to bar the entry of a money judgment against the IRS by the bankruptcy court. The Supreme Court, however, upheld the right of the bankruptcy court to enter declaratory and injunctive relief against the IRS.

(n3)Footnote 3. 28 U.S.C. § 1334(e). While 28 U.S.C. § 1334(d) grants the bankruptcy court exclusive jurisdiction over the property of the estate and of the debtor, this does not axiomatically mean that the bankruptcy court has exclusive jurisdiction over suits based on the debtor's causes of action, even though the causes of action may be property of the estate. *U.S. Brass Corp. v. California Union Ins. Co.*, 198 B.R. 940 (Bankr. N.D. Ill. 1996).

(n4)Footnote 4. See *In re De Lorean Motor Co.*, 13 C.B.C.2d 339, 49 B.R. 900 (Bankr. E.D. Mich. 1985) and *In re Park Nursing Center, Inc.*, 766 F.2d 261 (6th Cir. 1985).

(n5)Footnote 5. 28 U.S.C. § 1334(a).

(n6)Footnote 6. 28 U.S.C. § 1334(a) and (b).

(n7)Footnote 7. 28 U.S.C. § 157.

(n8)Footnote 8. 28 U.S.C. § 157(a).

(n9)Footnote 9. 28 U.S.C. § 157(c)(2).

(n10)Footnote 10. Pub. L. No. 103-394.

(n11)Footnote 11. 28 U.S.C. § 157(b)(2)(A)-(O). The list of core proceedings is not exhaustive. See 1 *Collier on Bankruptcy*, P 3.02[3] (Matthew Bender 15th Ed. Revised).

(n12)Footnote 12. 11 U.S.C. § 305 and 28 U.S.C. § 1334(c).

(n13)Footnote 13. *Fed. R. Bankr. P. 5011(c)*.

(n14)Footnote 14. 28 U.S.C. § 1334(c)(2).

(n15)Footnote 15. 28 U.S.C. § 1334(c)(1).

(n16)Footnote 16. See *In re Hunt*, 20 C.B.C.2d 870, 95 B.R. 442 (Bankr. N.D. Tex. 1989) for an example of discretionary abstention. See also, *In re Diez*, 45 B.R. 137 (Bankr. S.D. Fla. 1984) , and *In re Titan Energy*, 837 F.2d 325, 18 C.B.C.2d 717 (8th Cir. 1988) .

(n17)Footnote 17. 28 U.S.C. § 1334(c)(2).

(n18)Footnote 18. *In re Baldwin-United Corp.*, 13 C.B.C.2d 538, 52 B.R. 541 (Bankr. S.D. Ohio 1985) and *In re Boughton*, 13 C.B.C.2d 44, 49 B.R. 312 (Bankr. N.D. Ill. 1985) , motion for abstention denied, 60 B.R. 373 (N.D. Ill. 1986) .

(n19)Footnote 19. See *Seminole Tribe of Florida v. Florida*, 517 U.S. 44, 116 S. Ct. 1114, 134 L. Ed. 2d 252, 34 C.B.C.2d 1199 (1996) .

(n20)Footnote 20. Regarding discharge, see *In re Burke*, 200 B.R. 282 (Bankr. S.D. Ga. 1996) ; with regard to violation of the automatic stay, see *Headrick v. Georgia (In re Headrick)*, 200 B.R. 963 (Bankr. S.D. Ga. 1996) and *In re National Cattle Congress*, 91 F.3d 1113 (8th Cir. 1996) . For further interpretations of *Seminole Tribe*, restrictions on bankruptcy courts, and the operative effects of the 11th Amendment, see *Natural Resources Defense Council v. California Dept. of Transportation*, 96 F.3d 420 (9th Cir. 1996) , *In re Lazar*, 200 B.R. 358 (Bankr. C.D. Cal. 1996) and *In re Sacred Heart Hospital*, 199 B.R. 129 (Bankr. E.D. Pa. 1996) .

(n21)Footnote 21. See Bienenstock, *Bankruptcy Reorganization* (Practicing Law Institute, 1987).

(n22)Footnote 22. 11 U.S.C. § 105(a). Bankruptcy courts are authorized to conduct civil contempt proceedings and compensate a debtor as a result of violation of a court order. The rationale is that this jurisdiction is necessary and appropriate to carry out the provisions of the Bankruptcy Code. See *Placid Refining Co. v. Terrebonne Fuel & Lube, Inc.*, 108 F.3d 609 (5th Cir. 1997) following *In re Walters*, 868 F.2d 665 (4th Cir. 1989) , *In re Rainbow Magazine, Inc.*, 77 F.3d 278 (9th Cir. 1996) and *In re Hardy*, 97 F.3d 1384 (11th Cir. 1996) .

(n23)Footnote 23. *Fed. R. Bankr. P. 7065*.

(n24)Footnote 24. *A.H. Robins Co. Inc. v. Piccinin*, 788 F.2d 994, 15 C.B.C.2d 235 (4th Cir.) , cert. denied, 479 U.S. 876, 107 S. Ct. 251, 93 L. Ed. 2d 177 (1986) .

(n25)Footnote 25. IRS has been held in contempt for levying on postpetition disability payments of a debtor to collect a discharged tax liability in violation of 11 U.S.C. § 524. *In re Pansier*, 208 B.R. 41 (Bankr. E. Wis. 1997) . *In re Original Wild West Foods, Inc.*, 11 C.B.C.2d 1447, 45 B.R. 202 (Bankr. W.D. Tex. 1984) ; contra, *In re American Bicycle Association*, 895 F.2d 1277 (9th Cir. 1990) and *La Salle Rolling Mills, Inc. v. United States*, 832 F.2d 390, 17 C.B.C.2d 650 (7th Cir. 1987) . See also *Bankruptcy Court Jurisdiction and the Power to Enjoin the IRS*, 70 Minn. L.

Rev. 1279 (June 1986).

(n26)Footnote 26. 11 U.S.C. § 362.

(n27)Footnote 27. See *Fed. R. Bankr. P. 4001*. The legislative history of 11 U.S.C. § 362 makes it clear that the automatic stay is a fundamental protection to a debtor provided by the Bankruptcy Code. All collection efforts are terminated and all foreclosure actions cease. The debtor is given an opportunity to attempt a reorganization plan or commit property to the liquidation process. The financial pressure ceases.

(n28)Footnote 28. *In re Seafarer Fiberglass Yachts*, 1 C.B.C.2d 209, 1 B.R. 358 (Bankr. E.D.N.Y. 1979) .

(n29)Footnote 29. Those creditors who could act quickly would obtain payments on their claims, perfect liens or obtain extraordinary remedies such as attachment and garnishment. The race of diligence by creditors would force action by the debtor. The first to obtain assets because of its speedy action would have an advantage over others. The automatic stay concept is consistent with orderly and equitable distribution of assets.

(n30)Footnote 30. 11 U.S.C. § 362(a)(1) through (8).

(n31)Footnote 31. 11 U.S.C. § 362(a)(6); *In re Keuler*, 2008 Bankr. LEXIS 2391 (Bankr. M.D. Pa. 2008) ; *affirmed Keuler v. Monroe County Tax Claim Bureau*, 2009 U.S. Dist. LEXIS 5105 (M.D. Pa. 2009) , holding that tax liens filed against the debtor's property prior to the passage of the Bankruptcy Reform Act (BAPCPA) were not valid liens and were void as applied to a subsequent bankruptcy filed by the debtor after the BAPCPA. In other words Section 362(b)(18) did not apply retroactively to taxes assessed before this section was added to the Bankruptcy Code.

(n32)Footnote 32. 11 U.S.C. § 362(a)(4).

(n33)Footnote 33. 11 U.S.C. § 362(a)(3) and (5). See also *In re Price*, 103 B.R. 989 (Bankr. N.D. Ill. 1989) , *aff'd*, 130 B.R. 259 (N.D. Ill. 1991) .

(n34)Footnote 34. 11 U.S.C. § 362(a)(7).

(n35)Footnote 35. A typical examination and investigation is conducted under I.R.C. § 6672 to determine responsible officer liability. *In re H & H Beverage Distributors v. Dept. of Revenue of Pa.*, 850 F.2d 165 (3d Cir.) , *cert. denied*, 488 U.S. 994, 109 S. Ct. 560, 102 L. Ed. 2d 586 (1988) , has allowed a state to conduct a sales tax audit and issue notice of audit assessment during the pendency of an automatic stay without that action constituting a violation.

In *In re Metzger*, 2000 Bankr. LEXIS 1058 (Bankr. S.D. Fla. 2000) , the debtor carried the burden of demonstrating that he was not a responsible person and therefore not liable for tax assessed by the IRS under the responsible person penalty of Section 6672(a) of the Internal Revenue Code.

(n36)Footnote 36. *Western Reserve Oil & Gas Co. v. Comm.*, 95 T.C. 51 , No. 4 (1990).

(n37)Footnote 37. 11 U.S.C. § 362(b)(9). The National Bankruptcy Review Commission has recommended that this section be amended to clarify the definition of the term "assessed" or "assessment" to mean "that time at which a taxing authority may commence an action to collect the tax." Additionally, the Commission has recommended the amendment of this section to allow governmental units to set off an income tax refund which arose prior to the commencement of a chapter 7 or chapter 13 against undisputed income tax liability of an individual debtor that arose prepetition.

(n38)Footnote 38. *Halpern v. Commissioner*, 96 T.C. 895 (1991) . 11 U.S.C. § 362(a)(8). Even if tax litigation was pending before the Tax Court at the time the title 11 case was filed, debtors frequently request the bankruptcy court

to exercise jurisdiction to determine the debtor's tax liability (*See 11 U.S.C. § 505(a)*). The National Bankruptcy Commission has determined that *11 U.S.C. § 362(a)(8)* should be amended to overrule *Halpern v. Commissioner*. The Commission will propose that appeals from tax court decisions should be permitted without violating the automatic stay.

(n39)Footnote 39. *11 U.S.C. § 362(d)(1), (2), and (3)*.

(n40)Footnote 40. *11 U.S.C. § 362(d)(1), (2) and (3)*.

(n41)Footnote 41. *11 U.S.C. § 362(d)(1) and (2)*; *see In re Lile*, 96 B.R. 81 (Bankr. S.D. Tex. 1989) ; *In re Allen*, 83 B.R. 678 (Bankr. Mo. 1988) ; *In re Santa Rosa Truck Stop*, 74 B.R. 641 (Bankr. N.D. Fla. 1987) ; and *In re Shafer*, 63 B.R. 194 (Bankr. Kan. 1986) . *See also Hoffman v. Connecticut Dep't of Income Maintenance*, 492 U.S. 96, 109 S. Ct. 2818, 106 L. Ed.2d 76, 20 C.B.C.2d 1204 (1989) ; *In re Dyer*, 325 F.3d 464 (9th Cir. 2003) (discussing punitive damages for violating the stay and the interrelationship of § 362 and 105).

(n42)Footnote 42. *11 U.S.C. § 362(d)(1) and (2)*. *See In re Lile*, 103 B.R. 830 (Bankr. S.D. Tex. 1989) *cf. In re Germaine*, 152 B.R. 619 (B.A.P. 9th Cir. 1993) . *Also see Hoffman v. Connecticut Dept. of Income Maintenance*, 492 U.S. 96, 109 S. Ct. 2818, 106 L. Ed. 2d 76, 20 C.B.C.2d 1204 (1989) .

(n43)Footnote 43. *United States v. Nordic Village*, 503 U.S. 30, 112 S. Ct. 1011, 117 L. Ed. 2d 181, 25 C.B.C.2d 9 (1992) ; *In re Majors*, 298 B.R. 363 (Bankr. S.D. Iowa 2003) (IRS violation of the automatic stay was deemed sanctionable).

(n44)Footnote 44. *11 U.S.C. § 541(a)*.

(n45)Footnote 45. *11 U.S.C. § 541(a)(1)*.

(n46)Footnote 46. *Beigier v. IRS*, 496 U.S. 53, 110 S. Ct. 2258, 110 L. Ed. 2d 46, 22 C.B.C.2d 1080 (1990) .

(n47)Footnote 47. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 103 S. Ct. 2309, 76 L. Ed.2d 515, 8 C.B.C.2d 710 (1983) .

(n48)Footnote 48. *In re Prudential Lines, Inc.*, 928 F.2d 565, 24 C.B.C.2d 1503 (2d Cir.) , *cert. denied sub. nom. PSS S.S. Co. v. Official Committee of Unsecured Creditors*, 505 U.S. 821, 112 S. Ct. 82, 116 L. Ed. 2d 55 (1991) .

(n49)Footnote 49. *In re Prudential Lines, Inc.*, 928 F.2d 565, 24 C.B.C.2d 1503 (2d Cir.) , *cert. denied sub. nom. PSS S.S. Co. v. Official Committee of Unsecured Creditors*, 502 U.S. 821, 112 S. Ct. 82, 116 L. Ed. 2d 55 (1991) . *See also In re Russell v. United States*, 927 F.2d 413, 24 C.B.C.2d 1526 (8th Cir. 1991) , in which the court held that a net operating loss carryback is property of the estate. In *Russell*, the trustee sought to avoid the chapter 11 debtor's pre-filing irrevocable election to forego the carryback. Since the net operating loss carryback was considered property of the estate, it passed to the trustee free of any prior action taken by the title 11 debtor to affect its recovery. A tax refund which is the result of a net operating loss carryback in a sub chapter corporation belongs to the sub chapter S shareholders and not to the corporation.

(n50)Footnote 50. *In re Halle*, 25 C.B.C.2d 1113, 132 B.R. 186 (Bankr. D. Colo. 1991) .

(n51)Footnote 51. *Segal v. Rochelle*, 382 U.S. 375, 86 S. Ct. 511, 15 L. Ed. 2d 428 (1966) ; *Kokoszka v. Belford*, 417 U.S. 642, 94 S. Ct. 2431, 41 L. Ed. 2d 374 , *reh'g denied*, 419 U.S. 886, 95 S. Ct. 160, 42 L. Ed. 2d 131 (1974) . *Segal* and *Belford* were superseded by the Bankruptcy Code, as stated in *In re Goff*, 706 F.2d 574, 8 C.B.C.2d 894 (5th Cir. 1983) . *Wallerstedt v. Sosne*, 930 F.2d 630 , *reh'g denied*, 1991 U.S. App. LEXIS 1991 (8th Cir. 1991) ; *In re Canon*, 130 B.R. 748 (Bankr. N.D. Tex. 1991) . For a discussion of tax refunds as property of the estate, *see In re WDH Howell, LLC.*, 294 B.R. 613 (Bankr. N.J. 2003) .

(n52)Footnote 52. *EDP Med. Computer Sys., Inc. v. United States*, 2005 U.S. Dist. LEXIS 2906 (E.D.N.Y. 2005) .

(n53)Footnote 52a. *In re Myers*, 2009 Bankr. LEXIS 680 (Bankr. S.D. Ill. 2009) .

(n54)Footnote 52b. *In re Graves*, 2008 Bankr. LEXIS 2641 (B.A.P. 10th Cir. 2008) .

(n55)Footnote 53. *In re Wagers*, 2006 Bankr. LEXIS 242 (Bankr. D. Kan. 2006) .

(n56)Footnote 54. 11 U.S.C. § 522. See also 11 U.S.C. § 543(a) which deals with turnover of property by a custodian. *In re Martin*, 2009 Bankr. LEXIS 1722 (Bankr. N.D. Tex. 2009) (an income tax refund that consisted of solely managed community property of a non-debtor spouse was not property of the estate and not subject to turnover)..

(n57)Footnote 55. Custodian is defined in 11 U.S.C. § 101. Turnover of property by custodians is governed by 11 U.S.C. § 543.

(n58)Footnote 56. 11 U.S.C. § 363 governs the use, sale or lease of property.

(n59)Footnote 57. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 103 S. Ct. 2309, 76 L. Ed. 2d 515, 8 C.B.C.2d 710 (1983) ; 11 U.S.C. § 542(a).

(N60)Footnote 58. 11 U.S.C. §§ 363, 542(a), 544, 545, 547 and 548.

(n61)Footnote 59. 11 U.S.C. § 502(a) essentially provides that a claim or interest, proof of which is filed under section 501 is deemed allowed, unless a party in interest objects. See also *Fed. R. Bankr. P. 3001(f)*. The National Bankruptcy Review Commission proposes the amendment of 11 U.S.C. § 726(a)(1) to provide that the claim of a taxing authority for priority tax must be filed before the final order approving the trustee's report is entered. This proposal would step up the time for filing a tax priority proof of claim.

(n62)Footnote 60. *In re Lawrence v. IRS*, 2001 U.S. Dist. LEXIS 4953 (W.D. La. 2001 Mar. 26, 2001).

(n63)Footnote 61. *IRS v. Levy*, 130 B.R. 28 (E.D. Va. 1991) ; *In re Dakota Indus., Inc.*, 25 C.B.C. 2d 905, 131 B.R. 437 (Bankr. D.S.D. 1991) .

(n64)Footnote 62. 11 U.S.C. § 502(a); see also 4 *Collier on Bankruptcy*, P 502.02 (Matthew Bender 15th Ed. Revised).

(n65)Footnote 63. See *In re Coleman American Companies., Inc.*, 26 B.R. 825 (Bankr. D. Kan. 1983) ; *United States v. Kontaratos*, 36 B.R. 928 (D. Me. 1984) .

(n66)Footnote 64. *In re Fidelity Am. Fin. Corp.*, 91-1 U.S. Tax Cas. (CCH) P 50,161 (Bankr. E.D. Pa. 1990).

(n67)Footnote 65. *Helvering v. Taylor*, 293 U.S. 507, 55 S. Ct. 287, 79 L. Ed. 623 (1935) ; *United States v. Rexach*, 482 F.2d 10 (1st Cir. 1973) , cert. denied, 414 U.S. 1039, 94 S. Ct. 540, 38 L. Ed. 2d 330 (1973) .

(n68)Footnote 66. *In re Fry*, 91 B.R. 69 (Bankr. E.D. Mo. 1988) ; *In re Horton*, 95 B.R. 436 (Bankr. N.D. Tex. 1989) .

(n69)Footnote 67. *In re Premo*, 116 B.R. 515 (Bankr. E.D. Mich. 1990) ; *In re Summa T Corp.*, 73 B.R. 388 (Bankr. E.D. Ark. 1987) ; *In re Fidelity Holding Co. Ltd.*, 837 F.2d 696 (5th Cir. 1988) .

(n70)Footnote 68. *In re Fidelity Holding Co. Ltd.*, 837 F.2d 696 (5th Cir. 1988) ; *IRS v. Levy*, 130 B.R. 28 (E.D. Va. 1991) . See *In re Coleman American Companies, Inc.*, 26 B.R. 825 (Bankr. D. Kan. 1983) , for a discussion of the burden of persuasion shifting depending on whether the assessments were prepetition or postpetition.

(n71)Footnote 69. *Raleigh v. Illinois Department of Revenue*, 530 U.S. 15, 120 S. Ct. 1951, 147 L. Ed. 2d 13, 43 C.B.C.2d 869 (2000) .

(n72)Footnote 70. *Raleigh v. Illinois Department of Revenue*, 530 U.S. 15, 120 S. Ct. 1951, 147 L. Ed. 2d 13, 43 C.B.C.2d 869 (2000) .

(n73)Footnote 71. 11 U.S.C. § 505; *In re Universal Seismic Association, Inc. v. Harris County*, 288 F.3d 205 (5th Cir. 2002) ; *In re Mulberry Phosphates, Inc.*, 283 B.R. 347 (Bankr. M.D Fla. 2002) .

(n74)Footnote 72. 11 U.S.C. § 505(a)(1); *IRS v Luongo (In re Luongo)*, 259 F.3d 323 (5th Cir. 2001) ; *In re Kreidle*, 91-2 U.S. Tax Cas. (CCH) P 50,371 (Bankr. D. Colo. 1991).

(n75)Footnote 73. *Gwilliam v. United States*, 519 F.2d 407 (9th Cir. 1975) ; *Kilen v. United States (In re Kilen)*, 25 C.B.C.2d 326, 129 B.R. 538 (Bankr. N.D. Ill. 1991) ; *In re Palm Beach Resort Properties, Inc.*, 51 B.R. 363 (Bankr. S.D. Fla. 1985) . But see *In re New Haven Projects Ltd.*, 225 F.3d 283 (D. Conn. 2000) which affirmed a bankruptcy court and district court decision that permitted abstention by the bankruptcy court in redetermining a debtor's tax liability. This case involves a decision by the bankruptcy court to abstain from redetermining ad valorem tax liability of the debtor. The prior owner of the property, before it became the debtor's property had a tax assessment increased by the city. Because the prior owner failed to pay, tax liens were filed. The properties were conveyed to the debtor subject to the tax liens, and the debtor moved in to bankruptcy court for redetermination of tax liability pursuant to § 505(a). The court abstained and refused to redetermine debtor's tax liability. The significance of this case is an illustration of the use of abstention by a bankruptcy court when the possible tax redetermination would be a windfall to the debtor. . See *In re Frankum*, 2009 Bankr. LEXIS 246 (Bankr. E.D. Ark. 2009) (a motion for reimbursement and refund from the IRS of federal income tax is collected by a post-petition levy against the Debtor's social security benefits after the Debtor's bankruptcy discharge was denied by the Bankruptcy Court).

(n76)Footnote 74. *In re Palm Beach Resort Properties, Inc.*, 51 B.R. 363 (Bankr. S.D. Fla. 1985) .

(n77)Footnote 75. *In re Electronic Theater Restaurants, Inc.*, 85 B.R. 45 (Bankr. N.D. Ohio 1988) .

(n78)Footnote 76. 11 U.S.C. § 505(a)(2)(A); *In re Northwest Beverage, Inc.*, 46 B.R. 631 (Bankr. N.D. Ill. 1985) ; *In re Galvano*, 116 B.R. 367 (Bankr. E.D.N.Y. 1990) .

(n79)Footnote 77. 11 U.S.C. § 505(a)(2)(B).

(n80)Footnote 78. *United States v. Flora*, 362 U.S. 145, 80 S. Ct. 630, 4 L. Ed. 2d 623 , reh'g denied, 362 U.S. 972, 80 S. Ct. 953, 4 L. Ed. 2d 902 (1960) . See also *In re Custom Distribution Services, Inc.*, 224 F.3d 235 (3d Cir. 2000) , the Court of Appeals for the Third Circuit held that the bankruptcy court did not have jurisdiction to order a refund or the offset of real property taxes which a debtor overpaid because of reevaluation because there had been a failure by the debtor to comply with state law procedure for refund. The court affirmed the bankruptcy and district courts' rulings which excluded the bankruptcy court from deciding rights to refund under § 505 (a)(2)(B) where there had been a failure to comply with the proper state refund procedure.

Custom Distribution Service, Inc. follows a line of other courts where bankruptcy court jurisdiction has been denied in connection with request for refund where a debtor has failed to follow procedures requesting a tax refund. The significance of this case is that a Court of Appeals has determined that a bankruptcy court does not have jurisdiction to order a refund or offset a real property tax on behalf of a debtor, pursuant to the Bankruptcy Code, when there has been a failure to follow state court procedures prior to the request to the bankruptcy court for action.

(n81)Footnote 79. *Sterling Consulting Corp. v. U.S.*, 245 F.3d 1161 (10th Cir. 2001) .

(n82)Footnote 80. 11 U.S.C. § 505(b). The National Bankruptcy Review Commission will recommend tightening

notice requirements with respect to expedited audits under this section.

(n83)Footnote 81. 11 U.S.C. § 523(a)(1).

(n84)Footnote 82. 11 U.S.C. § 523(a)(1).

(n85)Footnote 83. 11 U.S.C. § 523(a)(1)(A), (B) and (C). A number of decisions have called into question the consistency of the term "willful" in section 523(a)(1)(C) and suggested that the definition be consistent with the criminal standard for willful in *I.R.C. § 7201*. See *In re Toti*, 24 F.3d 806 (6th Cir. 1994) holding taxes are nondischargeable because a debtor failed to file tax returns and failed to pay taxes, even though there was no evidence of any affirmative conduct disclosing a bad purpose or deliberate intent to avoid. Some courts have held that failure to file tax returns and pay taxes satisfies "in any manner" and tax liability is not discharged. See also *In re Landi*, 289 B.R. 173 (Bankr. M.D. Fla. 2002) ; *In re Colish*, 289 B.R. 523 (Bankr. E.D.N.Y. 2002) ; *In re Shrenker*, 258 B.R. 82 (Bankr. E.D.N.Y. 2001) (following *Mulcahy*). For more detailed discussion, see P TX4.02[2] *infra*. Where income was used to pay obligations other than income tax and where no tax return was filed, taxes owed by the Debtor were nondischargeable. *In re Schwartz*, 2009 Bankr. LEXIS 797 (Bankr. M.D. Fla. 2009) , and *In re Guben*, 2008 Bankr. LEXIS 2581 (Bankr. E.D. Pa. 2008) where Debtor, a lawyer, spent income on an art collection and filed tax returns for 7 years without remitting the taxes owed, discharge was denied.

(n86)Footnote 84. 11 U.S.C. § 507(a)(1), (2), (3) and (8). Priority of taxes is discussed in greater detail in P TX1.08[4] *infra* and chapter TX4 *infra*.

(n87)Footnote 85. 11 U.S.C. § 523(a)(1).

(n88)Footnote 86. IRS has detailed rules as to the manner and content of notification of a request for a section 505(b) determination. These are set forth in *Rev. Proc. 81-17, 1981 C.B. 688* . For cases interpreting these rules and determining disputes about notice, see *In re Flaherty*, 169 B.R. 267 (Bankr. D.N.H. 1994) and *In re Carie Corp.*, 128 B.R. 266 (D. Alaska 1989) ; see also Henderson and Goldring, *Tax Planning for Troubled Corporations*, § 1011 and n.2 (collecting cases) (2005 Edition).

(n89)Footnote 87. 2008 Bankr. LEXIS 378 (Bankr. D. Del. 2008) .

(n90)Footnote 88. The Debtor relied on Section 106(b) for its claim that the bankruptcy court had jurisdiction to order IRS to release the funds.

(n91)Footnote 89. *In re Wade Cook Fin. Corp.*, 375 B.R. 580 (B.A.P. 9th Cir. 2007) .

(n92)Footnote 90. *In re Sergeant*, 2007 Bankr. LEXIS 4244 (Bankr. E.D. Ky. 2007) .

(n93)Footnote 91. 11 U.S.C. §§ 1121 and 1123.

(n94)Footnote 92. 11 U.S.C. § 1125; the disclosure statement is akin to a proxy in securities solicitation. The statement must contain adequate information to inform the creditors and equity interest holders, as fully as possible, about the probable financial consequences of the plan to be voted on. *In re Stanley Hotel, Inc.*, 5 C.B.C.2d 64, 13 B.R. 926 (Bankr. D. Colo. 1981) .

(n95)Footnote 93. For a general discussion of requirements of a disclosure statement see *In re Malek*, 10 C.B.C.2d 189, 35 B.R. 443 (Bankr. E.D. Mich. 1983) and *In re Metrocraft Publishing Services, Inc.*, 10 C.B.C.2d 1182, 39 B.R. 567 (Bankr. N.D. Ga. 1984) . The disclosure statement discussion of tax effects of a plan should contain, *inter alia*, some of the following issues: tax attributes affected by the plan; amount and effect of net operating loss carryforward and carryback; availability and use of net operating losses if stock is exchanged for debt; tax consequences of the plan to investors and creditors; and whether a security results from the issuance of instruments in substitution of

debt.

(n96)Footnote 94. *Fed. R. Bankr. P.* 3017 and 3020; 11 U.S.C. §§ 1128 and 1129.

(n97)Footnote 95. 11 U.S.C. § 1129(a).

(n98)Footnote 96. 11 U.S.C. § 1146.

(n99)Footnote 97. 11 U.S.C. § 1146(d)(1) and (2).

(n100)Footnote 98. 11 U.S.C. § 1146(d)(1) and (2).

(n101)Footnote 99. 11 U.S.C. § 1129(a)(9)(A).

(n102)Footnote 100. 11 U.S.C. § 1129(a)(9)(A).

(n103)Footnote 101. 11 U.S.C. § 1129(a)(9)(C).

(n104)Footnote 102. 11 U.S.C. § 1129(a)(9)(A).

(n105)Footnote 103. 11 U.S.C. § 523(a)(14); see *In re Rollings, 2009 Bankr. LEXIS 360 (Bankr. D.N.M. 2009)* , holding that a credit card debt incurred as an advance used to pay tax which was later refunded to the Debtor was dischargeable.



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Collier on Bankruptcy Taxation

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CHAPTER TX1 Policies and History
II Survey of Bankruptcy Code Provisions Affecting Tax Law Issues

15-TX1 Collier on Bankruptcy Taxation P TX1.10

P TX1.10 Specific Bankruptcy Code Provisions Dealing Directly With Taxes

[1] Special Tax Provisions; Old Section 346

This has been deleted from the BAPCPA and section 346, as previously written, no longer exists in the Code. The former section 346 detailed provisions mandating a uniform outcome at the state and local level with respect to bankruptcy tax matters. New section 346 contains tax provisions which were formerly in sections 728 and 1146(b).

[2] New Section 346

This section now requires uniformity in tax treatment among federal, state and local tax provisions and administrative rules in the following manner.

- a. a bankruptcy filing will not result in the creation of a new taxable estate or the termination of the debtor's taxable year;
- b. tax consequences of transfer of property from the debtor to the bankruptcy estate for federal, state or local taxes are designed to be uniform;
- c. state or local tax is not imposed on discharge of indebtedness income unless the income is subject to tax under the Internal Revenue Code; and
- d. state and local entities must reduce tax attributes to reflect discharge of indebtedness income in the same manner as would be done in federal tax treatment.

[3] Debtor Reporting Requirements Regarding Tax Returns; section 308

The small business debtor is required to file periodic financial and other informational reports related to the timely filing of tax returns, other required governmental filings and payment of taxes when due. n1 In the event the debtor does not comply with the required tax return filing, then the debtor is obligated to report what the failures are and how and when they are to be remedied. n2

[4] The Automatic Stay and the United States Tax Court

A bankruptcy petition filing operates as a stay in connection with the commencement or continuation of a United States Tax Court proceeding concerning the debtor. n3 Such a stay is applicable to a corporate debtor's tax liability for the taxable period determined by the bankruptcy court and also applicable to an individual debtor's tax liability for the period of time ending before the date of the filing of the bankruptcy proceeding. n4

The automatic stay is not operable and does not affect to the interception of a tax refund, granted under the Social Security Act or under State law, where applicable. n5

The automatic stay is not operable to prevent or bar the creation or perfection of a statutory lien for ad valorem taxes or a special assessment on the debtor's real property, if the assessment or tax becomes due after the date of the filing of the bankruptcy petition. n6

The automatic stay is not operable to bar a set off, under nonbankruptcy law, of an income tax refund by a governmental unit, with respect to a taxable period that ended before the date the bankruptcy petition was filed. n7 In the situation where a set off of an income tax refund is not permitted by nonbankruptcy law, and where there is a pending action or litigation to determine the amount or legality of the tax liability, the taxing or governmental unit is permitted to hold the tax refund pending the resolution of the litigation or action. n8 However, the bankruptcy court, after an appropriate motion, and after notice and hearing, may grant the taxing unit adequate protection n9 for the claim of the taxing unit and thus prohibit the set off of the tax refund, but protect the taxing unit's claim.

[5] Timely Allowance of Tax Claims in Chapter 13

Allowance of claims and interest are provided for in the Bankruptcy Code. n10 With regard to claims of a governmental unit they are deemed timely filed if this is done before 180 days after the entry of the order for relief or such later time as may be provided in the Federal Rules of Bankruptcy procedure. In the case of a Chapter 13, the tax claim, if any, with respect to a tax return that is filed under section 1308, is deemed timely filed if it is filed on or before 60 days after the date on which the tax return was required to be filed. n11

[6] Administrative Expense Priority of Certain Taxes Incurred by the Bankruptcy Estate

The type of tax given administrative priority is broader. Any tax, whether it is unsecured or secured, and whether the liability for the tax is *in rem* or *in personam*, including property taxes are given administrative priority. n12 Even a tax carryback adjustment received by the bankruptcy estate, whether or not the taxable year of the adjustment was attributable to prepetition or postpetition has administrative priority. A fine, penalty or tax credit reduction related to such tax retains administrative priority. n13 A governmental unit, the taxing authority, which seeks payment of a tax, tax adjustment, fine or penalty is not required to file a request for payment as a condition to such a claim being allowed as an administrative expense. n14 It should be noted that those taxes which are entitled to priority in payment are to be distinguished from those taxes which are granted administrative expense payment. n15

[7] Priority Treatment of Taxes

Income taxes, gross receipts taxes, excise taxes, customs duties, employment taxes, and taxes which are required to be withheld and collected by the debtor for the taxable year ending on or before the filing of the bankruptcy petition are given priority in payment. n16 Also given priority treatment are penalties related to such taxes which are compensation for actual pecuniary loss. n17 There is a suspension of time limitations for any of the taxes if the governmental unit is prohibited by nonbankruptcy law from collecting tax as a result of the debtor requesting a hearing, or an appeal of the collection of taxes, plus an additional period of 90 days. n18

[8] Rate of Interest on Tax Claims Is Specifically Established

If there is an administrative or priority tax claim, or a payment of interest to permit any creditor to receive the present value of its allowed amount of a tax claim, the rate of interest is the rate determined by nonbankruptcy law. n19 Where taxes are to be paid in a confirmed plan, the rate of interest is determined as of the calendar month in which the plan is confirmed. n20

[9] Determination of Tax Liability, Bankruptcy Court Jurisdiction and Procedure for Service on Tax Authorities

The Bankruptcy Court is granted jurisdiction to determine the amount and legality of certain taxes, fines and penalties relating to such tax. n21 However the Bankruptcy Court cannot determine the amount or legality of an ad valorem tax on real or personal property if the time for contesting or redetermining the amount of that tax has expired. n22

The Bankruptcy Clerk shall keep a list of all governmental units responsible for tax collection within the judicial district and can designate an address for service and for requests for information. The clerk will also provide information regarding where additional requirements for filing requests for service can be found. n23

If there is no designation by the governmental unit of where service can be made on it, service can be made at the address for the filing of the tax return or the tax protest with the proper tax authority. n24 Procedures have been simplified for the service on taxing authorities. The bankruptcy trustee seeking a determination of tax liability can serve the request at the designated address of the governmental taxing authority. n25

[10] The Debtor's Duties With Regard to Federal Tax Returns

In any Chapter 7 or 13 bankruptcy case, the debtor must provide the trustee with a copy of the most recent filed federal income tax return. n26 The tax return must be the tax return due for the most recent tax year ending immediately before the bankruptcy case was filed. The debtor may elect to furnish a transcript of the tax return instead of a copy. Any creditor in the bankruptcy case may also request a copy of the tax return or the debtor's transcript of the tax return. n27 In the event the debtor fails to comply with the trustee's request or the creditor's request for the tax return or the transcript, the bankruptcy court shall dismiss the case, unless the debtor can show the bankruptcy court that the failure to comply with the request for the tax return or transcript is due to circumstances beyond the debtor's control. n28

Tax returns, tax liability, and information concerning income and expenditures during the pendency of a Chapter 7, 11, and 13 are required. n29

In the situation of an individual debtor a copy of the federal income tax return, or a transcript of the tax return must be filed with the court for each year during which the bankruptcy case is pending. n30 Tax returns or transcript of any tax return filed within 3 years prior to the commencement of the bankruptcy case must also be filed with the bankruptcy court. The filing requirement is applicable also if there has been an amendment to a federal income tax return or if there has been a late filed federal income tax return. n31 The object is to make the bankruptcy court and all interested parties aware of the debtor's prior and current federal income tax history.

There are more onerous tax burdens on a debtor in a Chapter 13. The debtor must either 90 days after the end of the tax year, or 1 year after the date the Chapter 13 was filed, whichever date is later, file a sworn statement of income and expenditures during the tax year. Such a statement must also be filed monthly and must disclose; the amount and sources of income; who, as well as the debtor, is responsible for the support of any dependent; and the identity of any person, who contributed to the debtor's household. n32 The reporting requirements continue annually either 90 days after the end of the tax year, or 1 year after the date the bankruptcy case was filed, unless a plan in Chapter 13 has been confirmed. If a Chapter 13 plan has been confirmed the reporting requirements continue until the bankruptcy case is closed. n33

All tax returns, amendments to tax returns, and statements of income and expenditures are available to the bankruptcy trustee, the bankruptcy administrator and any party in interest for copying. n34

FOOTNOTES:

(n1)Footnote 1. *11 U.S.C. § 308(b)(ii)*.

(n2)Footnote 2. *11 U.S.C. § 308(B)*.

(n3)Footnote 3. *11 U.S.C. § 362(a)(8)*.

(n4)Footnote 4. *11 U.S.C. § 362(a)(8)*.

(n5)Footnote 5. *11 U.S.C. § 362(b)(F)*.

(n6)Footnote 6. *11 U.S.C. § 362(b)(18)*.

(n7)Footnote 7. *11 U.S.C. § 362(b)26*.

(n8)Footnote 8. *11 U.S.C. § 362(b)26*.

(n9)Footnote 9. *11 U.S.C. § 361*.

(n10)Footnote 10. *11 U.S.C. § 502*.

(n11)Footnote 11. *11 U.S.C. § 502(b)(9)*.

(n12)Footnote 12. *11 U.S.C. § 503(b)(1)(B)(i)*. Such administrative expense priority may not be applicable to income taxes which are treated elsewhere in the Bankruptcy Code (For Example *11 U.S.C. § 507*).

(n13)Footnote 13. *11 U.S.C. § 503(b)(1)(C)*.

(n14)Footnote 14. *11 U.S.C. § 503(b)(1)(D)*.

(n15)Footnote 15. See *11 U.S.C. § 507(a)(8)* for an analysis of income taxes which are granted an eighth priority in payment.

(n16)Footnote 16. *11 U.S.C. § 507(a)(8)* (A through F).

(n17)Footnote 17. *11 U.S.C. § 507(a)(8)(G)*.

(n18)Footnote 18. Section 507(a)(8)(G) contains a listing of those reasons for the extension of time granted where other time periods would be otherwise applicable to a governmental unit in connection with the collection of a tax claim.

(n19)Footnote 19. *11 U.S.C. § 511(a)*.

(n20)Footnote 20. *11 U.S.C. § 511(b)*.

(n21)Footnote 21. *11 U.S.C. § 505(a)*.

(n22)Footnote 22. *11 U.S.C. § 505(a)(2)(C)*. Note that before BAPCPA the Bankruptcy Court had no jurisdiction

to determine the amount or legality of a tax, fine or penalty if the amount had been determined before the filing of the bankruptcy case by a judicial or administrative proceeding. The BAPCPA added the ad valorem tax provision.

(n23)Footnote 23. *11 U.S.C. § 505(b)(1)(A)*.

(n24)Footnote 24. *11 U.S.C. § 505(b)(1)(B)*.

(n25)Footnote 25. *11 U.S.C. § 505(b)(2)*.

(n26)Footnote 26. *11 U.S.C. § 521(e)(2)(A)(i)*. Note that the tax return or transcript must be provided not later than 7 days before the date set for the first meeting of creditors.

(n27)Footnote 27. *11 U.S.C. § 521(e)(2)(A)(ii)*.

(n28)Footnote 28. Section 521(e)(2)(B) applicable to the failure to provide the tax return or transcript at the trustee's request. Note that Section 521(e)(2)(C) provides that if a creditor requests the tax return or transcript and the debtor has provided such documentation to the trustee but not to the creditor the bankruptcy court shall dismiss the case. The same defense of circumstances beyond the debtor's control is applicable in this instance.

(n29)Footnote 29. *11 U.S.C. § 521(f)*.

(n30)Footnote 30. *11 U.S.C. § 521(f)(1)*.

(n31)Footnote 31. *11 U.S.C. § 521(f)(2)*.

(n32)Footnote 32. *11 U.S.C. § 521(f)(4)* and *521(g)(1)(A), (B) and (C)*.

(n33)Footnote 33. *11 U.S.C. § 521(F)(4)(A) and (B)*.

(n34)Footnote 34. *11 U.S.C. § 521(g)(2)*.



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CHAPTER TX2 Federal Taxation of the Non-Corporate Bankruptcy Estate

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CHAPTER TX2 Federal Taxation of the Non-Corporate Bankruptcy Estate

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P TX2.01 Introduction

As part of the Bankruptcy Tax Act of 1980, Congress decided that the bankruptcy estates created when individuals file for relief under chapter 7 or chapter 11 of the Bankruptcy Code, but not under chapter 13, should be treated as separate taxable entities. *I.R.C. section 1398* provides a detailed set of rules governing the taxation of these separate entities and the bankrupt individuals. This section sets forth which tax attributes of the individual debtor pass to the bankruptcy estate upon the filing and which tax attributes are returned to the individual debtor upon the completion of the bankruptcy case. In addition, *I.R.C. section 1398* provides rules relating to the carryforward and carryback of net operating losses generated by the bankruptcy estate. It sets forth how the taxable income of the bankruptcy estate should be determined and what tax rates should apply to such income. *I.R.C. section 1398* also provides for an election by the individual debtor to terminate his or her taxable year as of the time of the filing of the petition under the Bankruptcy Code. In some instances, failure to advise a taxpayer of this election may lead to disastrous results. The factual circumstances in which the election is most helpful, as well as the rules for making a timely election, are discussed in detail.

This chapter deals primarily with tax matters stemming from the statutory language and interpretation of *I.R.C. section 1398*. However, to put matters in the proper perspective, the chapter examines the individual's bankruptcy estate, both from a bankruptcy viewpoint and a tax viewpoint. Due to the varied treatment afforded administrative expense tax liabilities and priority tax liabilities, it is essential to have a sound understanding of both the tax rules and the bankruptcy rules. Indeed, a number of the more difficult and unanswered bankruptcy tax questions that arise from the administration of individual bankruptcy estates stem from the dichotomy between the treatment of a bankruptcy estate for bankruptcy purposes and the treatment of such bankruptcy estate for tax purposes. The chapter not only discusses various unresolved issues, including the tax consequences of the abandonment of tax-burdened property and the treatment of distributions of taxable income from pass-through entities, but also points out the competing self-interests and policies that must be considered as part of the decision-making process.

I.R.C. section 1398 has been part of the Internal Revenue Code for more than 25 years. As will be noted in this chapter, there are numerous issues and questions with respect to which practitioners have been seeking guidance. During the past several years there has been an increasing amount of focus on these issues, as evidenced by the number of speeches, articles, seminars, American Bar Association Task Forces, and the National Bankruptcy Review Commission addressing tax issues impacting financially distressed taxpayers.

In 1994, the United States Department of Treasury issued final regulations n1 under *I.R.C. section 1398* adding certain attributes to the enumerated list of attributes which pass between the debtor and the debtor's estate. Aside from these regulations there have been few revenue rulings or private letter rulings and very few decided cases to provide guidance in this area.

FOOTNOTES:

(n1)Footnote 1. *T.D. 8537 (May 12, 1994) ; Treas. Reg. § 1.1398-1, 2.*



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CHAPTER TX2 Federal Taxation of the Non-Corporate Bankruptcy Estate

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P TX2.02 The Non-Corporate Bankruptcy Estate for Bankruptcy and Federal Tax Purposes

[1] Prior Law

In 1978, a comprehensive revision of the bankruptcy laws was enacted as the Bankruptcy Reform Act of 1978. n1 The Bankruptcy Reform Act of 1978 represented the first complete revision of the bankruptcy laws since 1898 and the first major revision since 1938. The legislation which was ultimately enacted as the Bankruptcy Reform Act of 1978 originally included various provisions relating to federal, state and local taxes. However, the provisions relating to federal taxes were dropped, while the state and local provisions were retained. Two years later, the Bankruptcy Tax Act of 1980 n2 was enacted and made significant changes in the treatment of individuals in bankruptcy, n3 the tax consequences of the discharge of indebtedness, n4 and the procedures governing the determination of tax claims in bankruptcy. n5 In 2005, the Bankruptcy Abuse and Consumer Protection Act of 2005 (the "2005 Act") became law. n6 While the new law was not intended to make any significant changes in the taxation of bankrupt individuals, it did change the treatment of property which becomes included in the Chapter 11 estate. n7

[2] The Bankruptcy Practitioner's View of the Non-Corporate Bankruptcy Estate

[a] Commencement of Case and Appointment of Trustee

The commencement of a case under the Bankruptcy Code as a voluntary, involuntary or joint case creates the bankruptcy estate. n8 The bankruptcy estate is created as of the date the case is commenced. n9 In a chapter 7 case, the appointment of a trustee is mandatory. n10 In a chapter 11 case, a trustee may be appointed for cause or if the appointment would be in the best interests of the creditors, equity security holders and other interests of the estate. n11 If a trustee is not appointed in a chapter 11 case, the debtor, in the capacity of the debtor in possession, assumes the rights, powers and duties of a trustee. n12

The trustee has complete authority to represent the bankruptcy estate and to dispose of property of the estate. n13 The duties of the chapter 7 trustee include the collection and reduction to money of property of the bankruptcy estate. n14 Although a trustee is appointed in both chapter 12 and 13 cases, the duties of the trustee are usually limited to distributive, investigative and review functions. n15

[b] Overview of section 541 of the Bankruptcy Code

The bankruptcy estate is comprised of all legal or equitable interests of the debtor in property, wherever located, as of the commencement of the case under the Bankruptcy Code. n16 All types of property are contemplated, including real and personal property, tangible and intangible property, causes of action, possessory and leasehold interests, property recovered by the trustee, rights to tax refund claims, n16a and the tax losses of the bankruptcy estate. n17 The 2005 Act added a new section 1115 that specifically provides that property acquired after the commencement of the case as well as earnings from services performed by an individual debtor after filing a chapter 11 case but before the closure of the debtor Chapter 11 case become property of the bankruptcy estate. n18 This new provision is identical to the definition of property of the estate applicable to Chapter 13 cases. n18a

Although the bankruptcy estate is eventually composed of all of the nonexempt property of the individual debtor, the trustee may move to abandon property that is burdensome to the estate or that is of inconsequential value. n19 While property of the bankruptcy estate is usually abandoned to the individual debtor, the property may be abandoned to any party with a possessory interest in the property. n20 Often, the trustee attempts to abandon property of the bankruptcy estate that is overencumbered. The trustee is not required to abandon the overencumbered property. n21 Instead, the trustee may sell the property while it is an asset of the bankruptcy estate and, thereafter, attempt to abandon the sale proceeds or allow the secured creditor to enforce its security interest in the sale proceeds. n22 If the trustee does nothing with the property, it will be deemed to be abandoned at the closing of the bankruptcy case. n23

[3] The Tax Practitioner's View of the Non-Corporate Bankruptcy Estate

[a] Prior Law

Prior to the enactment of the Bankruptcy Tax Act of 1980, there were no specific Internal Revenue Code provisions addressing the federal tax treatment of bankrupt individuals and their corresponding bankruptcy estates. The only guidance was provided by a few rulings issued by the IRS and judicial decisions, which were often conflicting. The legislative history underlying the codification of *I.R.C. section 1398* emphasized the obvious lack of guidance that created uncertainty for taxpayers and the courts. n24

The IRS position was that the bankruptcy estate of an individual debtor was a new taxable entity for which the bankruptcy trustee was required to file fiduciary tax returns. n25 The IRS took the position that the bankruptcy estate was taxable as an estate pursuant to *I.R.C. section 641*, but that no deductions were available for distributions to creditors pursuant to *I.R.C. sections 651 and 661*. n26 Consistent with the above, the IRS ruled that when a bankruptcy estate held the stock of a subchapter "S" corporation, a separate taxable entity was created which was an ineligible shareholder. n27 Thus, the corporation's "S" status was destroyed. n28

Judicial determinations were inconsistent regarding whether the bankruptcy estate of an individual debtor was subject to federal taxation. Some courts concluded that the bankruptcy estate of an individual debtor that did not conduct a business was nevertheless subject to taxation. n29 In contrast, another court decided that the bankruptcy estate of an individual debtor that did not engage in business was not subject to taxation. n30 Yet another court held that since the bankruptcy trustee was deemed to be carrying on a trade or business, there was authority to impose federal tax liability on the bankruptcy estate. n31 Also, one court concluded that a bankruptcy filing did create a separate entity which was ineligible to be a shareholder of an "S" corporation. n32 However, the court approved an abandonment of the stock by the trustee which was given retroactive effect so as to avoid the loss of the "S" status. n33

[b] Federal Taxation of Individual Debtors and Their Estates

Enacted as part of the Bankruptcy Tax Act of 1980, n34 *I.R.C. section 1398* provides a comprehensive set of rules governing the federal taxation of individual debtors and their corresponding bankruptcy estates. First, a separate taxable entity is created when an individual commences a case under either chapter 7 or chapter 11 of the Bankruptcy Code. Second, the bankruptcy estate succeeds to certain tax attributes of the individual debtor. n35 Third, *I.R.C. section 1398*

establishes how to determine the income and deductions inuring to the bankruptcy estate, the exemptions available to the bankruptcy estate and the tax rates applicable to the taxable income of the bankruptcy estate. Fourth, *I.R.C. section 1398* provides that transfers, other than by a sale or exchange, between the individual debtor and the bankruptcy estate, are not taxable dispositions. n36

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 95-598 (1978), *reprinted in* Vol. A Collier on Bankruptcy, App. Pt. 4(a) (Matthew Bender 15th Ed. Revised).

(n2)Footnote 2. Pub. L. No. 96-589, 94 Stat. 3389 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(a) (Matthew Bender 15th Ed. Revised).

(n3)Footnote 3. *See P TX2.02[3][b] infra.*

(n4)Footnote 4. *See* chapter TX6 *infra.*

(n5)Footnote 5. *See* chapter TX5 *infra.*

(n6)Footnote 6. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n7)Footnote 7. *See* n.18 *infra* and accompanying text.

(n8)Footnote 8. *11 U.S.C. §§ 301, 302, 303 and 541(a).*

(n9)Footnote 9. *11 U.S.C. § 541(a)(1).*

(n10)Footnote 10. *11 U.S.C. § 701.*

(n11)Footnote 11. *11 U.S.C. § 1104(a).*

(n12)Footnote 12. *11 U.S.C. §§ 1101, 1106 and 1107.*

(n13)Footnote 13. *11 U.S.C. §§ 323 and 363.*

(n14)Footnote 14. *11 U.S.C. § 704.*

(n15)Footnote 15. *11 U.S.C. §§ 1202 and 1302.* Chapter 12 has been made permanent, effective July 1, 2005.

(n16)Footnote 16. *11 U.S.C. § 541(a)(1).* *11 U.S.C. §§ 541 (a)(1).* In *In re Mack*, 269 B.R. 392 (Bankr. D. Minn. 2001) . The bankruptcy court concluded that the income interest of an individual in a charitable remainder unitrust (CRUT) was property of the bankruptcy estate under *11 U.S.C. § 541.*

(n17)Footnote 16a. *See Nichols v. Birdsell*, 491 F.3d 987 (9th Cir. 2007) (court held that debtor's election to apply refund as a prepayment of next years tax liability was improper use of estate property that had to be turned over to trustee); *but see In re Graves*, 396 B.R. 70, 2008 Bankr. LEXIS 2641 (B.A.P. 10th Cir. 2008) where the court denied trustee's motion to require debtor to turnover value of pre-petition tax refund that debtor had applied to tax liability for the next year. The court held that turnover was not an appropriate remedy where the debtor had only a contingent reversionary interest in the property (a potential future tax refund).

(n18)Footnote 17. For an excellent analysis of what portion of a tax refund the bankruptcy estate is entitled to for

the tax year in which the debtor filed a Chapter 7 proceeding, See *In re Joe Donnell*, 357 B.R. 386 (W.D. Tex. 2006) . But see *In re Meyers*, 2009 Bankr. LEXIS 680 (Bankr. S.D. Ill. 2009) . While it is clear that certain tax attributes of the debtor will automatically pass to the bankruptcy estate, several cases have allowed trustees of bankruptcy estates to pursue fraudulent conveyance actions so as to avoid intentional acts of the individual debtor that would have prevented the bankruptcy estate from succeeding to otherwise valuable tax attributes of the debtor. See e.g., *In re Feiler*, 218 B.R. 957 (Bankr. N.D. Calif. 1998) , *aff'd*, 44 C.B.C.2d 702 (9th Cir. 2000) and *In re Taylor*, 386 B.R. 361 (Bankr. S. D. Fla. 2008) (prepetition elections to waive net operating loss carrybacks were avoidable as fraudulent transfers); where prepetition elections to waive net operating loss carrybacks were avoidable as fraudulent transfers pursuant to 11 U.S.C. § 548(a)(2). See n. 52 *infra* and accompanying text. See also *Wood v. Bright (In re Bright)*, 241 B.R. 664 (B.A.P. 9th Cir. 1999) (the Chapter 7 trustee's attempt to recover property, under a fraudulent conveyance theory, from the debtor's children following a disclaimer by the debtor was unsuccessful). However, not every right of the debtor is an asset of the bankruptcy estate. In *In re Kelso*, 196 B.R. 363 (Bankr. N.D. Tex. 1996) , the court found that a settlement offer received by a chapter 7 debtor was not property of the bankruptcy estate subject to postpetition transfer avoidance provisions.

(n19)Footnote 18. 11 U.S.C. § 1115, as added by Pub. L. No. 109-8 (2005). Prior to amendment section 541 (a)(6) provided that the bankruptcy estate included "proceeds, products, offspring, rents, or property of or from property of the estate," ... "except such as are earnings from services performed by an individual after the commencement of the case." There was a conflict among the courts as to the extent of the exclusion of an individual's postpetition earnings from his chapter 11 bankruptcy estate. While it was clear that where a real estate developer who filed chapter 11 would not have to turn over his postpetition earnings from his job as a short order cook at a local restaurant, it was unclear as to what portion of a physician's postpetition earnings of an established practice would be included in his bankruptcy estate. At one extreme was *In re Herberman*, 122 B.R. 273 (W.D. Tex. 1990) where Judge Leif Clark construed 541(a)(e) narrowly such that a sole proprietor physician's postpetition billings constituted property of his Chapter 11 estate. Under similar facts, Judge Brown in *Molina y Vedia*, 150 B.R. 393 (Bankr. S.D. Tex. 1992) , rejected the *Herberman* approach and concluded that the portion of the postpetition profits attributable to services performed by the physician after the commencement of the case was not property of the estate. See also *In re Cooley*, 87 B.R. 432 (Bankr. S.D. Tex. 1988) .

As a result of the enactment of new § 1115, it is now clear that all of the individual chapter 11 debtor's postpetition earnings, whether attributable to services as a physician or a short order cook, will become part of the bankruptcy estate under section 541 as modified by section 1115. Unfortunately, no corresponding changes have been made to section 1398 of the Internal Revenue Code to reflect the changes of the Bankruptcy Code.

For a thorough discussion of the issues stemming from the failure to make correlative amendments to section 1398, see Jack F. Williams & Jacob L. Todres, *Tax Consequences of Postpetition Income as Property of the Estate in an Individual Debtor Chapter 11 Case*, 13 Am. Bankr. Inst. L. Rev. 701 (2005).

(n20)Footnote 18a. 11 U.S.C. § 1306(a).

(n21)Footnote 19. 11 U.S.C. § 554. *In re Barker*, 51 C.B.C.2d 672, 301 B.R. 892 (Bankr. D. Colo. 2003) (court approved abandonment of collateral and granted creditor's request for relief from automatic stay, even though foreclosure would subject individual debtor to a \$180,000 capital gains tax liability).

(n22)Footnote 20. H.R. Rep. No. 595, 95th Cong., 1st Sess. 377 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 989, 95th Cong., 2d Sess. 92 (1978), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised).

(n23)Footnote 21. 11 U.S.C. § 554(a). However, a trustee's failure to timely abandon assets with tax liability in excess of any equity may subject him to personal exposure, at least according to the IRS. See P 2.03[2][c], n.46 *infra* and accompanying text.

(n24)Footnote 22. As discussed *P TX2.06[2] infra*, a trustee may abandon assets, the sale of which would generate tax liabilities in excess of the sales proceeds. However, the courts have generally held that a trustee's efforts to purge itself of the adverse tax consequences of a sale by abandoning the sales proceeds is ineffectual.

(n25)Footnote 23. Under 11 U.S.C. § 554(c), property of the estate that was scheduled under 11 U.S.C. § 521(l) and not otherwise administered will be deemed abandoned at the case's closing.

(n26)Footnote 24. H.R. Rep. No. 833, 96th Cong., 2d Sess. 19 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 1035, 96th Cong., 2d Sess. 24 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n27)Footnote 25. *Rev. Rul. 68-48, 1968-1 C.B. 301*; *Rev. Rul. 72-387, 1972-2 C.B. 632*.

(n28)Footnote 26. *Rev. Rul. 68-48, 1968-1 C.B. 301*.

(n29)Footnote 27. *Rev. Rul. 74-9, 1974-1 C.B. 241*. I.R.C. Section 1361(b) and Treasury Regulation Section 1.1361-1(b) establish who can be an eligible shareholder of an "S" corporation.

(n30)Footnote 28. *Rev. Rul. 74-9, 1974-1 C.B. 241*. I.R.C. Section 1361(b) and Treasury Regulation Section 1.1361-1(b) establish who can be an eligible shareholder of an "S" corporation. Under current law, I.R.C. § 1361(c)(3) permits the bankruptcy estate to be an eligible shareholder, so that the "S" election remains valid.

See *Alphonse Mourad v. Comm'r*, 387 F.3d 27 (1st Cir. 2004), where the Circuit court affirmed the Tax Court's decision that the filing of a Chapter 11 proceeding by an "S" corporation did not terminate the corporation's "S" election.

(n31)Footnote 29. *Williams v. United States*, 79-2 U.S.T.C. P 9618 (W.D. Va. 1979), *rev'd and remanded*, 667 F.2d 1108 (4th Cir. 1981). *But see In re Joplin*, 882 F.2d 1507, 1510 (10th Cir. 1989). See also, *Williams v. United States*, 79-2 U.S.T.C. P9618 (W.D. Va. 1979), *rev'd and remanded*, 667 F.2d 1108 (4th Cir. 1981). *But see In re Joplin*, 882 F.2d 1507, 1510 (10th Cir. 1989). For the converse situation, see *Mourad v. Commissioner*, 2003 U.S. Tax Ct. LEXIS 20; U.S.T.C. (CCH) P55,211 (July 2, 2003), in which the court held that the taxpayer owner of an S corporation was taxable on the gains realized by the corporation while it was in bankruptcy.

(n32)Footnote 30. *In re Kirby*, 62-2 U.S.T.C. P 9752 (S.D. Tex. 1962), *appeal dismissed*, 64-1 U.S.T.C. P 9184 (5th Cir. 1963). See also *In re Siehl*, 76-1 U.S.T.C. P 9217 (Bankr. S.D. Ohio 1976).

(n33)Footnote 31. *In re 4100 North High Ltd. v. United States*, 80-1 U.S.T.C. P 9454 (Bankr. S.D. Ohio 1980); see 28 U.S.C. § 960.

(n34)Footnote 32. *Mason v. Commissioner*, 168 T.C. 163 (1977), *nonacq.*, 1978-2 C.B. 4, *aff'd*, 646 F.2d 1309 (9th Cir. 1980). This result was changed by the Bankruptcy Tax Act. See I.R.C. § 1361(c)(3).

(n35)Footnote 33. *Mason v. Commissioner*, 68 T.C. 163, 1977 U.S. Tax Ct. LEXIS (1977), *nonacq.*, 1978-2 C.B. 4, *aff'd*, 646 F.2d 1309 (9th Cir. 1980).

(n36)Footnote 34. Pub. L. No. 96-589, 94 Stat. 3389 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(a) (Matthew Bender 15th Ed. Revised).

(n37)Footnote 35. See *P TX2.04[2] infra*. The tax attributes include net operating loss and capital loss carryovers, investment tax credit and foreign tax credit carryovers, charitable contributions carryovers, most recently, passive activity loss, credit and "at risk" loss carryovers, and the Section 121 exclusion of gain from the sale or exchange of debtor's principal residence.

(n38)Footnote 36. *I.R.C. § 1398(f)(1) and (f)(2).*



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Collier on Bankruptcy Taxation

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CHAPTER TX2 Federal Taxation of the Non-Corporate Bankruptcy Estate

15-TX2 Collier on Bankruptcy Taxation P TX2.03

P TX2.03 Property Belonging to the Non-Corporate Bankruptcy Estate

[1] Property Under the Bankruptcy Code

[a] Distinctions Based on Type of Debtor

[i] Single Individual Filing Bankruptcy Petition

All assets of the single debtor become property of the bankruptcy estate. As previously discussed, n1 the bankruptcy estate succeeds to all property, including real and personal property, tangible and intangible property, possessory and leasehold interests, and property recovered by the trustee.

[ii] Married Couple Filing Joint Bankruptcy Petition

When a married couple files a bankruptcy proceeding under section 302, only one petition is filed, only one case number is assigned, only one trustee is appointed, and only one tax identification number is assigned. n2 Nevertheless, it appears that two separate bankruptcy estates are created. n3 However, this may not always occur since the court has the authority to determine the extent, if any, to which the debtors' estates are to be consolidated. n4

[iii] Married Individual Filing Bankruptcy Petition

All assets of the spouse filing a petition become property of the filing spouse's bankruptcy estate. Such assets would include all separate property, determined in a manner similar to that for the single debtor. Additionally, all community property interests of both the filing and nonfiling spouse that were under the sole, equal or joint management and control of the filing spouse would become assets of the bankruptcy estate. n5

[b] Distinctions Based on Type of Property

[i] Exempt Property

Upon the commencement of a case under the Bankruptcy Code, all property interests of the debtor including exempt property become property of the bankruptcy estate. After the filing of the petition, the debtor is then permitted to exempt certain property from the bankruptcy estate. n6 The debtor may elect to exempt property under either the Bankruptcy Code or under federal nonbankruptcy statutes and statutes of the debtor's state of domicile, whichever may

be more liberal. n7 The debtor may not selectively choose exemptions from both. n8 Furthermore, state law may limit debtors to the state exemptions, prohibiting the election of the Bankruptcy Code exemptions. n9

The state law exemptions vary dramatically both as to the type of property that may be exempted, as well as the value of such property. For example, in Texas a debtor may exempt an urban homestead of not more than one acre of land with all improvements thereon, regardless of value, n10 whereas in Colorado the homestead exemption is not limited to acreage, but is subject to a limitation of \$30,000 of value. n11

[ii] Community Property

All property interests of the debtor and debtor's spouse in community property that are under the sole, equal or joint management and control of the debtor become property of the bankruptcy estate of the spouse filing the petition. n12 Thus, when the debtor and the debtor's spouse equally or jointly manage and control all of their community property, all of the community property would pass to the bankruptcy estate of the spouse filing the petition. n13 The only property that would not pass to the debtor's bankruptcy estate would be the separate property of the debtor's spouse and community property under the sole management of the nonfiling spouse. The specific assets that would become property of the debtor's bankruptcy estate in a community property jurisdiction would be governed by state law. Since the characterization of property as either separate or community, as well as the determination of when property is subject to sole management and control versus joint management and control, vary among states, the property comprising the debtor's bankruptcy estate may also vary. Similarly, the property passing to the bankruptcy estate of the filing spouse would not necessarily be identical to that which would be acquired by such spouse's estate in the event of the spouse's death. n14

[iii] After-Acquired Property

For Chapter 7 and pre-2005 Act Chapter 11 cases, only property owned at the time the petition is filed becomes property of the bankruptcy estate. After-acquired property belongs to the debtor, free and clear of all claims that would be dealt with pursuant to the case. However, certain after acquired assets are specifically excepted from this general rule and do become property of the bankruptcy estate. Such assets include any interest in property that would have been property of the estate if owned at the filing date of the petition that the individual debtor acquires or becomes entitled to within 180 days after the commencement of the case by bequest, devise, inheritance, property settlement resulting from an interlocutory or final divorce decree or as a beneficiary of a life insurance policy or death benefit plan. n15

In most states, an individual receiving an inheritance has a period of time in which to disclaim such inheritance. Accordingly, the issue has arisen as to whether a disclaimer is effective to keep such property out of the bankruptcy estate, or whether exercise of the disclaimer would be viewed as a fraudulent conveyance. While a question of state law, most courts appear to view the effect of the disclaimer as meaning the debtor never had an interest in the property. n16

Prior to the 2005 Act, except in chapter 12 and chapter 13 cases, earnings from services rendered by the individual debtor after the commencement of the case did not become property of the bankruptcy estate. n17 However, as the result of *section 1115 of the Bankruptcy Code*, an individual chapter 11 debtor's postpetition earnings will become part of his bankruptcy estate. n18 In a Chapter 7 case, postpetition proceeds and profits derived from bankruptcy estate assets will be property of the bankruptcy estate. n19

[iv] Abandoned Property

After notice and a hearing, the trustee may abandon any property of the bankruptcy estate that is either burdensome or of inconsequential value and benefit to the estate. n20 If, after proper notice of abandonment, no party objects to the trustee's motion, the trustee may abandon the property without either a hearing or court approval. n21 This includes property that has no realizable value or property that would be burdensome to preserve. n22 Moreover, any other party

in interest may request the bankruptcy court to either approve or order an abandonment of such property. n23

Upon abandonment, property ceases to be property of the bankruptcy estate. n24 Accordingly, title to property abandoned by the trustee reverts to the debtor who held the property prior to the commencement of the case. n25

Once the trustee has properly abandoned property of the bankruptcy estate, the abandonment is deemed to be irrevocable, regardless of any subsequent discovery that the property had greater value than previously believed. n26 However, property is not deemed abandoned if the property was unscheduled or otherwise concealed from the trustee. n27

[2] Property Under the Internal Revenue Code

[a] Distinctions Based on Nature of Case Under the Bankruptcy Code

[i] Chapter 7 and Chapter 11 Cases

A separate taxable entity is created upon the commencement of either a chapter 7 or chapter 11 case. n28 The separate taxable entity is called the bankruptcy estate and is completely distinct from the individual debtor for federal income tax purposes. n29 This separate taxable entity succeeds to the assets, liabilities and certain tax attributes of the debtor. Appropriate tax returns must be filed to reflect the activities of the bankruptcy estate. The responsibility for filing tax returns falls on the trustee in a chapter 7 case and the trustee or the debtor in possession in a chapter 11 case. n30 The trustee or debtor in possession, files a "U.S. Fiduciary Income Tax Return," Form 1041, with a completed Form 1040, reflecting the computation of the bankruptcy estate's tax liability, as an attached schedule. n31

The tax liability for the bankruptcy estate is computed in the same manner as for a married person filing separately. The bankruptcy estate is allowed one personal tax exemption and the appropriate standard deduction. Furthermore, the bankruptcy estate must file a tax return whenever *I.R.C. section 63(c)(2)(D)* gross income exceeds the threshold requirement even though there may be no tax liability. n32 As discussed earlier a major change in Chapter 11 cases results from the enactment of section 1115. This provides that an individual bankruptcy estate includes not only the property specified in section 541, also after acquired property and post petition earnings. n32a

[ii] Chapter 13 Case

No separate taxable entity is created when an individual commences a Chapter 13 case. n33 Any prepetition tax liabilities constitute priority claims against the bankruptcy estate and must be addressed under the Chapter 13 plan. n33a While priority taxes must ordinarily be paid in full in order to have a plan confirmed, a Chapter 13 plan may provide for less than full payment of such claims if all of the debtors projected disposable income for a 5-year period will be applied to make such payments. n33b Since the Chapter 13 bankruptcy estate is not a taxpayer it would seem that post petition tax liabilities n33c could not be "incurred" by the estate.

As stated by Judge Rosenthal, "to hold the Chapter 13 estate liable for [a] tax when it does not exist as a taxable entity defies common sense as well as Congress' intent." n33d Section 1305 provides that a governmental unit may file a proof of claim for the taxes that become payable while the case is pending. n33e In the *Whall* case n33f the debtor filed a Chapter 13 petition in April of 2006 and filed his Massachusetts personal return for 2006 in 2007 showing an unpaid tax liability for 2006. The Massachusetts Department of Review (MDOR) chose not to file a proof of claim pursuant to section 1305 because it would not have been able to assert a claim for interest and penalties. The court concluded that in a Chapter 13 case the taxing authority had the option to file a proof of claim for post petition taxes, but if it chose not to do so, the debtor was personally liable for the post petition taxes.

[iii] Chapter 12 Case

Chapter 12, Adjustment of Debts of a Family Farmer with Regular Income, was added to the Bankruptcy Code in 1986. n34 It was designed to help farmers resolve some of their financial problems by giving them an opportunity to reorganize their debts and keep their land. Prior to the enactment of the 2005 Act, there was an unusual dichotomy between the tax treatment of Chapter 12 estates under state and federal law. Similar to Chapter 13, no separate taxable entity was created when an individual filed a Chapter 12 case. n35 On the other hand, the Bankruptcy Code provided that for state and local tax purposes the taxable year for the individual debtor terminated on the date of the Chapter 12 filing and that a trustee should file tax return for the Chapter 12 estate. n36

Accordingly, prior to the 2005 Act, in Chapter 12 cases a new taxable entity was created for state and local purposes, but not for federal tax purposes. The 2005 Act amended Chapter 12 to remove the provision creating a separate taxable entity for state and local purposes. n37 Thus, after the changes made by the 2005 Act, it would have appeared that the tax liability for post-petition income would be the responsibility of the individual debtor as was the result in the Chapter 13 cases. n38

However, the 2005 Act added another provision to help the family farmer. It provided that the Chapter 12 plan should provide for full payment of all claims entitled to priority under section 507, unless "the claim is a claim owed to a governmental unit that arises as a result of the sale, transfer, exchange, or other disposition of any farm asset used in the debtor's farming operation, in which case the claim shall be treated as an unsecured claim that is not entitled to priority under section 507, but the debt shall be treated in such a manner only if the debtor receives a discharge." n38a

The question was posed as to whether section 1222(a)(2)(A) applied to post petition sales of assets and whether taxes on such sales could be treated as administrative expenses of the bankruptcy estate. Four bankruptcy courts have addressed the issue with three answering in the affirmative. In *In re Knudsen* n38b the court concluded that section 1222(a)(2)(A) was added to help family farmers and it would be illogical not to allow post petition sales to benefit from it. Similar results were reached in *In re Schilke* n38c and *In re Dawes*. n38d

On the other hand, *In re Hall* n38e concluded that section 1222 (a)(2)(A) would only apply to pre-petition tax liabilities. The court noted that Chapter 12 was modeled after Chapter 13 and that it was appropriate to look at Chapter 13 cases in the statute. The court placed great reliance on *In re Brown* n38f which found that a Chapter 13 estate cannot be held liable for capital gains taxes because it does not exist as a taxable entity.

The bankruptcy court decision in *Knudsen* was recently affirmed by the Iowa district court. n38g The court noted that if section 1222(a)(2)(A) were construed to be inapplicable to post-petition taxes it would be essentially meaningless as it would only benefit farmers who had the foresight to liquidate assets before filing bankruptcy. The court also concluded that the requirement that taxes be "incurred by the estate" simply refers to the timing of the fixing of the liability and does not require that the estate exists as a separate taxpayer.

[b] Distinctions Based on Type of Debtor

[i] Single Individual Filing Bankruptcy Petition

In most chapter 7 or chapter 11 cases, the debtor's bankruptcy estate from a tax viewpoint will appear the same as from a bankruptcy viewpoint, except for the express references to the debtor's tax attributes. In the instance of a single taxpayer, the bankruptcy estate will succeed to the enumerated tax attributes specified in *I.R.C. section 1398(g)*. n39

Example 1:

John Jones, an individual, commences a chapter 7 case on June 1. As of the preceding December 31, John Jones had a net operating loss carryover of \$100,000 and no other tax attributes. The bankruptcy estate will succeed to the \$100,000 net operating loss carryover.

[ii] Married Individual Filing Bankruptcy Petition

The situation is more complex when the debtor is married, particularly when the debtor's spouse does not join in the filing of the petition.

Example 2:

Same as above except John Jones is married to Judy Jones at the time he commences a chapter 7 case and the \$100,000 net operating loss carryover was generated and reflected on their joint income tax return filed for the preceding year.

In the above example, the amount of the net operating loss carryover which passes to the bankruptcy estate is not clear. It may depend on whether the net operating loss is separate property of the non-filing spouse, the spouse who files, or community property. n40 If it constitutes community property, its treatment will vary, depending on whether it was under the sole, equal or joint management and control of the debtor. n41 The answers to these questions may vary depending on applicable state law as well as which assets or activities generated the net operating loss.

[iii] Married Couple Filing Joint Bankruptcy Petition

When both spouses file a joint petition under *Bankruptcy Code section 302*, it appears that a single bankruptcy estate is created. However, there may be situations in which the bankruptcy court determines that this should not be the result. n42 On the other hand, for tax purposes, one court has held that there are two bankruptcy estates; one for each spouse, so that the spouses' respective bankruptcy estates apparently maintain their separate tax identities. n43 In this situation, it will be necessary to determine how the tax attributes, which may have been computed on a joint basis, are to be apportioned between the spouses. n44

[c] Abandoned Property

Courts have generally held that for federal income tax purposes, no sale or exchange occurs when the bankruptcy trustee abandons property. n45 If the abandonment of property does not give rise to a taxable event for the bankruptcy estate, the potential gain (or loss) associated with an abandoned asset remains with the asset and will be reflected on the tax return for the person to whom the asset was abandoned, presumably the debtor, when such asset is later sold or otherwise disposed of in a taxable transaction.

The IRS position is that while the bankruptcy estate in either a chapter 7 or chapter 11 case involving an individual debtor is not liable for federal taxes on property abandoned pursuant to *section 554 of the Bankruptcy Code*, the bankruptcy estate is liable for the federal taxes on any gain realized on the disposition of such property when the trustee sells encumbered property and, thereafter, abandons the sale proceeds. Consequently, when the disposition of bankruptcy estate property will result in a federal tax liability in excess of the funds held in the estate, there will be an incentive for the trustee to conclude that such property should be abandoned, particularly if, as the IRS has suggested, the trustee may have personal exposure for the unsatisfied tax liability that could have been avoided by an abandonment. n46

Any gain realized on a subsequent disposition of the abandoned property, such as a foreclosure, would be taxable to the debtor, not to the bankruptcy estate. n47 However, merely granting relief from the automatic stay to allow a foreclosure does not constitute a formal abandonment and does not shift the tax liability to the debtor. n48 Furthermore, a debtor who commences a case only to have property with built-in gains (thereby representing potential tax liability) abandoned back to him or her by the trustee may find himself or herself in a worse position. By filing for protection under the Bankruptcy Code, the debtor will give up assets which might have provided a source of funds with which to pay the tax liability as well as tax attributes which might have reduced the taxable income resulting from the triggering of the built-in gains. Because the bankruptcy estate succeeds to certain tax attributes, such as net operating loss carryovers and capital loss carryovers, these tax attributes would not be available to the debtor to offset the taxable gain corresponding

to a later disposition of the abandoned property back to the debtor. n49

FOOTNOTES:

(n1)Footnote 1. *See P TX2.02[2][b] supra.*

(n2)Footnote 2. *11 U.S.C. § 302.*

(n3)Footnote 3. *See In re Knobel*, 167 B.R. 436 (Bankr. W.D. Tex. 1994) , in which the court held that even though a married couple filed a joint petition, two estates were created. Each consisted of one spouse's separate property and sole management community property, plus the spouse's interest in joint community property. The cases were to be administered jointly, but not be substantively consolidated unless there was a request and proper justification. The court acknowledged that this result "makes segregation of property less than practical and ... may in the average case warrant substantive consolidation." *See also In re Smith v. Commissioner*, 70 T.C.M. 483 (1995) ; *In re Gale*, 177 B.R. 531 (Bankr. E.D. Mich 1995) . A similar result followed in *In re Harris*, 47 C.B.C.2d 537 A.F.T.R. 2d (RIA) 7242 (Bankr. D. Md. 2001), where four unrelated husband-wife debtor cases were joined. The court held that while joint filing under *Section 302 of the Bankruptcy Code* resulted in joint administration, it did not necessarily result in substantive consolidation.

(n4)Footnote 4. *11 U.S.C. § 302(b).*

(n5)Footnote 5. *11 U.S.C. § 541(a)(2)(A).*

(n6)Footnote 6. *11 U.S.C. § 522.* The Federal exemption limits in section 522 were raised by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised). In addition, the 1994 Reform Act amended section 104 by providing that on April 1, 1998, and at each three-year interval ending on April 1st thereafter, each dollar limitation in effect under section 522(d) will be adjusted for inflation, as represented by the Consumer Price Index for All Urban Consumers. *See* H.R. 5116, § 108(e)(2) (amending *11 U.S.C. § 104*), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised). As of the most recent increases on April 1, 2001, section 522(d) was amended to increase the specified dollar limitations on exemptions for homesteads, motor vehicles, household goods and furnishings, jewelry, property exempted in lieu of the homestead exemption, implements of trade, accrued dividends or loan value of unmaturing life insurance contracts and personal injury payments.

(n7)Footnote 7. *11 U.S.C. § 522(b).*

(n8)Footnote 8. *11 U.S.C. § 522(b).*

(n9)Footnote 9. *11 U.S.C. § 522(b)(1).*

(n10)Footnote 10. *Tex. Prop. Code Ann. § 41.002(a)* (Vernon 1983). For a discussion of the Texas exemption statutes, *see* 14 Collier on Bankruptcy (Matthew Bender 15th Ed. Revised).

(n11)Footnote 11. *Colo. Rev. Stat. § 38-41-201* (1991). *See* the Colorado exemption statutes in Vol. 14 Collier on Bankruptcy (Matthew Bender 15th Ed. Revised).

(n12)Footnote 12. *11 U.S.C. § 541(a)(2)(A).*

(n13)Footnote 13. *11 U.S.C. § 541(a)(2)(A).* *See In re Knobel*, 167 B.R. 436 (Bankr. W.D. Tex. 1994) . *See also Texaco, Inc. v. Bartlett* (*In re Bartlett*), 8 C.B.C.2d 979, 24 B.R. 605 (B.A.P. 9th Cir. 1982) ; *Teel v. Teel* (*In re Teel*), 34 B.R. 762 (B.A.P. 9th Cir. 1983) ; *In re Hendrick*, 45 B.R. 976 (Bankr. M.D. La. 1985) ; *In re Entz*, 44 B.R. 483

(*Bankr. D. Ariz. 1984*) ; *In re Barnes*, 14 B.R. 788 (*Bankr. N.D. Tex. 1981*) .

(n14)Footnote 14. Generally, upon the death of a spouse in a community property state the probate estate will include only the deceased spouse's one-half community interest in the property. *See, e.g., Tex. Prob. Code Ann. § 45* (Vernon 1979). Moreover, this result ensues regardless of who controlled the property.

(n15)Footnote 15. 11 U.S.C. § 541(a)(5).

(n16)Footnote 16. *See In re Bright*, 241 B.R. 664 (B.A.P. 9th Cir. 1999) . For cases holding that a disclaimer can be a fraudulent conveyance, *see In re Peery*, 40 B.R. 811 (*Bankr. M.D. Tenn. 1984*) , and *In re Stevens*, 112 B.R. 175 (*Bankr. S.D. Tex. 1989*) .

(n17)Footnote 17. 11 U.S.C. § 541(a)(6).

(n18)Footnote 18. 11 U.S.C. § 1115.. *See* discussion at P TX2.02[2][b] *supra*.

(n19)Footnote 19. 11 U.S.C. § 541(a)(6). In some cases it is difficult to distinguish between an individual's postpetition earnings and gains or income attributable to bankruptcy estate assets. For example, if a sole proprietor contractor has only partially performed a job calling for a fixed fee at the time of the filing of the petition, but he subsequently completes the job, how much, if any, of the "profit" earned should be allocated to the bankruptcy estate? If the contractor was using the completed contract method, no portion of the taxable profit would go to the estate. However, it is possible that a bankruptcy judge would still conclude that the bankruptcy estate was entitled to be compensated on a *quantum meruit* basis for work already performed at the date of the filing of the petition.

In *In re Brobeck, Phleger & Harrison LLP*, 408 B.R. 218, 2009 Bankr. LEXIS 2076 (*Bankr. N.D. Cal. 2009*) , the high profile law firm Brobeck, Phleger & Harrison, LLP went out of business and then filed chapter 7. The court determined that the law firm had a property interest in "unfinished business" and that an agreement between the firm and its departing partners waiving such interest was a fraudulent conveyance under Bankruptcy Code section 548(1)(a)(1)(A).

(n20)Footnote 20. 11 U.S.C. § 554(a). In *In re Stephenson*, 2009 Bankr. LEXIS 482(*Bankr. D. Idaho 2009*) , the court rejected a trustee's attempt to abandon a malpractice lawsuit. There was no showing that the claim was of no value or otherwise burdensome to the estate. Rather, the debtor was actually trying to "buy" the claim from the estate.

(n21)Footnote 21. *Hickman v. First State Bank of Cordele (In re Motley)*, 4 C.B.C.2d 36, 10 B.R. 141 (*Bankr. M.D. Ga. 1981*) .

(n22)Footnote 22. *In re Bryson*, 53 B.R. 3 (*Bankr. M.D. Tenn. 1985*) (lawsuit abandoned when the trustee determined that the lawsuit had no value to the estate); *In re Reich*, 13 C.B.C.2d 988, 54 B.R. 995 (*Bankr. E.D. Mich. 1985*) (if the burden and risk of maintaining the property is greater than the probable return to the estate, the trustee should abandon the property).

(n23)Footnote 23. 11 U.S.C. § 554(b).

(n24)Footnote 24. *Samore v. Olson (In re Olson)*, 100 B.R. 458, 462 (*Bankr. N.D. Iowa 1989*) , *aff'd*, 121 B.R. 346 (*N.D. Iowa 1990*) , *aff'd*, 930 F.2d 6, 8 (8th Cir. 1991) .

(n25)Footnote 25. *In re Bentley*, 17 C.B.C.2d 910 (*Bankr. S.D. Iowa 1987*) , *rev'd*, 89-2 U.S.T.C. P 9597 (S.D. Iowa 1989), *aff'd*, 916 F.2d 431, 432 (8th Cir. 1990) ; *Mason v. Commissioner*, 68 T.C. 163 (1977) , *aff'd*, 646 F.2d 1309, 1310 (9th Cir. 1980) .

(n26)Footnote 26. *In re Bryson*, 53 B.R. 3, 4 (*Bankr. M.D. Tenn. 1985*) ; *In re Sutton*, 10 B.R. 737 (*Bankr. E.D.*

Va. 1981) .

(n27)Footnote 27. *In re Bryson*, 53 B.R. 3, 4 (Bankr. M.D. Tenn. 1985) ; *In re Sutton*, 10 B.R. 737, 740 (Bankr. E.D. Va. 1981) .

There appears to be some confusion as to what happens at the end of an individual's chapter 7 case. The Bankruptcy Code, 11 U.S.C. § 554, provides that property which is not administered by the bankruptcy trustee is deemed abandoned to the debtor. The question is, as of when? In *Gulley v. Commissioner*, T.C. Memo 2000-190 (June 27, 2000) , the taxpayer, citing *In re Dewsnap*, 908 F.2d 588 (10th Cir. 1990) , argued that a partnership interest should be deemed abandoned and returned to the taxpayer as if the partnership interest had never been part of the chapter 7 estate. The court rejected this argument, finding that the partnership interest had been administered by the bankruptcy trustee who had tried to maximize the value of the taxpayer's partnership interest.

However, 11 U.S.C. section 554(a) does not allow the trustee to evade specific performance. In *In re Linton Properties, LLC*, 400 B.R. 1, 2009 Bankr. LEXIS 294 (Bankr. D.C. 2009) , the debtor had entered into an auction sale of real estate while it was serving as debtor in possession prior to the conversion of the case from chapter 11 to chapter 7. The chapter 7 trustee tried to abandon the property in order to avoid adverse tax consequences that might result from the sale. The court rejected the trustee's arguments.

(n28)Footnote 28. I.R.C. § 1398(a). Section 1398 has not been changed to reflect the addition of section 1115 of the Bankruptcy Code as added by the 2005 Act. As a result, it is unclear how the tax reporting will be handled where an individual receives postpetition earnings which are paid directly to his bankruptcy estate. In *Notice 2006-83*, 2006 IRB LEXIS 518 ; 2006-40 I.R. B. 596 , issued September 18, 2006, the IRS issued guidance for individuals and their employees for the reporting of payments on Forms W-2, 1099, 1099-DIV, 1099 MISC and other information returns. For a more detailed discussion of *Notice 2006-83* , see P TX2.07[1] *infra*.

(n29)Footnote 29. *In re Mirman*, 98 B.R. 742, 745 (Bankr. E.D. Va. 1989) .

(n30)Footnote 30. See 11 U.S.C. § 704(8); 11 U.S.C. § 1106(a)(1), (6).

(n31)Footnote 31. I.R.C. § 6012(b)(4). See also chapter TX10 *infra*.

(n32)Footnote 32. I.R.C. § 6012(b)(4). See *Feldman v. Maryland National Bank (In re Wills)*, 46 B.R. 333 (Bankr. D. Md. 1985) .

(n33)Footnote 32a. See. P TX 2.02[2][b] and note 18 *infra*.

(n34)Footnote 33. I.R.C. § 1399.

(n35)Footnote 33a. 11 U.S.C. 1322(a)(2); 11 U.S.C. 507(a)(8).

(n36)Footnote 33b. 11 U.S.C. 1322(a)(4).

(n37)Footnote 33c. See *In re Brown*, 2006 Bankr. LEXIS 3156 (Bankr. D. Mass. 2006) .

(n38)Footnote 33d. *Id.*

(n39)Footnote 33e. 11 U.S.C. § 1305(a)(1).

(n40)Footnote 33f. See *In re Whall*, 391 B.R. 1, 2008 Bankr. LEXIS 1672 (Bankr. D. Mass. 2008) . See also *In re Bryant*, 1998 Bankr. LEXIS 1889 (Bankr. E.D. Va. 1998) .

(n41)Footnote 34. Pub. L. No. 99-554 (1986), *reprinted in* Vol. E-1 Collier on Bankruptcy, App. Pt. 7(a) (Matthew

Bender 15th Ed. Revised).

(n42)Footnote 35. *I.R.C. § 1399*.

(n43)Footnote 36. *11 U.S.C § 1231*.

(n44)Footnote 37. Pub. L. No. 109-8 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n45)Footnote 38. *See P TX2.03[2][a][ii] infra*.

(n46)Footnote 38a. *11 U.S.C. § 1222(a)(2)(A)*.

(n47)Footnote 38b. *356 B.R. 480 (Bankr. N.D. Iowa, 2006)* .

(n48)Footnote 38c. *379 B.R. 899 (Bankr. D. Neb. 2007)* The court felt that this was the appropriate result when considering the apparent intent of the statute--to help farmers reorganize. Subsequent cases have reached the same result. *See In re Uhrenholdt, 2009 Bankr. LEXIS 144 (Bankr. D. Neb 2009)* ; *In re Rickert, 2009 Bankr. LEXIS 17 (Bankr. D. Neb. 2009)*

(n49)Footnote 38d. *382 B.R. 509 (Bankr. D. Kan. 2008)* . The position of the IRS, was that the taxes were not "incurred by the estate" [as required by the statute] because in a Chapter 12 case the filing of the petition does not create a new taxable entity. In rejecting this position, the court noted that no new taxable entity was created when corporations filed Chapter 7 and Chapter 11 and yet it was clear that post petition tax liabilities were allowed as administrative expenses against the bankruptcy estates.

(n50)Footnote 38e. *376 B.R. 741 ; 2007 Bankr. LEXIS 3385 ; 58 Collier Bankr. Cas. 2d (Bankr. D. Ariz. 2007)*.

(n51)Footnote 38f. *2006 Bankr. LEXIS 3156* .

(n52)Footnote 38g. *389 B.R. 643 (N.D. Iowa)* .

(n53)Footnote 39. *See P TX2.04[2] infra*.

(n54)Footnote 40. *I.R.C. § 1398(g)* provides that the estate shall succeed to the specified attributes, including net operating losses, of the debtor. The statute is silent and there have been no guidelines issued by the IRS as to how to determine the debtor's net operating loss carryover when the debtor was married but a joint petition was not filed. Moreover, since *11 U.S.C. § 541* provides that the debtor's bankruptcy estate includes all "property" held by the debtor, the bankruptcy result might differ from what the result would be for purposes of filing separate returns or allocating the loss as a result of a divorce.

In *Gulley v. Commissioner, 79 T.C.M. (CCH) 2171 (2000)* , a married taxpayer filed a petition under chapter 11 of the bankruptcy code in 1991. The court found that a partnership interest which generated a 1991 net operating loss was a community asset. The court concluded that one-half of the 1991 partnership loss was allocable to each of them. This conclusion seems erroneous. If the partnership interest was a community asset, then all of such interest, and presumably all of the associated net operating loss, should have passed to the taxpayer's bankruptcy estate. *See Katz v. Commissioner, 335 F.3d 1121 (10th Cir. 2003)* , where the Tenth Circuit concluded that the allocation of partnership income between the debtor and the bankruptcy estate was a partnership level proceeding.

(n55)Footnote 41. *11 U.S.C. § 541*.

(n56)Footnote 42. Presumably, if the spouses had separate creditors and significant separate property assets, the court would require the estates to be handled separately. *See P TX2.03[1][a][ii] supra*.

(n57)Footnote 43. See *In re Knobel*, 167 B.R. 436 (Bankr. W.D. Tex. 1994) ; *L.E. Smith*, 70 T.C.M. (CCH) 483, T.C. Memo 1995-406 (1995) .

(n58)Footnote 44. I.R.C. § 1398(g) provides that the estate shall succeed to the specified attributes, including net operating losses, of the debtor. The statute is silent and there have been no guidelines issued by the IRS as to how to determine the debtor's net operating loss carryover when the debtor was married but a joint petition was not filed. Moreover, since 11 U.S.C. § 541 provides that the debtor's bankruptcy estate includes all "property" held by the debtor, the bankruptcy result might differ from what the result would be for purposes of filing separate returns or allocating the loss as a result of a divorce. This situation may be even more complex when only one spouse files for relief under the Bankruptcy Code since, if the attribute is community property, it should pass to the estate of the first to file. But what if they file separate petitions simultaneously?

(n59)Footnote 45. *In re Terjen*, 154 B.R. 456 (E.D. Va. 1993) , *aff'd*, 30 F.3d 131 (4th Cir. 1994) ; *Samore v. Olson (In re Olson)*, 100 B.R. 458, 462 (Bankr. N.D. Iowa 1989) , *aff'd*, 121 B.R. 346 (N.D. Iowa 1990) , *aff'd*, 930 F.2d 6, 8 (8th Cir. 1991) ; *In re Bentley*, 17 C.B.C.2d 910 (Bankr. S.D. Iowa 1987) , *rev'd*, 89-2 U.S.T.C. P 9597 (S.D. Iowa 1989), *aff'd*, 916 F.2d 431, 432, 433 (8th Cir. 1990) . But see *In re A.J. Lane & Co., Inc.*, 25 C.B.C.2d 1202, 133 B.R. 264 (Bankr. D. Mass. 1991) . *In re Rubin*, 154 B.R. 897 (Bankr. D. Md. 1992) and *In re Matson*, No. 90-42308-7 (Bankr. D. Kan. Dec. 12, 1991). For a more detailed discussion of the controversy regarding the income tax consequences of abandonment, see P TX2.06[2] *infra*. See also Pittman, Abandonments in Bankruptcy-Unifying Competing Tax and Bankruptcy Policies, 88 Minn. L. Rev. 723 (April 2004).

(n60)Footnote 46. See *Priv. Ltr. Rul. 96-11-028*; 1995 PLR LEXIS 2151 (wherein IRS held that transfer of partnership interest from estate to debtor is not a taxable disposition whether it occurs at end of or during administration of case). Letter from the Associate Chief Counsel (litigation) of the IRS to the Deputy Assistant Attorney General in the Tax Division of the Department of Justice, dated March 14, 1989; Letter from the office of the District Director of the IRS to the United States trustee for Region 12, dated July 11, 1989. See also *Priv. Ltr. Rul. 89-180-16 (Jan 31, 1989)*.

(n61)Footnote 47. *In re Barker*, 51 C.B.C.2d 672, 301 B.R. 892 (Bankr. D. Colo. 2003) ; *In re Popp*, 166 B.R. 697 (Bankr. D. Neb. 1993) ; *Samore v. Olson (In re Olson)*, 100 B.R. 458, 462 (Bankr. N.D. Iowa 1989) , *aff'd*, 121 B.R. 346 (N.D. Iowa 1990) , *aff'd*, 930 F.2d 6, 8 (8th Cir. 1991) ; *Mason v. Commissioner*, 68 T.C. 163 (1977) , *aff'd*, 646 F.2d 1309, 1310 (9th Cir. 1980) . Moreover, if the bankruptcy estate does sell the property, any resulting tax liability will be an administrative expense which will have the same priority as other administrative expenses, including trustee fees. See *In re Goffena*, 175 B.R. 386 (Bankr. D. Mont. 1994) .

(n62)Footnote 48. *Nebel v. Richardson (In re Nebel)*, 175 B.R. 306 (Bankr. D. Neb. 1994) .; see also *Catalano v. Commissioner*, 279 F.3d 682 (9th Cir. 2002) . Note that the fact that the abandoned property may have a value greater than listed will not change the irrevocable nature of the abandonment. See *In re Ruggles*, 2006 Bankr. LEXIS 546 (Bankr. D. Vt. 2006) .

(n63)Footnote 49. This is what would have happened to the taxpayer in the case of *In re A.J. Lane & Co., Inc.*, 25 C.B.C.2d 1202, 133 B.R. 264 (Bankr. D. Mass. 1991) , had the trustee's motion for abandonment been granted. The harshness of this result has been alleviated somewhat by the regulations which provide that unused passive activity losses and "at risk" losses associated with properties abandoned by an estate back to the debtor will pass to the debtor along with the abandoned properties. For further discussion and analysis of the tax consequences of abandonment, see the compromise solution proposed by the Advisory Committee to the National Bankruptcy Review Commission, to the effect that an abandonment by the trustee would be treated as if it were a sale by the debtor immediately prior to the filing of the bankruptcy petition, see P TX2.06[2] *infra*.



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Collier on Bankruptcy Taxation

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CHAPTER TX2 Federal Taxation of the Non-Corporate Bankruptcy Estate

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P TX2.04 Federal Taxation of the Chapter 7 and Chapter 11 Non-Corporate Bankruptcy Estate

[1] Tax-Free Transfer of Assets to Estate

The transfer of assets from the debtor to the bankruptcy estate by virtue of commencing a case under the Bankruptcy Code is not a taxable event. n1 This is so even though the assets may be subject to liabilities in excess of the debtor's tax basis in such assets. Not only is the transfer of an asset tax free under *I.R.C. section 1398(f)(1)*, but the transfer is to be ignored for purposes of any other provision of the Internal Revenue Code assigning tax consequences to a disposition. Thus, the transfer of a partnership interest would not cause a termination of the partnership under *I.R.C. section 708(b)*, n2 nor a termination of the partnership year with respect to the debtor, n3 nor would a transfer result in recapture of investment tax credit. n4

[2] Determination of Tax Attributes of the Bankruptcy Estate

[a] In General

I.R.C. section 1398(g) provides that the bankruptcy estate succeeds to specific attributes of the debtor existing as of the first day of the debtor's taxable year in which the debtor's case was commenced.

Example 3:

John Jones filed a chapter 7 petition on July 1, John Jones' federal tax return for the prior year reflected a net operating loss carryover of \$15,000. On July 1, John Jones owned 1,000 shares of XYZ Company with an aggregate tax basis of \$20,000. Absent the short period election under *I.R.C. section 1398(d)* the bankruptcy estate of John Jones will succeed to these attributes, regardless of what may have occurred to John Jones during the first six months of 2006 from a tax viewpoint. n5

[b] Carryover of Tax Basis, Holding Period and Character of Property Belonging to the Non-Corporate Bankruptcy Estate

The bankruptcy estate succeeds to the adjusted tax basis, the holding period and character (*e.g.*, capital or ordinary) of all assets belonging to the debtor immediately prior to the commencement of the case under the Bankruptcy Code. n6 The attributes are determined as of the first day of the taxable year in which the case is commenced. n7 Under a literal reading of this provision, a calendar year taxpayer who files a petition and owns depreciable assets which he or she has

held since the beginning of the year will lose the benefit of the tax basis of such assets as of the beginning of the year. Arguably, this means the bankruptcy estate can claim the depreciation deduction for that portion of the taxable year before the petition was filed. n8 Of course, if the debtor makes the election to terminate his taxable year under *I.R.C. section 1398(d)(2)*, this issue is avoided. n9 Also, if the debtor sells the assets before filing a petition, and the section 1398(d)(2) election is made, logic suggests that the individual debtor would be entitled to the available depreciation deduction for that portion of the year preceding the bankruptcy filing. n10

In recent years, there has been a controversy as to whether the bankruptcy estate may defer or exclude gain from the sale of the debtor's personal residence if the debtor could have qualified for the benefits of *I.R.C. section 121*. n11 In the early cases, the courts concluded that the ability to qualify for the section 121 exclusion of gain was personal to the taxpayer and was not an attribute that passed to the bankruptcy estate. n12 However, after section 121 was amended by the Taxpayer Relief Act of 1997 to allow for tax-free recovery of up to \$500,000 of gain, the courts have generally found that the bankruptcy estate can utilize the benefits of Section 121. n13 Indeed, the Internal Revenue Service has finally acquiesced in this result n14 and has formally announced a change in its litigating position. n15

On October 30, 2000, the Treasury Department issued regulations to the effect that an individual's bankruptcy estate succeeds to and takes into account the section 121 exclusion. n16 The Internal Revenue Service did not challenge a bankruptcy estate's use of the section 121 exclusion prior to the effective date of the regulations, if the debtor would otherwise satisfy the section 121 requirements. n17

[c] Net Operating Loss and Capital Loss Carryovers

The bankruptcy estate succeeds to all net operating loss carryovers as determined pursuant to *I.R.C. section 172*. n18 Additionally, the bankruptcy estate succeeds to all capital loss carryovers as determined pursuant to *I.R.C. section 1212*. n19 These carryover amounts are determined as of the first day of the year of the filing of the petition under the Bankruptcy Code and, therefore, absent the short year election, equate to the amounts shown as carryovers on the tax return for the prior year.

[d] Investment Tax Credit and Foreign Tax Credit Carryovers

The bankruptcy estate succeeds to any tax credit carryovers, such as the investment tax credit or foreign tax credit, and all other items with respect to such credits, to which--but for the commencement of the case under the Bankruptcy Code--the debtor would have been entitled. n20

[e] Charitable Contributions Carryovers

The bankruptcy estate succeeds to any carryover of excess charitable contributions as determined pursuant to *I.R.C. section 170(d)(1)*. n21

[f] Recovery Exclusion

The bankruptcy estate succeeds to the possible recovery of any tax benefit items that may be excluded from income under *I.R.C. section 111*. n22 An example of the applicability of this provision would be the receipt of a refund of state income taxes. If the taxpayer had not itemized deductions in the prior year, no "tax benefit" would have been received from such tax payments and, therefore, the recovery of such state taxes would not constitute taxable income. n23

[g] Method of Accounting

[i] Cash or Accrual Method

The bankruptcy estate inherits the method of accounting used by the debtor immediately prior to the commencement of

the debtor's case. n24 In most cases, this means the bankruptcy estate will use the cash method of accounting since this is the most common method. n25 However, if a debtor is engaged in business as a sole proprietor, and is properly using the accrual method, this method must be continued by the bankruptcy estate. Presumably, the estate will also be bound by, or entitled to continue, the debtor's treatment of specific items, such as the election to deduct circulation expenditures, n26 research and experimental expenditures, n27 or soil and water conservation expenditures. n28

[ii] Taxable Year

Although the bankruptcy estate must use the debtor's method of accounting, the estate can adopt any taxable year. n29 A taxable year may be established by filing a tax return by the 15th day of the fourth month following the end of the month selected to be the last month of the taxable year. n30 If a taxable year is not established on a timely basis, the bankruptcy estate is required to adopt the calendar year as its taxable year. n31 The election of a taxable year, other than a calendar year, cannot be made by the filing of an application for extension of time to file the tax return. n32

The estate may change its accounting period one time without first obtaining approval of the IRS. n33 This special rule enables the bankruptcy trustee to close the taxable year of the bankruptcy estate and file a short year tax return for an expedited determination of federal tax liability pursuant to *section 505 of the Bankruptcy Code*. n34

[h] Passive Activity Losses and Credits

Treasury Regulation section 1.1398-1 provides that the bankruptcy estate succeeds to the passive activity losses and credits of an individual debtor in either a chapter 7 or chapter 11 case. n35 The passive activity losses and credits to which the bankruptcy estate succeeds are determined as of the first day of the debtor's taxable year in which the bankruptcy case commences. n36 As mentioned earlier, the bankruptcy estate also succeeds to the net operating losses of the individual debtor. However, when the passive activity losses become net operating losses by virtue of a disposition of a passive activity, the net operating losses are deemed to have originated with the estate, not the debtor. n36a This could be significant in determining the ability of the estate and the individual debtor to carry back losses. n36b

[i] "At Risk" Losses

Treasury Regulation section 1.1398-2 provides that the bankruptcy estate succeeds to any losses of an individual debtor that are not allowed under *I.R.C. section 465* in either a chapter 7 or chapter 11 case. n37 The "at risk" losses to which the bankruptcy estate succeeds are determined as of the first day of the debtor's taxable year in which the bankruptcy case commences. n38

[j] Other Tax Attributes

[i] Absence of Income Tax Regulations

As part of the Bankruptcy Tax Act of 1980, Congress specifically authorized the Secretary of the Treasury to promulgate regulations enumerating additional tax attributes which should pass from the debtor to the bankruptcy estate. n39 Nevertheless, the IRS did not issue any regulations until it issued *Treasury Regulations sections 1.1398-1* and *1.1398-2*, relating to passive activity losses, passive activity credits and "at risk" losses. Regardless of how logical it may seem that certain other tax attributes should pass to the bankruptcy estate, absent the promulgation of regulations, the courts addressing the issue have generally adopted a literal interpretation of *I.R.C. section 1398(g)* and have concluded that non-enumerated tax attributes of a debtor do not pass to the bankruptcy estate. n40

[ii] Examples of Non-Enumerated Attributes

Examples of tax attributes not specifically listed which logically should be inherited by the bankruptcy estate include

(1) percentage depletion carryovers, n41 (2) investment interest carryovers, n42 and (3) carryovers of unused *I.R.C. section 179* expense amounts. n43 To the extent the non-enumerated tax attributes are not available to the bankruptcy estate, the result may be to increase the taxes payable by the estate, thereby depleting funds otherwise available for distribution to unsecured creditors. The unavailability of these attributes may also increase the likelihood of creditors requesting the trustee or debtor in possession to abandon assets of the bankruptcy estate with built-in tax liabilities. n44

[iii] Retroactive or Prospective Application of Income Tax Regulations When Promulgated

Income tax regulations promulgated pursuant to *I.R.C. section 1398(g)(8)* constitute legislative regulations, as opposed to interpretive regulations. n45 Legislative regulations are generally given retroactive effect, unless otherwise provided. n46 However, the regulations adding passive activity losses and at risk losses provide for prospective effective dates. n47

[iv] Arguments That Non-Enumerated Attributes Should Pass to the Bankruptcy Estate, Notwithstanding Absence of Regulations

Under the Tax Law. The statutory language of *I.R.C. section 1398(g)* provides that other tax attributes of the debtor will pass to the bankruptcy estate "to the extent provided in regulations prescribed by the Secretary as necessary or appropriate to carry out the purposes of this section." In some cases, courts have found statutes to be self-executing even though the Secretary has not promulgated regulations as called for by the statute. n48 However, several courts held that a reading of *I.R.C. section 1398(g)* compels the conclusion that nonenumerated attributes are not property of the bankruptcy estate. n49

From 1980 forward, the only regulations promulgated under *I.R.C. section 1398(g)* were those designating passive activity losses and credits and suspended at risk losses as attributes passing to chapter 7 or chapter 11 estates. n50 No other regulations have been promulgated even though the Committee Reports clearly anticipated that regulations would be issued, for example, to allow the bankruptcy estate the benefit of *I.R.C. section 1341* (relative to the repayment of amounts previously included in income under a claim of right). n51

Since Congress has delegated to the Secretary the task of promulgating regulations on a more regular basis in recent years, the issue of what to do in the absence of the promulgation of regulations has become more significant. The Tax Court decisions in *Alexander* n52 and *Traylor* n53 illustrate the compliance uncertainties that surface when the Treasury Department fails to issue regulations in a timely manner even though directed by Congress to do so. In *Alexander*, the Tax Court adopted a literal interpretation of *I.R.C. section 465(c)(3)(D)*, which provided that another subsection would apply "only to the extent provided in regulations" and held that in the absence of regulations the other subsection would not apply. This conclusion resulted in a decision in favor of the taxpayer. In contrast, *Traylor* dealt with the application of *I.R.C. section 108(e)(4)*. Despite the absence of regulations being promulgated pursuant to *I.R.C. section 108(e)(4)*, which includes the "to the extent provided in regulations" language, the Tax Court made a favorable determination for the IRS and found that the related party rules should apply even in the absence of regulations. Although the decisions in *Alexander* and *Traylor* appear contradictory, the phrase "only to the extent provided in regulations" in *Alexander* contains the modifier "only," while the phrase "to the extent provided in regulations" in *Traylor* does not. Thus, *Traylor* could stand for the proposition that a statute is self-executing without implementing regulations if a plain reading of the statute enables a taxpayer to determine the tax consequences of a transaction. n54 Applying and extending this rationale to the question of whether nonenumerated attributes pass to the bankruptcy estate, one could argue that certain nonenumerated attributes, such as passive activity losses (for years or situations not covered by the recently finalized regulations) or investment interest carryovers, n55 are so much like the enumerated attributes, that the statute should be construed to include such attributes, or, at least, as not precluding the passage of such attributes, "if necessary or appropriate to carry out the purposes of this section." n56

In the case of passive activity loss carryovers, one could also argue that this attribute had not been defined at the time

I.R.C. section 1398 was enacted in 1980 and, in fact, Congress merely carved out a portion of net operating losses and redefined such portion as a passive activity loss. n57 The argument is that such attribute is so akin to a net operating loss that it should be treated as such insofar as becoming an attribute of the bankruptcy estate under *I.R.C. section 1398*. Notwithstanding the finalization of the regulations addressing passive activity losses, n58 there may still be instances in which this argument has validity as when individual debtors do not consent to the retroactive application of the regulation for bankruptcy cases commenced before November 9, 1992.

Under the Bankruptcy Law. The Bankruptcy Code provides that the bankruptcy estate includes "all legal and equitable interests of the debtor in property." n59 At least two courts have found that property of the bankruptcy estate includes the net operating losses of the debtor. n60 Accordingly, it would not seem out of the question for a bankruptcy court to find that other tax attributes of the debtor, such as investment interest carryovers should likewise constitute property of the estate under *section 541 of the Bankruptcy Code*.

[3] Determination of Gross Income

Gross income of the bankruptcy estate includes all gross income of the debtor which the bankruptcy estate is entitled to receive pursuant to the Bankruptcy Code and all income received by the bankruptcy estate following the commencement of the case. For example, wages earned by a cash basis debtor prior to the commencement of a case, but not received until after the commencement, would be deemed gross income of the bankruptcy estate.

[4] Determination of Taxable Income

[a] In General

Generally, taxable income of the bankruptcy estate is computed in the same manner as in the case of an individual. n61 Gross income is reduced by expenses paid or accrued by the bankruptcy estate that are properly deductible. n62 Such expenses are deductible to the same extent as they would have been had they been incurred by the individual debtor carrying on the same trade, business or income-generating activity as engaged in before the commencement of the case. n63 Further, the taxable income may be reduced by certain tax attributes that the bankruptcy estate inherited from the individual debtor. In contrast, the individual debtor cannot claim deductions for items paid by bankruptcy estate. n63a

[b] Income or Loss Attributable to Interests in Pass-Through Entities

In chapter 7 or chapter 11 cases in which the debtor owns a partnership interest or stock in an "S" corporation, a determination must be made as to who is taxable on the distributable income for the period prior to the filing of the petition. Upon the commencement of a case, a debtor's interest in a partnership or "S" corporation becomes an asset of the bankruptcy estate. n64 Clearly, the income or loss attributable to such interest, while an asset of the bankruptcy estate, should be reflected on the tax return for the bankruptcy estate. However, it is less clear what should happen to the income or loss attributable to the period from the beginning of the entity's taxable year to the date the debtor files a chapter 7 or 11 case.

As a general rule, if a partner sells, exchanges or liquidates the entire interest in a partnership, the partnership's taxable year with respect to that partner closes. n65 Similar results follow when an "S" corporation stockholder sells shares of stock. n66 Although the debtor is treated as conveying his or her entire partnership interest or shares of "S" corporation stock to the bankruptcy estate as of the commencement of the case, *I.R.C. section 1398(f)(1)* provides that such conveyance is not treated as a disposition for purposes of any other I.R.C. provision. It appears that *I.R.C. section 1398(f)(1)* overrides the "varying interests" rule embodied in *I.R.C. section 706(d)*, thereby causing the entire year's income or loss to be taxable to whoever is the partner or shareholder at the end of the year, presumably the bankruptcy estate. Indeed, there are two recent Tax Court decisions concluding that where the bankruptcy estate holds the partnership interest or S corporation shares at the end of the year; it is entitled to the loss for the entire year. n67

Under the Taxpayer Relief Act of 1997 ("TRA97"),ⁿ⁶⁸ the law was changed to provide that the tax year of a partnership closes with respect to a partner whose entire interest is terminated by death, liquidation or otherwise.ⁿ⁶⁹ However, the Conference Committee report provides that this provision does not change present law with respect to the effect on the partnership taxable year of a transfer by a debtor partner to the debtor's estate.ⁿ⁷⁰

[c] Administrative Expenses

The Internal Revenue Code appears to be liberal in its allowance of administrative expenses as deductible items to the bankruptcy estate. Any administrative expense allowed under *section 503 of the Bankruptcy Code* and any fee or charge incurred under Chapter 123 of title 28 of the United States Code, is a deductible expense unless disallowed under some other provision of the I.R.C.ⁿ⁷¹ Thus, expenses such as attorneys' and other professional fees incurred during the case would be a deductible administrative expense even though they might not constitute expenses incurred in carrying on a trade or business. However, the expenses would not be deductible if they constituted capital expenditures or their deductibility was specifically prohibited by another section of the I.R.C.ⁿ⁷² It appears that legal and professional expenses incurred in an individual chapter 7 or chapter 11 case are more likely to be deductible than similar expenses incurred in a corporate chapter 11 case. This may be because it is more difficult to find an appropriate entity or capital asset with respect to which such expenses should be associated and capitalized.ⁿ⁷³

Administrative expense carryovers may be carried back to the three preceding taxable years (assuming the bankruptcy estate was in existence) and, thereafter, to the seven succeeding taxable years.ⁿ⁷⁴ The amount of administrative expenses that may be carried over to another taxable year is determined after first giving effect to net operating losses.ⁿ⁷⁵ Also, on termination of the bankruptcy estate, the individual debtor may not receive the benefit of any unused administrative expense deduction.ⁿ⁷⁶ That is, it does not become part of a net operating loss carryover that is passed out to the debtor.ⁿ⁷⁷

[d] Carrybacks

[i] Bankruptcy Estate

If the bankruptcy estate incurs a net operating loss (as compared to a loss incurred by the debtor to which the estate succeeded), the estate can carry back such net operating loss to prior taxable years of the bankruptcy estate and to prebankruptcy taxable years of the individual debtor.ⁿ⁷⁸ Similarly, the bankruptcy estate may carry back excess credits, such as investment tax credits or foreign tax credits, to prior taxable years of the estate and to prebankruptcy taxable years of the debtor.ⁿ⁷⁹

[ii] Individual Debtor

In contrast, the individual debtor may not carry back any net operating loss carryover or tax credit carryover from a taxable year ending after the commencement of the case to any prepetition taxable year.ⁿ⁸⁰ The policy reason for the denial of the carryback to the debtor is based on the notion that any tax benefit gained pursuant to a carryback of either net operating losses or tax credits should belong to the bankruptcy estate for the benefit of the creditors.ⁿ⁸¹

In a recent case,ⁿ⁸² the Tax Court concluded that an individual was entitled to carry back losses to which he succeeded upon termination of his bankruptcy estate. In fact, the court allowed the individual taxpayer to carry back the losses to each individual tax year ending after the commencement of his bankruptcy case. Moreover, the losses to which he succeeded included both losses that had passed to his bankruptcy estate upon his filing of the bankruptcy proceeding, as well as to additional losses generated by the bankruptcy estate.

On a related issue, the Court of Appeals for the Eighth Circuit considered whether a trustee could avoid elections made by a debtor to forego the carryback of net operating loss carryovers on prepetition tax returns.ⁿ⁸³ The debtor had filed 1982 and 1983 returns making the irrevocable election to forego the carryback of net operating loss carryovers to earlier

years under the authority of *I.R.C. section 172(b)(3)*. The court held such elections could be set aside if they constituted fraudulent conveyances. If the loss was carried back, the estate could have received tax refunds in excess of \$1,200,000.

[e] Termination of Bankruptcy Estate

Upon the termination of the bankruptcy estate, the debtor succeeds to the same tax attributes as were passed to the estate upon the creation of the bankruptcy estate. n84 Of course, in most cases the attributes will have been consumed or depleted by the operating activities of the bankruptcy estate or the reductions required to account for the receipt of debt forgiveness income. n85 Accordingly, any net operating loss carryovers that a debtor succeeds to at the close of the bankruptcy case must be reduced by the amount of debt discharge income realized under section 108(a)(1). n86

In the event the individual debtor dies before the estate is terminated, the Internal Revenue Service takes the position that the debtor's surviving spouse may not take advantage of any unused NOL carryovers to which the debtor would have succeeded to under section 1398(i) if the debtor had lived. n87 However, in a recent case, the Tax Court held that the loss that would have passed to a bankrupt individual if he had not died before his bankruptcy case was confirmed could in fact be utilized on the last joint return filed by the individual and his spouse. n88

FOOTNOTES:

(n1)Footnote 1. *I.R.C. § 1398(f)*; H.R. Rep. No. 833, 96th Cong., 2d Sess. 26 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 1035, 96th Cong., 2d Sess. 31 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised); 126 Cong. Rec. H 12,463 (daily ed. Dec. 13, 1980) (statement of Rep. Ullman), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(iii) (Matthew Bender 15th Ed. Revised); 126 Cong. Rec. S 16,492 (daily ed. Dec. 13, 1980) (statement of Sen. Long), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(iii) (Matthew Bender 15th Ed. Revised).

(n2)Footnote 2. *I.R.C. §§ 708(b)(1)(B) and 1398(f)*; H.R. Rep. No. 833, 96th Cong., 2d Sess. 26 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 1035, 96th Cong., 2d Sess. 31 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised); 126 Cong. Rec. H 12,463 (daily ed. Dec. 13, 1980) (statement of Rep. Ullman), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(iii) (Matthew Bender 15th Ed. Revised); 126 Cong. Rec. S 16,492 (daily ed. Dec. 13, 1980) (statement of Sen. Long), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(iii) (Matthew Bender 15th Ed. Revised).

(n3)Footnote 3. *See P TX2.06[3] infra.*

(n4)Footnote 4. *I.R.C. § 1398(f)*; H.R. Rep. No. 833, 96th Cong., 2d Sess. 26 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 1035, 96th Cong., 2d Sess. 31 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n5)Footnote 5. *See P TX2.05[1] infra.*

(n6)Footnote 6. *I.R.C. § 1398(g)(6)*; *See Johnson v. Commissioner, T.C. Memo 2004-37, 87 T.C.M. 971 (2004)* (bankruptcy estate succeeded to debtor's tax basis in debt that became worthless, thus, estate was entitled to the loss); H.R. Rep. No. 833, 96th Cong., 2d Sess. 23 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 1035, 96th Cong., 2d Sess. 28 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b) (Matthew Bender 15th Ed. Revised). In *Reed v. United States*, 2006 U.S. Dist. LEXIS 25040 ; 2006-1 U.S. Tax Cas. (CCH) P 50,344 ; 97 A.F.T.R. 2d 2348 (N.D.TX, 2006) *aff'd* 2007 U.S. App. LEXIS 13115 , 99 A.F.T.R. (RIA) 3447 (5th Cir. Tex 2007) the District Court affirmed the decision of the bankruptcy court that the losses incurred from the sale of certain real property of the debtor should be capital not ordinary. The Court concluded that even though it was a chapter 7 liquidation, that was not a business; rather the sales were not in the ordinary course of the

debtor's prepetition business of transporting medical expenses.

(n7)Footnote 7. *I.R.C. § 1398(g)*; H.R. Rep. No. 833, 96th Cong., 2d Sess. 23 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 1035, 96th Cong., 2d Sess. 28 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n8)Footnote 8. *See* G. Newton & G. Bloom, *Bankruptcy & Insolvency Taxation*, § 2.5 at 33 (John Wiley & Sons 1991).

(n9)Footnote 9. *See* P TX2.05[1] *infra*.

(n10)Footnote 10. Under *I.R.C. § 168*, in some situations a taxpayer may not be entitled to claim depreciation in the year of sale.

(n11)Footnote 11. Prior to its amendment, § 121 allowed married taxpayers who were 55 years of age or older to exclude up to \$250,000 of gain upon sale of a personal residence assuming certain other requirements were met. After amendment, the exclusion was increased to up to \$500,000 and the age threshold requirement was eliminated.

(n12)Footnote 12. *In re Mehr*, 153 B.R. 430 (Bankr. D.N.J. 1993) and *In re Barden*, 205 B.R. 451 (Bankr. E.D.N.Y. 1996), *aff'd*, 105 F.3d 821 (2d Cir. 1997).

(n13)Footnote 13. *See* Pettigrew v. United States (*In re Curran*), 99-2 U.S.T.C. (CCH) P 50742 (1999); *In re Curran*, 222 B.R. 313 (Bankr. N.D. Ga. 1999); *Johnson v. IRS (In re Williams)*, 235 B.R. 795 (Bankr. D. Md. 1999); *In re St. Francis*, 232 B.R. 518 (Bankr. N.D. Ga. 1999); *In re Didario*, 41 C.B.C.2d 1510, 232 B.R. 311 (Bankr. D. N.J. 1999); *In re Munster*, 226 B.R. 632 (Bankr. E.D. Mo. 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 Popa*, 218 B.R. 420 (Bankr. N.D. Ill. 1998), *aff'd*, 42 C.B.C.2d 422, 238 B.R. 395 (N.D. Ill. 1999); *but see In re Winch*, 226 B.R. 591 (Bankr. S.D. Ohio 1998), in which the court concluded that the analysis in *Wehr* remains applicable to the current version of the statute.

(n14)Footnote 14. In AOD IPRO P 51, 232, announces acquiescence to *Internal Revenue Service v. Waldschmidt (In re Bradley)*, 245 B.R. 533 (M.D. Tenn. 1999).

(n15)Footnote 15. Chief Counsel Notice N(35)000-162. After reciting the case law, the notice states: "In the Service's view, Sections 1398(c)(1), (f)(1), and (g)(6), when read together, support the bankruptcy estate's claim to the Section 121 exclusion."

(n16)Footnote 16. *See* Treas. Reg. § 1.138-3, T.D. 9030.

(n17)Footnote 17. I.R.B. 2000-44, 447 (October 30, 2000).

(n18)Footnote 18. *I.R.C. § 1398(g)(1)*. Note that *I.R.C. § 172* was amended by the Taxpayer Relief Act of 1997 to provide that net operating losses may only be carried back two years (it was formerly three).

(n19)Footnote 19. *I.R.C. § 1398(g)(5)*.

Note, however, that a bad debt loss under Section 166 is not equivalent to a net operating loss carryover--or a method of accounting of the debtor--and has been held not to be an attribute that passes to the bankruptcy estate pursuant to Section 1398(g). *See* Chamberlin v. Commissioner, T.C. Memo, 2000-50, 79 TCM (CCH) 1498 (2000); *aff'd*, 88 A.F.T.R. 2d 2001-5151 (2d Cir. 2001), *cert. denied*, 534 U.S. 1163, 122 S. Ct. 1174, 152 L. Ed. 2d 118 (2002).

(n20)Footnote 20. *I.R.C. § 1398(g)(4)*.

(n21)Footnote 21. *I.R.C. § 1398(g)(2)*.

(n22)Footnote 22. *I.R.C. § 1398(g)(3)*. Prior to amendment by Pub. L. No. 99-514 (1986), *I.R.C. § 1398(g)(3)* provided an exclusion for the recovery of certain tax benefit items such as bad debts, prior taxes and delinquent amounts.

(n23)Footnote 23. *Treas. Reg. § 1.111-1(a)*.

(n24)Footnote 24. *I.R.C. § 1398(g)(7)*.

(n25)Footnote 25. Individuals are always on the cash method unless they are engaged in a trade or business where the accrual (or some method other than cash) method of accounting is required.

(n26)Footnote 26. *I.R.C. § 173(a)*; *Treas. Reg. § 1.173-1(a)*.

(n27)Footnote 27. *I.R.C. § 174(a)*; *Treas. Reg. § 1.174-3*.

(n28)Footnote 28. *I.R.C. § 175(a)*; *Treas. Reg. § 1.175-1*.

(n29)Footnote 29. Nothing in *I.R.C. § 1398* requires the bankruptcy estate to use the individual's accounting period. Also, the legislative history of *11 U.S.C. § 346(b)(3)*, dealing with the state tax aspects of an individual bankruptcy, clearly provides that the bankruptcy estate must use the same accounting method but not accounting period. S. Rep. No. 989, 95th Cong., 2d Sess. 45 (1978), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(e) (Matthew Bender 15th Ed. Revised).

(n30)Footnote 30. *Treas. Reg. § 1.441(c)* (1987).

(n31)Footnote 31. *Treas. Reg. § 1.441-1T(b)(4)* (1987).

(n32)Footnote 32. *Treas. Reg. § 1.441-1T(b)(2)* (note parenthetical phrase).

(n33)Footnote 33. *I.R.C. § 1398(j)(1)*.

(n34)Footnote 34. H.R. Rep. No. 833, 96th Cong., 2d Sess. 25 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 1035, 96th Cong., 2d Sess. 30 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised). There may be other situations where this provision would be helpful. For example, if discharge of indebtedness income has already been triggered which would eliminate net operating loss carryovers, it may be advantageous to terminate the year as of the month ending before the discharge income is generated. This will allow the utilization of the net operating loss carryovers against all *I.R.C. § 1001* gains or other income realized during the prior year. This technique avoids addressing the question as to whether a net operating loss generated during the year cancellation of indebtedness income is recognized may be carried back to a prior year before attribute reduction occurs.

(n35)Footnote 35. *Treas. Reg. § 1.1398-1(c)*, *57 Fed. Reg. 53300* (1992) .

(n36)Footnote 36. *Treas. Reg. § 1.1398-1(b)(2)(3)*, *57 Fed. Reg. 53300* (1992) .

(n37)Footnote 36a. This was the conclusion of the *United States Tax Court in Benton v. Comm'r, T.C. Memo 2006-198, 2006 Tax Ct Memo LEXIS 200, 92 TC.M. (CCH) 280 (T.C. 2006)* . In this case one Oren Benton filed a Chapter 11 proceeding on February 23, 1995. He made the *§ 1398(d)(2)(D)* election to close his 1995 tax year. He filed his individual tax returns for the balance of the 1995 year and for 1996 and 1997. When he filed Chapter 11 his bankruptcy estate inherited his tax attributes, including some \$50 million in NOLS and \$84 million in suspended passive actively losses. In 1997 a settlement agreement was entered into by and between Benton the individual, Benton's wife, Benton as debtor in possession and the Internal Revenue Service. Pursuant to this settlement agreement it was agreed that Benton would not be allowed the use of any net operating losses arising in any taxable period on or

before the bankruptcy filing date. In 1997 a Chapter 11 plan was confirmed whereby various assets were transferred into a liquidating trust. Because there was a complete disposition of the passive activity the \$84 million of suspended passive activity losses now became net operating losses which passed out to Benton pursuant to § 1398 (i). Benton then filed amended returns for his individual 1995-97 years attempting to carry back some portion of this \$84 million NOL to these years. This action would be permitted under § 1398 (j) but the Internal Revenue Service argued such action was precluded by the settlement agreement. The Tax Court concluded that the \$84 million of suspended passive activity losses inherited by the bankruptcy estate were not NOLS inherited by the bankruptcy estate but rather NOLS generated by the bankruptcy estate. Thus, their use by Benton was not precluded by the settlement agreement.

(n38)Footnote 36b. *See infra* P Tx2.04 [d.3] and [e].

(n39)Footnote 37. *Treas. Reg. § 1.1398-2(c)*, 57 *Fed. Reg.* 53300 (1992) .

(n40)Footnote 38. *Treas. Reg. § 1.1398-2(b)(2)*, 57 *Fed. Reg.* 53300 (1992) .

(n41)Footnote 39. *I.R.C. § 1398(g)(8)* provides:

(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.

(n42)Footnote 40. *See In re Rueter*, 158 B.R. 163 (N.D. Cal. 1993) (nonenumerated tax attributes do not pass to bankruptcy estate); *In re Mehr*, 153 B.R. 430 (Bankr. D.N.J. 1993) (one-time exclusion of gain from sale of principal residence under *I.R.C. § 121* is not available to bankruptcy estate of individual who would be eligible therefore); *but see* change in the Internal Revenue Service position as described in footnotes 9d-9g leading to the issuance of proposed regulations allowing the bankruptcy estate the benefit of the Section 121 exclusion. *In re Antonelli*, 150 B.R. 364 (Bankr. D. Md. 1992) (§ 1398's list of tax attributes is an exhaustive one). For the conclusion that a Section 166 deduction of an individual debtor does not pass to the bankruptcy estate, *see Chamberlin v. Commissioner*, 79 T.C.M. (CCH) 1498, T.C. Memo 2000-50 (2000) , *aff'd*, 88 A.F.T.R. 2d 5151 (2d Cir. 2001) , *cert. denied* 534 U.S. 1163, 122 S. Ct. 1174, 152 L. Ed. 2d 118 (2002) . For the conclusion that debtor's right to a deduction under the claim of right doctrine in *I.R.C. § 1341* did not pass to the bankruptcy estate, *see Cooper v. United States*, 86 A.F.T.R. 2d 2000-5374 (W.D.N.C. 2000) and 88 A.F.T.R. 2d 2001-7190 (W.D.N.C. 2001) (where the district court adopted part of the magistrate's recommendation and rejected part and the court agreed that while § 1398(g) did not include § 1341 claims, such claims might have been transferred to the trustee independently). *But see Cooper v. United States*, 362 F. Supp. 2d 649, 59 C.B.C.2d 184 (2005) , where the court reverses this position, starting, "On May 24, 2004, this Court entered a Order asserting that bankruptcy trustees do have standing to assert entitlement to claim of right refunds on behalf of debtors and for the benefit of the estate creditors under Internal Revenue Code (I.R.C.) § 1341, regardless of § 1341's absence from *I.R.C. § 1398*, which lists the tax attributes to which a bankruptcy estate succeeds." What is even more significant about the *Langdon Cooper* decision is the conclusion by the bankruptcy court that the debtor would have been unable to utilize § 1341 because of his prior fraudulent acts but since the bankruptcy trustee and not the debtor was the plaintiff, the purpose of § 1341, an equitable relief provision, was served by allowing a tax refund. Thus, the victims of the fraud, the creditors would receive a distribution.

(n43)Footnote 41. *I.R.C. § 613A(d)*.

(n44)Footnote 42. *I.R.C. § 163(d)(2)*.

(n45)Footnote 43. *I.R.C. § 179*.

(n46)Footnote 44. 11 U.S.C § 554(b).

(n47)Footnote 45. M. Rogovin, *The Four R's: Regulations, Ruling, Reliance & Retroactivity--A View From Within*, 43 *Taxes* 756 (1965).

(n48)Footnote 46. *I.R.C. § 7805(b)*. See also *Helvering v. Reynolds*, 41 B.T.A. 59 (1940) , *aff'd*, 114 F.2d 804 (4th Cir. 1940) , *rev'd*, 313 U.S. 428, 61 S. Ct. 971, 85 L. Ed. 1438 (1941) ; *Manhattan Gen. Equip. Co. v. Commissioner*, 29 B.T.A. 395 (1933) , *aff'd*, 76 F.2d 892 (2d Cir. 1935) , *aff'd*, 297 U.S. 129, 56 S. Ct. 397, 80 L. Ed. 528 (1936) .

(n49)Footnote 47. *Treas. Regs. §§ 1.1398-1 and 1.1398-2*, 57 *Fed. Reg.* 53300 (1992) .

(n50)Footnote 48. See *Occidental Petroleum Corp. v. Commissioner*, 82 T.C. 819, 829 (1984) (the alternative minimum tax provisions of *I.R.C. § 58* were found to be effective even though no regulations had been promulgated). See also *First Chicago Corp v. Commissioner*, 88 T.C. 663, 669, 676-677 (1987) , *aff'd*, 842 F.2d 180 (7th Cir. 1988) .

(n51)Footnote 49. See *In re Rueter*, 158 B.R. 163 (N.D. Cal. 1993) (nonenumerated tax attributes do not pass to bankruptcy estate); *In re Mehr*, 153 B.R. 430 (Bankr. D.N.J. 1993) (holding that one-time exclusion of gain from sale of principal residence under *I.R.C. § 121* is not available to bankruptcy estate of individual who would be eligible therefor); *but see* recent cases at n.9c *supra* holding that *I.R.C. § 121* is available to the bankruptcy estate. See also *In re Bakersfield Westar, Inc.*, 40 C.B.C2d 1439, 226 B.R. 227 (B.A.P. 9th Cir. 1998) (the trustee sought to avoid the revocation of a Subchapter S election as a fraudulent transfer under section 548. The court found that the right to revoke a Subchapter S election was a property right and the issue of revocation in a Subchapter S election, a property interest. The court relied on *In re Russell*, 927 F.2d 413 (8th Cir. 1991) , which held that a net operating loss election was a property interest. The court also found no distinction between an NOL election and a Subchapter S election and concluded that the Subchapter S election and its revocation were property interests. The IRS position that there is no basis to permit avoidance or revocation of the election was rejected.) *In re Antonelli*, 150 B.R. 364 (Bankr. D. Md. 1992) (holding that § 1398's list of tax attributes is an exhaustive one).

(n52)Footnote 50. *Treas. Regs. §§ 1.1398-1(f) and 1.1398-2(f)*, 57 *Fed. Reg.* 53300 (1992) , provide that the regulations are to be effective for cases commencing on or after November 9, 1992. For cases commenced before November 9, 1992, the rules apply only if a joint election is made by the debtor and the bankruptcy estate. *Treas. Regs. §§ 1.1398-1(f)(2) and 1.1398-2(f)(2)*, 57 *Fed. Reg.* 53300 (1992) . In a chapter 7 case, the election is made by obtaining the written consent of the bankruptcy trustee and filing a copy of the written consent with the returns of the debtor and the estate for their first taxable years ending after November 9, 1992. In a chapter 11 case, the election is made by incorporating the election into a chapter 11 plan that is confirmed by the bankruptcy court or into an order of such court and filing it with the returns of the debtor and the estate for the first taxable years ending after November 9, 1992.

(n53)Footnote 51. H.R. Rep. No. 833, 96th Cong., 2d Sess. 24 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised).

(n54)Footnote 52. *Alexander v. Commissioner*, 59 T.C.M. (CCH) 121 (1990) , *aff'd on rehearing*, 95 T.C. 467 (1990) , *aff'd*, 959 F.2d 970 (11th Cir. 1992) .

(n55)Footnote 53. *Traylor v. Commissioner*, 59 T.C.M. (CCH) 93 (1990) .

(n56)Footnote 54. M. Rogovin, *The Four R's: Regulations, Ruling, Reliance and Retroactivity--A View From Within*, 43 *Taxes* 756 (1965).

(n57)Footnote 55. *Treas. Regs. §§ 1.1398-1(f) and 1.1398-2(f)*, 57 *Fed. Reg.* 53300 (1992) , provide that the regulations are to be effective for cases commencing on or after November 9, 1992. For cases commenced before November 9, 1992, the rules apply only if a joint election is made by the debtor and the bankruptcy estate. *Treas. Regs. §§ 1.1398-1(f)(2) and 1.1398-2(f)(2)*, 57 *Fed. Reg.* 53300 (1992) . In a chapter 7 case, the election is made by obtaining the written consent of the bankruptcy trustee and filing a copy of the written consent with the returns of the debtor and the estate for their first taxable years ending after November 9, 1992. In a chapter 11 case, the election is made by incorporating the election into a chapter 11 plan that is confirmed by the bankruptcy court or into an order of such court and filing it with the returns of the debtor and the estate for the first taxable years ending after November 9, 1992.

(n58)Footnote 56. *See I.R.C. § 1398(g).*

(n59)Footnote 57. For example, prior to the enactment of the passive activity loss rules in *I.R.C. § 469*, a real estate developer might have had a \$100,000 loss from a particular real estate project that, when added to his other losses, gave him a \$1,000,000 net operating loss carryover. In this situation, the impact of *I.R.C. § 469* is simply to leave this taxpayer with a \$900,000 net operating loss carryover and a \$100,000 suspended passive activity loss.

(n60)Footnote 58. *Treas. Reg. § 1.1398-1; Treas. Reg. § 1.1398-2.*

(n61)Footnote 59. *11 U.S.C. § 541(a).*

(n62)Footnote 60. *See In re Prudential Lines, Inc.*, 22 C.B.C.2d 436, 114 B.R. 27 (Bankr. S.D.N.Y. 1989), *aff'd*, 119 B.R. 430 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 565, 24 C.B.C.2d 1503 (2d Cir.), *cert. denied*, 502 U.S. 821, 112 S. Ct. 82, 116 L. Ed. 2d 55 (1991) (the net operating losses were property and attempts or actions of a third party could be enjoined so as to protect that property); *In re Russell*, 91-1 U.S.T.C. P 50128 (8th Cir. 1991) (the net operating loss of an individual debtor which could have been carried back to obtain a tax refund was property subject to the fraudulent conveyance rules).

In *In re Feiler*, 218 B.R. 957 (Bankr. N.D. Calif. 1998), *aff'd*, 218 F.3d 948, 44 C.B.C.2d 702 (9th Cir. 2000), under facts similar to *Russell*, the individual debtor's election to forego carryback of losses was subject to attack as a fraudulent conveyance. *See also In re Taylor*, 386 B.R. 361, 2008 Bankr. LEXIS 1127 (Bankr. S.D. Fla. 2008) *affirmed by United States v. Kapila*, 2008 U.S. Dist. LEXIS 107680 (S.D. Fla. Aug. 18, 2008). In *Trans-Lines West, Inc.*, 203 B.R. 653 (Bankr. E.D. Tenn. 1996), the court held that a debtor's revocation of its Subchapter S status shortly before filing bankruptcy could be set aside as a fraudulent conveyance. *See also In re Bakersfield Westar*, 40 C.B.C.2d 1439, 226 B.R. 227 (B.A.P. 9th Cir. 1998). In *In re Bakersfield Westar, Inc.*, the trustee sought to avoid the revocation of a Subchapter S election as a fraudulent transfer under section 548. The court found that the right to revoke a Subchapter S election was a property right and the issue of revocation in a Subchapter S election, a property interest. The court relied on *In re Russell*, 927 F.2d 413 (8th Cir. 1991), which held that a net operating loss election was a property interest. The court also found no distinction between an NOL election and a Subchapter S election and concluded that the Subchapter S election and its revocation were property interests. The IRS position that there is no basis to permit avoidance or revocation of the election was rejected.

(n63)Footnote 61. H.R. Rep. No. 833, 96th Cong., 2d Sess. 23 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 1035, 96th Cong., 2d Sess. 28 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n64)Footnote 62. H.R. Rep. No. 833, 96th Cong., 2d Sess. 23 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 1035, 96th Cong., 2d Sess. 28 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

In *Priv. Ltr. Rul. 200127022 (April 4, 2001)*, the Internal Revenue Service held that the bankruptcy estate of a doctor was entitled to Section 162 deductions for amounts the bankruptcy estate was required to pay pursuant to a breach of non-competition agreements arbitration award against the doctor.

(n65)Footnote 63. *I.R.C. § 1398(e)(3)*; H.R. Rep. No. 833, 96th Cong., 2d Sess. 24 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 1035, 96th Cong., 2d Sess. 28, 29 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n66)Footnote 63a. In *In re Waters*, 2008 Bankr. LEXIS 374 (Bankr. D. Conn. 2008), the debtor was unsuccessful in his attempt to claim tax deductions for items of interest and taxes paid for with proceeds from the sale of bankruptcy estate assets.

(n67)Footnote 64. 11 U.S.C. § 541(a)(1).

(n68)Footnote 65. I.R.C. § 706(c)(2)(A); *Treas. Reg. § 1.706-1(c)(2)(i)*. In contrast, however, I.R.C. § 706(d)(1) provides that if there is a change in any partner's interest during the partnership taxable year, each partner's distributive share of income or loss should be determined by a method prescribed by regulations, taking into account the "varying interests" of the partners during the partnership taxable year. Generally, the allocable distributive share of income or loss may be determined using either of two methods. Under the first method, the interim closing of the books method, the partnership would close its books on the date of the transfer of the partnership interest and the transferor partner's distributive share would reflect only those items of income and loss arising before the transfer. Under the proration method, the transferor partner would be allocated a *pro rata* portion of the income or loss that the transferor partner would have been allocated for the entire year had he or she remained a partner.

(n69)Footnote 66. I.R.C. § 1377(a).

(n70)Footnote 67. In *Williams v. Commissioner*, 123 T.C. 144 (2004), the Tax Court held that an individual who owned an S corporation and who filed for bankruptcy in December was not entitled to any of the losses sustained by the corporation. Rather, the bankruptcy estate was entitled to the entire loss for the year, because income or loss is determined as of the last day of the year and the bankruptcy estate was the shareholder on that date. In *Gulley v. Commissioner*, 79 T.C.M. 2171, T.C. Memo 2000-190 (2000), the Tax Court considered whether a petitioner, who was a general partner of a partnership, or his bankruptcy estate, should be entitled to claim the tax loss from the partnership for the year of the bankruptcy filing. The court rejected the petitioner's arguments that (1) the partnership terminated when the petitioner filed bankruptcy, when it carried on no business, or had no assets after the foreclosure of its real estate property; and (2) the partnership's taxable year as to the petitioner closed under section 706(c)(2)(A) upon the filing of bankruptcy by the petitioner. Rather, the court concluded that the partnership losses for the entire taxable year were allocated to the bankruptcy estate since it held the partnership interest as of the last day of the taxable year. See also *Katz v. Commissioner*, 335 F.3d 1121, 2003 U.S. App. LEXIS 13584 (10th Cir. 2003), reversing and remanding the Tax Court decision, 116 T.C. 5 (2001), which concluded that the determination of the amount of partnership loss allowable to the bankruptcy estate and the debtor required a partnership level proceeding. Accordingly, the Tax Court did not have the requisite jurisdiction. This has been the position of the Internal Revenue Service. See *IRS CCA 200217008*, 2001 IRS CCA LEXIS 274.

The Tax Simplification Bill of 1991 would have amended I.R.C. § 706(c)(2) to provide that, effective for partnership taxable years beginning after December 31, 1991, a partnership's taxable year would close if the partner's entire interest in the partnership terminated, whether by reason of death, liquidation or otherwise. It had been suggested that Congressional, tax-writing staffs were considering a proposed change to I.R.C. § 706 to include a case under the Bankruptcy Code. See H.R. Rep. No. 2777, 102d Cong., 1st Sess. 99 (1991); S. 1394, 102d Cong., 1st Sess. 443 (1991). See also *Congress May Act to Close Partnerships' Taxable Years When a Partner Files for Bankruptcy*, 32 Tax Mgmt. Memo 26, 405 32 Tax Mgmt. Memo 26, 405 (1991). Additionally, some commentators have suggested that the "varying interest" rule should apply when an individual partner commences a case under the Bankruptcy Code. See Rubin, *Tax Planning for the Debtor in Bankruptcy*, 19 J. Real Est. Tax'n 322 (1992). In 1992, the IRS issued *Priv. Ltr. Rul. 9304008* (Oct. 27, 1992) which held that all items of income, gain, loss, deduction or credit of a calendar year partnership were allocable to the bankruptcy estate of an individual partner who filed a petition under chapter 7 or 11 of the Bankruptcy Code during the year.

(n71)Footnote 68. Pub. L. No. 105-34 (1997).

(n72)Footnote 69. TRA97, § 1246(a), amending I.R.C. § 706(C)(2)(A).

(n73)Footnote 70. Conference Committee Report at -.

(n74)Footnote 71. I.R.C. § 1398(h)(1); H.R. Rep. No. 833, 96th Cong., 2d Sess. 24 (1980), reprinted in Vol. E

Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 1035, 96th Cong., 2d Sess. 29 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

In *In re Miller*, 252 B.R. 110 (Bankr. E.D. Texas 2000), the bankruptcy court held that a bankruptcy estate's administrative expenses were not miscellaneous itemized deductions subject to the Section 67 two percent floor. See also IRS CCA 200630016 where the Office of Chief Counsel agreed with the bankruptcy court's *Miller* decision that the exception in I.R.C. § 67(e) applies to bankruptcy estates and even recommends that Internal Revenue Service Publication 908, Bankruptcy Tax Guide, be revised appropriately; see also GLAM 2007-0010 (June 30 2006).

(n75)Footnote 72. For example, the income taxes payable by the estate constitute an administrative expense under 11 U.S.C. § 503. However, they would not be deductible under I.R.C. § 1398(h)(1), because deductibility is prohibited by I.R.C. § 275. Also, the mere allegation that certain expenses, such as refinancing expenses, should be deductible administrative expenses, since they were incurred to preserve the bankruptcy estate, was not sufficient to overcome the obvious capital nature of such expenses. See *In re Carden*, 1998 Bankr. LEXIS 1024, 98-2 U.S. Tax Ct. P50,686 (Bankr. E.D. La. 1998).

(n76)Footnote 73. In PLR 9204001 (May 13, 1991), the IRS held that expenses related to the resolution of mass tort litigation handled as part of a case under the Bankruptcy Code had to be capitalized. These expenses were administrative expenses within the meaning of 11 U.S.C. § 503. See *In re Placid Oil Co.*, 140 B.R. 129 (Bankr. N.D. Tex. 1990), *aff'd*, 148 B.R. 464 (N.D. Tex. 1991), *rev'd and remanded*, 988 F.2d 554 (5th Cir. 1993). The Court of Appeals instructed the bankruptcy court that it "should not bind itself by a sweeping characterization that Placid's bankruptcy proceedings were 'in substance' a 'reorganization,' with the result that all Placid's bankruptcy-related fees and expenses must be capitalized to an intangible asset without amortization." 988 F.2d 554, 559.

(n77)Footnote 74. I.R.C. § 1398(h)(2)(B); H.R. Rep. No. 833, 96th Cong., 2d Sess. 24 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 1035, 96th Cong., 2d Sess. 29 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n78)Footnote 75. I.R.C. § 1398(h)(2)(C); H.R. Rep. No. 833, 96th Cong., 2d Sess. 24 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 1035, 96th Cong., 2d Sess. 29 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n79)Footnote 76. I.R.C. § 1398(h)(2)(D).

(n80)Footnote 77. I.R.C. §§ 1398(i) and 1398(j)(2)(B).

(n81)Footnote 78. I.R.C. §§ 1398(j)(2)(A) and 1398(j)(2)(C)(i); H.R. Rep. No. 833, 96th Cong., 2d Sess. 24, 25 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 1035, 96th Cong., 2d Sess. 29 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n82)Footnote 79. I.R.C. §§ 1398(j)(2)(A) and 1398(j)(2)(C)(i); H.R. Rep. No. 833, 96th Cong., 2d Sess. 24, 25 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 1035, 96th Cong., 2d Sess. 29 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n83)Footnote 80. I.R.C. § 1398(j)(2)(B); H.R. Rep. No. 833, 96th Cong., 2d Sess. 26 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 1035, 96th Cong., 2d Sess. 31 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n84)Footnote 81. H.R. Rep. No. 833, 96th Cong., 2d Sess. 26 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 1035, 96th Cong., 2d Sess. 31 (1980), *reprinted in*

Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised); 126 Cong. Rec. H 12,463 (daily ed. Dec. 13, 1980) (statement of Rep. Ullman), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(iii) (Matthew Bender 15th Ed. Revised); 126 Cong. Rec. S 16,492 (daily ed. Dec. 13, 1980) (statement of Sen. Long), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(iii) (Matthew Bender 15th Ed. Revised).

(n85)Footnote 82. *Benton v. Commissioner*, 122 T.C. 353 (2004) ; motion for summary judgment granted in part, denied in part, *Benton v. Comm'r*; T.C. Memo 2006-198 ; 2006 T.C. Memo LEXIS 200, 92 TCM (CCH) 280 (T.C. 2006)

(n86)Footnote 83. *In re Russell*, 927 F.2d 413, 24 C.B.C.2d 1526 (8th Cir. 1991) , on remand, 154 B.R. 723 (Bankr. W.D. Ark. 1993) (holding that election was not actually fraudulent for avoidance under 11 U.S.C. § 548(a)(1)), *aff'd and rev'd*, 189 B.R. 190 (W.D. Ark. 1994) (remanding for determination of whether election was a fraudulent transfer under 11 U.S.C. § 548(a)). *See also In re Feiler*, 218 B.R. 957 (Bankr. N.D. Calif. 1998) , *aff'd*, 218 F.3d 948, 44 C.B.C.2d 702 (9th Cir. 2000) and *In re Taylor*, 386 B.R. 361 (Bankr. S.D. Fla. 2008) .

(n87)Footnote 84. I.R.C. § 1398(I). In *Benton v. Commissioner*, 122 T.C. 353 (2004) , the court concluded that an individual chapter 11 case or estate "terminated" on the confirmation date of the Plan.

(n88)Footnote 85. Under section 108(b), a taxpayer must reduce certain tax attributes to reflect the receipt of debt forgiveness income. In chapter 7 and 11 proceedings, where the debtor is discharged from the payment of debts, the resulting debt discharge income will typically absorb any unused net operating losses or net operating loss carryovers.

(n89)Footnote 86. *See Firsdon v. U.S.*, 95-1 U.S.T.C. P 50,040 (N.D. Ohio 1994), *aff'd*, 95 F.3d 444 (6th Cir. 1996) , *cert. denied*, 519 U.S. 1115, 117 S. Ct. 957, 136 L.Ed. 2d 843 (1997) . *See also McGuirl v Comm'r*, 77 T.C.M. (CCH) 1289, T.C. Memo 1999-21 (1999) .

(n90)Footnote 87. Priv. Ltr. Rul. 2001-18003 (December 26, 2000).

(n91)Footnote 88. *Lassiter v. Commissioner*, T.C. Memo 2002-025 (2002) .



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Collier on Bankruptcy Taxation

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CHAPTER TX2 Federal Taxation of the Non-Corporate Bankruptcy Estate

15-TX2 Collier on Bankruptcy Taxation P TX2.05

P TX2.05 The I.R.C. section 1398 Short Period Election

[1] In General

The commencement of a case under the Bankruptcy Code does not interrupt the taxable year of the debtor in which the case is commenced. n1 However, the debtor may elect to close his or her taxable year on the day before the "commencement date" and begin a new taxable year on the "commencement date." n2 If a debtor does not choose to close his or her taxable year under *I.R.C. section 1398(d)(2)(A)*, the debtor will file a single tax return for the year in which the case is commenced. The tax return would reflect all activities for the period prior to the commencement and those items impacting the individual for the remaining portion of the taxable year.

Example 4:

John Jones files a chapter 7 petition on June 1. Through May 31 he had a salary income of \$50,000, capital gains of \$20,000 and a Schedule C loss of \$15,000. n3 From June 1 through the balance of the year, he had a salary of \$70,000. If no election is made under *I.R.C. section 1398(d)*, John Jones will file one return for the full calendar year, which will reflect \$120,000 of salary, capital gains of \$20,000 and a Schedule C loss of \$15,000.

If the short year election is made, the debtor will file a return for the period ending the day before the chapter 11 petition was filed and another return for the balance of the taxable year. If the debtor has no assets other than exempt property, as classified by *section 522 of the Bankruptcy Code*, the debtor cannot elect to terminate his taxable year. n4

Example 5:

Same as above, except John Jones elects to terminate his taxable year as of the day before he filed his chapter 7 petition pursuant to *I.R.C. section 1398(d)*. Thus, John Jones will file two tax returns for the year. The first return will be for the period January 1 through May 31 and will reflect the \$50,000 of salary, \$20,000 of capital gains and the Schedule C loss of \$15,000. The second return will cover the period June 1 through December 31 and will reflect only the \$70,000 of salary earned subsequent to the filing of the petition.

[2] Tax Liability for Short Year as a Priority Claim

If the short year election is made, the debtor's liability for the short taxable year constitutes a priority claim against the

bankruptcy estate. n5 The debtor can avail himself or herself of *I.R.C. section 1398(d)(2)* and terminate the taxable year the day before the commencement of the case, creating a prepetition liability for the shortened taxable year that fits squarely under *section 507(a)(8)(A)(iii) of the Bankruptcy Code*. n6 However, the tax liability attributable to the portion of the debtor's tax year ending on the day before the petition date will constitute a claim against the bankruptcy estate *only* if the debtor makes the *I.R.C. section 1398(d)* short period election in a timely fashion. n7

If the short period election is not made, the tax liability for the entire calendar year is collectible directly from the individual debtor. This result stems from the fact that the tax liability cannot be computed and, therefore, technically does not arise until the close of the taxable year and is not due until the time for filing the federal income tax return. n8 Since the "claim" does not arise until after the filing of the petition, it is a postpetition claim and no portion would be collectible from the bankruptcy estate. n9 The tax liability for the full taxable year of the debtor would be determined without regard to the case under the Bankruptcy Code and regardless of the reasons for the debtor's failure to make the short period election. n10 However, if a refund is generated for the year of the bankruptcy filing, it has been held that the refund attributable to the pre-petition period is property of the bankruptcy estate. n11

If the assets in the bankruptcy estate are not sufficient to pay the tax liability for the first short year, the remaining tax liability is not dischargeable and can be collected from the individual debtor. n12 Also, any interest accruing on the tax liability for the first short year is collectible from the individual debtor, even if the assets in the bankruptcy estate are sufficient to pay the tax liability. n13

Example 6:

A, an individual, files a chapter 7 petition on July 1. During the period January 1 through June 30, A has earned \$100,000 and would have a tax liability of \$25,000 if the short period election is made. The bankruptcy schedules for A reflect cash of \$50,000, other nonexempt assets of \$100,000 and unsecured claims of \$500,000. If A makes the *I.R.C. section 1398(d)(2)* short period election, the \$25,000 tax liability will constitute a priority claim and will be payable in full from funds available in the bankruptcy estate. If A does not make the election, his individual tax return for the calendar year will include all income and A will have to pay the total tax liability (presumably \$25,000, plus the tax on income earned for the remainder of the year) for the year from his postpetition earnings.

Example 7:

Same as Example 6, except the bankruptcy schedules for A reflect cash of only \$1,000 and other assets with a value of \$100,000 but subject to secured claims of \$200,000. If the short year election is made, the \$25,000 tax liability, while constituting a priority claim, will be paid only to the extent of \$1,000. The unsatisfied portion would be a nondischargeable tax liability for which A would have personal exposure and responsibility. n14 However, the IRS would be precluded from attempting to collect the unsatisfied deficiency so long as the automatic stay under *section 362 of the Bankruptcy Code* is in force.

Example 8:

Same as Example 6, except A realized a capital loss of \$500,000 from the sale of securities in June. In this case A probably would not want to make the election so that the \$500,000 capital loss would be available to offset future capital gains. A may conclude that he is better off paying \$25,000 in taxes so as to preserve the capital loss for future use.

[3] Significance of Election When Taxpayer Has Net Operating Loss Carryovers

As discussed earlier, when a taxpayer files under chapter 7 or chapter 11, the bankruptcy estate succeeds to certain of the taxpayer's tax attributes, including net operating loss carryovers, that exist as of the first day of the taxable year in which the case under the Bankruptcy Code was commenced. Absent the short period election, this means the bankruptcy estate will succeed to the attributes as they existed on December 31 of the prior year (assuming a calendar year taxpayer). When a taxpayer has generated gains in the portion of the year preceding a filing under the Bankruptcy

Code, failure to make the short period election can produce disastrous results.

Example 9:

D, a developer, was unsuccessful in his efforts to renegotiate the indebtedness on his apartment project and the lender foreclosed in March and thereafter filed suit for a \$1 million deficiency. To prevent the lender from getting a judgment, D commenced a case under the Bankruptcy Code on July 1. When D asked his tax advisor about the tax consequences of the foreclosure he was told not to worry because he had a large net operating loss carryover which would more than offset any gain from the foreclosure. Unfortunately, after the time period for making the short year election had expired, D learned that the foreclosure gain was \$1 million and the \$2 million net operating loss D had at the end of the prior year had passed to his bankruptcy estate and was not available to offset the \$1 million prepetition gain.

If D had made the short period election, the entire net operating loss carryover would have been available to offset the prepetition foreclosure gain. While there may have been some alternative minimum tax liability, the amount would have been nominal and would have been a priority claim against the bankruptcy estate.

Another advantage of the short period election is to make sure that the deduction for depreciation is available in computing the tax liability for the short year. Absent the election, it appears that the depreciation deduction for assets on hand on the first day of the year and on the date of commencement of the case belongs to the bankruptcy estate. n15

[4] Procedures for Making a Valid Short Period Election

[a] Filing of Tax Return on Due Date Without Extensions

The short period election must be made on or before the due date for filing the tax return for the taxable year ending the day before the commencement of the case under the Bankruptcy Code. n16 Thus, the election must be made on or before the 15th day of the fourth month following the commencement date of the case. n17 For example, if the case commenced on March 10th, the short period election must be made no later than July 15th of that same year.

The election is considered made if the complete tax return for the short period is timely filed. n18 In the above example, the return for the short period ending March 9th should be filed by July 15th. The taxpayer should clearly write "SECTION 1398 ELECTION" at the top of the tax return. n19

[b] Filing of Application for Extension of Time to File the Tax Return

There is no provision for extending the time for making the short period election. n20 However, the short period election may be made by attaching a statement expressly making the election to an application for an extension of time to file the tax return. n21 This statement must expressly state that the taxpayer affirmatively elects, pursuant to *I.R.C. section 1398(d)(2)*, to close the taxable year as of the day immediately prior to the commencement of the case under the Bankruptcy Code. n22

Generally, the individual debtor will be filing the tax return or extension request at least three months after the filing of the debtor's petition. The tax law provides that an extension request relates only to an extension of time to file and not an extension of time to pay. n23 The IRS generally takes the position that an extension request is invalid if the taxpayer does not pay the estimated tax liability with the request. n24 Generally, the individual debtor will not have sufficient funds available to pay the taxes, but even if he or she did, the tax liability for this short year should not be paid by the individual debtor since it is a priority claim against the estate. n25 Unfortunately, it may be difficult to obtain the funds from the bankruptcy estate at this relatively early date in the case. Nevertheless, for policy reasons neither the short period election nor the extension request should be invalid. n26

[c] Ability of Debtor and Spouse to Jointly Make the Short Period Election

[i] When Both Spouses File a Joint Petition Under the Bankruptcy Code

A joint case is a voluntary case concerning a wife and husband. n27 *Bankruptcy Code section 302* specifies that a joint case is commenced by the filing of a petition under an appropriate chapter by an individual and that individual's spouse. The bankruptcy court determines the extent, if any, to which the bankruptcy estates of the two married debtors should be consolidated. n28 Presumably, the bankruptcy court's determination as to whether to allow consolidation will depend on the extent of jointly-held property and the amount of joint liabilities.

However, the short period election may be made by either or both of the spouses whether or not their individual bankruptcy estates are consolidated. n29

[ii] When Only One Spouse Files a Petition Under the Bankruptcy Code

In the case of a married individual, the nonfiling spouse may join in the short period election if the debtor spouse and the nonfiling spouse file a joint return for the short taxable year ending on the "commencement date." n30 However, the short period election is only available to the nonfiling spouse if the nonfiling spouse is eligible to file, and does file, a joint tax return with the debtor spouse for the short taxable year ended as a result of the short period election. n31 The nonfiling spouse joins in the short period election either by making a joint return with the debtor spouse within the time prescribed for filing the tax return for the short taxable year, by joining in on the application for an extension of time before the due date of the tax return or by signing an express statement that a short period election is being made. n32 If a joint tax return is not filed for the first short taxable year, the short period election made by the nonfiling spouse with the application for an extension of time is deemed void. n33

[iii] When Both Spouses File a Petition Under the Bankruptcy Code, but at Different Times

Joining or failing to join in a debtor spouse's short period election will not bar a nonfiling spouse, who later in the same taxable year becomes involved in his or her own case under the Bankruptcy Code, from electing a short taxable year. n34 Further, if the late filing spouse had joined in with the debtor spouse's short period election, or if the debtor spouse did not make the short period election, the debtor spouse may join in with the late filing spouse's election, provided that the debtor spouse is otherwise eligible to file a joint tax return with the late filing spouse. n35 Thus, separate cases under the Bankruptcy Code could result in one or both spouses having one, two or three short taxable years in the same calendar year.

Example:

John Jones commences a case under the Bankruptcy Code on March 1st and his wife, Mary, commences one on October 10th. If neither John nor Mary makes the short period election, they will each file a separate return for the calendar year, or a single joint return if they prefer. If John makes the short year election, his first short year would end on February 28th. Mary can join in the election, but only if she and John file a joint return for this short period. When Mary commences her case on October 10th, she could elect to terminate her year as of October 9th, regardless of whether she had joined in John's election. However, if she did join in the earlier election, she would have three returns for the calendar year: January 1st-February 28th, March 1st-October 9th, and October 10th-December 31st. If John and Mary file a joint return for the post-October 10th portion of the year, John also would have the third short year.

[d] Irrevocable Election

Once the short period election is timely made, it is irrevocable. n36

[5] Treatment of Penalties and Interest Attributable to Federal Taxes Due for the Short Taxable Year

Any tax liability for the short taxable year constitutes a priority claim against the bankruptcy estate. n37 While there are no reported cases dealing specifically with interest and penalties corresponding to the tax liability resulting from the *I.R.C. section 1398(d)* short year election, other cases generally hold an individual debtor to be personally liable for interest accruing on nondischargeable prepetition tax debts. n38

In a bankruptcy court decision, n39 the court was asked to decide whether the debtor's discharge was effective to block the efforts of the IRS to collect postpetition interest and penalties. The *Woodward* court found that the penalties were precluded by *I.R.C. section 6658*. This statute clearly prohibits penalties being added to the tax while a case is pending under the Bankruptcy Code if the tax is a prepetition tax and the penalties are postpetition. Accordingly, even though the IRS will automatically compute a penalty n40 if the tax is not paid with the short period return or extension request, *I.R.C. section 6658* should preclude imposition of this penalty.

Moreover, even though the filing of the petition under the Bankruptcy Code normally prevents the accrual of interest with respect to tax claims against the bankruptcy estate n41 unless the IRS claim is fully secured and, therefore, is paid from assets in the estate, n42 the individual debtor will have personal liability for the interest which accrues with respect to such priority taxes. While there is one reported decision which granted relief to an individual debtor from the accrual of interest when the bankruptcy estate had the funds to pay the priority taxes but took an inordinately long time to do so, the decision was reversed on appeal. n43 The *Woodward* court found the *Irvin* decision which relied on equitable arguments which had no judicial or statutory support to be an aberration of well established case law n44 holding that postpetition interest is payable by debtors on nondischargeable tax obligations.

In summary, the *I.R.C. section 1398(d)* short year election is often advisable and should be valid, notwithstanding that the tax liability for the short year is not paid with the tax return or extension request containing the election. However, a taxpayer-debtor needs to be aware that if the taxes are not paid, he or she will be liable for any interest accruing with respect to such unpaid tax, even if the bankruptcy estate has sufficient funds to pay the tax.

A taxpayer in this situation would be well-advised to make estimated tax payments so as to minimize or eliminate the amount of tax liability upon which interest could accrue. n45

FOOTNOTES:

(n1)Footnote 1. *I.R.C. § 1398(d)(1)*.

(n2)Footnote 2. *I.R.C. § 1398(d)(2)(A)*. Pursuant to *I.R.C. § 1398(d)(3)*, the "commencement date" is defined as the day on which the case under the Bankruptcy Code commenced. In the case of *J.D. Kreidle, 146 B.R. 464 (Bankr. D. Colo. 1991)*, *aff'd*, *143 B.R. 941 (D. Colo. 1992)*, the court found that a case commenced when the Order for Relief was entered rather than the date that the involuntary petition was filed.

(n3)Footnote 3. The income or loss of a sole proprietorship of either a business or professional practice is reported on Schedule C which is filed with Form 1040 and reported on line 12 of Form 1040.

(n4)Footnote 4. *I.R.C. § 1398(d)(2)(C)*.

(n5)Footnote 5. *11 U.S.C. § 507(a)(8)*; *In re Prativadi, 49 C.B.C.2d 296, 281 B.R. 816 (Bankr. W.D.N.Y. 2002)*; *In re Johnson, 190 B.R. 724 (Bankr. D. Mass. 1995)*; *In re Moore, 132 B.R. 533 (Bankr. W.D. Pa. 1991)*; *In re Mirman, 98 B.R. 742, 745 (Bankr. E.D. Va. 1989)*.

(n6)Footnote 6. *In re Gonzalez, 112 B.R. 10, 11 (Bankr. E.D. Tex. 1989)*.

(n7)Footnote 7. *In re Knee, 2006 Bankr. LEXIS 2417 (Bankr W.D. Pa. 2006)*; *W.R. Johnson, 190 B.R. 724*

(Bankr. D. Mass. 1995) ; *W.C. Moore*, 91-2 U.S.T.C. P 50,390 (Bankr. N.D. Pa. 1991); *In re Mirman*, 98 B.R. 742, 745 (Bankr. E.D. Va. 1989) . Notwithstanding the line of cases adopting a strict interpretation of the requirement for an affirmative section 1398(d) election in order to split the debtor's tax year into two separate years, the court in *In re Gilliam*, 2008 Bankr. LEXIS 4057 (Bankr. D.S.C. 2008) rejected debtor's attempt to require the chapter 7 trustee to file an amended return for the bankruptcy estate. The debtor did not make the IRC section 1398 election, but the trustee filed returns for the bankruptcy estate on the basis that the debtor had two taxable years for the year of filing. The court noted that the IRS had accepted the returns filed by the bankruptcy estate and concluded that the real issue was whether the IRS should have accepted the returns filed.

(n8)Footnote 8. *I.R.C. § 6151. See In re Gonzalez*, 112 B.R. 10, 12 (Bankr. E.D. Tex. 1989) ; *Leonard O Parker, Jr. v. Comm'r*, 91 T.C.M. 1242 (2006) .

(n9)Footnote 9. *In re Moore*, 132 B.R. 533 (Bankr. W.D. Pa. 1991) ; *In re Turboff*, 93 B.R. 523, 525 (Bankr. S.D. Tex. 1988) . In *In re Fleming*, 277 B.R. 751 (Bankr. S.D. Ohio 2002) , the debtors filed their 1999 return and requested that an overpayment be applied to their year 2000 liability. The bankruptcy trustee then ordered them to file amended returns on the basis that the potential refund was property of the estate. The trustee convinced the IRS to give him the refund. The debtors were then held liable for the entire year 2000 deficiency since they did not make the § 1398(d) election.

(n10)Footnote 10. *In re Jeffery L. Allen*, 2007-1 U.S. Tax Cas. (CCH) P50,249, 2006 U.S. Dist. LEXIS 55516 (Bankr. D. Mass 2006) ; *In re Turboff*, 93 B.R. 523, 525 (Bankr. S.D. Tex. 1998) .

(n11)Footnote 11. In a Chief Council Advice (cited as LTR 1994-1002, July 1, 1999), the Internal Revenue Service determined that it was obligated to turn over the prepetition portion of a refund to a bankruptcy estate because it was property of the bankruptcy estate. It is not clear how the amount of the refund attributable to the prepetition period was determined or what the result would have been had there been a loss for the full taxable year. *See In re Haedo*, 211 B.R. 149 (Bankr. S.D.N.Y. 1997) . *See In re Joe Donnell*, 357 B.R. 386 (W.D. Tex. 2006) ; but see *In re Meyers*, 2009 Bankr. LEXIS 680 (Bankr. S.D. Ill. 2009) .

(n12)Footnote 12. The tax liability for the short taxable year is clearly a priority tax under 11 U.S.C. § 507(a)(8)(A)(iii), and, therefore, is not dischargeable because of 11 U.S.C. § 523(a)(1).

(n13)Footnote 13. *See P TX2.05[4] infra.*

(n14)Footnote 14. The tax liability for the short taxable year is clearly a priority tax under 11 U.S.C. § 507(a)(8)(A)(iii), and, therefore, is not dischargeable because of 11 U.S.C. § 523(a)(1).

(n15)Footnote 15. *See P TX2.04[2][b] supra.* This is a strange result and one that may be possible to avoid with appropriate prepetition tax planning. For example, if a debtor sells the asset before filing a petition under the Bankruptcy Code, the depreciation up to the date of sale as well as any gain or loss on the sale will be reflected by the debtor on his or her individual return, regardless of whether the short year election is made. Arguably, the individual debtor would reflect the depreciation deduction even if the debtor transferred the depreciable asset to a corporation or partnership in a tax-free transaction.

(n16)Footnote 16. *I.R.C. § 1398(d)(2)(D).*

(n17)Footnote 17. *I.R.C. § 6072(a).*

(n18)Footnote 18. *Treas. Reg. § 301.9100-14T(d); Treas. Reg. § 1.6081-1(b)(2).*

(n19)Footnote 19. *Treas. Reg. § 301.9100-14T(d).*

(n20)Footnote 20. *See In re Vela*, 87 B.R. 229 (Bankr. D.P.R. 1988) ; *In re Turboff*, 93 B.R. 523 (Bankr. S.D. Tex. 1988) . *See also In re Rognstad*, 121 B.R. 45 (Bankr. D. Haw. 1990) .

(n21)Footnote 21. Treas. Reg. § 301.9100-14T(d).

(n22)Footnote 22. Treas. Reg. § 301.9100-14T(d).

(n23)Footnote 23. *I.R.C. §§ 6081 and 6161*; *Treas. Reg. §§ 1.6081-1(a) and 1.6161-1*.

(n24)Footnote 24. *See I.R.C. § 6651 and 1979-1 C.B. 389, Rev. Rul. 79-113* .

(n25)Footnote 25. The tax liability for the short taxable year is clearly a priority tax under 11 U.S.C. § 507(a)(8)(A)(iii), and, therefore, is not dischargeable because of 11 U.S.C. § 523(a)(1).

(n26)Footnote 26. *See P TX2.05[4] supra*.

(n27)Footnote 27. 11 U.S.C. § 302(a); S. Rep. No. 989, 95th Cong., 2d Sess. 32 (1978), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n28)Footnote 28. 11 U.S.C. § 302(b); S. Rep. No. 989, 95th Cong., 2d Sess. 32 (1978), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised). If the separate bankruptcy estates are not consolidated, it appears that separate returns must be filed for each spouse's bankruptcy estate. *See P TX2.03[1][a][ii]*.

(n29)Footnote 29. Even though husband and wife may choose to file a joint petition under the Bankruptcy Code, there appears to be no requirement that they file joint income tax returns, each should be entitled to make, or not make, the short year election.

Example: H and W file a joint petition under the Bankruptcy Code on July 1, 2002. H makes the short year election and files a separate return for the period January through June 30, 2002, showing a tax liability of \$300,000 attributable to his separate property. W does not make the election and her return for 2002 will include a \$1,000,000 capital loss generated from the sale of her separate property in August of 2002.

(n30)Footnote 30. *I.R.C. § 1398(d)(2)(B)*.

(n31)Footnote 31. Treas. Reg. § 301.9100-14T(b).

(n32)Footnote 32. Treas. Reg. § 301.9100-14T(d).

(n33)Footnote 33. Treas. Reg. § 301.9100-14T(d).

(n34)Footnote 34. Treas. Reg. § 301.9100-14T(f).

(n35)Footnote 35. Treas. Reg. § 301.9100-14T(f). *See also* Treas. Reg. § 301.9100-14T(g), examples (1), (2), (3) and (4) (1981).

(n36)Footnote 36. *I.R.C. § 1398(d)(2)(D)*; Treas. Reg. § 301.9100-14T(e). *See also In re Turboff*, 93 B.R. 523, 526 (Bankr. S.D. Tex. 1988) . Query as to whether a court might attempt to set aside the irrevocable election if the result would be to enhance significantly the distribution to unsecured creditors of the bankruptcy estate? *See, e.g., In re Russell*, 927 F.2d 413, 24 C.B.C.2d 1526 (8th Cir. 1991) .

(n37)Footnote 37. 11 U.S.C. § 507(a)(8)(A)(i); *In re Gonzalez*, 112 B.R. 10, 11 (Bankr. E.D. Tex. 1989) .

(n38)Footnote 38. *Bruning v. United States*, 192 F. Supp. 826 (S.D. Cal. 1961) , *aff'd*, 317 F.2d 229 (9th Cir.

1962), *aff'd*, 376 U.S. 358, 84 S. Ct. 906, 11 L. Ed. 2d 772 (1964) (postpetition interest on nondischargeable tax debt remains a personal liability of debtor); see also *In re Hanna*, 872 F.2d 829 (8th Cir. 1989) (reversed two unreported bankruptcy court, N.D. Iowa decisions); *In re Jaylaw Drug, Inc.*, 79-2 U.S.T.C. P 9479 (S.D.N.Y. 1979), *aff'd*, 621 F.2d 524 (2d Cir. 1980); *Cline v. IRS (In re Cline)*, 100 B.R. 660 (W.D.N.Y. 1989); and *In re JAS Enters., Inc.*, 143 B.R. 718, 719 (Bankr. D. Neb. 1992).

(n39)Footnote 39. *Woodward v. United States (In re Woodward)*, 113 B.R. 680 (Bankr. D. Or. 1990). In *In re Mitchell*, 210 B.R. 978, 1997 LEXIS 1128 (Bankr. N.D. TX. 1997), the court rejected the IRS position that *Bruning* and *Woodward* should apply in a chapter 12 case and that postpetition interest on prepetition taxes was not dischargeable.

(n40)Footnote 40. I.R.C. § 6651 imposes a penalty at the rate of five percent per month up to a maximum of 25 percent of the tax not paid.

(n41)Footnote 41. 11 U.S.C. § 502.

(n42)Footnote 42. See *In re Ron Pair Enterprises*, 86-2 U.S.T.C. P 9642 (E.D. Mich. 1986), *aff'd*, 872 F.2d 778 (6th Cir. 1989), *rev'd*, 489 U.S. 235, 109 S. Ct. 1026, 103 L. Ed. 2d 290, 20 C.B.C.2d 267 (1989), interpreting 11 U.S.C. § 506(b) so as to allow the IRS to recover interest on its nonconsensual oversecured claim.

(n43)Footnote 43. *Irvin v. United States (In re Irvin)*, 20 C.B.C.2d 1007, 95 B.R. 1014 (Bankr. W.D. Mo. 1989), *rev'd*, 129 B.R. 187 (W.D. Mo. 1990).

(n44)Footnote 44. Subsequent cases have followed *Woodward v. United States (In re Woodward)*, 113 B.R. 680 (Bankr. D. Or. 1990). For example, in the case of *In re Fox*, 25 C.B.C.2d 583, 130 B.R. 571 (Bankr. W.D. Wash. 1991), the court sustained the objection of the IRS to an individual's chapter 11 plan since the plan did not provide for the payment of postpetition, preconfirmation interest and penalties (not covered by I.R.C. § 6658). Similarly, the individual debtor was liable for interest on prepetition taxes in *In re Johnson*, 146 F.3d 252, 40 C.B.C.2d 578 (5th Cir. 1998), and *In re Lapiana*, 100 B.R. 998 (D. Ill. 1989), *aff'd*, 909 F.2d 221, 23 C.B.C.2d 766 (7th Cir. 1990).

(n45)Footnote 45. In the case of *In re Weir*, 90-1 U.S.T.C. P 50229 (Bankr. D. Kan. 1990), the taxpayer made an estimated tax payment shortly before filing for bankruptcy. The trustee sought to recover the tax paid on the grounds that the estimated payment constituted a preferential payment or fraudulent conveyance. The court rejected the trustee's arguments, finding that the estimated tax payment was not property of the bankruptcy estate and the transfer of the payment to the government was neither a voidable preference nor a fraudulent conveyance. See also *In re Simmons*, 124 B.R. 606 (Bankr. M.D. Fla. 1991) and *In re Middendorf*, 381 B.R. 774 (Bankr. D. Kan. 2008) (estimated tax payment could not be a preferential transfer because it was not made on account of an antecedent debt). But see *In re Fleming*, 277 B.R. 751 (Bankr. S.D. Ohio 2002) (trustee of chapter 7 debtor recovered a 1997 tax overpayment by the debtor which the debtor had attempted to apply toward his year 2000 tax liability); but see *In re Graves*, 396 B.R. 70, 2008 Bankr. LEXIS 2641 (B.A.P. 10th Cir. 2008), where a chapter 7 trustee's attempt to require a turnover of funds in similar circumstances was rejected.

In *In re Middendorf*, 381 B.R. 774, 2008 Bankr. LEXIS 265 (Bankr. D. Kan. 2008) the debtor sold various assets giving rise to significant capital gains. He then took a portion of the proceeds and made estimated tax payments to cover the potential tax liability on such gains. Eight days later he filed for chapter 7 relief. Later, the chapter 7 trustee demanded that the IRS turn over the entire tax prepayment as a preferential transfer. The court held that the prepayment was neither a preferential transfer nor a fraudulent conveyance. However, it did hold that the trustee would be entitled to share in any refund received by the debtor to the extent it was properly attributable to such prepayment.



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Collier on Bankruptcy Taxation

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CHAPTER TX2 Federal Taxation of the Non-Corporate Bankruptcy Estate

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P TX2.06 Conflicts Between Debtor, Debtor's Spouse, Bankruptcy Trustee, Bankruptcy Estate and Creditors

[1] In General

The individual debtor and unsecured creditors will often have adverse interests as to whether the bankruptcy estate or the debtor is liable for certain federal taxes. Similarly, the individual debtor, the debtor's spouse, other creditors and the bankruptcy trustee may have conflicting interests as well.

Whether the bankruptcy estate or the individual debtor is liable for federal income taxes on the disposition of property held by the bankruptcy estate can have a dramatic impact on the debtor, unsecured creditors and the IRS. If the bankruptcy estate is subject to the tax liability on the gain generated by the disposition of an asset held by the bankruptcy estate, such tax liability would be treated as an administrative expense. n1 Accordingly, this tax liability would be paid before other priority claims and all unsecured creditor claims. n2 As a result, the assets of the bankruptcy estate that would otherwise be available for distribution to unsecured creditors would be reduced by the amount of the tax liability. More importantly from the debtor's viewpoint, the debtor would not be personally liable if any such taxes remained unpaid upon the termination of the case. n3 If the debtor, rather than the bankruptcy estate, was liable for the taxes arising from the disposition of assets during the case, the unsecured creditors would enjoy a greater return and the debtor would emerge from the case with a substantial nondischargeable debt to the IRS. Thus, the unsecured creditors and the debtor have conflicting interests regarding whether the bankruptcy estate or the debtor is liable for such taxes.

[2] Determining the Income Tax Effect of Abandonment

Nowhere does the conflict between the debtor and creditors become more real than when the estate acquires property from the debtor with built-in gains and corresponding tax liabilities which exceed any equity in the property. The individual debtor, aware of a potential foreclosure of such property, may be motivated to commence a case under the Bankruptcy Code that would delay a foreclosure sale and hopefully cause the gain to be taxable to the bankruptcy estate. However, the debtor faces the risk that the trustee may abandon the property back to the individual debtor in order to cause the debtor rather than the bankruptcy estate to be subject to the tax liability.

In most cases an abandonment will be proposed by the unsecured creditors who do not want their distribution depleted by unnecessary priority taxes. However, in some situations, the trustee may personally benefit by abandoning property. When the trustee liquidates encumbered property and, after satisfaction of the debt, there are insufficient funds to pay the resulting federal tax liability and other administrative expenses, all administrative expenses, including trustee's fees and

expenses, would be only partially paid since all administrative claimants share equally in the available cash. n4 Thus, the trustee may be inclined to minimize the administrative tax expense by abandoning the assets creating the problem.

A number of courts dealing with the abandonment issue have recognized the conflict between two--well established bankruptcy goals, viz, enabling the debtor to obtain a "fresh start" and maximizing the distribution to creditors. n5 To date, most courts have concluded that a timely abandonment is effective to shift the tax liability away from the bankruptcy estate. n6 The courts have often been sympathetic to the plight of the debtor but have felt that it is up to Congress to change the result. n7 However, if a bankruptcy judge views one of the competing bankruptcy goals as more important, it is likely the judge will find support in the tax law for his or her position. n8 Therefore, until the Supreme Court decides the issue, or Congress amends the Bankruptcy Code to resolve the inherent conflict, whether a judge will allow abandonment will likely vary from case to case.

As set forth in private letter rulings, the position of the Internal Revenue Service has been that an abandonment of property is effective to shift any built-in tax liability back to the debtor. n9 Regulations were adopted on November 9, 1992 that provide that transfers to the debtor from the bankruptcy estate (other than by sale or exchange) before the termination of the bankruptcy estate are not treated as taxable events. n10 The interest transferred must be in a passive activity, former passive activity or *I.R.C. section 465* activity, including transfer of property characterized as exempt by *section 522 of the Bankruptcy Code*. n11 Further, abandonments of property of the bankruptcy estate to the debtor pursuant to *section 554(a) of the Bankruptcy Code* are expressly included. n12

If the bankruptcy estate abandons an interest in either a passive activity, former passive activity or *I.R.C. section 465* activity to the debtor prior to the termination of the bankruptcy estate, part or all of the unused passive activity loss, unused passive activity credit, and "at risk" loss must be allocated to such interest. n13 For either a passive activity or former passive activity, the allocation must be determined as of the first day of the bankruptcy estate's taxable year in which the transfer occurs. n14 For an *I.R.C. section 465* activity, the debtor succeeds to and takes into account the transferred interest's share of the unused "at risk" loss, beginning with the debtor's taxable year in which the transfer occurs although determined as of the first day of the bankruptcy estate's taxable year in which the transfer occurs. n15 Thus, the transferred interest's share of any "at risk" loss is the amount, if any, by which such "at risk" loss would be reduced if the transfer had occurred as of the close of the preceding taxable year of the bankruptcy estate and had been treated as a disposition on which gain or loss would otherwise be recognized. n16 Further, the debtor succeeds to and takes into account the unused passive activity loss or unused passive activity credit allocated to the transferred interest, beginning with the debtor's taxable year in which the transfer occurs. n17

[a] Potential Legislation to Resolve Issue

The Advisory Committee n18 has recommended two proposals which would respond to the perceived inequities of current law. One proposal would provide that an abandonment by the bankruptcy trustee would not be taxable to the bankruptcy estate, but that where the abandoned property is thereafter sold or foreclosed, such sale or foreclosure will be deemed to have occurred immediately prior to the date the debtor filed for bankruptcy. The result of this approach is that the debtor will have the same tax consequences as if the disposition had occurred prior to the bankruptcy filing. The advantage to the debtor is that the tax liability would be computed with the benefit of net operating loss carryovers that passed to the estate. The bankruptcy estate, or more specifically the unsecured creditors, may be worse off under this approach, because the bankruptcy estate will no longer have the full amount of the debtor's net operating loss carryovers to offset other income of the estate. However, from the debtor's perspective, the creditors are merely not getting the benefit of the windfall they would have enjoyed if the trustee was able to abandon the tax-burdened asset and retain the debtor's net operating loss carryovers.

The second proposal expands the concept adopted in the section 1398 regulations by treating passive activity losses and credits as being attached to the property. The abandonment will shift the tax consequences of a sale to the debtor; however, the proposal would provide that any tax attributes that passed to the estate under section 1398 that may be

reasonably traced to the abandoned property will follow the property upon abandonment and may be used by the debtor in computing his tax liability.

Either of these proposals, if adopted, would respond to the arguments advanced by taxpayers opposing abandonment that current law is unfair in that it leaves them in a worse position than if the sale or foreclosure had occurred prior to bankruptcy. n19

[3] Determining Which Tax Attributes Pass to the Debtor's Bankruptcy Estate

As discussed earlier, certain of the debtor's tax attributes pass to the bankruptcy estate. n20 Even if it is clear that non-enumerated attributes do not pass to the debtor's bankruptcy estate, there may be a conflict between the creditors, the debtor, and the debtor's spouse. To the extent there is flexibility in characterizing an item or in making elections or decisions that could impact the amount of an enumerated item, the individual debtor will try to retain attributes to shelter postpetition earnings, whereas the creditors will want the estate to succeed to the maximum possible attributes to shelter income. Moreover, the non-filing spouse will opt for a position that maximizes his or her community or marital property interest in tax attributes so as to shelter his or her future income and possibly the postpetition earnings of the debtor as well.

[4] Reporting of Income or Loss Attributable to Pass-Through Entities

The uncertainty regarding whether the bankruptcy estate should report the income or loss attributable to a partnership interest or stock in an "S" corporation will necessarily cause conflicts. If the entity Schedule K-1 (which reports the interest holder's share of income or loss) reflects a loss for the year, the bankruptcy estate will benefit if the entire amount is income of the estate, whereas the debtor may prefer to adopt the "varying interest" rule. n21 If the Schedule K-1 reflects income, the position of the parties is reversed. Also, a non-filing spouse would be inclined to assert an interest in a Schedule K-1 loss but disavow an ownership interest in a Schedule K-1 gain. Moreover, if the income or gain has already been triggered at the entity level, it may be too late for the trustee to abandon the ownership interest and avoid the undesired tax results, particularly if the entity's tax year has come to an end. n22

The Eighth Circuit ruled that in a chapter 7 case, the bankruptcy trustee could avoid a debtor's prepetition or postpetition irrevocable election to forego the net operating loss carryback period. n23 It was determined that the purpose underlying the avoidance powers of the bankruptcy trustee coupled with the danger of permitting a debtor to improperly manipulate federal tax laws required that the trustee have the ability to avoid the debtor's election to carry forward net operating loss carryovers.

FOOTNOTES:

(n1)Footnote 1. 11 U.S.C. § 503(b)(1)(B). See *In re Goffena*, 175 B.R. 386 (Bankr. D. Mont. 1994) .

(n2)Footnote 2. 11 U.S.C. § 507. Tax liabilities for prior years would generally qualify as priority claims under 11 U.S.C. § 507(a)(8). Section 507 was renumbered by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, effective as of the day of enactment.

(n3)Footnote 3. This conclusion stems from the fact that the taxes constituting administrative expenses would not be among the priority taxes described in 11 U.S.C. § 523 as nondischargeable.

(n4)Footnote 4. The situation described is where the bankruptcy estate is administratively insolvent. The bankruptcy courts have treated all administrative claims as having equal priority. Each claim would share *pro rata* with each claimant. See 11 U.S.C. § 726(b). See also *In re Goffena*, 175 B.R. 386 (Bankr. D. Mont. 1994) .

(n5)Footnote 5. *See, e.g., In re A.J. Lane & Co., Inc.*, 25 C.B.C.2d 1202, 1214, 133 B.R. 264, 274 (Bankr. D. Mass. 1991) , in which the court concluded that taxing the debtor on a foreclosure would impose a clear burden on the debtor's fresh start but acknowledged that enhancement of distribution to creditors was also a basic policy of bankruptcy law. *Accord In re Rubin*, 154 B.R. 897 (Bankr. D. Md. 1992) , in which the bankruptcy court concluded that the overriding bankruptcy policy of a fresh start militates against imposing a tax burden arising from abandonment upon the debtor after his emergence from title 11. *But see In re Nevin*, 135 B.R. 652, 654 (Bankr. D. Haw. 1991) , wherein the bankruptcy court ordered the chapter 7 trustee to abandon to the debtors their respective partnership interests because the potential tax liability would have been burdensome to the bankruptcy estate; *see also In re Johnston*, 49 F.3d 538, 32 C.B.C.2d 1653 (9th Cir. 1995) , in which the court of appeals held that a chapter 11 trustee could abandon the debtors' personal mansion, even though a pending foreclosure sale might generate a large taxable gain to the debtors.

(n6)Footnote 6. *See In re Barker*, 51 C.B.C. 2d 672, 301 B.R. 892 (Bankr. D. Colo. 2003) , where the court allowed an abandonment of property even though the result was to saddle the individual debtor with a large capital gains tax liability. *In re Olson*, 100 B.R. 458 (Bankr. N.D. Iowa 1989) , *aff'd*, 121 B.R. 346 (N.D. Iowa 1990) , *aff'd*, 930 F.2d 6, 8 (8th Cir. 1991) .

(n7)Footnote 7. *In re Olson*, 100 B.R. 458, 464 (Bankr. N.D. Iowa 1989) , *aff'd*, 121 B.R. 346 (N.D. Iowa 1990) , *aff'd*, 930 F.2d 6, 8 (8th Cir. 1991) .

(n8)Footnote 8. *See, In re A.J. Lane & Co., Inc.*, 25 C.B.C.2d 1202, 1210, 1211 , and 133 B.R. 264, 271, 275 (Bankr. D. Mass. 1991) , in which the court relied on the *Court Holding* doctrine to determine that an abandonment would be ineffective to shift the tax consequences away from the estate. *Court Holding Co. v. Commissioner*, 2 T.C. 531 (1943) , *nonacq.*, 1969-2 C.B. XXVI, *rev'd and remanded*, 143 F.2d 823 (5th Cir. 1944) , *rev'd*, 324 U.S. 331, 65 S. Ct. 707, 89 L. Ed. 981 (1945) .

(n9)Footnote 9. In *Priv. Ltr. Rul. 9245023* (Aug. 7, 1992) , the IRS ruled that the bankruptcy estate did not recognize gain or loss upon the abandonment of an asset to the debtor. *See also Priv. Ltr. Rul. 8918016* (Jan. 31, 1989) .

(n10)Footnote 10. Treas. Reg. § 1.1398-(d)(1).

(n11)Footnote 11. Treas. Reg. § 1.1398-(d)(1).

(n12)Footnote 12. Treas. Reg. § 1.1398-(d)(1).

(n13)Footnote 13. *Treas. Reg. § 1.1398-1(d)(2)(i). Treas. Reg. § 1.1398-2(d)(2).*

(n14)Footnote 14. *Treas. Reg. § 1.1398-1(d)(2)(1).*

(n15)Footnote 15. *Treas. Reg. § 1.1398-2(d)(2).*

(n16)Footnote 16. *Treas. Reg. § 1.1398-2(d)(2).*

(n17)Footnote 17. *Treas. Reg. § 1.1398-1(d)(2)(ii).*

(n18)Footnote 18. *See Advisory Report, Section 2, No. 425.*

(n19)Footnote 19. *See, e.g., A. J. Lane*, 25 C.B.C.2d 1202, 133 B.R. 264 (Bankr. D. Mass (1991) , where the taxpayer argued that he would be in a much worse position after abandonment, because several million dollars of tax losses would be unavailable to offset the tax gains to be recognized upon a foreclosure of the abandoned property. *Advisory Report, Section 2, No. 425.*

(n20)Footnote 20. *See P TX2.04[2][b] supra.*

(n21)Footnote 21. *See I.R.C. § 706(c); see also P TX2.04[4][b] supra.*

(n22)Footnote 22. *Erickson v. United States (In re Bentley)*, 916 F.2d 431, 433 (8th Cir. 1990) (when crops sold in 1983, an order of abandonment not entered until 1986, taxable event was at the bankruptcy estate level); *see also Gulley v. Commissioner*, 79 T.C.M. (CCH) 2171 (2000) .

(n23)Footnote 23. *In re Russell*, 927 F.2d 413, 24 C.B.C.2d 1526 (8th Cir. 1991) . *See also In re Feiler*, 218 B.R. 957 (Bankr. N.D. Calif. 1998) , *aff'd*, 218 F. 3d 948, 44 C.B.C. 2d 702 (9th Cir. 2000) .



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CHAPTER TX2 Federal Taxation of the Non-Corporate Bankruptcy Estate

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P TX2.07 Other Tax Considerations

[1] Characterization of Payments to Chapter 11 Debtor in Possession and Tax Reporting Considerations

As a result of changes made by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA), the post-petition earnings of a Chapter 11 debtor now belong to his bankruptcy estate n1. The bankruptcy estate of a chapter 11 debtor who is an individual is a separate taxable entity. n2. The estate must include in its gross income all of the debtor's income to which the estate is entitled under the Bankruptcy Code. Thus, the bankruptcy estate must now include in its gross income earnings the debtor's gross from his or her performance of services after the filing of the case and the gross income from property acquired by the debtor after the filing of the case. The gross earnings from post-petition services include wages and other compensation earned by the debtor as an employee and any self-employment income earned by a self-employed debtor. However, no corresponding changes were made to section 1398, section 1398(e) provides that the gross income of the estate includes the gross income of the debtor to which the estate is entitled under Title 11; the gross income of the debtor shall not include any item to the extent that such income is included in the gross income of the estate; and, in general whether any amount paid or incurred by the estate is allowable as a deduction or constitutes wages shall be made as if the amount were paid by the debtor while he was engaged in the trade or business in which he was engaged prior to the filing of the case.

The failure to making any corresponding amendments to section 1398 might not be so troublesome if the bankruptcy estate actually retained all the debtor's post - petition earnings from services. However, it is customary in individual chapter 11 cases for the individual debtor to receive payments from the bankruptcy estate to pay living and personal expenses. n3 Applying this test, the IRS had previously concluded that amounts withdrawn by a farmer serving as a debtor in possession of his or her chapter 11 bankruptcy estate did not constitute wages paid to the farmer as an employee of the bankruptcy estate. n4

If the withdrawals do not constitute wages, are the amounts nevertheless distributions taxable to the individual and deductible by the bankruptcy estate? Generally, it would be more advantageous to the debtor if the amounts paid constitute nontaxable distributions from the bankruptcy estate, rather than income. This will be true if the individual debtor has insufficient deductions to offset income received from the bankruptcy estate. Similarly, the bankruptcy estate may not be concerned with the deductibility of such payments if the estate has net operating loss carryovers which it acquired from the individual debtor.

In an attempt to provide some guidance in this confusing area, the IRS has issued *Notice 2006-83*.ⁿ⁵ Pursuant to *Notice 2006-83*, the debtor in possession, or trustee is applicable, must prepare and file the income tax returns of the bankruptcy estate. The debtor in possession or trustee should provide the bankruptcy estate's EIN to persons required to file information returns with respect to gross income or gross proceeds received by the estate. However, where the debtor is an employee, the Notice provides that the estate's EIN should not be provided to the employer. Rather, the employer should continue to report all wage payments and accompanying tax withholdings on a W-2 issued to the debtor using the debtor's social security number. Similarly, where the debtor is a self-employed individual, the debtor should continue to report self-employment income on schedule SE and must pay the resulting self-employment tax.

The Notice provides that the debtor in possession or the trustee "must allocate in a reasonable manner wages, salary, or other compensation...and the withheld income tax between the debtor and the estate. The debtor must attach a statement to his income tax return reflecting the foregoing allocations of income and withheld income tax and must describe the method used to allocate income and withheld tax between the debtor and the estate."

The Notice does not provide what the tax treatment of any payments made by the estate to the debtor will be. Indeed, the Notice requests comments as to the appropriate tax treatment to the estate and debtor of the portion of the post-petition compensation from a third party employer that the estate allows the debtor to retain for the payment of his personal or living expenses. Amazingly, the Notice states, "In particular, comments are requested regarding whether such post-petition compensation is subject to double taxation as gross income to the debtor under section 61 and earnings under *section 1115(a)(2) of the Bankruptcy Code* includible in the estate's gross income under section 1398(e)(1), without a corresponding deduction for the estate." Hopefully, the IRS will not seriously attempt to pursue such a punitive approach.

The situation is complicated by the addition of section 1115 to the Bankruptcy Code. Now in an individual chapter 11 proceeding, the bankruptcy estate will be entitled to receive an individual's postpetition earnings, even though the individual debtor will arguably be taxable on the same income.ⁿ⁶

[2] Federal Tax Implications of Withdrawals by Bankruptcy Estate From IRAs or Qualified Plans

In general, the bankruptcy estate is liable for the payment of taxes that become due after the petition under the Bankruptcy Code is filed and that would be classified as administrative expenses.ⁿ⁷ Thus, the Court of Appeals for the Seventh Circuit has concluded that the premature withdrawal of funds from a debtor's individual retirement account by the bankruptcy trustee for the benefit of creditors makes the bankruptcy estate liable for the withdrawal penalty.ⁿ⁸ The Court reasoned that the withdrawal penalty fell on the bankruptcy estate just as the tax liability corresponding to dividend income received by the bankruptcy estate would have been the estate's liability.

On the other hand, the Tax Court held that the involuntary withdrawal from an ERISA-qualified Keogh account to satisfy a federal tax lien was not subject to the premature withdrawal penalty.ⁿ⁹ The Tax Court observed that the taxpayer did not make a voluntary withdrawal. Instead, the Keogh funds were withdrawn pursuant to a federal tax levy, an involuntary act, without any active participation by the taxpayer. The Tax Court stated that "to impose the penalty herein would be like throwing salt into a wound."ⁿ¹⁰

Regardless of how the apparent conflict between *Kochell* and *Larotonda* is resolved, a taxpayer-debtor may benefit if the IRS has already filed a lien against his or her IRA or Keogh account when he or she files a petition under the Bankruptcy Code, at least if the account is an asset of the bankruptcy estate.ⁿ¹¹ This is because the filing of the lien makes the IRS a secured party and because secured claims are paid in full, up to the value of the secured interest, before any administrative expenses are paid.ⁿ¹² Thus, the full amount of the IRA or Keogh account would be available to satisfy prepetition secured tax claims. If the estate did not have sufficient funds to pay the resulting administrative tax liability (with or without additional penalties for premature withdrawal), the unpaid administrative expenses would not be the responsibility of the debtor.

[3] Determination of When Individual Bankruptcy Estate Is Terminated

The date of termination of the individual's bankruptcy estate is often critical to a resolution of numerous tax issues affecting both the debtor and the estate. Unfortunately, neither the Bankruptcy Code nor the Internal Revenue Code provides any meaningful guidance on the date on which the estate terminates. If the date of the termination of the bankruptcy estate is the effective date of the individual's discharge, which in a chapter 7 case often occurs within a few months of the filing of the petition under the Bankruptcy Code, n13 who is responsible for reporting the gains or losses attributable to the subsequent sale of assets that comprised his or her bankruptcy estate? n14 It would seem that the bankruptcy estate should remain open for a reasonable period of time so that the assets can be liquidated and the tax consequences of the dispositions reflected on the tax return for the bankruptcy estate. However, even in this instance the tax results would be unfortunate if the grant of the discharge to the individual debtor was deemed to trigger debt forgiveness income, which in turn caused a reduction in the favorable tax attributes the estate was assuming would be available to offset gains from the liquidation of assets. n15

The issue may be even more critical in a chapter 11 case. There are often substantial assets (either by dollar value and/or number) that are to be disposed of pursuant to the chapter 11 plan after the confirmation date. If the bankruptcy tax estate terminates as of the confirmation date, n16 who is responsible for the gains corresponding to assets to be sold or transferred to creditors? In this respect, many chapter 11 plans for individual debtors call for assets to be transferred on the "effective date" which may be as early as ten days after the confirmation date. n17 Again, it seems appropriate that the bankruptcy estate should remain open for tax purposes for a reasonable period of time to allow for the sale or disposition of those very assets which comprised the bankruptcy estate. n18

Another uncertainty arises when an individual does not receive a discharge early in a chapter 7 case or at the time of the confirmation of a chapter 11 plan, because, for example, the discharge is contingent on some future event or expiration of a time period. n19 Presumably, the date of the individual's discharge is controlling for purposes of measuring debt forgiveness income. To the extent the debtor is realizing discharge of indebtedness income under the plan, the bankruptcy estate will be required to reduce its remaining tax attributes.

When the individual debtor receives his or her discharge in a chapter 7 or chapter 11 case, the debtor no longer has any personal liability for debts that were scheduled except for certain debts that may be specifically nondischargeable, such as claims for certain taxes or child support. However, it may be more difficult to compute the exact amount of debt forgiveness and when it should be taken into account, as demonstrated by the following example:

Example 10:

John Jones files a chapter 7 petition on July 1. His only nonexempt asset is Blackacre. He has no secured creditors and has unsecured creditors with claims of \$200,000. He receives his discharge on November 1 of that year. On January 1 of the next year, the trustee finally sells Blackacre and is able to make a distribution of \$100,000 to the creditors. Assume that he had a tax basis of \$50,000 in Blackacre and \$75,000 net operating loss carryover when he commenced his case.

Since John Jones received his discharge on November 1 of the year in which he filed chapter 7, this would seem the appropriate date to compute debt forgiveness income. If the value of Blackacre was reasonably estimated to be \$100,000, the bankruptcy estate would reflect \$100,000 of debt forgiveness income (\$200,000 of claims less value of Blackacre) in its tax return for its fiscal year which includes the November 1 filing date. If Blackacre is not sold by the end of this fiscal year, the \$75,000 of net operating loss carryovers will be eliminated as a result of the attribute reduction caused by the \$100,000 of debt forgiveness income. When Blackacre is sold for \$100,000, there will be a taxable gain of \$50,000. Presumably, the corresponding tax liability will have to be paid as an administrative expense and will deplete what is available to be distributed to unsecured creditors.

On the other hand, it could be argued that the value of Blackacre is speculative and therefore the amount of debt

forgiveness cannot be determined until Blackacre is sold. Under this approach, no debt forgiveness income would be realized until Blackacre is sold and the exact amount of debt forgiveness income computed. Under this approach, the entire \$75,000 of net operating loss carryovers would be available to offset the \$50,000 of gain, thereby eliminating any regular tax liability. n20

FOOTNOTES:

(n1)Footnote 1. 11 U.S.C. § 1115. See *infra* TX2.02 [2][b]

(n2)Footnote 2. I.R.C. § 1398

(n3)Footnote 3. I.R.C. § 1398(e)(3)(B).

(n4)Footnote 4. *Tech. Adv. Mem. 8728056 (Apr. 15, 1987)* .

(n5)Footnote 5. 2006 IRB LEXIS 518 ; 2006-40 I.R.B. 596

(n6)Footnote 6. See P TX2.02[2][b], n.18 *supra*. See also Williams article, n.18 *supra*.

(n7)Footnote 7. 11 U.S.C. § 503(b)(1)(B); S. Rep. No. 989, 95th Cong., 2d Sess. 66 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised).

(n8)Footnote 8. *In re Kochell*, 13 C.B.C.2d 732, 53 B.R. 250 (Bankr. W.D. Wis. 1985) , *aff'd*, 14 C.B.C.2d 65, 55 B.R. 380 (W.D. Wis. 1985) , *rev'd*, 804 F.2d 84, 87 (7th Cir. 1986) . See also I.R.C. § 408(f)(1). See also, *Baas v. Commissioner*, 83 T.C.M. 1744 (2002) .

(n9)Footnote 9. *Larotonda v. Commissioner*, 89 T.C. 287 (1987), *nonacq.*, 1988-2 C.B. 1. See I.R.C. § 72(m)(5).

(n10)Footnote 10. *Larotonda v. Commissioner*, 89 T.C. 287, 292 (1987). See I.R.C. § 72(m)(5). See also, *Murillo v. Commissioner*, T.C. Memo 1998-13 , *aff'd*, 166 F.3d 1201 (2d Cir. 1998) , where no penalty was imposed when funds were forfeited to the federal government as part of a plea agreement.

(n11)Footnote 11. In *Patterson v. Shumate*, 504 U.S. 753, 112 S. Ct. 2242, 119 L. Ed. 2d 519, 26 C.B.C.2d 1119 , *reh'g denied*, 505 U.S. 1239, 113 S. Ct. 13, 120 L. Ed. 2d 940 (1992) , the Supreme Court held that under § 541(c)(2), a debtor's interest in an ERISA plan was excludable from the chapter 7 estate regardless of whether it was protected under state spendthrift law. Thus, it may be difficult in most cases to successfully maintain the position that the account is property of the estate. See *In re Meehan*, 102 F.3d 1209, 37 C.B.C. 2d 375 (11th Cir. 1997) ; *In re Holst*, 192 B.R. 194 (Bankr. N.D. Iowa 1996) , *aff'd*, 197 B.R. 856 (N.D. Iowa 1996) . Even if it is property of the estate, an abandonment by the trustee would force the debtor to deal with the tax consequences of a withdrawal from the account.

(n12)Footnote 12. If the IRS has a lien, it should have the status of a secured creditor and be entitled to 100% of the value of the IRA or Keogh account, up to the amount of their lien. *In re Connor*, 27 F.3d 365, 31 C.B.C.2d 237 (9th Cir. 1994) , *aff'g*, 91-2 U.S.T.C. P 50582 (Bankr. D. Alaska 1991). The premature withdrawal penalty as well as the income tax liability corresponding to the withdrawal would then be the responsibility of the bankruptcy estate, and not the debtor. 11 U.S.C. § 503(b)(1)(B)(i); S. Rep. No. 989, 95th Cong., 2d Sess. 66 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised). On the other hand, if the IRS was not a secured party, the premature withdrawal penalty and income tax liability would constitute administrative expenses of the estate and would reduce the amount that could be applied toward the individual's nondischargeable tax liability. 11 U.S.C. § 503(b)(1)(B)(i); S. Rep. No. 989, 95th Cong., 2d Sess. 66 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised).

(n13)Footnote 13. 11 U.S.C. § 727(a); S. Rep. No. 989, 95th Cong., 2d Sess. 98 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised). *See also* Fed. R. Bankr. P. 4004(c).

(n14)Footnote 14. In a chapter 7 case, the trustee is responsible for liquidating the assets. Even though the individual may have been granted a discharge, he or she is not entitled to receive any of the assets that passed to the bankruptcy estate under *section 541 of the Bankruptcy Code*. Moreover, I.R.C. § 1398 provides that any unused attributes of the bankruptcy estate pass out to the individual debtor upon termination of the bankruptcy estate.

(n15)Footnote 15. *See* chapters TX6 and TX7 of this volume for discussion of debt forgiveness income and attribute reduction.

(n16)Footnote 16. Prior to the 2005 amendments to the Bankruptcy Code, an individual received a discharge upon confirmation of the plan. Under the 2005 Act, individual Chapter 11 debtors will not obtain a discharge at confirmation. New section 1141(d)(5)(A) provides that an individual Chapter 11 debtor generally cannot obtain a discharge until all plan payments have been made.

(n17)Footnote 17. In *Lisenmeyer v. United States (In re Linsenmeyer)*, 93 A.F.T.R. 2d 907 (6th Cir. 2003), *cert. denied*, 541 U.S. 1063, 124 S. Ct. 2390, 158 L. Ed. 2d 963 (2004), the court concluded that the tax burden associated with the sale of collateral after the effective date of the chapter 11 case was the responsibility of the individual debtor and not the bankruptcy estate. *See also In re Redcay*, 2007 Bankr. LEXIS 4075 (Bankr. E.D. Pa. 2007).

(n18)Footnote 18. In *McGuirl v. Commissioner*, 77 T.C.M. (CCH) 1289 (1999), the court determined that net operating losses were still in the bankruptcy estate and not available to the individual debtor because the bankruptcy estate had not terminated. The court stated that the termination of the estate is the equivalent of the closing of the estate which could not occur until the administration was completed, the trustee was discharged and the court issued a final decree closing the case.

(n19)Footnote 19. 11 U.S.C. § 1141(d).

(n20)Footnote 20. Moreover, the fact that the 2005 Act provides that an individual Chapter 11 debtor will not obtain a discharge until all plan payments under the plan are completed should mean that no cancellation of indebtedness income need be taken into account until this time. This change may actually alleviate some of the concerns expressed above.



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CHAPTER TX3 Tax Reporting Requirements

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CHAPTER TX3 Tax Reporting Requirements

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P TX3.01 Introduction

Burdened with such cumbersome issues as prioritizing claims, confirming plans, and distributing assets, liquidating trustees and fiduciaries often overlook tax filing, reporting, and payment obligations imposed by taxing authorities. n1 Similarly, debtors, upon the commencement of a title 11 proceeding, mistakenly assume that their tax filing and payment obligations are automatically stayed and become the responsibility of the bankruptcy estate. This chapter focuses on the intricacies of who, in a title 11 proceeding, is responsible for reporting, withholding, and payment of certain federal tax liabilities, the filing of federal tax returns, and the penalties which may ultimately be imposed for failing to meet these responsibilities.

The general obligation to file tax returns is expressed in the Internal Revenue Code as follows: when required by regulations prescribed by the Secretary of the Treasury, any person n2 that is liable for any tax imposed by the Internal Revenue Code, or is responsible for collecting any tax imposed by the Internal Revenue Code, shall file the returns or statements according to the forms and regulations prescribed. n3

The Internal Revenue Code identifies the "persons" required to file income tax returns by reference, in part, to the amount of income earned by the taxpayer in question. n4

These statutory obligations to file income tax returns also apply to individuals, corporations and partnerships after they file a case under title 11. The failure to comply with these provisions of the Internal Revenue Code may result in the imposition of penalties either against a title 11 estate or against a trustee or other fiduciary acting on behalf of the estate. n5

The Bankruptcy Reform Act of 1994 (the "BRA 94") was enacted on October 22, 1994. n6 The Act contains significant changes affecting the IRS. n7

Before BRA 94, the Bankruptcy Code prohibited assessments of a tax liability unless the court granted relief from the automatic stay. After October 22, 1994, in most cases, the automatic stay for assessment of any tax, including original tax returns, adjustments, Trust Fund Recovery Penalty (TFRP), and agreed audit deficiencies is no longer effective. Deficiencies in which the statutory period for petitioning the tax court has expired prior to the bankruptcy petition can also be assessed.

Notwithstanding the progress of BRA 94, The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act"), is still arguably the most sweeping bankruptcy reform legislation enacted since 1978, with notable changes to tax filing and reporting requirements. n8 This chapter will highlight relevant sections of the legislation.

The 2005 Act clarifies that the IRS's filing of a substitute tax return on behalf of a taxpayer based on information that he/she has provided, does in fact constitute the filing of a tax return for discharge purposes. n9 It also gives taxing authorities the right to request that the bankruptcy court dismiss or convert a case if the debtor fails to file a post petition tax return or obtains an extension. n10 Finally, individuals seeking protection under Chapter 13 are now required to file all prepetition tax returns for the 4-year period immediately preceding the filing of the petition. n11 Other significant tax filing, reporting and payment requirements imposed by the latest reform legislation will be discussed in this chapter.

The commencement of a case under title 11 may raise questions regarding who is responsible for the withholding of certain taxes, the filing of tax returns and the payment of tax liabilities. The Supreme Court has answered many of these questions in *Holywell Corp. v. Smith*. n12 This chapter will identify these issues and explain their unique application in the context of a title 11 case.

FOOTNOTES:

(n1)Footnote 1. A discussion of state tax filing, payment, and reporting obligations in title 11 cases is beyond the scope of this manuscript. Trustees and fiduciaries should consult applicable state and local tax laws regarding state filing and reporting requirements.

(n2)Footnote 2. "Person" is defined in *I.R.C. § 7701(a)(1)* to include individuals, corporations, associations taxable as corporations, partnerships, trusts, estates and other taxable entities.

(n3)Footnote 3. *I.R.C. § 6011(a)*.

(n4)Footnote 4. *I.R.C. § 6012* defines the tax return reporting requirements for: (1) individuals in *I.R.C. § 6012(a)(1)(A)*; (2) corporations in *I.R.C. § 6012(a)(2)*; (3) estates in *I.R.C. § 6012(a)(3)*; and (4) trusts in *I.R.C. § 6012(a)(4)*. Most directly relevant, *I.R.C. § 6012(a)(9)* provides that "every estate of an individual under chapter 7 or 11 of title 11 of the United States Code (relating to bankruptcy) the gross income of which for the taxable year is not less than the sum of the exemption amount plus the basic standard deduction under § 63(c)(2(D))" (the latter citation referring to the *I.R.C.*) shall file an income tax return. *I.R.C. § 6012(b)(3)* also prescribes rules for the filing of tax returns by "fiduciaries and receivers," including chapter 7 and 11 estates and receivers. See *P TX3.03 infra* for a more detailed discussion of the statutorily and judicially imposed return filing obligations.

(n5)Footnote 5. See *P TX3.06 infra* for a discussion of penalties assessable under the Internal Revenue Code against fiduciaries.

(n6)Footnote 6. Pub. L. No. 103-394, *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n7)Footnote 7. IRM § 4.27.1-1(12).

(n8)Footnote 8. Pub. L. No. 109-8 (2005), effective for cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n9)Footnote 9. Pub. L. No. 109-8, § 714 (2005), effective for cases commenced on or after October 17, 2005.

(n10)Footnote 10. Pub. L. No. 109-8, § 720 (2005), effective for cases commenced on or after October, 17, 2005.

(n11)Footnote 11. Pub. L. No. 109-8, § 716 (2005), effective for cases commenced on or after October, 17, 2005.

(n12)Footnote 12. *Holywell Corp. v. Smith*, 911 F.2d 1539 (11th Cir. 1991) , rev'd, 503 U.S. 47, 112 S. Ct. 1021, 117 L. Ed. 2d 196, 26 C.B.C.2d 1 (1992) . For an in-depth discussion of *Holywell*, see P TX3.03[1][c][ii] *infra*.



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CHAPTER TX3 Tax Reporting Requirements

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P TX3.02 The Taxable Entities

[1] Individuals

[a] Individuals as Taxable Entities and General Rule Requiring Tax Return Filing

Every individual is a taxable "entity" that may be required to file a tax return. n1 An income tax return must be filed if a taxpayer's gross income exceeds the sum of (i) the applicable personal exemption amount n2 plus (ii) the applicable standard deduction amount n3 or a larger amount depending upon whether the taxpayer qualifies for increased exemption amounts as a result of old age or blindness. n4

A common misconception is that the general rules regarding the filing of tax returns are superseded when a taxpayer files a title 11 case. In fact, the filing of a case under the Bankruptcy Code by an individual does not eliminate the requirement that income tax returns be filed by either the individual taxpayer or by the trustee for that taxpayer's bankruptcy estate. n5 Internal Revenue Manual (IRM) section 4.27, entitled "Bankruptcy," formerly the "Bankruptcy Handbook," contains policy, procedures, information, instructions, guidance, and references concerning the various types of bankruptcy proceedings and issues handled by the Internal Revenue Service (IRS). It provides information relevant to the processing actions that IRS employees must take on bankruptcy cases. Similar issues may arise with respect to state taxes as well. These topics are discussed in chapter TX12.

According to the Internal Revenue Manual, "a bankruptcy case should be considered a proceeding pertaining to tax administration if the bankruptcy court's jurisdiction is properly invoked in any manner to determine a tax matter, and the federal government and the debtor (taxpayer) are properly before the court" (IRM section 5.9.19.1(5)). Examples of this, according to the manual, would be the debtor listing the IRS as a creditor, or the IRS taking formal action, such as filing a motion to compel filing of a tax return. It could also include the IRS filing a proof of claim for taxes owed, even though the debtor failed to list the IRS as a creditor in the debtor's schedules filed with the bankruptcy court.

[b] Internal Revenue Code Provisions Regarding the Separate Entity Status of an Individual's Bankruptcy Estate in Chapter 7 and 11 Cases

Prior to the passage of the Bankruptcy Tax Act of 1980, there was no guidance in the Internal Revenue Code concerning whether a debtor's bankruptcy estate was a separate taxable entity from the individual debtor. This absence of statutory direction led to litigation regarding who would recognize the prepetition and postpetition income, deductions, credits

and other tax attributes of the debtor. n6

In response to this problem, Congress enacted *I.R.C. section 1398* as part of the Bankruptcy Tax Act of 1980 and created what is now known as the "separate entity rule." That rule requires that the bankruptcy estate of an individual be treated as a separate taxable entity for federal income tax purposes. n7

Under the 2005 Act, earnings from services performed by an individual Chapter 11 debtor after the commencement of the case, but before the case is closed, dismissed or converted are considered property of the bankruptcy estate. n8 The bankruptcy estate of a Chapter 11 debtor who is an individual is a separate taxable entity under *section 1393 of the Internal Revenue Code*. The estate, rather than the debtor, must include in its gross income all of the debtor's income to which the estate is entitled under the Bankruptcy Code, except for amounts received or accrued by the debtor before the commencement of the case.

I.R.C. section 1398 applies to any case filed by an individual under chapter 7 or 11 of the Bankruptcy Code. n9 The trustee in a chapter 7 liquidation or the estate's representative for a chapter 11 liquidating plan is required to obtain an employer identification number n10 and file the appropriate tax returns for the debtor's liquidating estate. n11 In the case of a chapter 11 reorganization, these duties accrue to the trustee or the debtor in possession. n12 The only exception to this general rule is that a separate taxable entity for the debtor's estate will not be created or maintained if the bankruptcy petition is dismissed. n13 Even though an individual's separate bankruptcy estate may exist for a temporary period of time prior to dismissal, the estate is not a taxable entity if the petition is dismissed. n14

[c] Internal Revenue Code Provisions Regarding the Separate Entity Status of an Individual's Bankruptcy Estate in Chapter 13 Cases

A separate taxable entity for an individual's bankruptcy estate is not created upon commencement of a chapter 13 case under the Bankruptcy Code. n15 The legislative history explains the reasoning for this different treatment of chapter 13 cases:

The rationale for generally treating the individual debtor and the bankruptcy estate as separate entities [for chapter 7 and 11 purposes] 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 11 cases. n16

In a chapter 13 case, all assets owned by the debtor prepetition ultimately vest in the debtor. n17 There is, therefore, no transfer of property or property rights in a chapter 13 case to another entity represented by a trustee or other fiduciary, and the chapter 13 debtor remains the only taxable entity for the recognition of all prepetition and postpetition income, deductions and credits. Additionally, the postconfirmation income of the debtor is retained by the debtor and used to satisfy the terms of the plan and make distributions to creditors. n18

Under the 2005 Act, "super discharge", whereby debtors who had not filed tax returns were previously permitted to discharge taxes under a Chapter 13 plan, is no longer allowed. n19 Accordingly, taxes resulting from failure to file a return, from fraudulent filing of a return, or from untimely filing of a return, are not dischargeable under a Chapter 13 plan. n20 Likewise, in a chapter 13 case, post petition tax liabilities can not be treated as administrative expenses. In the case, *In re Whall*, n20a, a debtor attempted to treat the Massachusetts Department of Revenue's post-petition tax claim as an administrative expense to the bankruptcy estate. The court held that under chapter 13 a separate entity does not exist and therefore the debtor cannot treat the post-petition tax liability as an administrative expense.

[d] Internal Revenue Code Provisions Regarding the Separate Entity Status of an Individual's Bankruptcy Estate in Chapter 12 Cases

Chapter 12 of the Bankruptcy Code contains provisions applicable to the adjustment of debts for a family farmer or fisherman. n21 It should be noted that Chapter 12 of title 11 of the *Bankruptcy Code* was permanently reenacted by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, effective July 1, 2005. n22 Prior to its permanent reenactment, Congress periodically extended the sunset date of Chapter 12 to keep it in effect. n23

Chapter 12 of the Bankruptcy Code is silent with respect to the obligations of the debtor farmer or that debtor's trustee to file income tax returns and pay income tax liabilities. A comparison of certain provisions of the Bankruptcy Code applicable to cases under chapters 12 and 13 confirms that the separate entity rule does not apply to a chapter 12 case. n24

Chapter 12 of the Bankruptcy Code does contain one special tax provision applicable to farmers. *Section 1231 of the Bankruptcy Code* provides that, for state and local income tax return purposes, the taxable year of an individual will terminate on the date of the entry of an order for relief. n25 For state and local income tax purposes, a taxable estate for all postpetition taxable periods is created by the Bankruptcy Code, and the trustee for the chapter 12 debtor farmer is required to file all state and local income tax returns for that estate. n26 The provisions of *Bankruptcy Code section 1231* do not, however, provide any guidance concerning the creation of a taxable estate for a chapter 12 farmer for federal income tax purposes. Because Congress provided specific separate entity treatment for the bankruptcy estate for state, but not federal, tax purposes, section 1231 should not be extended to require the filing of any tax returns for a chapter 12 estate for federal income tax purposes.

Even though a comparison of the statutory language of chapters 12 and 13 indicates that the separate entity rule does not apply to chapter 12 cases, it could be argued that federal tax returns for a chapter 12 debtor's estate must be filed by a chapter 12 trustee based on the language of *I.R.C. section 6012(b)(4)* n27 and judicial authority interpreting *I.R.C. section 641(a)*. Under prior law, some courts treated bankruptcy estates as taxable trusts under *I.R.C. section 641(a)* and held that bankruptcy estates must file income tax returns as required by *I.R.C. section 6012(b)(4)*. n28 This line of pre-1980 authority should not, however, be relevant in identifying the taxable entity under current law. This conclusion is particularly true in light of the congressional intent supporting the enactment of *I.R.C. sections 1398* and *1399*--to eliminate confusion over the separate entity rule. n29

Based on the similarity of the statutory language of chapters 12 and 13 of the Bankruptcy Code, the tax return filing rules relative to chapter 13 debtors should also be applicable to chapter 12 debtors. Thus, the separate entity rule of *I.R.C. section 1398* should not apply to a case filed under chapter 12 for federal income tax reporting purposes.

The IRS has recently issued guidance and procedures for requesting determinations of income tax effects for proposed plans under chapter 12 when such requests are authorized by the bankruptcy courts. n29a In accordance with *Rev. Proc. 2006-52*), updated annually. n29b Additionally, the request must be signed by the proponent under penalties of perjury. Plan proponents requesting income tax effect determinations will be notified within 270 days from the receipt of the application as to the determination.

[2] Corporations

[a] Corporations as Taxable Entities and General Rule Requiring Tax Return Filing

Corporations, associations taxable as corporations, joint-stock companies and any other entities that are characterized as corporations for federal income tax purposes are taxable entities that may be required to file an income tax return. n30 Generally, every corporation subject to taxation under subtitle A must file a corporate income tax return. n31 The corporate income tax is imposed by *I.R.C. section 11(a)* and is imposed on the taxable income for each taxable year for

each corporation. n32

[b] Internal Revenue Code Provisions Regarding the Separate Entity Status of a Corporation

A corporation's filing of a petition under title 11 does not generally affect its filing of income tax returns. A separate taxable entity is not created upon (or as a result of) the commencement of a case by a corporation under the Bankruptcy Code. n33 If a corporation commences a case under title 11, its taxable year will not be changed (*i.e.*, shortened or terminated) as of the petition date. n34 The corporate income tax return for the year in which the petition is filed will include all of the income, deductions and other tax attributes recognized by the debtor corporation during the taxable year that includes the petition date.

If a corporation retains any valuable assets, continues to conduct any business operations, or disposes of appreciated assets, it will continue to exist for federal income tax reporting purposes and it will continue to be required to file income tax returns. n35 If a corporation is in existence during any part of a taxable year, it is required to file an income tax return. n36 If a corporation is in existence during only a portion of a taxable year, an income tax return is required only for the fractional part of the year in which the corporation existed. n37 The primary issue arising from a corporate title 11 case is who among the parties in control of the debtor's assets (the debtor or the trustee) is required to file tax returns for the corporation. n38

[3] Partnerships

[a] Partnerships as Taxable Entities and General Rule Requiring Tax Return Filing

Partnerships are included in the definition of the term "person" in the Internal Revenue Code and are therefore required to file tax returns. n39 A partnership includes a syndicate, group, pool, joint venture or other unincorporated organization through which any business or venture is operated and which is not a corporation. n40 Every partnership is required to file an information return n41 that reflects the items of gross income recognized and expenses allowable under the Internal Revenue Code that pass through to the partners. n42 As such, a partnership is not a separate tax paying entity. n43

[b] Internal Revenue Code Provisions Regarding the Separate Entity Status of a Partnership

Prior to the enactment of the Bankruptcy Tax Act of 1980, the IRS contended that a partnership's filing of a title 11 petition created a new taxable entity. n44 However, under current law, no separate taxable entity will result from the commencement of a case by a partnership under the Bankruptcy Code. n45 Like a corporation, when a partnership files a title 11 case, its taxable year will not be changed (*i.e.*, shortened, or terminated) as of the petition date. n46 The partnership income tax return for the year in which the petition is filed will include all of the income, deductions and other tax attributes recognized by the debtor partnership during the taxable year that includes the petition date.

It is important to note here that when a partner files a bankruptcy petition, a bankruptcy estate is created that is comprised of "all legal or equitable interests of the debtor in property as of the commencement of the case," including his or her interest in a partnership. n47 Additionally, if a partner commences a bankruptcy case before the last day of the partner's tax year and the bankruptcy estate holds the partnership interest on the last day of that year, then that partner's share of any income, gain, loss, deduction, or credit of the partnership is treated as earned by the bankruptcy estate. n48 The hallmark of a partnership item is that it affects the distributive shares reported to the other partners. n49

In *Katz v. Commissioner*, n50 the 10th Circuit Court of Appeals held that the Tax Court lacked authority to reallocate the losses because of the Commissioner's failure to conduct a partnership-level proceeding. The court further held that the word "partner" in Treas. Reg. section 301.6231(c)-7T(a) did not encompass the bankruptcy estate and therefore the regulation did not convert the partnership losses into nonpartnership items. In addressing the issue of whether the IRS could challenge an allocation in a proceeding involving only the Taxpayer and not the partnership, it was held that the

Commissioner must first bring a partnership-level proceeding.

In the reversed opinion, the Tax Court held that when an individual partner filed a bankruptcy petition, his entire interest in the partnership, including potential NOLs, passed to the bankruptcy estate. ⁿ⁵¹ The court also held that it had jurisdiction to disallow the NOL carryovers at issue because the taxpayer's bankruptcy petition rendered the losses "nonpartnership" items for purposes of the unified partnership audit provisions.

The taxpayer in *Katz* held limited partnership interests in a number of partnerships in 1990, when he filed a chapter 7 bankruptcy petition. Some of the partnerships divided his partnership interest for the year into pre--and post-petition filing items. The prepetition items for tax year 1990 resulted in losses and were the major portion of the taxpayer's reported net operating losses (NOL) for 1990. Accordingly, he claimed the benefit of the partnership losses on his individual income tax return for the taxable year 1990, and carried over the unused losses to reduce his taxable income for taxable years 1991, 1992, 1993, and 1994. The IRS issued a deficiency notice disallowing the NOL carryovers claimed by the taxpayer on his joint tax returns for years 1991 through 1994. The taxpayer challenged the disallowance of the NOL carryovers, arguing that the IRS lacked jurisdiction and authority to make such a determination. He argued that the NOL carryovers were "affected items" governed by unified audit and litigation procedures and that the IRS failed to comply with such procedures by not proceeding against the relevant partnerships.

The issue before the *Katz* court was "once a partnership has allocated partnership items in respect of the interest of a partner who has commenced a bankruptcy proceeding during the partnership taxable year, whether the subdivision of those items between the partner and his bankruptcy estate constitutes a partnership item." The Court viewed this inquiry as tantamount to determining whether a partner in bankruptcy and his bankruptcy estate should be treated as separate entities. ⁿ⁵²

Ultimately, the 10th Circuit concluded that partnership-level proceedings were required and that the determination of each partner's distributive share was more appropriately made at the partnership level and was, therefore, a partnership item. According to the court on appeal, "What is important is that the debtor was a partner during part of the partnership year, so the partnership returns must set forth the debtor's share of income, loss, etc." It reasoned that:

To say that the allocation is not a partnership item is to confuse the process with the result. The statute requires partnership-level proceedings if a partnership item is being challenged. The partnership item is, of course, the result of the allocation of the partnership's income, losses, etc; but the allocation process itself is not a partnership item. The requirement of a partnership-level proceeding is triggered regardless of how the partnership item was calculated.

Accordingly, the 10th Circuit reversed the Tax Courts' decision, ruling in favor of the Taxpayer.

Partners and partnerships should be aware of these intricacies. Again, no separate taxable entity will result from the commencement of a case by a partnership under the Bankruptcy Code. It is also worth noting here that Subchapter S corporations may face issues similar to those discussed above for partnerships. Section 6244 makes certain provisions of the TEFRA procedures relating to partnership items applicable to subchapter S items, except as modified or made inapplicable by the regulations. ⁿ⁵³ Among the incorporated provisions is section 6226, which governs the judicial determination of partnership items. ⁿ⁵⁴ In the case, *Hang v. Commissioner*, an allocation of subchapter S items between a shareholder of record and the purported beneficial owner of such shares was held to be not expressly within the scope of section 6226(f). ⁿ⁵⁵

FOOTNOTES:

(n1)Footnote 1. *I.R.C. §§ 7701(a)(1) and 6012(a)(1)(A). I.R.C. § 6012(a)(1)(A)(iv)* defines the return threshold

provisions.

(n2)Footnote 2. The "exemption amount" is defined in *I.R.C. § 151(d)(1)* and is \$3,650 per person for 2009. *Rev. Proc. 2008-66*, § 3.19. Additionally, for tax years 2005 and 2006, individuals who housed evacuees of Hurricane Katrina for more than 60 days are entitled to an additional exemption amount of \$500 per individual up to \$2,000. *See Katrina Emergency Tax Relief Act of 2005*, Pub. L. No. 109-73, § 302 (2005).

(n3)Footnote 3. This may be phased out (reduced or eliminated) for higher-income taxpayers under *I.R.C. § 151(d)*. For tax years beginning 2006 and 2007, the amount of the exemption phase-out reduction that would otherwise apply is reduced by one-third and for tax years beginning in 2008 and 2009 by two-thirds. For tax years beginning 2010, the exemption phase-out is repealed. (*I.R.C. § 151(d)(3)(E) and (F)*).

The standard deduction amount is defined in *I.R.C. § 63(c)(2)* and varies depending on the tax year and the taxpayer's filing status. For example, for the 2009 tax year, the standard deduction is \$5,700 for a single taxpayer, \$11,400 for a married taxpayer filing a joint return, and \$8,350 for a taxpayer who qualifies for "head of household" status under *I.R.C. § 2(b)*; *Rev. Proc. 2008-66*, § 3.10(1). Accordingly, the threshold amount for tax return a filing in 2009 is \$9,350 for a single taxpayer, \$18,700 for a taxpayer who is married and filing a joint return, and \$12,000 for a taxpayer who qualifies for head of household status.

(n4)Footnote 4. *I.R.C. § 63(c)(3) and (f)*. The additional standard deduction amount for aged or blind taxpayers for 2009 is \$1,100 for married individuals and surviving spouses and \$1,400 for single individuals; *Rev. Proc. 2008-66*, § 3.10(3).

(n5)Footnote 5. *See, e.g., Treas. Reg. § 1.6012-3(b)(5)*, which provides that a person who stands in the place of an individual as that individual's receiver must file the Form 1040, U.S. Individual Income Tax Return required for that individual. If, however, the receiver controls only a portion of the individual's property, then the individual must file the income tax returns and the receiver has no filing obligation. *Treas. Reg. § 1.6012-3(b)(5)*.

(n6)Footnote 6. For example, in several rulings, the IRS contended that a new and separate taxable entity was created when an individual filed a bankruptcy petition. *See, e.g., Rev. Rul. 68-48, 1968-1 C.B. 301*; *Rev. Rul. 72-387, 1972-2 C.B. 632*. However, in the case of *In re Siehl*, 76-1 U.S. Tax Cas. (CCH) P 9217 (Bankr. S.D. Ohio 1975); and *In re Kirby*, 62-2 U.S. Tax Cas. (CCH) P 9752 (Bankr. S.D. Tex. 1962), liquidating trustees were not required to file income tax returns on behalf of either the debtor or the debtor's bankruptcy estate. Other courts attempted to tax bankruptcy estates as simple or complex taxable trusts under Subchapter J of the Internal Revenue Code, specifically *I.R.C. § 641(a)*. *See, e.g., Williams v. United States*, 667 F.2d 1108 (4th Cir. 1981); *United States v. State Farm Fire & Casualty Co. (In re Joplin)*, 882 F.2d 1507 (10th Cir. 1989); *Richardson v. United States*, 386 F. Supp. 424 (C.D. Cal. 1974); *In re Goff*, 57 B.R. 442 (Bankr. W.D. Tex. 1985). *See also In re Volpe*, 120 B.R. 843 (W.D. Tex. 1990).

(n7)Footnote 7. *I.R.C. § 1398* does not specifically state that a separate taxable entity is created for a debtor's bankruptcy estate. *I.R.C. § 1398*, however, contains provisions that operate to achieve this result and confirm the Congressional intent to create a separate taxable entity for the bankruptcy estate. *See, e.g., I.R.C. § 1398(c)(1)* (referring to the manner in which the estate's taxable income is calculated); *I.R.C. § 1398(e)(1)-(3)* (defining how the income, deductions and credits of the debtor will be divided between the debtor and the bankruptcy estate). For a complete discussion of *I.R.C. § 1398*, see chapter TX2 *supra*. *I.R.C. § 6012(a)(9)* essentially confirms the "separate entity rule" by providing:

Returns with respect to income taxes under subtitle A shall be made by the following:

*

(9) Every estate of an individual under chapter 7 or 11 of title 11 of the United States Code (relating

to bankruptcy) the gross income of which for the taxable year is not less than the sum of the exemption amount plus the basic standard deduction under § 63(c)(2)(D).

After recognition of all allowable deductions, an estate may have net taxable income of zero, but an income tax return will nevertheless have to be filed if the gross income exceeds the \$7,900 for 2004 threshold test. *See, e.g., Wills v. Maryland Nat'l Bank*, 46 B.R. 333, 334 (Bankr. D. Md. 1985), in which the court required a bankruptcy trustee for an individual to file a tax return for the estate in order to report a \$195,000 gain recognized by the trustee upon the sale of the estate's assets. The court held that the obligation to file an income tax return would not be relieved even if other tax attributes would reduce the estate's income tax liability to zero. The Court in *In re Knobel*, 167 B.R. 436 (Bankr. W.D. Tex. 1994) summarized the separate entity rule and its genesis: The United States has long taken the position that a bankruptcy estate is a taxable entity separate and apart from the bankrupt individual. *Williams v. United States*, 667 F.2d 1108, 1110 (4th Cir. 1981); *see also In re Turboff*, 93 B.R. 523, 525 (Bankr. S.D. Tex. 1988); *In re Goff*, 57 B.R. 442, 443-44 (Bankr. W.D. Tex. 1985); *Gen. Counsel Mem. 24,617, 1945-1 C.B. 235*; *Rev. Rul. 72-387, 1972-2 C.B. 632*. The rationale for treating the individual debtor and the bankruptcy estate as separate entities for tax purposes was explained in the legislative history of the Bankruptcy Tax Act of 1980: [T]he individual may obtain new assets or earn wages after transfer of the prebankruptcy property to the trustee and thus derive income independent of that derived by the trustee from the transferred 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 afteracquired assets of the individual debtor and assets of the bankruptcy estate as in chapter 7 or chapter 11 cases. H.R. Rep. No. 833, 96th Cong., 2d Sess. 19 n. 2 (1980).

(n8)Footnote 8. *Section 1115 of the Bankruptcy Code* was enacted by § 321(a)(1) of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005), effective for cases commenced on or after October 17, 2005. *See also Jenks, The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: Summary of Tax Provisions*, 79 Am. Bankr. L.J. 893, 912; Williams and Todres, *Tax Consequences of Postpetition Income as Property of the Estate in an Individual Debtor Chapter 11 Case*, 13 Am. Bankr. Inst. L.Rev. 701 (2005).

(n9)Footnote 9. The provisions of I.R.C. § 1398 apply exclusively to individuals. The provisions of I.R.C. § 1399 apply to corporations and partnerships. I.R.C. § 1398 by its terms is not applicable to chapter 13 wage earner plans or chapter 12 farm reorganizations. The tax reporting requirements for these forms of title 11 cases are discussed at P TX3.02[1][c] and [d] *infra*.

(n10)Footnote 10. The employer identification number is obtained by filing Form SS-4, Application for Employer Identification Number.

(n11)Footnote 11. *Holywell Corp. v. Smith*, 503 U.S. 47, 112 S. Ct. 1021, 117 L. Ed. 2d 196, 26 C.B.C.2d 1 (1992). For an in-depth discussion of *Holywell*, *see P TX3.03[1][c][ii] infra*. *See also In re Perlman*, 188 B.R. 704 (Bankr. S.D. Fla. 1995) (asset transfers to a chapter 7 estate are not taxable transfers and the estate assumes all the tax attributes of the transferor and recognizes all the gain from the sale of the property); *In re Young*, 153 B.R. 886 (Bankr. D. Neb. 1993) (gains on sales of real property were taxable to the bankruptcy estate).

(n12)Footnote 12. 11 U.S.C. § 1107.

(n13)Footnote 13. I.R.C. § 1398(b)(1).

(n14)Footnote 14. S. Rep. No. 1035, 96th Cong. 2d Sess. 28 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n15)Footnote 15. 11 U.S.C. § 1301, *et. seq.*

(n16)Footnote 16. S. Rep. No. 1035, 96th Cong. 2d Sess. 28 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n17)Footnote 17. 11 U.S.C. §§ 1306(b) and 1327(b) both vest the property of the debtor's chapter 13 estate in the individual debtor after confirmation of the plan.

(n18)Footnote 18. 11 U.S.C. § 1306(b).

(n19)Footnote 19. Pub.L.No. 109-8, § 716 (2005), effective for cases commenced on or after October 17, 2005.

(n20)Footnote 20. *Id.*

(n21)Footnote 20a. 391 B.R. 1 (Bankr. D. Mass. 2008) .

(n22)Footnote 21. See 8 Collier on Bankruptcy, Chs. 1200-1231 (Matthew Bender 15th Ed. Revised).

(n23)Footnote 22. Pub. L. No. 109-8, §§ 1001-1007 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n24)Footnote 23. The provisions, as in effect on Sept. 30, 1998, were reenacted by § 149(a) of Division C of Act, Oct. 21, 1998, P.L. 105-277 (note to this §), for the period beginning on Oct. 1, 1998, and ending on April 1, 1999. Such § 149(a), as subsequently amended by Acts: March 30, 1999, P.L. 106-5, § 1, 113 Stat. 9; Oct. 9, 1999, P.L. 106-70, § 1, 113 Stat. 1031; May 11, 2001, P.L.107-8, § 1, 115 Stat. 10; June 26, 2001, P.L. 107-17, § 1, 115 Stat. 151; May 7, 2002, P.L. 107-170, § 1, 116 Stat. 133; May 13, 2002, P.L. 107-171, Title X, Subtitle I, § 10814, 116 Stat. 532; Dec. 19, 2002, P.L. 107-377, § 2(a), 116 Stat. 3115; and August 15, 2003, P.L. 108-73, § 2(a), 117 Stat. 891.

(n25)Footnote 24. This conclusion that the separate entity rule is not applicable in a chapter 12 case was confirmed by a bankruptcy court in *In re Lindsey*, 142 B.R. 447 (Bankr. W.D. Okla. 1992) . The standing chapter 12 trustee sold property pursuant to the plan, and the debtors therefore asked the court to require the trustee to file a return for the chapter 12 estate and pay the tax from the proceeds of the sale. The court rejected this request and concluded the chapter 12 standing trustee had no obligation to file a return and pay the tax, because there was no separate entity chapter 12 estate for tax return filing purposes. The court concluded the sales conducted by the standing chapter 12 trustee were not made in the capacity as a liquidating trustee. The court also concluded it was clear that, pursuant to *Internal Revenue Code sections 1398 and 1399*, the standing chapter 12 trustee neither files a return nor pays federal income tax when his actions giving rise to a federal tax liability are undertaken in that capacity. The tax burden in a chapter 12 case shifts to the trustee when a separate entity is created and the actions giving rise to the tax were undertaken in the capacity of trustee for this separate entity. Sections 1207 and 1227 of the bankruptcy code are almost identical to sections 1306 and 1327 in that they each provide, except as otherwise provided in the confirmed plan, the farmer shall remain in possession of all property of the estate, and those assets revert in the debtor upon confirmation of the plan. As a result, it is unlikely that a separate taxable entity would be deemed to exist in a chapter 12 case, and the debtor should continue to file his or her own income tax returns on both a prepetition and postpetition basis.

(n26)Footnote 25. 11 U.S.C. § 1231(a). For a discussion of state and local tax liabilities, see chapter TX12 *infra*.

(n27)Footnote 26. 11 U.S.C. § 1231(b). Sections 1231(a) and (b) were removed from the Bankruptcy Code by § 719 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, and subsections (c) and (d) were redesignated subsections (a) and (b), effective for cases arising after October 17, 2005.

(n28)Footnote 27. I.R.C. sections 6012(b)(4) & 6012(a)(9) requires a fiduciary of a trust or of an estate of an individual under chapter 7 or 11 of title 11 to file tax returns for that trust or estate.

(n29)Footnote 28. See, e.g., *In re Goff*, 57 B.R. 442 (Bankr. W.D. Tex. 1985) , and the cases cited therein. I.R.C. §

641(a) is part of Subchapter J of the Internal Revenue Code, which applies to the taxation of "Estates, Trusts, Beneficiaries, and Decedents." § 641(a) imposes an income tax on the taxable income of estates or of any kind of property held in trust. The court in *Goff* held that *I.R.C. § 641(a)* was applicable to bankruptcy estates even though the plain language of that statute applied only to estates and trusts arising from decedents. 57 B.R. 442, 445-46. The court, in interpreting the legislative intent behind the Bankruptcy Tax Act of 1980, gave deference to pre-1980 Treasury Regulations that interpreted *I.R.C. § 641(a)* to include bankruptcy estates. 57 B.R. 442, 445-446.

(n30)Footnote 29. S. Rep. No. 1035, 96th Cong. 2d Sess. 24, 28-29 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n31)Footnote 29a. *Rev. Proc. 2006-52*

(n32)Footnote 29b. *Id.*

(n33)Footnote 30. *I.R.C. § 7701(a)(1)* and (3) and *§ 6012(a)(2)*; *see also* *Treas. Reg. § 1.6012-2(a)(1)*, which requires a corporation to file an income tax return "whether it has taxable income or regardless of the amount of its gross income."

(n34)Footnote 31. *I.R.C. § 6012(a)(2)*.

(n35)Footnote 32. *I.R.C. § 11(a)*. The rates of taxation imposed by the Internal Revenue Code are contained in *I.R.C. § 11(b)*. Other tax rates applicable to corporations are cross-referenced in *I.R.C. § 12*. The most notable of these additional corporate income tax liabilities is the alternative minimum tax contained in *I.R.C. § 55*.

(n36)Footnote 33. *I.R.C. § 1399*.

(n37)Footnote 34. Pursuant to *I.R.C. § 1399*, no separate taxable estate results for a corporation after it files a title 11 petition. Thus, the taxable year of a corporation remains unaffected by the filing.

(n38)Footnote 35. *Treas. Reg. § 1.6012-3(b)(4)*. A corporation is not in existence for purposes of the return filing rules if "it ceases business and dissolves and retains no assets, whether or not under state law it may thereafter be winding up its affairs." *Treas. Reg. § 1.6012-2(a)(2)*. A corporation will not, however, cease to exist under this rule if a receiver or trustee is appointed to continue to operate the corporation's business activities. *Treas. Reg. § 1.6012-2(a)(2)*. If a receiver, trustee in dissolution, trustee in bankruptcy or assignee, by court order or otherwise, takes possession of all or substantially all of the property or business of a corporation, that representative or fiduciary is required to file the same returns required of the corporation. *See, e.g., Holywell Corp. v. Smith*, 911 F.2d 1539 (11th Cir. 1991), *rev'd*, 503 U.S. 47, 112 S. Ct. 1021, 117 L. Ed. 2d 196, 26 C.B.C.2d 1 (1992) (in which the Supreme Court held that the trustee of a liquidating trust was required to file income tax returns for the debtor corporation). If all or substantially all of a corporation's assets are held by a fiduciary, that fiduciary is required to file the corporation's income tax returns even if no business operations are conducted by the fiduciary. *Treas. Reg. § 1.6012-3(b)(4)*. If, however, a fiduciary only holds a "small portion" of a corporation's property, that fiduciary will not be required to assume control over the filing of returns for the corporation. *See* the discussions of 28 U.S.C. § 960 at P TX3.03[1][a] *infra* and *Holywell Corp. v. Smith* at P TX3.03[1][b][ii] *infra*.

(n39)Footnote 36. *See, e.g., Stoller v. United States*, 320 F.2d 340 (Cl. Ct. 1963) (appointment of a receiver did not end the existence of the corporation as a taxpayer entity; therefore, the entire calendar year's income, deductions and credits would be included in a tax return for the entire taxable year and not just the period of receivership). Under the language of *Treas. Reg. § 1.6012-3(b)(4)* applicable to receivers and trustees in a title 11 case, the reasoning of the Court of Claims in *Stoller* could be applied to all forms of fiduciaries who have control over substantially all of the assets of a corporation and would require those fiduciaries to file income tax returns for the debtor's estate as long as the fiduciary was in possession of substantially all of the debtor's assets. *See also* *Yeckes v. Commissioner*, 25 T.C.M. (CCH) 924 (1966); *Rev. Rul. 69-641*, 1969-2 C.B. 241.

(n40)Footnote 37. *Treas. Reg. § 1.6012-2(a)(2)*.

(n41)Footnote 38. This issue is discussed at *P TX3.03[1][a], [b][ii] infra*.

(n42)Footnote 39. *I.R.C. § 7701(a)(2)*.

(n43)Footnote 40. *Id.*

(n44)Footnote 41. Form 1065, U.S. Partnership Income Tax Return.

(n45)Footnote 42. *I.R.C. § 6031(a)*. Form 1065 reports all of the income, expenses and tax credits realized by the partnership and allocates them to the partners based on the partnership's terms. A partnership's income, expenses and tax credits are then reported and recognized by the partners on their income tax returns. *See* chapter TX13 *infra*.

(n46)Footnote 43. *I.R.C. § 701; Treas. Reg. § 1.701-1*.

(n47)Footnote 44. *Rev. Rul. 68-48, 1968-1 C.B. 301*.

(n48)Footnote 45. *I.R.C. § 1399*.

(n49)Footnote 46. A partnership is a "pass-through" entity for federal income tax purposes. Partners are liable for income tax only in their separate capacities based upon their *pro rata* shares of the taxable income of the partnership. *I.R.C. §§ 701, 702*. Because, pursuant to *I.R.C. § 1399*, no separate taxable entity is created as a result of the filing of a partnership title 11 case, the partnership must continue with no change in its taxable year in order to pass-through the taxable income and other tax attributes to its partners as required by the Internal Revenue Code.

(n50)Footnote 47. *See Beaman v. Shearin (In re Shearin)*, 224 F.3d 346, 349, 44 C.B.C.2d 1363 (4th Cir. 2000), *cert. denied sub. nom. Vandeventer Black v. Beaman*, 531 U.S. 1149, 121 S. Ct. 1090, 148 L. Ed. 2d 964 (2001) (debtor's interest in law firm partnership became property of the estate).

(n51)Footnote 48. *Gulley v. Commissioner*, 79 T.C.M. (CCH) 2171, 2176 (2000). *See also Shunk v. Commissioner*, 173 F.2d 747, 750 (6th Cir. 1949) ("a partner is taxable upon his distributive share of the ordinary net income of the partnership for the partnership's taxable year, whether or not distribution is made to him. But the amount of this taxable income is not determined until the end of the partnership's fiscal year.")

(n52)Footnote 49. *See Grigoraci v. Commissioner*, T.C. Memo 2002-202; 2002 Tax Ct. Memo LEXIS 207; 84 T.C.M. (CCH) 186 citing *Blonien v. Commissioner*, 2002 U.S. Tax Ct. LEXIS 33, 118 T.C. 541 (2002).

(n53)Footnote 50. 335 F.3d 1121 (10th Cir. 2003).

(n54)Footnote 51. *See Katz v. Commissioner*, 116 T.C. 5, 2001 U.S.T.C. 2 (2001), *rev'd and remanded*, 335 F.3d 1121 (10th Cir. 2003).

(n55)Footnote 52. *Grigoraci v. Commissioner*, T.C. Memo 2002-202; 2002 Tax Ct. Memo LEXIS 207; 84 T.C.M. (CCH) 186 citing *Blonien v. Commissioner*, 2002 U.S. Tax Ct. LEXIS 33, 118 T.C. 541 (2002).

(n56)Footnote 53. The S corporation procedures were enacted shortly after the TEFRA procedures as part of the Subchapter S Revision Act of 1982, Pub. L. 97-354, § 4(a), 96 Stat. 1691. The S corporation procedures were repealed as of Dec. 31, 1996, by the Small Business Job Protection Act of 1996, Pub. L. 104-188, § 1307(c)(1), 110 Stat. 1781.

(n57)Footnote 54. *See I.R.C. § 6244(2)*; *See also* S. Rep. No. 97-640, at 25 (1982), 1982-1 C.B. 718, 729.

(n58)Footnote 55. *See Hang v. Commissioner*, 95 T.C. 74, 80 (1990).



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Collier on Bankruptcy Taxation

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CHAPTER TX3 Tax Reporting Requirements

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P TX3.03 Obligation to File Tax Returns and Pay Tax Liabilities

[1] Statutory Provisions Relating to the Obligation to File Tax Returns During a Title 11 Case

Several federal statutes, including 28 U.S.C. section 960 of the Judicial Code, section 1115 of the Bankruptcy Code, I.R.C. section 6012(b)(3), and I.R.C. section 6012(b)(4), require a trustee, the debtor in possession or other applicable fiduciary to file income tax returns during a case filed under title 11 and to pay the tax reflected thereon. Another federal statute, 31 U.S.C. section 3713, extends similar obligations in non-title 11 cases to a receiver or other representative of an insolvent taxpayer who is liquidating the assets of a taxpayer. Section 3713 has also been applied to trustees in title 11 cases who fail to properly distribute assets of an estate pursuant to the Bankruptcy Code's priority schedule.

As a general rule, Bankruptcy Code section 505(a) permits the Bankruptcy Court to determine the amount or the legality of any tax, addition to tax, or tax penalty. The Bankruptcy Court has the authority to determine the amount any administrative taxes due upon the completion of the IRS examination per Bankruptcy Code section 505(b). Accordingly, a trustee in a bankruptcy proceeding may ask the IRS to make a prompt determination of any unpaid liability of the estate for any tax incurred during the administration of the case. The trustee can request this by submitting a tax return setting forth the tax and by requesting a prompt determination of the return. n1

The government has 60 calendar days from the date of the request to notify the trustee that the return(s) has been selected for examination. The government has 180 calendar days from the date of the request to complete the examination (or a longer period may be granted by court permission) and to notify the trustee of any additional tax due. n2 In the case *In re Pt-1 Communs, Inc.*, the IRS failed to notify the trustee in a bankruptcy proceeding that a return had been selected for audit within the 60-day statutory period. n2a The IRS filed its proof of claim two and a half months after the expiration of the period. In this case, the court held that when the IRS failed to respond within the 60 day statutory period, the debtor in possession was discharged from any further tax liability for the tax year at issue and, in the absence of fraud or misrepresentation, the trustee was also discharged from any liability for such tax.

[a] 28 U.S.C. section 960

Section 960 of the Judicial Code establishes the responsibility of officers and agents of any United States court to file tax returns and pay the tax reflected thereon:

Any officers and agents conducting any business under authority of a United States court shall be subject to all Federal, State and local taxes applicable to such business to the same extent as if it were conducted by an individual or corporation.

The purpose of this provision of the Judicial Code is to insure that any business operated by an agent or representative of a federal court will be subject to the same tax burdens as competitive businesses that are not being supervised by any federal court. n3 Businesses operated by a receiver, a title 11 trustee or other fiduciary cannot therefore be operated on a tax-free basis.

The scope of the application of section 960 should be extended equally to trustees or other fiduciaries who are either liquidating a debtor's assets or operating a debtor's continuing active businesses, and section 960 should require them to file tax returns for a debtor's title 11 estate. n4 The Bankruptcy Abuse and Prevention and Consumer Protection Act of 2005 extended *Sierra Summit* by amending section 960 to make it clear that payments that must be made under section 960 must be made on the same time schedule applicable outside bankruptcy.

[b] Chapter 11 Filing Requirements for Individuals

IRS Notice 2006-83 provides guidance for individuals who file Chapter 11 bankruptcies as well as employers of these individuals, and persons filing Forms W-2, 1099's and other information returns (including Schedule K-1). n5 *Section 1115 of the Bankruptcy Code*, which was enacted by section 321(a)(1) of the 2005 Act, requires that the bankruptcy estate, rather than the debtor, must include in its gross income both (1) the debtor's gross earnings from his or her performance of services after the commencement of the case (post-petition services) and (2) the gross income from property acquired by the debtor after the commencement of the case (post-petition property).

Section 1115 of the Bankruptcy Code requires that the debtor in possession or the trustee, if one is appointed, must prepare and file the income tax returns of the bankruptcy estate if one is required under section 6012(a)(9). n6. Additionally, within a reasonable time after the commencement of a Chapter 11 case, the trustee must provide notification of the bankruptcy estate's EIN to persons that are required to file information returns to the bankruptcy estate reporting gross income, gross proceeds, or other types of reportable payments. n7 The EIN should not be provided to the debtor's employer or other person filing Form W-2 reporting wages or other compensation, since section 1115 does not affect the determination of what constitutes wages for purposes of federal income tax or Federal Insurance Contributions Act (FICA) withholding. n8

In accordance with section 1115 of the 2005 Act, employers should continue to report all wage income and tax withholdings, whether pre-petition or post-petition, for individuals filing Chapter 11 on a Form W-2 issued to the debtor under the debtor's social security number. n9 Additionally, the debtor is not required to file a new Form W-4 with his employer adjusting his withholding allowances solely because he has filed a Chapter 11 case and his post-petition wages will be included in the gross income of the estate.

[c] I.R.C. Section 6012

I.R.C. section 6012 identifies the individuals and entities required to file income tax returns. The threshold tests for the filing of income tax returns by individuals, corporations, estates, trusts, political organizations and the estate of an individual under chapter 7 or 11 of the Bankruptcy Code are contained in *I.R.C. section 6012(a)*. n10 The threshold tests for the filing of income tax returns by trustees, receivers and other fiduciaries are contained in *I.R.C. section 6012(b)*.

[i] Individual Tax Returns

After the enactment of *I.R.C. section 1398* and the creation of the "separate entity rule" in the Bankruptcy Tax Act of

1980, questions regarding who must bear the responsibility of filing income tax returns for an individual debtor are easier to resolve. n11 A trustee or other fiduciary for an individual debtor under chapter 7 or 11 n12 must file a tax return for the individual debtor's bankruptcy estate if certain income levels are exceeded. n13

In *In re Vale*, n14 the court held that every estate of an individual under chapter 7 or 11 of title 11 of the bankruptcy code, the gross income of which for the taxable year is not less than the exemption amount plus the basic standard deduction under *Internal Revenue Code* section 63(c)(2)(D), has the duty to file a Form 1041 Fiduciary Income Tax Return on behalf of the bankruptcy estate pursuant to section 6012(a)(9). Returns of any estate of an individual under chapter 7 or 11 of title 11 of the *United States Code* must be made by the fiduciary thereof pursuant to section 6012(b)(4). n15 The duty of a fiduciary to file a return for an individual debtor under *I.R.C. section 6012*, however, extends only to tax returns for the individual's bankruptcy estate and not for the individual debtor. n16

[ii] Corporate Tax Returns and the Supreme Court's Opinion in *Holywell Corp. v. Smith*

Another subsection of *I.R.C. section 6012* imposes tax return filing obligations on fiduciaries and receivers for corporate debtors. *I.R.C. section 6012(b)(3)* provides:

In a case where a receiver, trustee in a case under title 11 of the United States Code or assignee, by order of a court of competent jurisdiction, by operation of law or otherwise, has possession of or holds title to all or substantially all the property or business of a corporation, whether or not such property or business is being operated, such receiver, trustee, or assignee shall make the return of income for such corporation in the same manner and form as corporations are required to make such returns. n17

I.R.C. section 6012(b)(3) ignores the operating trustee versus liquidating trustee dichotomy that has been at the heart of disputes concerning the applicability of 28 U.S.C. section 960 n18 and requires a fiduciary to file corporate tax returns as long as the fiduciary has possession of all or substantially all of a corporation's assets.

Under the long-standing Treasury Regulations that have interpreted *I.R.C. section 6012*, a receiver, trustee, or assignee must file a corporate income tax return if such person "has possession of or holds title to all or substantially all the property or business of a corporation," regardless of "whether or not the [fiduciary] is operating the property or business of the corporation." n19 Thus, a liquidating trustee who is in possession of substantially all of the assets of a corporation will, according to the Treasury Regulations, be required to file a corporate income tax return and pay the tax reflected thereon. n20 If a receiver or trustee is in charge of or has possession of only a "small part of the property of a corporation," that fiduciary is not required to file an income tax return. n21

Any questions regarding a trustee's obligation to file tax returns for a debtor's estate have been answered by the Supreme Court in *Holywell Corp. v. Smith*. n22 In *Holywell*, a group of related debtors that included a limited partnership, corporations, and individuals filed bankruptcy petitions. Under the plan confirmed by the bankruptcy court, the estates of the various debtor entities and individuals were consolidated, a liquidating trust was created and a liquidating trustee was appointed. n23 The liquidating trust was funded by the proceeds of two postpetition property sales. The debtors demanded that the trustee, who held all of the sale proceeds from both sales under the plan, pay the income tax liabilities from the sales. Neither the debtors nor the trustee filed corporate income tax returns to report the postpetition gain realized by the trustee from the sale of assets of the consolidated debtors.

The United States contended that the liquidating trustee was required to file income tax returns under *I.R.C. section 6012(b)(3)* and (4) and pay the tax liability reflected thereon under *I.R.C. section 6151*. n24 The Court of Appeals for the Eleventh Circuit rejected the United States' argument and concluded:

Based on our review of the statutory provisions, we agree with the district court's conclusion that 26 U.S.C. section 6012 does not apply in this case. By its terms, section 6012 refers only to trustees who are

appointed under Chapter 11 of the Bankruptcy Code. If Congress had intended that all trustees be subjected to the provisions of section 6012, it would have so provided. We also conclude that section 6012 was not intended to apply to a broad range of individuals without regard to the functions which they perform. n25

The Eleventh Circuit thus restricted the applicability of the statutory language of *I.R.C. section 6012(b)(3)* and the long-standing Treasury Regulations that required a debtor's representative to file income tax returns if he or she is in possession of all or substantially all of the debtor's assets. The Eleventh Circuit also imposed a standard for the determination of income tax return filing responsibility that would have required a factual review of the scope and nature of the duties of any trustee or fiduciary--operating versus non-operating trustee--to determine if there was an obligation on the part of that fiduciary to file tax returns and pay the tax reported thereon.

The Supreme Court reversed, concluding that the liquidating plan's trustee was required to file income tax returns and pay the tax reflected thereon for the estates. n26 The liquidating trustee in *Holywell* was the assignee of all of the assets of Holywell Corporation and was therefore specifically required by *I.R.C. sections 6012(b)(3)* and *6151* to file income tax returns for the liquidation process and pay the resulting tax. n27 The distinction between a liquidating and an operating trustee was rejected by the Supreme Court because *I.R.C. section 6013(b)(3)* required the filing of income tax returns regardless of the operation of an active trade or business. n28

[d] 31 U.S.C. Section 3713

Section 3713 of title 31 n29 creates a preference or priority payment status in favor of the United States, and the failure to honor and pay certain claims to the United States may result in the accrual of personal liability against the receiver or other representative for the taxpayer. A receiver or other liquidator of a non-title 11 taxpayer may be required by section 3713 to make sure that obligations owed to the United States are paid before any distributions are made on the claims of other creditors.

Section 3713 is not directly applicable to a trustee or other representative of a debtor who has filed a petition under title 11. n30 However, a trustee or other fiduciary appointed under the Bankruptcy Code can become personally liable to the United States under *31 U.S.C. section 3713* if he or she fails to make distributions to the United States on its scheduled and allowed claims. n31

A personal representative of an insolvent, liquidating taxpayer in a title 11 case may come within the scope of *31 U.S.C. section 3713*. n32 For example, receivers for a taxpayer are subject to liability under section 3713, and a receiver who is aware of a debt owed to the United States and who fails to pay that liability before those of other claimants may be held liable to the United States for the unpaid liability. n33

[2] IRS Procedures for Determining Estate's Unpaid Tax Liability

In 2006, the IRS set forth their steps for promptly determining the unpaid tax liability of the bankruptcy estate. n34 This procedure is initiated by the Trustee or a Debtor In Possession who seeks prompt determination of any unpaid tax liability of the bankruptcy estate, and wants the IRS to provide that information. The procedure is as follows:

- A. A written request signed by the party seeking the information must be prepared;
- B. The written request, in duplicate, must be submitted to the IRS's Centralized Insolvency Operation;
n35
- C. The party requesting the tax determination must include copy of the tax returns for the tax period;

D. The tax returns to be included should be those prepared by and filed by the Trustee or Debtor In Possession or those filed by the debtor with the Internal Revenue Service; and

E. The request must also contain the name of the debtor, the IRS location where the tax return was filed, the debtor's social security number, tax identification number or the entity identification number, the type of bankruptcy estate, the bankruptcy case number, the court where the bankruptcy case is pending, and the tax year, or years, or period for which the tax determination is requested.

The importance of following the procedure outlined above is critical because a time limit for action is imposed on the IRS to act and notify the Trustee or Debtor in Possession within 60 days, either to accept the tax return as filed or to examine the tax return. n36

[3] Partnership Returns

Before enactment of the Bankruptcy Tax Act of 1980, the IRS contended that the income of a debtor partnership, like that of an individual debtor, should be taxed as income of an estate n37 and that the income, deductions, credits and other tax attributes of the partnership should be reported on a Form 1041, U.S. Fiduciary Income Tax Return. n38 The taxation of partnership bankruptcy estates was overruled by the enactment of *I.R.C. section 1399*, which specifically provides that a taxable estate does not exist for a partnership. After the enactment of *I.R.C. section 1399*, the proper result is that the partnership should file its own Form 1065, and the trustee or other fiduciary should have no duty to file such a return. n39 On the other hand, one court has held that a trustee's operation of a debtor partnership's businesses prior to their sale required the trustee to file an income tax return for the partnership's bankruptcy estate in order to report the income realized by the trustee during the liquidation process. n40

In *In re Gellati*, the Supreme Court held that the timely assessment of employment taxes against a partnership suffices to extend the statute of limitations to collect the tax in a judicial proceeding from the general partners who are liable for the payment of the partnership's debts. With this ruling, the Supreme Court reversed a prior decision by the Ninth Circuit in which it was held that the assessment of federal employment taxes against a partnership was not a sufficient basis on which to collect the taxes through a proof of claim filed in the individual partners' bankruptcy proceedings. The Supreme Court rejected the lower courts' rationale, concluding that the IRS was not required to separately assess taxes against each partner individually and that its assessment of tax against the partnership extended the statute of limitations period for collecting the tax from the individual partners. n41

Although the IRS conceded that it had not assessed the partners individually during the Code section 6501 three-year limitations period, it argued that its timely assessment of the taxes against the partnership extended the limitations period for collecting taxes against the partners under Code section 6502. The bankruptcy court sustained the taxpayers' objections to the IRS's proof of claim in each case.

The *Gellati* ruling is a consolidated decision of two cases, each of which involved two partners who had filed for chapter 13 protection as a married couple. Prior to their filing for chapter 13 protection, the IRS had timely assessed taxes against the partnership for unpaid employment taxes within the applicable three year statute of limitations period. Then, after the three year statute of limitations period had lapsed, the IRS filed a proof of claim against the individual partners' bankruptcy estates seeking to collect taxes owed by the partnership from the partners.

The Supreme Court disagreed with both the bankruptcy court and the Ninth Circuit. The decision hinged upon the Courts' interpretation of *I.R.C. section 6502(a)*, which states, in relevant part, that if a tax is properly assessed within three years, the statute of limitations for the collection of the tax is extended by 10 years from the date of assessment. The central issue for determination, according to the Supreme Court, was whether in order for the IRS to avail itself of the 10-year increase in the statute of limitations for collection of a tax debt, it must assess the taxes not only against a partnership that is directly liable for the debt, but also against each individual partner who might be jointly and severally

liable for the debts of the partnership. The court noted that the only relevant "taxpayer" for purposes of Code sections 6501-6502 in this case is the partnership. As such, it was held that the proper assessment of the tax against the partnership sufficed to extend the statute of limitations for collection of the tax from the general partners who were liable for the payment of the partnerships' debts.

The *Gellati* decision is a significant ruling that should be considered in advance by partners seeking chapter 13 protection. The courts' broad interpretation of the term "taxpayer" for statute of limitations purposes in this case makes clear that the liable taxpayer for unpaid employment tax assessments may ultimately be the partner who will not be protected if the IRS files a claim against the bankruptcy estate within 10 years of the date of liability.

[4] Trustee's Obligation to File Tax Returns for Prepetition Periods

The Supreme Court's opinion in *Holywell Corp. v. Smith* n42 makes it clear that a trustee must file tax returns for postpetition periods to reflect income, deductions and other tax attributes recognized by the title 11 estate. However, a trustee or other representative of a debtor may also be obligated to file income tax returns for taxable years that ended before the petition date if he or she must pay that tax liability as a claim scheduled by the debtor or as a claim reflected on a creditor's proof of claim. In the case of *In re Hudson Oil Co.*, n43 the court held:

Nowhere in this section [I.R.C. section 6012(b)(3)] does it state that a trustee's duty to file returns is limited to those years when he *held* possession or title to all or substantially all the property or business during the actual tax year. On the contrary, the section clearly provides that if the trustee *has* property or business of the corporation now he shall file the return in the same manner as corporations are required. As such, if the trustee *has* all or substantially all the property of the business of a corporation and the tax return is due, the trustee should file the return even though the taxable year may have ended prior to the filing of the petition. n44

Similarly, in *Nicholas v. United States*, n45 the Supreme Court approved the assessment of penalties against a liquidating trustee for failure to file tax returns reflecting payroll tax liabilities incurred by the debtor pre-liquidation. The Court relied on the trustee's succession in interest to the title of the debtor in possession, who, as an officer of the bankruptcy court, was clearly subject to such taxes. As successor in interest, the trustee is bound by all authorized acts of the debtor in possession. n46

Thus, the duty to file income tax returns may not have to correspond to the time period in which the trustee has possession of the debtor's property. However, the *Nicholas* Court emphasized that this is a limited duty: "[N]othing in this opinion may be taken as imposing any obligation upon a trustee in bankruptcy to file returns for taxes incurred before the initiation of proceedings under the Act." n47

[5] IRS Action; Substitute Return Filings

Faced with economic hardships and the related stress of administering creditor claims, people and businesses in financial trouble often fail to file their tax returns. As a result, in accordance with *section 6020(b) of the Internal Revenue Code*, the IRS commonly prepares substitute income tax returns, based on whatever information it has available. Recognizably, substitute returns prepared by the IRS typically overstate the taxpayers' actual liability since no expenses or deductions are allowed. Ultimately, the resulting assessment and follow-up collection activities may precipitate a bankruptcy filing, if one has not already been commenced by the debtor.

Section 523(a)(1)(B) of the Bankruptcy Code allows the discharge of taxes in bankruptcy proceedings, but excludes from dischargeability, among other categories, those taxes arising from a return filed less than two years before the petition for bankruptcy. If the section 6020(b) return prepared by the IRS is a "return" for this purpose, then it may well have been "filed" more than two years before the bankruptcy petition. In addition, it is not uncommon for taxpayers to

actually proceed to file returns for those same years--and those returns may very well have been filed more than two years before the bankruptcy filing, perhaps because the bankruptcy filing was delayed until after the end of the two-year period. This raises the question of whether a return filed after a section 6020(b) return has been filed is a "return" for bankruptcy code purposes.

The 2005 Act clarifies the treatment of substitute returns and provides that a return which is filed by the IRS under section 6020(a) on behalf of a taxpayer, who has provided enough information to complete it, will constitute the filing of a return for discharge purposes. n48 However, the rule does not apply to returns based on information obtained through testimony or otherwise under section 6020(b). n49

In a recent case, *Ranney v. IRS*, it was held that a debtor's tax obligation for the tax year at issue was not subject to discharge under Chapter 7 of the Bankruptcy Code because he never filed a tax return for that year. n50 In reaching its decision, the court noted that the substitute return filed by the IRS on behalf of the debtor for that year was not considered for purposes of determining dischargeability of his tax debt. The fact that the debtor had neither signed the substitute return nor acknowledged that it represented the actual amount of taxes due were key factors considered by the court in ruling that the taxes were not dischargeable.

Additionally, in *Izzo v. US*, it was held that an individual debtor's tax liabilities were not dischargeable in a Chapter 7 proceeding where the debtor had only submitted his individual tax returns after the IRS had prepared substitute returns on his behalf and made the subject assessments. n50a The *Izzo* court concluded that where the debtor submitted tax forms only after the IRS had prepared substitute returns and made assessments, there was no tax purpose served by filing the tax forms. The debtor in this instance had failed to respond to either the 30- or 90-day letters issued by the IRS requesting his return. Furthermore, after receiving the letters, the taxpayer had entered into negotiations with the IRS to reduce his tax liability. In order to facilitate these discussions, the IRS asked the taxpayer to submit the Form 1040 tax returns for the years at issue. The taxpayer submitted the returns and subsequently filed a chapter 7 petition seeking discharge of the tax liabilities reported on the Forms 1040.

The *Izzo* court established a four pronged test for evaluating whether a document constitutes 'a return' as required by statute with a tax liability that may dischargeable: 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. Prior to the *Izzo* decision, other courts had interpreted the fourth requirement to mean whether or not the filing had a tax purpose. n50b The court in *Izzo* concluded that where the debtor submitted tax forms only after the IRS had prepared substitutes returns and made assessments, that there was no tax purpose served when the debtor filed the tax forms. Thus, since the debtor had not filed the returns, the tax liability was not discharged under his chapter 7 petition.

Prior to this clarification, courts relied on cases such as *Billy J. Brown v. United States* and *Mathis v. United States*, n51 which addressed treatment of substitute returns. In the *Billy J. Brown* case, a U.S. bankruptcy court held that an individual's income tax debt was nondischargeable because he failed to file income tax returns. The IRS had prepared substitute income tax returns for, and issued deficiency notices to the taxpayer after he failed to file his 1987-1990 returns. The IRS assessed the taxes due and entered into an installment agreement with the taxpayer who later filed a chapter 7 petition and sought a dischargeability determination.

The court ruled that the tax debt at issue was nondischargeable based on the taxpayers' failure to file returns for 1987-1990. The court explained that neither the IRS's substitute returns nor the installment agreement between the taxpayer and the IRS satisfied the requirements for filing a return. Additionally, according to the court, "while ... [the taxpayer] had signed an installment agreement, such an agreement to pay a tax debt is not equivalent to filing a return." Accordingly, the income taxes were not discharged in this chapter 7 bankruptcy.

It is important to note that the *Brown* decision did not stand for the premise that substitute returns prepared by the IRS

could never qualify as "returns" for bankruptcy discharge purposes. Section 6020(a) provides that if the taxpayer signs the return prepared by the IRS, then that return "may be received by the Secretary as the return of such person." A return qualifying under section 6020(a) may also qualify as a "return" for bankruptcy purposes.

In the case, *John H. Mathis Jr. v. United States*, for example, the taxpayer had provided to the IRS information allowing it to file substitute returns for him for the years 1983 to 1990. n52 The revenue agent prepared a Form 4549, "Revenue Agent's Report of Examination Changes" rather than Forms 1040 for each of the years and the taxpayer signed them. The court ruled that the signed Forms 4549 qualified as valid tax returns for purposes of the Internal Revenue Code and constituted "returns" for purposes of *section 523(a)(1)(B) of the Bankruptcy Code*.

It held that by signing the Form 4549, the taxpayer had consented to the immediate assessment and the collection of his tax obligations and had waived his right to both receive a deficiency notice and contest the determination in Tax Court. Furthermore, rejecting the taxpayers' argument that unlike the Form 1040, Form 4549's signature line does not contain a perjury clause, the court concluded that he had "cooperated fully" with the IRS by disclosing all necessary information to permit the preparation of Forms 4549 for the missing years. The IRS, in turn, had prepared the forms, which were signed, filed and accepted. Thus, accordingly to the court, every requirement of section 6020(a) had been satisfied. Consequently, it was held that the signed Forms 4549 qualified as valid tax returns for purposes of the Internal Revenue Code and constituted "returns" for purposes of *section 523(a)(1)(B) of the Bankruptcy Code*. n53

The court has also addressed whether the signing of other IRS forms constitutes a return for purposes of chapter 7. In *Woods v. Commissioner*, the court held that the filing by an individual debtor of Forms 4852 rather than Forms 1040, does not constitute the filing of a tax return because Form 4852 is not filed or purport to be a return, nor is it an honest and reasonable attempt to satisfy the tax laws. n53a The debtor in *Woods* had filed Forms 1040 for tax years 1988 through 1991, 1993, and 1995 but failed to pay the balance reportedly due with the returns. No Forms 1040 were filed for tax years 1996 or 1997, but the debtor instead filed Forms 4852 for these years. The *Woods* court held that the tax liens at issue for tax years 1996 and 1997 were not extinguished by bankruptcy and that the Form 4852 did not constitute a tax return because it was not filed purport to be a return, nor was it an honest and reasonable attempt to satisfy the tax laws.

[6] IRS Tracking of Unfiled Tax Returns

It is unwise for debtors (or their appointed trustees and representatives) who have filed bankruptcy to assume that unfiled tax returns will go unnoticed after submission and/or acceptance of a bankruptcy petition. The Internal Revenue Manual specifically addresses the treatment of unfiled tax returns. Specifically, the IRM notes the adverse impact of unfiled returns since those not filed prior to confirmation may result in:

- (1) unassessed (estimated) amounts on proof of claim;
- (2) motions to compel;
- (3) objections to cash collateral primarily in Chapter 11 cases;
- (4) objections to confirmation in Chapters 11, 12, and 13 cases;
- (5) objections to distribution in Chapter 7 asset cases;
- (6) objections for feasibility of plans problems--based on the inability of the Service to ascertain the full amount of federal tax debt owed;
- (7) Rule 2204 Examinations (motions to compel); and

(8) Dischargeability concerns (confusion at discharge time determining what taxes meet dischargeability criteria).

IRM section 4.27 advises IRS employees to conduct preliminary research to identify unfiled tax returns and to determine what, if any, action is required. The Services' objective is to avoid the use of field Compliance resources to pursue what it considers "low priority returns" (i.e., unfiled returns that would not be pursued if the taxpayer was not in bankruptcy) while minimizing the risk of loss of revenue due to unclaimed taxes. IRS employees are specifically warned not to "expended excessive resources" in trying to obtain returns that appear to be below the tolerance amount(s) and/or do not meet other criteria listed in its Collection Law Enforcement Manual (LEM).

The potential tax due on unfiled returns and the unassessed amount listed on the proof of claim will generally be based on information contained in the last filed tax return. However, other available information (such as the debtor's bankruptcy schedules, statement of financial affairs, etc.) may be considered in preparing as accurate an estimate as possible.

If the debtor has failed to file returns, and if it is appropriate per referenced sections of the LEM and IRM section 4.27 to pursue the filing of the returns, employees are advised to consider requesting that a motion to compel be filed. Alternatively, a motion to dismiss may be pursued, but is not advised in Chapter 13 cases after confirmation has been granted. As a final alternative, the IRS may refer unfiled tax returns to Counsel to request that the bankruptcy court compel the debtor to produce the information necessary to determine the tax liability.

In cases involving unfiled tax returns, an IRS Insolvency employee may be assigned to monitor the case for unfiled tax returns to ensure that timely appropriate actions may be taken.

[7] Trustee's Obligation to File Amended Tax Returns for Prepetition Periods

The IRS makes administrative provision for the filing of amended tax returns. n54 Courts have not addressed, however, the issue of whether a trustee or fiduciary has any obligation to file an amended tax return for a prepetition taxable period. The Supreme Court has confirmed that a trustee has a duty to seek out and pay only those postpetition taxes that accrued against the bankruptcy estate during the bankruptcy itself. n55 The court, in the case of *In re Hudson Oil Co.*, n56 required the trustee to file prepetition tax returns that were due but had not been filed before the title 11 case, and thus did not address the amendment of returns that actually had been filed by the debtor.

On the basis of the Supreme Court's limited view of the role of the trustee with respect to prepetition tax returns, the best rule to follow would be that no obligation is imposed upon a trustee in bankruptcy to file amended tax returns for prepetition periods. Instead, such an obligation should remain that of the taxpayer-debtor.

[8] Filing of Tax Returns

[a] Income Tax Returns Prepared by Tax Authorities

Under present law, an individual may not receive a discharge in Chapter 7 in respect of a tax for which a return, if required, has not been filed. Under the 2005 Act, a return will include a written stipulation to a judgment or a final order entered by a non-bankruptcy tribunal and a return based upon information supplied by the taxpayer and signed by him, but prepared by a taxing authority pursuant to section 6020(a) or similar state or local law. It will not include a substitute return under section 6020(b), which is not a full return, but merely a predicate for assessment. n57

[b] Requirement to File Tax Returns to Confirm Chapter 13 Plans

Under previous law, a debtor was entitled to the benefits of Chapter 13 notwithstanding the fact that he had unfiled

returns outstanding. n58 Under the 2005 Act, effective in cases commenced on or after October 17, 2005, debtors are required to have filed tax returns for the four taxable years immediately preceding the filing of the petition. Limited extensions are permitted.

If the returns are not filed by the date of the first scheduled meeting of creditors, the trustee can hold open the meeting for a reasonable period of time to allow the debtor to file any unfiled tax returns. However, the additional period of time can not exceed 120 days from the date of the meeting of the creditors. n59 For returns that are not past due on the petition date, the additional period of time can not exceed the date on which the return is due under the last automatic extension of time for filing. In any event, the debtor may still obtain an extension from the court beyond the date set by the trustee, if the debtor demonstrates by a preponderance of the evidence that the failure to file was attributable to circumstances beyond the debtor's control. n60 Conversion or dismissal will result from failure to file within the extended periods.

In a string of recent decisions, the courts have emphasized the importance of filing returns within the prescribed period to avoid conversion or dismissal of a chapter 13 proceeding. In *Goodell v. U.S.*, for example, the court addressed the issue of whether or not a chapter 13 case could be approved when the debtor was a tax protester who refused to file tax returns. n60a Rejecting the taxpayer's contention that the IRS must prove its entitlement to collect taxes from him, the court dismissed the debtor's chapter 13 case, noting that absent the filing of a good faith return, the IRS's assessment is presumed to be correct.

Additionally, in *Parker v. US*, the IRS objected to confirmation of a chapter 13 plan because the debtor failed to file individual tax returns for the years at issue. n60b The bankruptcy court in this instance provided the debtor with numerous opportunities to file the returns, but he asserted a frivolous legal position that the 16th amendment was not properly ratified and thus he was not required to pay taxes. The *Parker* court noted that as result of the debtor's failure to file returns, the IRS was unable to determine the extent of its claim. It was thus held that the facts and circumstances in the case established that the debtor acted in bad faith in the bankruptcy proceeding and the court dismissed his chapter 13 case.

Finally, in the case *In re McCluney* the court dismissed a Chapter 13 case where the taxpayer did not file a return until after the meeting of the creditors was held. n60c In reviewing the timeliness of the filings, the Court concluded that the requirements of section 1307(e) were unambiguous, stating that "if a debtor fails to file a tax return [under section 1308] after proper motion, notice, and hearing, the court shall dismiss or convert the case." Although the *McCluney* court agreed with the debtor that dismissal or conversion of the case was a harsh penalty, the court reasoned that it was required to construe the unambiguous terms of the statute. Thus, based upon the rulings and rationale of the *Goodell*, *Parker*, and *McCluney* courts, trustees and debtors in Chapter 13 proceedings must be particularly careful to file any required returns with the prescribed period to avoid dismissal of the case.

[c] Dismissal for Failure to Timely File Tax Returns

Under present law, a debtor may continue to exercise the right to reorganize under bankruptcy protection notwithstanding the failure to file post-petition tax returns. n61 Under the 2005 Act, a debtor who fails to file post-petition returns may, on request of a taxing authority, have his case converted or dismissed. n62 If the debtor fails to file a return or fails to obtain an extension of time to file within 90 days, the court must either convert or dismiss the case, whichever is deemed to be in the best interest of the creditors and the estate. n63

In yet another case, *Colsen v. U.S.*, the court held that tax liabilities owed on late returns filed by the taxpayer after the IRS had prepared substitute returns on his behalf, are dischargeable, provided that there is no evidence that the returns are inaccurate or fabricated and the taxpayer has made a genuine attempt to satisfy the law. n63a This case involved a debtor who had failed to timely file tax returns for tax years 1992 through 1996. The IRS subsequently prepared substitute returns on his behalf and issued notices of deficiency. In 1999, after the IRS had assessed taxes, penalties, and

interest, for the years at issue, the taxpayer filed forms 1040 for the missing years and four years later, in 2003, he filed for bankruptcy under chapter 7.

In permitting the discharge of the tax liabilities reported on the debtor's late filed returns, the *Colsen* court emphasized that "exceptions from discharge are to be strictly construed so as to give maximum effect to the policy of the bankruptcy code to provide debtors with a fresh start." n63b

In another recent case, *Gliem v. United States Department of Treasury*, the court held that where the IRS had already assessed unpaid taxes, the debtor's subsequent filing of a "return" did not constitute an "honest and reasonable attempt" to comply with the law, and thus the related tax liability was not dischargeable under the chapter 7 bankruptcy. n63c The debtor in *Gliem* had not filed tax returns for a ten year period when he filed for bankruptcy. The IRS had issued deficiency notices, assessed liabilities, and offered the debtor an opportunity to contest the assessment in Tax Court. Subsequent to the IRS's offer, the debtor filed his tax returns. In reviewing the underlying facts, the *Gliem* court concluded that returns filed after the assessment of tax did not meet the criteria set forth in governing case law as to an honest and reasonable attempt to comply. Accordingly, the tax liabilities at issue were not discharged in this chapter 7 case.

Taxpayers granted extensions of time to file returns by the Internal Revenue Service should note that certain extensions may not affect the priority or dischargeability of tax liabilities in bankruptcy proceedings. *I.R.C. sections 7508 and 7508A*, for example, were enacted to provide relief for taxpayers in disaster areas and combat zones who were unable to timely file their tax returns. n63d Notably, however, unlike extensions under *I.R.C. section 6081*, the grant of relief under *I.R.C. sections 7508 and 7508A* does not change the date on which a tax return is last due, including extensions for bankruptcy purposes. n63e Therefore, the postponement of time to file a return pursuant to these types of relief does not change the priority and dischargeability of the tax liability in a bankruptcy proceeding. n63f Debtors taking advantage of these relief provisions should seek to understand the priority and dischargeability of the tax debt prior to filing a petition.

[d] Providing Requested Tax Documents to the Court

Under the 2005 Act, the court may not grant an individual a Chapter 7 discharge or confirm the Chapter 11 or Chapter 13 plan of an individual unless requested tax documents have been filed with the court. The court must retain such documents for three years, subject to extension in the event of an audit or enforcement action. n64

[e] Tax Reporting of Cancelled Mortgage Debt

In response to the sub prime mortgage and credit crises that has resulted in increased mortgage foreclosures and bankruptcy filings by struggling homeowners, the Mortgage Forgiveness Debt Relief Act of 2007 was enacted on December 20, 2007. n65 This law, introduced in Congress as H.R. 3648, amended the Internal Revenue Code by adding section 108(a)(1)(E), which provides, in relevant part, that taxpayers may exclude debt forgiven on their principal residence in 2007, 2008, or 2009 if the balance of their loan was less than \$2 million dollars (or \$1 million for married persons filing separate returns). n66 The law does not apply to real estate other than the taxpayer's principal residence. n67 Individuals filing bankruptcy should seek to take advantage of this relief provision which in effect eliminates tax liabilities associated with discharged or forgiven mortgage debt.

The exclusion applies to discharges occurring after 2006 and before 2010 and was extended for an additional three years by the Emergency Economic Stabilization Act of 2008. n67a The recently enacted American Recovery and Reinvestment Act of 2009 ("the Act") allows taxpayers to elect to defer cancellation of indebtedness income arising from a "reacquisition" of "an applicable debt instrument" after December 31, 2008, and before January 1, 2011. n67b Income deferred pursuant to the election must be included in the gross income of the taxpayer ratably in the five taxable years beginning with (1) for repurchases in 2009, the fifth taxable year following the taxable year in which the

repurchase occurs, or (2) for repurchases in 2010, the fourth taxable year following the taxable year in which the repurchase occurs. The Act also provides special rules for debt-for-debt exchanges, acceleration of deferred items, and partnerships.

Prior to enactment of the Mortgage Forgiveness Debt Relief Act of 2007, the portion of mortgage debt forgiven in foreclosure and bankruptcy proceedings, as reported by lenders on IRS Form 1099-C, Cancellation of Indebtedness Income, was generally taxable to petitioners. n68 Under the new law, however, taxpayers may exclude debt forgiven on their principal residence if the balance of their loan was less than \$2 million dollars. The limit is \$ 1 million for a married person filing a separate return.

Reporting procedures for the new law require taxpayers who have had all or part of their mortgage indebtedness forgiven during years 2007 through 2009 to use newly revised IRS Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and section 1082 Basis Adjustment). n69 Taxpayers must use Form 982 to exclude any portion of mortgage debt forgiven as reported on Form 1099-C. The completed form should be attached to the debtor's tax return.

According to the IRS, Form 982 is rarely used and most taxpayers are not aware of the form. n70 IRS Form 982 provides taxpayers and tax return preparers with an approved method for claiming exclusions from income for a discharge of indebtedness that has been reported both to taxpayers and to the IRS on Form 1099. Form 982 is also the mechanism for reporting required reductions in "tax attributes" as defined by the Code as well as adjustments in the depreciable basis of real property for which an exemption from recognition of income due to forgiveness of indebtedness has been claimed.

In a recent case evaluating tax reporting implications for discharged indebtedness in bankruptcies, *Zilka v. Bayer Employees Federal Credit Union*, a creditor corporation's filing of Forms 1099-C, Cancellation of Debt, in response to its charging off of the outstanding indebtedness of loans to a debtor, was held to be not the legal equivalent of a discharge of the indebtedness, and did not serve as a discharge from further liability on any of its claims. n71 According to the *Zilka* court, the issuance of a Form 1099-C is not an admission by a creditor that it has discharged its debt. The court specified that the sole purpose of issuing and filing a Form 1099-C is to satisfy an IRS information reporting requirement. The court clarified that issuance of the form does not constitute a contractual agreement not to sue or a contractual renunciation of rights against a debtor.

FOOTNOTES:

(n1)Footnote 1. IRM § 4.27.5.3

(n2)Footnote 2. 11 U.S.C. § 505(b).

(n3)Footnote 2a. See *In re PT- 1 Communs, Inc.*, 357 B.R. 217 (Bankr. E.D.N.Y. 2006) .

(n4)Footnote 3. See, e.g., *Palmer v. Webster & Atlas Nat'l Bank*, 312 U.S. 156, 163 (1941) ; *In the Matter of New York, New Haven, & Hartford R.R. Co.*, 360 F. Supp. 1155, 1158 (D. Conn. 1973) ; *United States v. City of Roanoke*, 258 F. Supp. 415, 417 (W.D. Va. 1966) ; *In re Hubs Repair Shop*, 28 B.R. 858, 868 (Bankr. N.D. Iowa 1983) .

(n5)Footnote 4. See *California State Board of Equalization v. Sierra Summit, Inc.*, 490 U.S. 844, 109 S. Ct. 2228, 104 L. Ed. 2d 910, 20 C.B.C.2d 1501 (1989) .

(n6)Footnote 5. IRS Notice 2006-83 , citing § 1115 of the Bankruptcy Code as enacted by § 321 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005), effective for cases filed on or after October 17, 2005.

(n7)Footnote 6. *IRS Notice 2006-83* § 3.01. *See also I.R.C. § 6012(b)(4).*

(n8)Footnote 7. *IRS Notice 2006-83* § 3.03. *See also I.R.C. § 6109(a)(2).*

(n9)Footnote 8. *IRS Notice 2006-83* . *See also I.R.C. §§ 3121(a) and 3401(a).*

(n10)Footnote 9. *IRS Notice 2006-83* § 3.03.

(n11)Footnote 10. *See P TX3.02[1] supra.*

(n12)Footnote 11. The separate entity rule of *I.R.C. § 1398* requires that the bankruptcy estate of an individual be treated as a separate entity for tax purposes. *I.R.C. § 6012(a)(9)* includes bankruptcy estates as entities that must file tax returns. *See P TX3.02[1][b] supra* for a discussion of the separate entity rule.

(n13)Footnote 12. *I.R.C. § 6012(b)(4)* provides:

Returns of an estate, a trust, or an estate of an individual under chapter 7 or 11 of the United States Code shall be made by the fiduciary thereof. The Supreme Court confirmed this duty in the case of a fiduciary of a liquidating trust in *Holywell Corp. v. Smith*, 503 U.S. 47, 112 S. Ct. 1021, 117 L. Ed. 2d 196, 26 C.B.C.2d 1 (1992) . For an in-depth discussion of *Holywell*, see *P TX3.03[1][b][ii] infra*. *See also In re Joplin*, 882 F.2d 1507 (10th Cir. 1989) .

(n14)Footnote 13. *I.R.C. § 6012(a)(9)* requires that a return be filed for:

(9) Every estate of an individual under chapter 7 or 11 of title 11 of the United States Code (relating to bankruptcy) the gross income of which for the taxable year is not less than the sum of the exemption amount plus the basic standard deduction under § 63(c)(2)(D).

See, e.g., In re Pflug, 146 B.R. 687 (Bankr. E.D. Va. 1992) in which the court concluded the provisions of § 6012 of the Internal Revenue Code required the chapter 7 trustee to file an income tax return for the estate of the debtor, even when the estate did not conduct any financial transactions that generated any tax liability. The trustee argued that § 6012 of the Internal Revenue Code and the Supreme Court's decision in *Holywell Corp. v. Smith*, 503 U.S. 47, 112 S. Ct. 1021, 1026, 117 L. Ed. 2d 196, 26 C.B.C.2d 1 (1992) , imposed an obligation to file tax returns only on trustees of liquidation trusts. That is, only trustees who actually engaged in the sale of estate property and thereby realized the threshold amount of gross income must file income tax returns for the estate. The court concluded that the fact the trustee did not engage in the sale of any estate property factually distinguished this case from that in *Holywell*, but that distinction did not have any effect on the clear and unambiguous text of *Internal Revenue Code § 6012(b)(4)*. Justice Thomas, speaking for a unanimous Supreme Court in *Holywell* stated: "§ 6012(b)(4), as the debtors assert, applies to the fiduciary of a trust as well as the fiduciary of a bankruptcy estate." *Holywell Corp. v. Smith, supra*. The bankruptcy court was thus not persuaded that the distinction raised by the trustee was a distinction that made any difference. The court agreed with the debtor that a chapter 7 bankruptcy trustee had a general obligation to file tax returns on behalf of a bankruptcy estate that realized the threshold amount of gross income required to trigger the filing of a return regardless of the nature or the source of this income.

See, U.S. Dep't of Justice Executive Office for U.S. Trustees, Handbook for Chapter 7 Trustees 33-34 (April 1992).

(n15)Footnote 14. 204 B.R. 716 (Bankr. N.D. Ind. 1996) .

(n16)Footnote 15. In addition, the trustee has the duty to see that any tax computed as taxable income of the estate is paid pursuant to § 1398(c)(1)); *In re McRae*, 181 B.R. 866, 868 (Bankr. S.D. Tex. 1994) (the trustee contended

installment sale payments received after the petition filing were not taxable to the estate but the court disagreed; the trustee was found to be a fiduciary required by *Internal Revenue Code* § 6012(b)(4) to file a return for the estate, and the trustee was required to report and pay the taxes on all gains realized and interest income received by the trustee and used for the benefit of the estate, provided the trustee has possession of, or title to, substantially all the debtor's property); *In re Knobel*, 167 B.R. 436 (Bankr. W.D. Tex. 1994) (not only is the chapter 7 trustee required to file income tax returns for the estate pursuant to § 6012(a)(9) of the *Internal Revenue Code*, but the estate for a husband and wife is entitled to two personal exemptions and standard deductions); *In re Swann*, 28 C.B.C.2d 857, 149 B.R. 137 (Bankr. D. S.D. 1993) (the trustee sold property during the course of administration of the estate and was required to pay the capital gains tax on that property as an administrative claim). The Court of Appeals for the Fifth Circuit has similarly required the chapter 7 trustee for a corporation to liquidate the defunct entity's pension plan on the basis of the similar fiduciary duties imposed on the trustee to file tax returns for the debtor. *Pension Benefit Guar. v. Pritchard*, 50 F.3d 315 (5th Cir. 1995) Compare these holdings, however, to cases involving transactions by a chapter 12 trustee. In *In re Lindsey*, 142 B.R. 447 (Bankr. W.D. Okla. 1992), the court concluded the sales conducted by the standing chapter 12 trustee were not made in the capacity as a liquidating trustee. The court concluded that it was clear that, pursuant to *Internal Revenue Code* §§ 1398 and 1399, the standing chapter 12 trustee neither files a return nor pays federal income tax when his actions giving rise to a federal tax liability are undertaken in that capacity. The tax burden in a chapter 12 case shifts to the trustee when a separate entity is created, and the actions giving rise to the tax were undertaken in the capacity of trustee for this separate entity.

(n17)Footnote 16. *Rev. Rul. 72-387*, 1972-2 C.B. 632. The tax return filed by a trustee/fiduciary for a debtor is a Form 1041, U.S. Fiduciary Income Tax Return and the trustee has no obligation to file a Form 1040, U.S. Individual Income Tax Return for the debtor. *See also Rev. Rul. 68-48*, 1968-1 C.B. 301, which directs that the trustee file a Form 1041 for a bankruptcy estate.

(n18)Footnote 17. A similar statute was contained in the Revenue Act of 1916. *See* § 13(c) of the Revenue Act of 1916, Pub. L. No. 64-271, 39 Stat. 756, 771. Later revisions of the Internal Revenue Code required "receivers, trustees in bankruptcy, or assignees" to file income tax returns for the estates they managed. *See, e.g., In re Nab Food Services, Inc.*, 7 C.B.C.2d 944, 25 B.R. 221 (Bankr. S.D. Ohio 1982), in which the court held that although the debtor corporation had ceased to exist, the trustee who was liquidating all of the debtor's assets was required to file a return on the income earned as a result of the liquidation. This obligation included not just the filing of the return but also the payment of the tax liability reflected thereon as required by *I.R.C. § 6151*. The Treasury Regulations that interpreted § 13(c) of the Revenue Act of 1916 interpreted this provision to apply to "trustees in dissolution," and subsequent revisions of the Internal Revenue Service's regulations have included similar language. *See, e.g., Treas. Reg. § 1.6012-3(b)(4)*, which includes "trustee in dissolution" in the category of representatives who must file tax returns for a corporate debtor.

(n19)Footnote 18. *See* the discussion of 28 U.S.C. § 960 at P TX3.03[1][a] *supra*.

(n20)Footnote 19. *Treas. Reg. § 1.6012-3(b)(4)*.

(n21)Footnote 20. *Id.*

(n22)Footnote 21. *Treas. Reg. § 1.6012-3(b)(4)* and (5).

(n23)Footnote 22. *Holywell Corp v. Smith*, 503 U.S. 47, 112 S.Ct. 1021, 117 L. Ed. 2d 196, 26 C.B.C.2d 1 (1992). Prior to the *Holywell* opinion, courts were in disagreement over whether a trustee or fiduciary was obligated to file income tax returns for a liquidation bankruptcy estate or for a liquidating trustee. *See also In re Pizza Pronto, Inc.*, 970 F.2d 783 (11th Cir. 1992) in which the court confirmed the chapter 7 trustee was required to file income tax returns for a corporation in a chapter 7 case. The accountant for the trustee asked the court to award the fees incurred to prepare returns for the trustee and the lower courts refused; the Eleventh Circuit Court of Appeals reversed, confirming the need for the trustee to file the returns and authorizing the payment of the costs associated with the fulfillment of that obligation. *Compare In the matter of Statmaster Corp.*, 332 F. Supp. 1248, 1261 (S.D. Fla. 1971), *aff'd*, 465 F.2d 978

(5th Cir. 1972) (a non-operating trustee in bankruptcy is not subject to federal income taxes); *In re Town Crier Bottling Co.*, 123 F. Supp. 588, 592 (E.D. Mo. 1953) (a liquidating trustee had no obligation to file income tax returns for a debtor during the liquidation process); with *In re I.J. Knight Realty Corp.*, 501 F.2d 62, 65 (3d Cir. 1974) (a non-operating trustee of a bankrupt corporation was liable for the payment of income taxes on the income realized from the sale and liquidation of the debtor's assets); *United States v. Metcalf*, 131 F.2d 677 (9th Cir. 1942) (liquidating trustee who collected royalty income was required to file tax returns to report the income recognized during the administration); *In re Hudson Oil Co.*, 91 B.R. 932, 946 (Bankr. D. Kan. 1988) (a corporation's trustee is required to file income tax returns for any period within which the trustee had possession of all or substantially all of the debtor's assets); *In re Knight's Mill, Inc.*, 7 C.B.C.2d 655, 658, 24 B.R. 143 (Bankr. E.D. Mich. 1982) (liquidating trustee who collected interest income earned on liquidation proceeds of debtor's business assets was required to file tax returns and pay tax on the recognized interest income); *In re Nab Food Services, Inc.*, 7 C.B.C.2d 944, 25 B.R. 221 (Bankr. S.D. Ohio 1982) (a non-operating trustee is liable for federal income tax upon interest earned on deposits of estate funds).

(n24)Footnote 23. The plan in the *Holywell* case approved by the Bankruptcy Court was proposed by a secured creditor, but the plan was silent concerning the necessity for the liquidating trustee to file income tax returns.

(n25)Footnote 24. The United States relied upon the language in *Treas. Reg. § 1.6012-3(b)(4)*, which refers to "receivers, trustees in dissolution, trustees in bankruptcy and assignees" to identify the kind of fiduciary entities who are required to file income tax returns.

(n26)Footnote 25. *In re Holywell Corp.*, 911 F.2d 1539, 1545 (11th Cir. 1990) , *rev'd*, 503 U.S. 47, 112 S. Ct. 1021, 117 L. Ed. 2d 196, 26 C.B.C.2d 1 (1992) .

(n27)Footnote 26. *Holywell Corp. v. Smith*, 503 U.S. 47, 112 S. Ct. 1021, 1025, 117 L. Ed. 2d 196, 203, 26 C.B.C.2d 1, 4 (1992) . *See also* discussion of *Holywell* in chapter TX14 *infra* .

(n28)Footnote 27. *Holywell Corp. v. Smith*, 503 U.S. 47, 112 S. Ct. 1021, 117 L. Ed. 2d 196, 203, 26 C.B.C.2d 1, 4 (1992) . The parties disagreed whether the trustee was an "assignee" or "a trustee under title 11." The Court was not, however, required to resolve this dispute. The trustee was the recipient of all of the debtor's property and was therefore an "assignee" for purposes of *I.R.C. § 6012(b)(3)* and required to file the necessary tax returns.

(n29)Footnote 28. *Holywell Corp. v. Smith*, 503 U.S. 47, 112 S. Ct. 1021, 117 L. Ed. 2d 196, 203, 26 C.B.C.2d 1, 4 (1992) . The liquidating trustee for the consolidated debtors argued in his appellate brief that the ministerial responsibility of a liquidating trustee "was to identify and pay all valid claims and to pay over any remaining funds to the debtors. The Liquidating Trustee does not have a title 11 bankruptcy trustee's powers under § 544, 547, 548 or 549 of the Bankruptcy Code, and he is not compensated under § 326 of the Bankruptcy Code." Answer Brief of Fred Stanton Smith, Trustee of the Miami Center Liquidating Trust at 7 (No. 89-5862). The liquidating trustee summarized the argument as follows:

The lower court's determination that the Liquidating Trustee is a contract trustee rather than a trustee under title 11 of the United States Code, and that the trustee's duties are more like those of a disbursing agent than those of a fiduciary or assignee [was correct] The tax code provisions relied on by the government only apply to trustees under title 11, receivers, assignees and fiduciaries. Tax statutes cannot be construed beyond their plain meaning, and the provisions of the Internal Revenue Code relied on by the government do not apply to the Liquidating Trustee.

Holywell Corp. v. Smith, 503 U.S. 47, 112 S. Ct. 1021, 117 L. Ed 2d 196, 203, 26 C.B.C.2d 1 (1992) . There were other issues addressed by the bankruptcy court and by the circuit court, but the application of the statutes discussed herein was the only issue addressed in the appeal to the Supreme Court. The liquidating trustee was also required to file a tax return as a result of his status as a fiduciary for the individual debtors in the case. *I.R.C. § 6012(b)(4)*. *See P*

TX3.03[1][b][i] *supra*.

(n30)Footnote 29. 31 U.S.C. § 3713 provides, in summary, that a claim of the United States Government shall be paid first when a person indebted to the government and is insolvent, or files a bankruptcy petition. The section specifically provides that:

(a)

(1) A claim of the United States Government shall be paid first when--

(A) a person indebted to the Government is insolvent and--

(i) the debtor without enough property to pay all debts makes a voluntary assignment of property;

(ii) property of the debtor, if absent, is attached; or

(iii) an act of bankruptcy is committed; or

(B) the estate of a deceased debtor, in the custody of the executor or administrator, is not enough to pay all debts of the debtor.

(2) This subsection does not apply to a case under title 11.

(b) A representative of a person or an estate (except a trustee acting under title 11) paying any part of a debt of the person or estate before paying a claim of the Government is liable to the extent of the payment for unpaid claims of the Government.

(n31)Footnote 30. A trustee in bankruptcy cannot be personally liable under 31 U.S.C. § 3713 for federal taxes of a debtor that accrued either before or after the filing of the bankruptcy case. *See, e.g., In re Dolard*, 519 F.2d 282 (9th Cir. 1975), a case filed under the former Bankruptcy Act and interpreting the predecessor of 31 U.S.C. § 3713, 31 U.S.C. § 192.

(n32)Footnote 31. *See, e.g., United States v. Kaplan*, 74 F.2d 664 (2d Cir. 1935), in which a bankruptcy trustee under the former Bankruptcy Act was liable under the predecessor of 31 U.S.C. § 3713 for that trustee's failure to pay the United States in its capacity as a priority creditor. The trustee in *Kaplan* distributed the debtor's estate to the debtor's general creditors and failed to pay the United States' claim; the court surcharged the trustee for the amount of the United

States' claim because he failed to fulfill his duties as a trustee. *See also United States v. King*, 322 F.2d 317 (3d Cir. 1963).

(n33)Footnote 32. *See, e.g., King v. United States*, 379 U.S. 329, 85 S. Ct. 427, 13 L. Ed. 2d 315 (1964), in which the Supreme Court broadly interpreted the scope of the predecessor of 31 U.S.C. § 3713. Thus, corporations that acquire the assets of another entity, assignees for the benefit of creditors, estate administrators and executors, corporate officers directing a liquidation, and receivers can be liable for tax liabilities owed to the United States that are not paid before the claims of creditors that are subordinate to the claims of the United States.

(n34)Footnote 33. *See, e.g., United States v. Crocker*, 313 F.2d 946 (9th Cir. 1963); *United States v. Burczyk*, 389 F. Supp. 782 (E.D. Wis. 1975).

(n35)Footnote 34. *Rev. Proc. 2006-24*.

(n36)Footnote 35. The address provided in the Internal Revenue Procedure for the IRS's Centralized Insolvency Operation is P.O. Box 21126, Philadelphia, Pa. 19114. A request sent to an address other than that set forth in the Internal Revenue Bulletin may not be treated as a valid request and may not trigger the required time limitations on the IRS's actions. *Rev. Proc. 2006-24* § 3.01.

(n37)Footnote 36. The IRS is affirmatively required to notify the party requesting determination of the estate's unpaid tax liability of whether the tax returns are accepted as filed or will be audited.

(n38)Footnote 37. This taxation as an "estate" would be accomplished by taxing the partnership income under I.R.C. § 641(a) of the Internal Revenue Code. *See, e.g., In re Goff*, 57 B.R. 442 (Bankr. W.D. Tex. 1985), and the cases cited therein. I.R.C. § 641(a) is part of Subchapter J of the Internal Revenue Code, which applies to the taxation of "Estates, Trusts, Beneficiaries, and Decedents." § 641(a) imposes an income tax on the taxable income of estates or of any kind of property held in trust. The court in *Goff* held that I.R.C. § 641(a) was applicable to bankruptcy estates even though the plain language of that statute applied only to estates and trusts arising from decedents. 57 B.R. 442, 445-46. The court, in interpreting the legislative intent behind the Bankruptcy Tax Act of 1980, gave deference to pre-1980 Treasury Regulations that interpreted I.R.C. § 641(a) to include bankruptcy estates. 57 B.R. 442, 445-46.

(n39)Footnote 38. *See Rev. Rul. 68-48, 1968-1 C.B. 301*.

(n40)Footnote 39. *See, e.g., In re Samoset Assocs.*, 5 C.B.C.2d 1052, 1058, 14 B.R. 408, 410 (Bankr. D. Me. 1981) (there was no requirement in the Internal Revenue Code, specifically I.R.C. § 6012, for the trustee of a partnership to file income tax returns for the partnership debtor).

(n41)Footnote 40. *See In re 4100 North High Ltd.*, 1 C.B.C.2d 752, 3 B.R. 232 (Bankr. S.D. Ohio 1980). The trustee in this case was conducting income producing activities for the benefit of the bankruptcy estate. The income produced by the trustee was taxable, and the court held that the partnership estate's taxable income had to be reported to the IRS as taxable to the bankruptcy estate pursuant to 28 U.S.C. § 960. The fact that the business was conducted as a partnership in prior years was immaterial to the determination of whether the trustee or the partnership's partners were required to pay tax on the postpetition income. The court stated:

The test is clearly one of analogy, that is, the court officer is subjected to every tax to which any fictional individual or corporation would have been subjected had the same business been conducted in the same way for the same period with the same results, not by the court officer, but by such fictional individual or corporation Therefore, the Court is of the opinion that the plaintiff by seeking, obtaining and exercising authority to operate the businesses of the respective bankrupts herein brought himself within the coverage of § 960 The plaintiff should have the option of calculating his income tax due, if any, as if the business "... were conducted by an individual ..." or as if it "... were conducted by ... a corporation." He should then be permitted to select the less burdensome tax consequence, and

tender amended returns for the period of his court authorized operations.

In re 4100 North High Ltd., 1 C.B.C.2d 752, 761, 25 B.R. 221 (Bankr. S.D. Ohio 1980) . The result in this case is inconsistent with the congressional mandate that a partnership will not be a tax paying entity. I.R.C. § 701. The result in *4100 North High Ltd.* may also be inconsistent with state laws that provide that a partnership does not cease to exist after the filing of its title 11 case. *In re 4100 North High Ltd.*, 1 C.B.C.2d 752, 759, 3 B.R. 232, 239 (Bankr. S.D. Ohio 1980) . If the partnership does not cease to exist for tax purposes, then the conduit principles of I.R.C. §§ 701 and 702 should still apply to pass through the postpetition income, deductions and credits to the taxpayer partners. This result is also consistent with the rule of I.R.C. § 1399 that no separate taxable estate is created for a partnership after the filing of a title 11 case. The result in *4100 North High Ltd.* also appears faulty because there is no authorization in the Internal Revenue Code for the selection of the lowest applicable tax rate for a non-individual taxpayer.

(n42)Footnote 41. *In re Galletti*, 368 F.3d 1081, 14 F.3d 336 (9th Cir. 2002) , *rev'd*, 124 S. Ct. 1548, 158 L. Ed. 2d 279 (2004) .

(n43)Footnote 42. 503 U.S. 47, 112 S. Ct. 1021 (1992) . See P TX3.03[1][b][ii] *supra* for a discussion of the *Holywell* decision.

(n44)Footnote 43. *In re Hudson Oil Co.*, 91 B.R. 932 (Bankr. D. Kan. 1988) .

(n45)Footnote 44. 91 B.R. 946.

(n46)Footnote 45. *Nicholas v. United States*, 384 U.S. 678, 86 S. Ct. 1674, 16 L. Ed. 2d 853 (1966) .

(n47)Footnote 46. *Nicholas v. United States*, 384 U.S. 678, 692, 86 S. Ct. 1674, 1684, 16 L. Ed. 2d 853, 864 (1966) .

(n48)Footnote 47. *Id.*

(n49)Footnote 48. Pub. L. No. 109-8, § 714 (2005), effective for cases commenced on or after October 17, 2005.

(n50)Footnote 49. *Id.*

(n51)Footnote 50. *Ranney v. IRS*, 2006-1 USTC P 50,320 (2006) . Additionally, in the case *Miles v. US*, 2007-1 USTC P 50,414 (2007) where the IRS filed a substitute return on the debtor's behalf in a chapter 13 proceeding and the debtor challenged the accuracy of the underlying tax and penalties assessed, the court ruled that the taxes and penalties were not dischargeable. In reviewing the validity of the IRS's claim in this instance, the *Miles* court stated that "the law is clear that failure to timely file a tax return results in interest charges and penalties, unless it is shown that such failure is due to reasonable cause and not willful neglect." Accordingly, the court held that since the taxpayer failed to produce any evidence to show that he should not have been subject to the penalties, or that the assessment was incorrect, the amount of the claim by the IRS was upheld and deemed appropriate.

(n52)Footnote 50a. See *Inzzo v. United States*, 340 B.R. 586 (Bankr. E.D. Mich. 2006) .

(n53)Footnote 50b. See *Beard v. Commissioner*, 82 T.C. 766 (1984) , *aff'd*, 793 F.2d 139 (6th Cir. 1986) ; see also *In re Hindenlang*, 164 F.3d 1029 (6th Cir. 1999) .

(n54)Footnote 51. *Billy J. Brown v. United States*, 280 B.R. 760 (Bankr. M.D. Ga. 2002) .

(n55)Footnote 52. *Mathis v. United States*, 249 B.R. 324 (S.D. Fla. 2000) .

(n56)Footnote 53. See P TX4.02[2] *infra* for a discussion of the § 523(a)(1)(B) issue.

(n57)Footnote 53a. See *Woods v. Commissioner*, T.C. 2006-38 (2006).

(n58)Footnote 54. Although there is no provision in the Internal Revenue Code that provides for or compels the filing of amended returns, the IRS provides for amended returns by its publication and acceptance of, *e.g.*, Forms 1040X and 1120X, the amended return forms for individuals and corporations.

(n59)Footnote 55. See *Nicholas v. United States*, 384 U.S. 678, 86 S. Ct. 1674, 16 L. Ed. 2d 853 (1966) .

(n60)Footnote 56. *In re Hudson Oil Co.*, 91 B.R. 932 n.43 (Bankr. D. Kan. 1988) .

(n61)Footnote 57. Pub. L. No. 109-8, § 714 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n62)Footnote 58. See *generally* H.R. Rep. No. 109-31, pt. 1 at 104 (2005).

(n63)Footnote 59. Pub. L. No. 109-8 § 716 (2005), effective in cases commenced on or after October 17, 2005.

(n64)Footnote 60. *Id.*

(n65)Footnote 60a. See *In re Boyd Ellis Goodell, Debtor*, 2006-2 USTC P 50,402 (2006).

(n66)Footnote 60b. See *Parker v. US*, 2007 US Dist. Lexis 24351 ; 99 A.F.T.R.2d (RIA) 1837 (2007).

(n67)Footnote 60c. See *In re McCluney*, 2007 Bankr Lexis 2088 (2007) .

(n68)Footnote 61. See *generally* Henderson and Goldring, Tax Planning for Troubled Corporations § 1006.2 (2005 ed.).

(n69)Footnote 62. Pub. L. No. 109-8, § 720 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n70)Footnote 63. *Id.*

(n71)Footnote 63a. See *Colsen v. US*, 2006-1 USTC P 50,300 (2006).

(n72)Footnote 63b. See *In re Geiger*, 113 F.3d 848, 853 (8th Cir. 1997) (en banc), *aff'd*, *Kawaauhau v. Geiger*, 523 US 57 (1998) .

(n73)Footnote 63c. *Gliem v. United States Department of Treasury*, 2006 Bankr. Lexis 3147, 98 2007-1 U.S. Tax Case. (CCH) P 50,256 (Bankr. M.D. Fla. 2006).

(n74)Footnote 63d. *I.R.C. § 7508A(a)(1)* provides for the disregard of a period of time of up to one year in determining the timeliness of specified acts performed by taxpayers who are determined by the IRS to be affected by a presidentially-declared disaster or a terroristic or military action. Revenue ruling 2007-59 provides that a postponement under *I.R.C. § 7508A* makes timely the filing of a return any time during the postponement period and this timely filing is not considered an extension. *I.R.C. § 7508A* relief is not automatic, but requires a grant of relief by the IRS, which is generally in the form of a news release or a notice published in the Internal Revenue Bulletin. The specified acts include the acts described in *I.R.C. § 7508(a)*, such as the filing of income tax returns.

(n75)Footnote 63e. *Section 507(a)(8)(A)(i) of the Bankruptcy Code* provides either priority for allowed unsecured pre-petition income tax claims for which a return is "last due, including extensions" after three years before the date of the filing of a bankruptcy petition. Therefore, if a postponement is provided under *I.R.C. § 7508A*, this does not affect the "last due" date for purposes of § 507(a)(8)(A)(i).

(n76)Footnote 63f. *Id.*

(n77)Footnote 64. Pub. L. No. 109-8, § 1228 (2005), effective in cases commenced on or after October 17, 2005, reprinted in Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n78)Footnote 65. See Pub.L. No. 110-142 (2007), amending *I.R.C. § 108(a)(1)(E)*.

(n79)Footnote 66. *Id.*

(n80)Footnote 67. The code provides a specific exclusion from income for cancellation of indebtedness where the taxpayer is insolvent. See *I.R.C. § 108(a)(1)(B)*.

(n81)Footnote 67a. See The Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343.

(n82)Footnote 67b. See The American Recovery and Reinvestment Act of 2009, § 1231, Pub. L. No. 111-5, February 17, 2009. In this section, an "applicable debt instrument" is defined as any debt instrument issued by (1) a C corporation or (2) any other person in connection with the conduct of a trade or business by such person. For purposes of the provision, a "debt instrument" is broadly defined to include any bond, debenture, note, certificate or any other instrument or contractual arrangement constituting indebtedness (within the meaning of § 1275(a)(1)). A "reacquisition" is any "acquisition" of an applicable debt instrument by (1) the debtor that issued (or is otherwise the obligor under) such debt instrument, or (2) any person related to the debtor within the meaning of § 108(e)(4).

(n83)Footnote 68. Debt forgiven on second homes, rental properties, or business property does not qualify for the new tax-relief provision. Additionally, the debt must have been used to buy, build or substantially improve the taxpayer's principal residence and must have been secured by that residence. Debt used to refinance qualifying debt is also eligible for the exclusion, but only up to the amount of the old mortgage principal, just before the refinancing. In some cases, however, other kinds of tax relief, based on insolvency, for example, may be available. See also Pub. L. No. 110-142.

(n84)Footnote 69. See IRS News Release IR-2008-17, Issued February 12, 2008.

(n85)Footnote 70. IRS Newswire, IR-2008-087, July 8, 2008.

(n86)Footnote 71. See *In re Stephen M. Zilka v. Bayer Employees Fed. Credit Union*, 2009-2 U.S.T.C. P 50,589 (Bankr. W.D. Penn. Jul. 16, 2009) .



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CHAPTER TX3 Tax Reporting Requirements

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P TX3.04 Regulations Require Information Reporting to Attorneys

A reporting requirement that trustees should be aware of, *I.R.C. section 6045(f)*, was added to the Internal Revenue Code by section 1021 of the Taxpayer Relief Act of 1997. n1 *I.R.C. section 6045(f)* generally requires information reporting for payments of gross proceeds made in the course of a trade or business to attorneys in connection with legal services (whether or not the services are performed for the payor). However, under Treasury regulation section 1.6045-5(c)(7), payments made to a trustee in a private bankruptcy under Title 11 are exempt from these reporting requirements. Accordingly, payments to attorneys acting as bankruptcy trustees are not reportable. Government entities making payments to bankruptcy trustees should be aware of this exception to the information return filing requirements for bankruptcy trustees. Under *I.R.C. section 6045* payments for legal services made to attorneys including corporations, are generally subject to reporting on IRS Form 1099-MISC. Payments for professional services are reportable in box 7, and gross proceeds of any amount paid to an attorney are reportable in box 14 of Form 1099-MISC. No information return is required under section 6045(f) for the portion of any payment that is required to be reported under section 6041(a) (or that would be required to be reported under section 6041 but for the \$600 limitation) or under section 6051. The 1997 Act also provides that the general exception in section 1.6041-3(p)(1) for reporting payments made to corporations does not apply to payments of attorneys' fees.

Regulations under *I.R.C. section 6045(f)* clarifying the requirement to report gross payments to attorneys on Form 1099-MISC have been finalized. n2 These rules impact attorneys with the exception of bankruptcy trustees who receive payments on behalf of clients, as well as defendants and the companies making the payments.

The regulations require issuance of Form 1099-MISC for aggregate payments to attorneys of gross proceeds over \$600 in any calendar year. Where the amount of the payment that relates to the attorney's fees is known, the payment is reportable under section 6041 and the \$600 threshold applies. In addition, the payments are reportable to corporations providing legal services.

The definition of the term "legal services" in *Treas. Reg. section 1.6045-5(d)(2)* of the regulations was criticized as being overly broad, however, the language was not modified when the final regulations were enacted. Commentators requested an exception to the section 6045(f) information reporting requirement in certain circumstances where they believed the specific payment bears little or no correlation to the taxable income of the attorney or the attorney's client. Specifically, they suggested exceptions to reporting for payments to payee attorneys who were acting as trustees of trusts (such as pension plans and bankruptcy estates). Such an exception has been recognized by the IRS with the

introduction of *Treasury Regulation 1.6045-5(c)(7)*, which provides that payment made to a trustee in a private bankruptcy under Title 11 are exempt from these reporting requirements.

FOOTNOTES:

(n1)Footnote 1. 1997-4 C.B. 1, 136 (vol. 1).

(n2)Footnote 2. *Treas. Reg. 1.6045-5*.



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CHAPTER TX3 Tax Reporting Requirements

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P TX3.05 Obligation to Collect, Account for, and Pay Over Withheld Taxes, and File Corresponding Tax Returns

[1] The Obligation to Withhold

Except as otherwise provided for in the statute, the Internal Revenue Code requires every employer that pays wages to deduct and withhold certain taxes from the wages of employees. n1 These withholdings are held in trust for the United States in a special fund. n2 It is clear that a trustee or other representative of a debtor taxpayer in a case under title 11 bears a responsibility for the withholding of taxes to the extent that wages are paid by that representative. n3

In *Otte v. United States*, n4 proofs of claim were filed by employees of the debtor for wages that had been earned during the three months prior to the petition date. No proofs of claim were filed by the United States or the State or City of New York with respect to the taxes which would otherwise have been withheld from these wages. The trustee sought the Court's approval for a distribution to wage creditors without the payment of the required withheld taxes, and also requested a determination that he had no obligation to pay the payroll taxes that would otherwise have been withheld. n5 The Court required the trustee to withhold the payroll tax liabilities relating to the wage claim payments and further held that the withholding tax liability was a second level priority equal in priority with the wage payments. n6

The fact that the employees' services were performed for the debtor prior to the filing of the title 11 petition did not convert the payment into something other than wages as defined in the Internal Revenue Code. Additionally, the fact that the payment was made by the trustee and not by the debtor did not eliminate the necessity to withhold payroll taxes because the Internal Revenue Code's definition of the term "employer" includes "the person having control of the payment of such wages," n7 and the trustee had such control.

Following the Supreme Courts' mandate, circuit courts have applied the holding in *Otte* to conclude that the person having control of the payment of the wages is also the employer for purposes of Code section 3111, which imposes FICA excise tax on employers. In *In re Armadillo Corp.*, the tax court held a trustee in bankruptcy liable for withholding and payment of employment taxes since he had control of the payment of wages and thus was an employer for purposes of withholding. n8 The trustee was held liable for claims on both priority wage claims and general unsecured wage claims. Interestingly, in this case, the court also held that the government was not required to file proof of claims with respect to withholding taxes for either priority wage claims or general unsecured wage claims. n9 The court further noted that the withholding taxes were not entitled to a priority because wage claim related taxes are

entitled only to the same priority as the wages from which they emerge.

Armadillo involved two unrelated companies that went bankrupt. The bankruptcy judge had categorized the wage claims as priority wage claims under section 64(a)(2) of the Bankruptcy Act or as general unsecured wage claims. n10 On appeal, the trustees challenged their liability for (a) withheld income taxes and employees' FICA taxes in relation to wages earned prior to but paid after the initiation of bankruptcy proceedings and (b) for employers' FICA and FUTA taxes in relation to such wages. They questioned their liability for payment of the taxes, the priority to be afforded the tax claims, and the need for the government to file a proof of claim of the taxes.

The trustees in *Armadillo* argued collectively that FICA and FUTA taxes at issue were excise taxes for which they should not be held liable for since no employment relationships were established or maintained between trustees and wage claimants. They further argued that they should not be liable for the employer's portion of FICA or FUTA taxes on general unsecured wage claims because the wages to which these claims were traced had lost their identity as wages and were simply part of the general mass of unsecured non-priority claims. Finally, they noted that these general unsecured claims had lost their identity as wages and should not be treated any differently than other general unsecured claims.

The *Armadillo* court considered three issues: (1) the trustee's liability, (2) the priority to be afforded the claim if liability was present, and (3) whether the government was required to file a formal proof of claim. The court noted that the pivotal question with respect to the issue of liability centered upon the degree to which a trustee is required to function as an employer in paying and withholding wage claim related taxes. Relying on *Otte*, the *Armadillo* court held that 'employer' means the person having control of the payment of such wages under section 3402 for the purpose of withholding income taxes from employees. The court specifically commented that the fact that the FICA withholding provisions of the Code do not define 'employer' is of no significance since the term may not be given a narrower construction for FICA withholding than for income tax withholding. The court further cited legislative intent, noting "that trustees [should be] liable for wage claim related taxes since this is consistent with the purpose of Congress to enable employees displaced by bankruptcy to secure, ... money due in back wages." n11

In considering whether the government was required to file proofs of claims, the *Armadillo* court noted that *Otte* did not address general unsecured wage claims and did not differentiate between the withheld income taxes and the "added increment" excise taxes for FICA contributions. Even so, the *Armadillo* court reasoned that "the pivotal factor is limited to the proper nature of wage claim taxes as bankruptcy debts and not in relation to the genesis of the wage claims giving rise to the taxes and debts. Accordingly, the court held that the filing of proofs of claims was not necessary for the taxes at issue here.

Finally, with respect to the priority of the wage claims, the *Armadillo* court held that not all wage claim related taxes are entitled to be treated as first priority debts. Again citing *Otte*, the *Armadillo* court noted that wage claim related taxes are only entitled to the same priority as the wages from which they emerge. The court rejected the governments' contention that first priority treatment is the only feasibly administrative means of assuring that such taxes are paid. Accordingly, it was held that the employees' withheld and FICA taxes on priority wage claims are entitled to the same priority as the wages from which they emerge.

The results in *Otte v. United States* and *In re Armadillo Corp.* also apply to receivers and trustees who operate a debtor's business either before or after the filing of a case under title 11. A fiduciary such as a receiver has an absolute duty both to withhold taxes from wages paid during the period in which he or she operates a business and to pay the appropriate amount to the United States. n12 Such a fiduciary will not be able to shift the payment liability to the estate because a bankruptcy estate's assets should not be depleted to pay withholding tax liabilities that were the obligation of a prepetition receiver. n13

Corporate fiduciaries filing Chapter 11 bankruptcies must also be aware of tax withholding and reporting requirements

on payments to executives that may be considered parachute payments under *I.R.C. section 280G*.ⁿ¹⁴ In *Revenue Ruling 2004-87*, the Service held that when there is a change in ownership of a corporation in bankruptcy, payments made to executives pursuant to an employment contract that are triggered by a sale of the corporation are not considered parachute payments under *I.R.C. section 280G*.ⁿ¹⁵ The payments to the executive were held to be exempt from the definition of parachute payment and thus the corporation was permitted to make the payment as provided for in the employment contract. Accordingly, the Service noted that such payments made to executives by a bankruptcy estate are payments for services preformed by an employee, and therefore are considered wages for withholding purposes.

I.R.C. section 280G(b)(5)(A)(ii) provides, in relevant part, that a parachute payment for a corporation does not include any payment to a disqualified individual if immediately before a change in ownership of the corporation none of its stock was readily tradeable on an established securities market and the payment was approved by persons owning more than seventy five percent (75%) of the voting power of all outstanding stock in the corporation before the change in ownership with adequate disclosure of all material facts concerning any parachute payments. Additionally, according to Q/A 29 of *Treas. Reg. 1.280G-1*, if there is a change in ownership of at least one third (1/3) of the total gross fair market value of the all of the assets of the corporation, then there is deemed a change in ownership of the corporation for purposes of *I.R.C. section 280G*.

The taxpayer in *Revenue Ruling 2004-87* had filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code and an unrelated corporation purchased more than one third of the assets of the taxpayer. The taxpayer's stock was de-listed from the stock exchange on which it was traded and was no longer tradeable on any established securities market. Pursuant to an employment contract with an executive of the taxpayer, any sale of the company triggered certain payments to the executive, who was a disqualified individual with respect to the taxpayer. The executive filed a request to allow the taxpayer to make the payment as an administrative expense of the bankruptcy estate. The bankruptcy court approved the request for payment of the administrative expenses.

It was noted that since the continuing interests of equity owners of a corporation in bankruptcy can be difficult to determine or predict, the bankruptcy court can make factual findings that certain payments were actual, necessary costs and expenses of preserving the estate. Such approval by the court is deemed to satisfy the requirement of shareholder approval. Therefore, the payments to the executive were held to be exempt from the definition of parachute payment and thus the corporation was permitted to make the payment as provided for in the employment contract.

Citing *I.R.C. section 3401(d)*, the Service noted that such payments made to executives by a bankruptcy estate are payments for services preformed by an employee, and therefore are considered wages for withholding purposes. In situations such as those described in *Revenue Ruling 2004-87*, where the bankruptcy court approves certain payments to executives upon a change in control of the insolvent corporation, the bankruptcy estate must keep in mind the reporting and withholding requirements as they pertain to the compensation paid to the outgoing executives.

[2] The Obligation to File Tax Returns and Other Reports Required by the Internal Revenue Code

In *Otte v. United States*, the Supreme Court also addressed the necessity for a fiduciary to file returns or information reports required by the IRS. *I.R.C. sections 6001* and *6011* require every person responsible for the payment or collection of taxes to keep such records and make such returns as the Secretary of the Treasury may require.ⁿ¹⁶ The court in *Otte* stated that the "trustee must comply with these provisions if he is subject to the withholding requirements of *I.R.C. sections 3402* and *3102*."ⁿ¹⁷ This compliance requirement may include the filing of tax returns for periods before the date the fiduciary was appointed if the tax claims are due and will be claims against the estate.ⁿ¹⁸ Trustees should also ensure that they are filing information returns in the proper format using the IRS specified medium. Although return filers may submit up to 249 information returns on paper, the IRS generally encourages filers to transmit information returns electronically or magnetically.^{n18a} Recently enacted regulations under *section 6011(e)(2)(A) of the Internal Revenue Code* provide that any person, including a corporation, partnership, individual, estate, and trust, who is required to file 250 or more information returns, must file such returns electronically or

magnetically. The 250 or more requirement applies separately for each type of return and separately to each type of corrected return filed.

The Internal Revenue Code also requires taxpayers to file different kinds of information reporting forms with the IRS. n19 The court in *Otte* held that the trustee was required to supply employees with annual W-2 forms. n20 This requirement should, however, be limited to the amounts actually paid by the trustee, receiver or fiduciary. Thus, the filing of information returns related to wages paid prior to the filing of a case under title 11 should be the sole responsibility of the debtor because it is the employer and it is in control of the payment of the wages in question. On the other hand, the trustee or applicable fiduciary should file the appropriate information returns attributable to (i) wage claims paid by the trustee and (ii) wages actually paid by the trustee during the administration of the title 11 case. n21

Courts have uniformly interpreted *Otte* to mean that section 3401(d)(1) employers are liable for withholding income taxes, withholding FICA taxes, and paying FUTA taxes. n22 In addition, since *Otte*, courts have uniformly applied the definition of section 3401(d)(1) to FUTA. n23

FOOTNOTES:

(n1)Footnote 1. *I.R.C. § 3402* requires the withholding of income tax from wages. *I.R.C. § 3401* defines which wages are subject to withholding, broadly providing that wages for withholding purposes include, with certain exceptions, all remuneration for services performed by an employee for his or her employer. An employer is defined in *I.R.C. § 3401(d)* as the person for whom an individual performs or performed any service, of whatever nature, as the employee of such person. *I.R.C. § 3102(a)* requires the withholding of premiums payable by employees under the Federal Insurance Contributions Act (FICA).

(n2)Footnote 2. *Treas. Reg. § 31.3402(a)-1(f)*.

(n3)Footnote 3. See *Otte v. United States*, 419 U.S. 43, 48, 95 S. Ct. 247, 251, 42 L. Ed. 2d 212, 220 (1974) and the cases cited therein.

(n4)Footnote 4. *Id.*

(n5)Footnote 5. The trustee contended he was not an employer because the priority wage claims were prepetition claims against the debtor and not against the trustee in his capacity as a trustee. The fact that he was paying claims against the estate did not, under the trustee's argument, raise those payments to the level of "wage payments" as defined in *I.R.C. §§ 3401* and *3402*. *Otte v. United States*, 419 U.S. 43, 49, 95 S. Ct. 247, 252, 42 L. Ed. 2d 212, 220 (1974) .

(n6)Footnote 6. *Otte v. United States*, 419 U.S. 43, 95 S. Ct. 247, 42 L. Ed. 2d 212 (1974) . The distinction regarding the priority of the withheld tax liabilities is a significant one. The district court held that under the Bankruptcy Act, the withheld taxes were a fourth priority claim. *In re Freedomland, Inc.*, 341 F. Supp. 647, 655-56 (S.D.N.Y. 1972) , *aff'd in part and rev'd in part*, 480 F.2d 184 (2d Cir. 1973) , *aff'd sub nom.* *Otte v. United States*, 419 U.S. 43, 95 S. Ct. 247, 42 L. Ed. 2d 212 (1974) . Under the Bankruptcy Code, applying the district court's logic, the withheld taxes would have been only a seventh priority claim. The classification of the withholding tax liability relative to priority wages on a par with the priority wages increased the likelihood the IRS would be paid and reduced the amounts available for distribution to other creditors. See the discussion of the priority of tax claims in ch. TX4 *infra* .

(n7)Footnote 7. *I.R.C. § 3401(d)(1)*.

(n8)Footnote 8. *In the Matter of Armadillo Corporation and Republic Drug Corporation, Bankrupt v. Charles W. Ennis, Trustee and Roger C. Gifford, Trustee*, 561 F.2d 1382 (10th Cir. 1977) USTC ¶ 9659, *aff'g*. 76-2 USTC ¶ 9546 .

(n9)Footnote 9. According to the *Armadillo* court, these taxes arise only when wages are paid by the bankrupt's estate, so they are debts of the estate rather than the bankrupt.

(n10)Footnote 10. Refers to 11 USCA § 104(a)(2) of the Bankruptcy Act.

(n11)Footnote 11. *Id.*, citing *Carlson v. Landon*, 342 U.S. 524 (1952) .

(n12)Footnote 12. See, e.g., *In re Vanity Fair Laminates, Inc.*, 76-2 U.S. Tax Cas. (CCH) P 9614 (Bankr. M.D. Pa. 1976) (a receiver generated a payroll tax liability during a Chapter XI arrangement proceeding under the Bankruptcy Act; the trustee was personally responsible for that liability and the tax liability was not payable out of the subsequent liquidation estate). A prepetition receiver, trustee or fiduciary will also probably be assessed the liability for the unpaid withholding tax liability pursuant to I.R.C. § 6672. See ch. TX15 *infra* for a more detailed discussion of § 6672 of the Internal Revenue Code.

(n13)Footnote 13. See, e.g., *In re Vanity Fair Laminates, Inc.*, 76-2 U.S. Tax Cas. (CCH) P 9614 (Bankr. M.D. Pa. 1976) (a receiver generated a payroll tax liability during a Chapter XI arrangement proceeding under the Bankruptcy Code, applying the district court's logic, the withheld taxes would have been only a seventh priority claim. The classification of the withholding tax liability relative to priority wages on a par with the priority wages increased the likelihood the IRS would be paid and reduced the amounts available for distribution to other creditors. See the discussion of the priority of tax claims in chapter TX4 *infra* .

(n14)Footnote 14. *Rev. Rul. 2004-87* , I.R.B. 2004-32, July 19, 2004.

(n15)Footnote 15. *Id.*

(n16)Footnote 16. *Otte v. United States*, 419 U.S. 43, 52 , S. Ct. 247, 254, 42 L. Ed. 2d 212, 222 (1974). The requirements issued by the IRS for the reporting of withholding tax liabilities are contained in the following: *Treas. Reg. §§ 31.6001-1, 31.6001-2, 31.6001-5, 31.6011(a)-6(a)(1) and 31.6051-1 and Rev. Proc. 71-19, 1971-1 C.B. 684* .

(n17)Footnote 17. *Otte v. United States*, 419 U.S. 43, 52, 95 S. Ct. 247, 254, 42 L. Ed. 2d 212, 222 (1974). See also *Nicholas v. United States*, 384 U.S. 678, 693, 86 S. Ct. 1674, 1684, 16 L. Ed. 2d 853, 865 (1966) (if the trustee is liable for a tax claim incurred by the debtor, "there can be no question that, under § 6011(a) of the Internal Revenue Code, the trustee was under an obligation to file returns for these taxes, even though the taxes themselves were incurred by the debtor in possession during the pendency of the arrangement proceeding").

(n18)Footnote 18. This was the result in *Nicholas v. United States*, 384, U.S. 678, 693, 86 S. Ct. 1674, 1684, 16 L. Ed. 2d. 853, 865 (1966) , in which the IRS successfully assessed penalties against the fiduciary for failure to file such returns. See also *In re Hudson Oil Co.*, 91 B.R. 932 (Bankr. D. Kan. 1988) .

(n19)Footnote 18a. *Rev. Proc. 2007-51* , § 4.01.

(n20)Footnote 19. See, e.g., I.R.C. § 6051. The most common example of this requirement is the Form W-2 Wage Statement. I.R.C. § 6051(a) requires every person who is required to deduct and withhold from an employee a tax under I.R.C. §§ 3101 or 3402 to furnish to each such employee with respect of the remuneration paid by such person a written statement showing certain information concerning the amounts so paid.

(n21)Footnote 20. *Otte v. United States*, 419 U.S. 43, 52, 95 S. Ct. 247, 254, 42 L. Ed. 2d 212, 222 (1974). On the basis of the *Otte* opinion, trustees and other fiduciaries should file all information reporting forms required by the IRS to the extent the event triggering the required filing occurs after the fiduciary assumes control over the debtor's assets.

(n22)Footnote 21. See *An Overview of the State and Federal Tax Responsibilities of Bankruptcy Trustees and*

Debtors, 93 Com. L.J. 43, 57-58 (Spring 1988).

(n23)Footnote 22. *Winstead v. United States*, 109 F.3d 989, 991 (4th Cir. 1997) ("while [the § 3401(d)(1) definition of employer] is for income tax purposes, the Supreme Court has held that it is equally applicable to FICA").

(n24)Footnote 23. *In re Laub Baking Co.* [81-1 USTC P 9333] , 642 F.2d 196, 198-99 (6th Cir. 1981) ; *In re Armadillo Corp.* [77-2 USTC P 9659] , 561 F.2d 1382, 1386 (10th Cir. 1977) ; *In re Terex Corp.*, 93 B.R. 127, 129-30 (N.D. Ohio 1988) .



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CHAPTER TX3 Tax Reporting Requirements

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P TX3.06 Penalties Attributable to Tax Returns Filed or Required to Be Filed by a Representative of a Debtor

Statutory civil and criminal penalties may be asserted against a trustee or other fiduciary of a debtor for the failure to file tax returns, to truthfully report tax liability, or to pay taxes. n1 Civil penalties may be imposed for failure to timely file tax returns, n2 failure to timely file information returns, n3 failure to timely pay taxes reported on tax returns, n4 failure to timely pay estimated income taxes n5 and for the filing of inaccurate tax returns. n6 These "accuracy-related penalties" incorporate former negligence and civil fraud penalties. n7 Criminal penalties may be imposed for failure to file tax returns n8 and for attempting to willfully evade or defeat a tax liability. n9

For example, in a case filed under the former Bankruptcy Act, the Supreme Court in *Nicholas v. United States* held that a trustee was subject to penalties for failing to file income tax returns required for a debtor in possession. n10 The Supreme Court was presented with the question of whether a superseding trustee in bankruptcy was liable for interest and penalties on federal taxes incurred by a debtor in possession during an arrangement proceeding under the Bankruptcy Act. During the arrangement proceeding, the debtor continued to operate its business and incurred a payroll tax liability to the United States. Neither the debtor nor the subsequent trustee filed the tax returns necessary to report these payroll tax liabilities to the IRS. The Court held that the trustee was subject to a penalty for his failure to file the payroll tax returns that would have reported the payroll tax liability.

The trustee was liable for the failure to file returns reflecting payroll tax liabilities because, in part, of the requirements of 28 U.S.C. section 960. n11 A trustee who operates a business of the debtor is required to file all income and payroll tax returns that a nondebtor would be required to file during the normal operations of its business. n12 The *Nicholas* Court observed that the trustee, in his capacity as the successor in interest to the debtor in possession, was required to pay the arrangement period tax liabilities to the extent of their priority under the Bankruptcy Act. If the trustee had that payment obligation under 28 U.S.C. section 960, then the trustee also bore the statutory responsibility "to file returns for these taxes, even though the taxes themselves were incurred by the debtor in possession during the pendency of the arrangement proceeding." n13

Thus, to the extent the trustee or other fiduciary of a debtor bears a reporting or payment obligation under the Bankruptcy Code or the Internal Revenue Code, penalties can be imposed against the trustee or the debtor's estate as a result of the failure to take the required action. n14

FOOTNOTES:

(n1)Footnote 1. A detailed discussion of the civil and criminal provisions of the Internal Revenue Code is beyond the scope of this work. Therefore, the scope of this discussion will be limited to the effect of penalties that may be asserted against a trustee or other fiduciary in a case filed under title 11.

(n2)Footnote 2. *I.R.C. § 6651(a)(1)*.

(n3)Footnote 3. *I.R.C. § 6652*.

(n4)Footnote 4. *I.R.C. § 6651(a)(2)*.

(n5)Footnote 5. *I.R.C. §§ 6654* (individuals) and *6655* (corporations).

(n6)Footnote 6. *I.R.C. § 6662*.

(n7)Footnote 7. In 1989, Congress passed the Improved Penalty Administration and Compliance Tax Act as part of the Omnibus Reconciliation Act of 1989 (Pub. L. No. 101-239). The Internal Revenue Code was amended to restructure and simplify the pre-1989 penalty provisions contained in the Internal Revenue Code. The pre-1989 separate civil penalties for negligence, substantial understatement of income tax, substantial valuation misstatement, substantial overstatement of pension liabilities and substantial understatement of estate or gift tax valuation were incorporated into one penalty provision in *I.R.C. § 6662*.

(n8)Footnote 8. *I.R.C. §§ 7201-7203*.

(n9)Footnote 9. *I.R.C. § 7201*.

(n10)Footnote 10. *Nicholas v. United States*, 384 U.S. 678, 86 S. Ct. 1674, 16 L. Ed. 2d 853 (1966) .

(n11)Footnote 11. See the discussion of 28 U.S.C. § 960 at P TX3.03[1][a] *supra*.

(n12)Footnote 12. This is the stated reason for the creation of 28 U.S.C. § 960--to place all taxpayers in equal economic positions. See P TX3.03[1][a] *supra* and *Boteler v. Ingels*, 308 U.S. 57, 60 S. Ct. 29, 84 L. Ed. 78 (1940) , in which the Court held that a state automobile license penalty asserted against a trustee was proper because the trustee would have been liable for the same license amount if the trustee's business had been operated outside of bankruptcy.

(n13)Footnote 13. *Nicholas v. United States*, 384 U.S. 678, 693-94, 86 S. Ct. 1674, 1685, 16 L. Ed. 2d 853, 865 (1966) .

(n14)Footnote 14. See, e.g., *In re Sapphire Steamship Lines*, 762 F.2d 13 (2d Cir. 1985) , in which the Court of Appeals for the Second Circuit confirmed a non-operating trustee's liability for the corporate estimated income tax payment penalty on income earned by the debtor postpetition.



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CHAPTER TX3 Tax Reporting Requirements

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P TX3.07 New FBAR Filing Requirements for Bankruptcy Estates with Foreign Bank Accounts

In the current IRS increased enforcement environment, compliance with reporting requirements is more important than ever. While the laws requiring disclosure of foreign bank or financial accounts took affect nearly four decades ago, only recently has the U.S. government taken steps to enhance compliance with these rules by increasing its focus on offshore tax evasion via the use of "secret" foreign bank accounts. n1 Accordingly, the U.S. government has promulgated new legislation clarifying filing requirements and penalties associated with non filing of the Report of Foreign Bank and Financial Account (FBAR) forms. Since the existing FBAR filing requirements contain no exception for bankruptcy estates, bankruptcy trustees should carefully evaluate their responsibility both pre- and post-petition to file FBAR forms. Under the FBAR rules, bankruptcy estates may be required to report any financial interest in or signature authority over more than \$10,000 that the estate holds in a financial interest or a foreign bank account. The Department of Treasury form used to report this information is known as Form TD F90-22.1, Report of Foreign Bank and Financial Accounts. n2

The FBAR is not a tax return, but is an annual report filed with the Secretary of Treasury stating that the person or entity filing the form has a financial interest in or signatory authority over, financial accounts in a foreign country with an aggregate value exceeding \$10,000 at any time during the tax year. The deadline for filing an FBAR for each calendar year is on or before June 30[th] of the following year--and this date cannot be extended. n3 The instructions to the FBAR explain how compliance with the statute is achieved and sets forth in detail the required information and those persons obligated to comply with the FBAR reporting requirements. n4

[1] IRS Enforcement of Treasury Mandate

It is important to note that the FBAR filing requirement is a mandate of the U.S. Treasury Department. As such, the FBAR form is not an IRS tax form, but the IRS has been "engaged" to assist in the treasury's enforcement efforts. In 2003, in an effort to raise the FBAR compliance rate, the Financial Crimes Enforcement Network ("FinCEN") delegated its enforcement authority for the FBAR to the IRS. n5 The agreement marked a significant step in the IRS's efforts to identify entities or persons with undisclosed foreign bank accounts. Included among the reasons cited for the delegation of enforcement authority are the greater resources available to the IRS to devote to FBAR compliance. n6 As a result of this delegation, the IRS has the authority to assess and collect penalties for noncompliance with FBAR requirements, to issue administrative rulings in possible violations, and to take any other action reasonably necessary for enforcement of these provisions, including pursuit of injunctions. n7

[2] Who Must File

Each person subject to U.S. jurisdiction (except a foreign subsidiary of a U.S. person) who has a financial interest in, or signature or other authority over, a bank, securities, or other financial account in a foreign country must report that relationship if the aggregate value of the accounts exceeds \$10,000 at any time during the year. The October 2008 FBAR form instructions define a "U.S. person" as "a citizen or resident of the United States, or a person in and doing business in the United States". "Person" is defined in *31 CFR 103.11(z)* as:

An individual, a corporation, a partnership, a trust or estate, a joint stock company, an association, a syndicate, joint venture, or other unincorporated organization or group, an Indian Tribe (as that term is defined in the Indian Gaming Regulatory Act), and all entities cognizable as legal personalities.

Also, under the rules, "United States person" means (1) a citizen or resident of the United States (2) a domestic partnership (3) a domestic corporation or (4) a partnership, corporation, domestic estate or trust.

With very limited exceptions, each U.S. person with a financial interest in, or signature or other authority over, any foreign financial account must file Form TD F 90-22.1 if the aggregate value of all such accounts exceeds \$10,000 at any time during the calendar year. There are, however, very specific statutory exceptions to the filing requirements. Note, however, that there is no specific exception for bankruptcy estates. The rules specify that an officer or employee of a domestic corporation need not file an FBAR if the corporation's stock is publicly traded, **or** the corporation has assets exceeding \$10 million and 500 or more shareholders **and** the individual has no personal financial interest and has been advised in writing by the CFO that the corporation has filed a current report which includes that account. Notably, these are very limited exceptions and the IRS and Treasury are expected to issue additional clarification and guidance on reporting and filing requirements. Again, it is important to emphasize that, to date, there is no exception for bankruptcy estates.

[3] Penalties for Nonfiling of FBAR Forms

Refer to the table below for a summary of potential civil and criminal penalties that may be imposed for noncompliance with FBAR filing requirements. Bankruptcy trustees should also evaluate the likelihood that penalties may be assessed for prior (pre-petition) tax years when the debtor may have failed to file a tax return or to otherwise report any interest held in foreign bank accounts.

[4] Civil Penalties

In its attempt to close the tax gap and better identify offshore interests in foreign bank accounts, Congress has strengthened the penalties for noncompliance with FBAR reporting requirements. An individual who fails to comply with the reporting requirements, regardless of whether his action was willful, can be subject to a penalty of up to \$10,000 per violation. n8 Civil penalties for a willful violation can range from the greater of \$100,000 or 50 percent of the amount in the account at the time of the violation. n9 In addition to the FBAR penalty, an individual may also be subject to a variety of other tax penalties for failing to properly report the income from their foreign accounts on their tax return. n10 Finally, criminal penalties for violating the FBAR requirements while also violating certain other laws can range up to a \$500,000 fine, 10 years imprisonment or both. n11 Civil and criminal penalties may also be imposed together. n12

The civil penalty imposed under *31 USC section 5321* for failure to file the FBAR is not considered a tax penalty under Title 26 and therefore is not subject to the notice of deficiency procedures prescribed by the Code. n13 Notably, without a notice of deficiency, the U.S. Tax Court lacks jurisdiction over disputes involving the IRS's assessment of the FBAR penalty. n14 Enforced collection of the FBAR penalty is, by statute, the subject of a civil action to recover a civil penalty. n15 Further, once assessed, liability for the FBAR penalty falls within the exception to discharge in bankruptcy

as found under Title 11, section 523(a)(7).ⁿ¹⁶ Finally, it is also important to remember that in addition to the FBAR penalty, an individual may also be subject to a variety of tax penalties if they have not properly reported the income from their foreign accounts on their tax return.

[5] Criminal Penalties

Criminal penalties for violation of FBAR requirements can result in fines of up to \$250,000 and five (5) years imprisonments.ⁿ¹⁷ Additionally, if the FBAR violation occurs while violating another law, the penalties may be increased to \$500,000 in fines and/or 10 years imprisonment.ⁿ¹⁸ Finally, civil and criminal penalties may be imposed together since the assessment of civil penalties does not preclude imposition of criminal penalties.ⁿ¹⁹

Again, bankruptcy trustees should evaluate the likelihood that penalties may be assessed for prior pre-petition years when the debtor may have failed to report any interest held in foreign bank accounts.

FOOTNOTES:

(n1)Footnote 1. See S. Brown, *Journal of Tax Practice and Procedure*, "FBAR Violations: The IRS's New Tool for Improved Compliance" (Jan. 1, 2009).

(n2)Footnote 2. Due to the recent increase in IRS enforcement activity relating to foreign financial accounts, the instructions to the FBAR were revised in October 2008. Definitions were clarified in the instructions and the form itself was revised to require U.S. persons to provide more information on the accounts.

(n3)Footnote 3. See FBAR form filing instructions; see also *IRS Announcement 2009-51* and subsequent notices regarding unfiled returns and related due dates.

(n4)Footnote 4. In March 2009, the IRS initiated a voluntary disclosure program related to offshore activities, including the failure to file the FBAR. One aspect of the program allows U.S. persons who have properly reported all income and paid tax to come forward and file any delinquent FBARs with respect to prior years by September 23, 2009 without penalties.

(n5)Footnote 5. See S. Brown, *Journal of Tax Practice and Procedure*, "FBAR Violations: The IRS's New Tool for Improved Compliance" (Jan. 2009) citing See U.S. Treasury Department, Report to Congress in Accordance Act Sec. 361(b) of Pub. L. No. 107-56 of the USA PATRIOT Act (April 26, 2002) ("Treasury Report"), at 6. *Id.*, citing 68 FR 26,468 (May 16, 2003) (codified at 31 CFR §103.56(g))

(n6)Footnote 6. *Id.*, citing Final Rule (RIN 1506-AA45) (May 15, 2003).

(n7)Footnote 7. *Id.*, citing 31 CFR §103.56(g)).

(n8)Footnote 8. 31 U.S.C. § 5321(a)(3).

(n9)Footnote 9. 31 U.S.C. § 5321(a)(5)(C)(i), as amended by the Jobs Act.

(n10)Footnote 10. 31 U.S.C. § 5322(b).

(n11)Footnote 11. 31 U.S.C. § 5321(d).

(n12)Footnote 12. 31 U.S.C. § 5321(a)(5)(A).

(n13)Footnote 13. 31 U.S.C. § 5321(b)(1); 31 CFR § 103.56(g)(2007).

(n14)Footnote 14. See S. Brown, *Journal of Tax Practice and Procedure*, "FBAR Violations: The IRS's New Tool for Improved Compliance (Jan. 2009) citing J.B. Williams, 131 TC 6 (Oct. 2, 2008).

(n15)Footnote 15. 31 U.S.C. § 5321(b)(2).

(n16)Footnote 16. United States v. Simonelli, 614 F. Supp. 2d 241; 2008 U.S. Dist. LEXIS 76028 (D. Conn. Sept. 30, 2008).

(n17)Footnote 17. 31 U.S.C. § 5322(a)

(n18)Footnote 18. 31 U.S.C. § 5322(b).

(n19)Footnote 19. 31 U.S.C. § 5321(d).



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CHAPTER TX3 Tax Reporting Requirements

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P TX3.08 Form: Treasury Form TD F 90.22-1 FBAR Violation Penalties Chart

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CHAPTER TX4 Priority and Dischargeability of Tax Claims

15-TX4 Collier on Bankruptcy Taxation TX4.syn

AUTHOR: Myron M. Sheinfeld, Esq.

§ TX4.syn Synopsis to Chapter TX4: Priority and Dischargeability of Tax Claims

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FOOTNOTES:

(n1)Footnote *.

This chapter was originally prepared by Myron M. Sheinfeld, Esq. and Walter B. Thurmond, Esq., and beginning in 2002 has been updated by Brian A. Kilmer, Esq., a partner at Okin Adams & Kilmer LLP. The author gratefully acknowledges the assistance of John M. Crosby in the editing, revising and updating of the 2009 edition of this chapter.



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CHAPTER TX4 Priority and Dischargeability of Tax Claims

15-TX4 Collier on Bankruptcy Taxation P TX4.01

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P TX4.01 Introduction

[1] Tax and Bankruptcy Public Policy

At the intersection of the Bankruptcy Code and the Internal Revenue Code ("I.R.C."), there occurs a collision of technical, complicated statutory law, in each case reflecting different and divergent public policy. The I.R.C. provides the system of taxation and collection of taxes, the purpose of which is to raise revenue for the operation of the federal government. The Bankruptcy Code provides the system for the treatment of insolvent debtors, the purpose of which is to equalize distribution among creditors and provide a fresh start to debtors. These independent purposes, when forced together, create a three-way tension among: (1) general creditors, whose recovery should not be diminished by excessive taxes from past years; (2) the taxing authority, whose recovery should not be diminished by taxes for which a reasonable time to collect was unavailable; and (3) the debtor, whose fresh start should not be diminished by the nondischargeability of taxes.

The attempted resolution of this tension can be seen in *Bankruptcy Code section 507(a)(8)*, prioritizing tax claims and expenses, and *Bankruptcy Code section 523(a)(1)*, providing for the nondischargeability of certain taxes. Equalizing distribution among creditors is too broad a principle to apply in practice; some creditors must be preferred to others to ensure their repayment before depletion of the bankruptcy estate. Sections 507 and 523 provide the conditions for the preference of one creditor over another. Given the apparent omnipresence of taxes, it is perhaps surprising to discover that, as among the nine priorities, taxes are next to last. The debtor's fresh start is provided by the discharge, while the creditor's right to recovery is protected by the nondischargeability of certain debts, including certain tax debts.

[a] Legislative History

Pursuant to section 64a of the Bankruptcy Act of 1898, nondischargeable taxes that were legally due and owing to the United States, any State or any subdivision of any State were entitled to a fourth priority. Dischargeable taxes were entitled to the same priority as claims of general unsecured creditors. Prior to 1966, under section 17(a)(1) of the Bankruptcy Act, taxes that became due and owing to the United States, any State or any subdivision of any State were nondischargeable. In 1966, the exception for taxes applied only to taxes due and owing during the three-year period preceding bankruptcy. In addition, the discharge did not apply to taxes: (1) that were assessed in any case in which the bankrupt failed to make a return required by law; (2) that were assessed within one year before bankruptcy in any case

in which the bankrupt failed to make a return required by law; (3) that were not reported on a return made by a bankrupt and that were not assessed before bankruptcy because of a prohibition; (4) with respect to which the bankrupt made a false or fraudulent return or willfully attempted in any manner to evade or defeat; or (5) that the bankrupt collected or withheld from others as required by law but failed to pay.

On April 25, 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act")ⁿ¹ was signed into law by President George W. Bush. With certain enumerated exceptions, the 2005 Act took effect on October 17, 2005 and applies only to cases commenced on or after such date. This chapter has been updated to reflect changes made by the 2005 Act to the Bankruptcy Code.

[b] In General

This chapter addresses the priority and dischargeability of secured and unsecured tax claims, including a discussion of the treatment of priority tax claims,ⁿ² administrative tax liabilitiesⁿ³ tax penaltiesⁿ⁴ and interest on tax claims.ⁿ⁵ The discussion of dischargeability in this chapter applies only to individuals, unless otherwise indicated, because a discharge is only available to individuals.ⁿ⁶

If a tax liability is dischargeable, then the debtor is relieved of all obligations to repay the debt (but there may be adverse tax consequences involving cancellation of debt income). Nondischargeable tax liabilities continue as obligations after the close of the bankruptcy case. If a tax is dischargeable, and the taxing authority after proper notice fails to file a proof of claim before the expiration of the bar date, then the claim may be discharged without any payment to the taxing authority.ⁿ⁷ In addition, properly perfected prepetition tax liens ride through the bankruptcy and continue to encumber the debtor's property postpetition.ⁿ⁸ Pursuant to section 507, there are nine priorities, including priority tax claims treated in section 507(a)(2), (3) and (8). Priority tax claims are nondischargeable pursuant to section 523(a)(1) and, in chapter 11 cases, before a plan of reorganization can be confirmed, priority tax claims must be properly treated.ⁿ⁹

A debtor may initiate the determination of the dischargeability of a debt by filing an adversary proceeding seeking such a determination.ⁿ¹⁰ A taxing authority is not required to request an exception to discharge in order for the debt to be collectible after the case has been closed, and its failure to do so does not affect the nondischargeability of the tax liability.ⁿ¹¹

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n2)Footnote 2. *See P TX4.02 and P 4.04 infra* .

(n3)Footnote 3. *See P TX4.03 infra*.

(n4)Footnote 4. *See PP TX4.02[1][d] and 4.03 infra* .

(n5)Footnote 5. *See P TX4.05 infra*.

(n6)Footnote 6. 11 U.S.C. § 727(a)(1); 11 U.S.C. § 109(e).

(n7)Footnote 7. 11 U.S.C. § 502(b)(9). Section 502(b)(9) was revised by the 2005 Act to note that "except in a case

under Chapter 13, a claim of a governmental unit for a tax with respect to a return filed under section 1308 shall be timely if the claim is filed on or before the date that is 60 days after the date on which such return was filed as required."

(n8)Footnote 8. *In re Wrenn*, 40 F.3d 1162, 32 C.B.C.2d 987 (11th Cir. 1994) ; *Vilamar v. Hersch*, 37 Fed. Appx. 919 (9th Cir. 2002) ; *In re Orr*, 180 F.3d 656 (5th Cir. 1999) ; *In re Isom*, 901 F.2d 744 (9th Cir. 1990) ; *United States v. Alfano*, 34 F. Supp. 2d 827 (E.D.N.Y. 1999) ; *In re Wampler*, 345 B.R. 730 (Bankr. D. Kan. 2006) ; *In re Green*, 310 B.R. 772 (Bankr. M.D. Fla. 2004) .

(n9)Footnote 9. *United States v. Gurwitch*, 794 F.2d 584 (11th Cir. 1986) ; *In re Gill*, 343 B.R. 732 (Bankr. M.D. Fla. 2006) ; *In re Gulf Coast Holdings, Inc.*, 2007 Bankr. LEXIS 1685 (Bankr. N.D. Tex. April 30, 2007); *In re Shin*, 306 B.R. 397 (Bankr. D.D.C. 2004) ; *In re Made in Detroit, Inc.*, 299 B.R. 170 (Bankr. E.D. Mich. 2003) , *aff'd*, 414 F.3d 576 (6th Cir. 2005) ; *In re Newman*, 399 B.R. 541 (Bankr. M.D. Fla. 2008) .

(n10)Footnote 10. *See Fed. R. Bankr. P. 7001(6); 4007(a).*

(n11)Footnote 11. *11 U.S.C. § 1129(a)(9).*



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CHAPTER TX4 Priority and Dischargeability of Tax Claims

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P TX4.02 Priority and Dischargeability of Unsecured Tax Claims

[1] Priority of Tax Claims

Section 507 of the Bankruptcy Code sets forth the claims and expenses that are granted a priority in distribution in a title 11 reorganization case. Under section 507, there are nine priorities, including certain tax liabilities having priority pursuant to section 507(a)(2), (a)(3) and (a)(8). Unsecured priority tax claims in an involuntary title 11 case under section 507(a)(2) and unsecured priority tax claims specified in section 507(a)(8) are excepted from discharge. n1

While only those tax liabilities of an individual debtor with section 507(a)(3) or (8) priority are expressly made nondischargeable in section 523(a)(1), section 507 priority tax liabilities can affect the outcome of the title 11 case in other ways because, before a plan of reorganization can be confirmed, it must provide for the payment of section 507 priority tax liabilities pursuant to section 1129(a)(9). n2

[a] Second Priority: Administrative Tax Claims

An administrative, second priority status is allowed for expenses incurred postpetition to preserve the assets of the bankruptcy estate and for any secured or unsecured tax liabilities that accrue during the administration of the estate. n3 Included in this priority are employee and employer portions of employment taxes for wages paid, n4 property taxes (for which liability is in rem, in personam, or both), income tax liabilities incurred during the administration of the bankruptcy estate, taxes "attributable to an excessive allowance of a tentative carryback adjustment that the estate received" n5 and any fine, penalty or reduction in credit relating to a tax specified in section 503(b)(1)(B). n6 Courts are split on whether post-petition interest on such taxes and penalties is also a first priority claim. n7

Administrative tax liabilities are not expressly made nondischargeable by section 523(a)(1)(A). However, pursuant to section 727(b), only debts arising before the entry of the order for relief are subject to discharge unless otherwise excepted in section 523(a). Administrative claims, by their nature, arise after entry of the order for relief. Unlike most administrative claimants, under the 2005 Act, governmental units are not required to file a request for payment of an administrative expense for a tax or a tax penalty as a condition to allowance of an administrative expense. n8 In chapter 11, 12 and 13 cases, administrative tax liabilities must, unless the claimant agrees to a different treatment under the plan, receive a cash payment equal to the allowed amount of the claim on the effective date of the plan. n9

[b] Third Priority: Involuntary Gap Tax Claims

In an involuntary case, tax claims may accrue in the ordinary course of business during the "gap period," such period being the period of time immediately after a chapter 7 or 11 involuntary petition has been filed but before the earlier of an order for relief under section 303(h) is entered or a trustee is appointed. These tax claims are given a third payment priority after spousal support payments and administrative expenses and, under section 523(a)(1), are nondischargeable. n10

[c] Fourth Priority: Tax Claims on Certain Wages, Salaries or Commissions

To a limited extent, wages, salaries or commissions earned within 180 days before the petition date are granted a fourth priority. n11 This priority includes any withheld income taxes and the employees' share of social security taxes. n12 However, the wages, salaries and commissions within this priority are limited to \$10,000 n13 for each employee.

The employer's and employee's payroll tax liabilities associated with fourth priority wage claims are not incurred until the debtor or the trustee pays the third priority wages as part of the claims distribution process. Therefore, there is no prepetition tax liability attributable to any fourth priority wages because the employer's and employee's tax liabilities accrue postpetition when the wages are paid. n14 The priority classification of the tax liabilities associated with these third priority wages is different for each of the employee's and employer's tax liabilities.

As explained below, income and other payroll taxes withheld from third priority wages paid pursuant to section 507(a)(4) are also a fourth priority claim because those taxes are part of the wage claim. The trustee in bankruptcy or the debtor in possession is an "employer" within the meaning of *I.R.C. section 3402(a)*. n15

The employee's withholding tax liabilities withheld by an employer are entitled to the same priority in a title 11 case as the wages from which they arise, because these withheld taxes are carved out of the wages themselves. n16 If the trustee fails to collect, account for or pay to the taxing authority the trust fund tax liabilities related to the fourth priority wages, the trustee may become personally liable for the unpaid trust fund taxes that were not paid. n17

The treatment of the debtor's nontrust fund, employment tax liability (the employer's matching FICA tax liability) related to the priority wages has been less clear. n18 The IRS has argued that the employer's matching FICA tax liability should be granted an administrative, first priority claim or, in the alternative, the same priority as the wages paid, *i.e.*, a fourth priority claim. n19 Courts that have considered this issue have rejected the IRS's argument for an administrative claim because that classification would result in the depletion of the bankruptcy estate to the detriment of the third priority wage claimants. n20

Following *Otte v. United States*, n21 courts have also rejected the IRS's contention that the employer's tax liability on fourth priority wages is a fourth priority tax claim. n22 A split of authority, however, continues to exist regarding the granting of an eighth priority to the employer's tax liability if the fourth priority is disallowed. One line of cases, represented by *In re Armadillo Corp.*, n23 rejects any priority treatment at all for the employer's tax liability related to priority wages, instead classifying such taxes as general unsecured claims. n24 The logic behind the rejection of any priority classification for the employer's tax liability on fourth priority wage claims is that the debtor, as an employer, did not pay prepetition wages and incur a prepetition tax liability. Under section 507(a)(8)(D), the employer's prepetition payroll tax liability will be a priority tax claim only if the liability related to wages earned from the debtor before the petition date. Because the fourth priority wage claims are not paid until after the petition date and the payroll taxes are not payable until the trustee pays those wage claims, the employer's tax liability is not due and owing from the debtor before the petition date.

Other courts have held that the employer's tax liability on priority wage claims is an eighth priority tax claim under section 507(a)(8)(D). n25 In the case of *In re Richardson Dinner Theatre, Inc.*, n26 the court granted the employer's tax

liability a fourth priority under the Bankruptcy Act (an eighth priority under the Bankruptcy Code) because the basis for the tax claim was the prepetition wage claim, *i.e.*, the tax claims were a valid prepetition claim but of a lesser priority than the wages paid. The court stated:

The court feels that the genesis of the employer's FICA tax in prebankruptcy events should control its characterization. The obligation to pay the wages which generates the tax is fixed before the date of bankruptcy [I]t is inconsistent with the policy of the Bankruptcy Act to dismiss the priority of this tax because of the sequential manner in which priorities are paid. The tax obligation, like the underlying wage obligation, is attributable to and limited by prebankruptcy events. If the bankruptcy trustee stands in the bankrupt's shoes for purposes of paying wages (and thus becomes liable under the Internal Revenue Code for income withholding and social security taxes), he should also stand in the bankrupt's shoes for purposes of paying the taxes on the wages. The court therefore holds that the employer's FICA taxes in this case are "legally due and owing by the bankrupt." n27

This analysis led the court in *Richardson Dinner Theatre* to hold that the employer's tax liability related to the priority wage claims was a fourth priority tax claim under the Bankruptcy Act (an eighth priority tax claim under section 507(a)(8)(D)). The contrary holdings of *Richardson Dinner Theatre* and *In re Armadillo Corp.* regarding the classification of the employer's tax liability are irreconcilable, and additional decisions will be necessary to resolve this split of authority.

Tax liabilities attributable to section 507(a)(4) wages are not expressly made nondischargeable in section 523(a)(1)(A) but, before a plan can be confirmed, any section 507(a)(4) tax liabilities must be paid in full on the effective date of the plan or, with the consent of the taxing authority, in deferred cash payments equal to the allowed amount of the tax claim as of the effective date of the plan. n28

[d] Eighth Priority: Prepetition Income Tax Claims

Certain allowed unsecured claims of governmental units that are for a tax on or measured by income or gross receipts are accorded an eighth payment priority in section 507(a) and are nondischargeable pursuant to section 523(a)(1). Included in this eighth priority are specific categories of tax liabilities such as income taxes, employment taxes, gross receipts taxes, excise taxes, property taxes assessed before the commencement of a case and taxes required to be collected or withheld for which the debtor is liable in any capacity. Pecuniary and compensatory loss penalties and prepetition interest are granted the same priority as the tax liability to which they relate. n29

To determine whether tax liabilities should be classified as eighth priority, nondischargeable claims, section 507(a)(8) provides two tests that consider the age of the tax liability. These dischargeability tests are commonly referred to as "the three-year rule" n30 and "the 240-day rule." n31 Other tax liabilities are treated pursuant to priority and dischargeability rules that generally are unrelated to any time limitations. n32

[i] Income and Gross Receipts Taxes: The Three-Year Rule

Section 507(a)(8)(A)(i) provides an eighth priority for prepetition income and gross receipts taxes that were due within the three-year period before the date of the petition for relief. n33 The due date for a tax return, including any extension periods, n34 is the key factor in the application of this three-year rule. n35 For example, if the petition date is January 1, 1990, all tax liabilities for the taxable years for which the due date of the tax return, including extensions, existing before January 1, 1987, are nonpriority, dischargeable general unsecured claims. The 1986 tax year's liability due on April 15, 1987 would be classified as a priority tax liability under section 507(a)(8)(A)(i) because its due date was within the three-year period before the petition date.

Section 1398 of the Internal Revenue Code allows an individual debtor in a chapter 7 or 11 case to elect to close the

taxable year on the day before the "commencement date" and begin a new taxable year on the "commencement date." n36 When a debtor elects to bifurcate the tax year under section 1398, the federal income tax liability for the first short taxable year becomes an allowable claim against the bankruptcy estate as a claim arising before the commencement of the case. Accordingly, any tax liability for the prepetition short year is entitled to priority under section 507(a)(8) and is collectible from the estate to the extent assets are available. n37

The term "the date of the filing of the petition" in section 507(a)(8)(A) may produce an unexpected result when a case under chapter 11 or 13 is converted to or from a chapter 7 case. The date of the filing of a petition refers to the original petition date. n38 The three-year period of section 507(a)(8)(A)(i) is determined from the earlier petition date and not the later conversion date. n39

Serial filings may also inadvertently result in the creation of an eighth priority nondischargeable tax liability. If the debtor has been the subject of a bankruptcy case or cases during the three-year period, the three-year period will be extended for the length of time that the automatic stay was in effect during the prior case or cases. The 2005 Act explicitly amended section 507(a)(8) to state that the three-year rule is tolled during any time period where there is a stay of collection proceedings (plus 90 days), incorporating the holding of the Supreme Court in *Young v. United States*, n39a which held very clearly that the three-year period is tolled during the time period that the automatic stay is in effect.

[iii] Erroneous Refund Claims

Section 507(c) states that a liability "arising from an erroneous refund or credit of a tax has the same priority as a claim for the tax to which such refund or credit relates." n40 Thus, under the plain language of section 507(c), the government's claim for an erroneous refund is entitled to the same priority as the underlying tax. n41 Indeed, the courts have uniformly reached the conclusion that an erroneous refund is entitled to the same priority as the underlying tax. However, the courts have disagreed sharply over the dischargeability of an erroneous refund claim.

For example, the bankruptcy court in *In re Jackson* stated that an erroneous refund paid to a taxpayer for a particular year is tested for discharge under the statutory periods for the determination of priority and dischargeability tax claims and noted that if the taxable year of the erroneous refund is nondischargeable due to the application of the testing periods of section 507(a)(8) or the delinquent return rules of section 523(a)(1), the liability for the erroneous refund is also not discharged and remains a priority tax claim. n42 Consequently, the bankruptcy court concluded that an erroneous refund could not be discharged since it was received in the three year look-back period. However, the district court, after examining the 1984 Bankruptcy Act and the amendments made by Congress to section 507(c), reversed the bankruptcy court's decision, noting that "[the changes made to 507(c) pursuant to the 1984 Act implies that Congress intended to place on a pedestal only the priority, not the dischargeability, of a claim for an erroneous tax refund and credit ...]" n43 In another case, *In re Frontone*, the bankruptcy court held that a claim arising out of an erroneous tax refund was not given the same status of nondischargeability as the underlying tax. n44 Hence, the bankruptcy court held that the government's claim for an erroneous tax refund was dischargeable. n45 The district court affirmed the bankruptcy court with regard to this issue. n46 However, after examining the legislative history surrounding the changes to section 507 of the Bankruptcy Code, the Seventh Circuit reversed the decision of the lower courts and held that the erroneous refund was nondischargeable. n47

One distinction that may account for the difference between the district court's decision in *Jackson* and the Seventh Circuit's recent opinion in *Frontone* is the fact that the erroneous refund in *Jackson* dealt with a situation where the debtor was not the intended payee of the erroneous refund whereas the debtor in the *Frontone* case merely received an erroneous refund due to an incorrect IRS determination that they had overpaid their taxes. However, while there is clearly a distinction, it does not appear that the distinction was dispositive of either court's decision and it remains to be seen how future cases deal with this distinction.

[iii] Income and Gross Receipts Taxes: The 240-Day Rule

In addition to the three-year test, the 240-day test of section 507(a)(8)(A)(ii) must also be satisfied before a tax liability will be discharged. n48 Any income taxes and gross receipts taxes assessed within 240 days prior to the filing of a petition under title 11 will be classified as eighth priority, nondischargeable tax liabilities. n49 It is the debtor's responsibility to properly calculate the time period of the 240-day rule so as to make sure more than 240 days have passed from the assessment date. n50 An erroneous calculation of the 240-day time period by the IRS will not excuse a debtor who files a petition before the 240-day period has expired. n51 When there are multiple assessments for a taxable year, the date of the latter deficiency assessment is the date from which the 240-day rule must be calculated. n52

The 240-day rule must be carefully reviewed when a taxpayer has filed prior title 11 cases or has filed an "offer in compromise" with the IRS. The 240-day assessment period is suspended during the pendency of any prior title 11 cases filed by a debtor. n53 The 240-day period is also suspended for any period during which (i) an offer in compromise is pending with the Internal Revenue Service and for 30 days thereafter n54 or (ii) a waiver of the statute of limitations on assessment is in effect. n55

After a tax assessment has been made, a taxpayer may be tempted to submit an offer in compromise, Form 656, in order to negotiate the settlement or potential reduction of a tax liability. The filing of an offer in compromise will, however, extend the 240-day time period. n56 Income taxes are nondischargeable if they are assessed within 240 days, plus any time during which an offer in compromise with respect to that tax liability was made and an additional 30 days thereafter. The filing of an offer in compromise with the IRS before the expiration of the 240-day period indefinitely extends the 240-day period until the offer in compromise is rejected by the IRS or is withdrawn by the taxpayer. An offer in compromise can be filed after the 240-day period has expired without affecting the priority classification or dischargeability of a tax liability. The filing of an offer in compromise *before* a tax is assessed does not toll the running of the 240-day period. n57

[iv] Taxes Assessable After the Petition Date

The Bankruptcy Code provides that certain tax liabilities assessable after the petition date, either by operation of law or by agreement of the taxpayer, are eighth priority, nondischargeable tax liabilities. n58 The IRS has three years beginning with the date the return is filed during which it may audit a taxpayer's return and assess a deficiency. n59 When a taxpayer files a chapter 11 case during the course of its audit, any deficiency claim resulting from the audit will be assessable after the petition date and will be a priority, nondischargeable tax claim. n60 A taxpayer may consent to an extension of the three-year statute of limitations, allowing the IRS to assess an income tax liability even though that tax liability is more than three years old. n61 The execution of a waiver of the statute of limitations for tax assessment may cause a tax liability for a year covered by that waiver to be classified as an eighth priority, nondischargeable tax liability, even if all of the other dischargeability predicates are satisfied. n62 If a waiver of the statute of limitations is necessary, an unlimited waiver should be avoided and a limited period, revocable waiver should be used. n63 Amended section 523(a) also notes that "the term 'return' means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared pursuant to *section 6020(a) of the Internal Revenue Code of 1986*, or similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but does not include a return made pursuant to *section 6020(b) of the Internal Revenue Code of 1986*, or a similar State or local law."

[v] Property Taxes

Any property taxes incurred, n64 whether or not assessed, before the commencement of the bankruptcy case and last payable without penalty within one year before the petition date are eighth priority, n65 nondischargeable tax claims. n66 To distinguish between postpetition property taxes, entitled to an administrative expense priority, and prepetition property taxes, courts have used: (i) a proration method based on the number of days before the petition date; n67 (ii)

state law to determine when economic liability arises; n68 and (iii) the date of assessment pursuant to state law. n69

[vi] Withholding Tax Claims

The Internal Revenue Code requires every employer paying wages to deduct and withhold certain taxes from the wages of employees. n70 The amount of any tax withheld and collected by the employer is a special fund held in trust for the United States. n71 The IRS is permitted to collect the total amount of such unpaid trust fund taxes from any responsible person who willfully fails to withhold them. n72

Pursuant to section 507(a)(8)(C), these trust fund taxes are accorded an eighth priority, nondischargeable status irrespective of their age, n73 and are collectible outside of bankruptcy. n74 Trust fund taxes from a prior bankruptcy case will remain priority claims in a subsequent case. n75 The liability of a responsible person for failure to withhold taxes is also nondischargeable. n76

Compare, however, an "alter ego" claim against individuals for tax claims incurred by a corporation. In *In re Grothues*, n77 the debtors' corporation owed the IRS excise taxes and at the time of the accrual of those liabilities, there was no section 3505 or section 6672 trust fund or responsible party theory applicable to allow the IRS to directly assess a derivative tax liability against the debtor. The IRS obtained creditor status against the individuals by asserting an alter ego, nominee or related veil-piercing theory of liability against the individuals. The lower court held that the "alter ego" claims by the IRS were not tax liabilities but were general equitable claims that were dischargeable. n78 However, the Fifth Circuit reversed and held that the IRS' claim was fundamentally a claim for taxes, reasoning that the IRS's alter ego theory was not an independent cause of action under Texas law but merely a remedy to enforce the tax. n79 As a result, under either the "responsible person" theory or the "alter ego" theory, the liability for failure to withhold taxes is nondischargeable. However, it is possible that future courts applying the law of other States could agree with the lower court in *Grothues* and conclude that the "alter ego" claims by the IRS are not tax liabilities but are general equitable claims that are dischargeable.

[vii] Employment Taxes on Wages, Salaries or Commissions

An employment tax on a wage, salary or commission of a kind specified in section 507(a)(4) earned by the debtor's employees before the date of the filing of the petition, whether or not actually paid before such date, for which a return is last due after three years before the date of the petition is an eighth priority, n80 nondischargeable n81 tax claim. Section 507(a)(4) refers to wages, salaries or commissions, to a maximum of \$10,950 n82 for each employee, earned within 180 days before the earlier of the petition date or the cessation of the debtor's business. n83 Federal unemployment and social security taxes, n84 state unemployment taxes or contributions to state unemployment programs n85 are included within the scope of section 507(a)(8)(D). Only the employer's share of employment taxes falls under section 507(a)(8)(D); the employee's share is covered by section 507(a)(8)(C). The cross reference to section 507(a)(4) does not limit the priority for employment taxes to wages, salaries or commissions that were paid within 180 days of the petition date because such an interpretation would negate the three-year time period contained within section 507(a)(8)(D). n86

[viii] Excise Taxes

Certain excise taxes are accorded an eighth priority n87 and are nondischargeable. n88 Determining whether an exaction is an excise tax or a penalty is complicated because the Bankruptcy Code provides no definition of "excise," "tax" or "excise tax." In *United States v. CF & I Fabricators of Utah, Inc.*, n89 the Supreme Court employed, in the absence of dispositive legislative history, a functional analysis to determine whether claims by the IRS for "taxes" under *I.R.C. section 4971(a)* n90 were entitled to an eighth priority.

According to the Court, a functional analysis requires an examination, behind the appellation placed on the exaction, of

the operation of the provision in question. A tax operates as a "pecuniary burden laid upon individuals or property for the purpose of supporting the Government" n91 whereas a penalty operates as "an exaction imposed by statute as punishment for an unlawful act." n92 Employing such an analysis, the Court concluded that section 4971 imposed a penalty, not a tax, and held that the "tax" under section 4971(a) was not entitled to an eighth priority as an excise tax under section 507(a)(8)(E). Accordingly, the IRS's claim was classified as a general unsecured claim. n93

The following have been characterized as excise taxes entitled to priority treatment under section 507(a)(8)(e): reclamation fee assessments in favor of the United States, n94 gift taxes asserted under the I.R.C., n95 workers' compensation premiums, n96 sales tax liabilities, n97 occupation taxes, n98 motor fuel taxes, n99 uninsured motor vehicle assessments, n100 and transportation taxes. n101 User fees or charges assessed by a governmental entity for the privilege to use public facilities are not treated as excise taxes in the bankruptcy context. n102

The Seventh Circuit opinion in *Haysett/Judy Oil, Inc.* n103 provides an excellent summary and discussion of the categories and type of tax covered by section 507(a)(8)(C) and (E). The primary question is whether the debtor is liable to pay the tax and whether the tax is dischargeable. In brief, the key is who is taxed, the consumer, who is the debtor, or the retailer who collects the tax? There are many state taxes which are generally categorized and classified as dischargeable, for example, sales or excise, income, worker's compensation, or employment/occupation.

[ix] Tax Penalties

[A] In General

A penalty in compensation for actual pecuniary loss that is related to any tax claim specified in section 507(a)(8) is also accorded priority treatment. n104 A claim for a penalty that is not compensation for an actual pecuniary loss is subordinate in distribution to general unsecured creditors. n105 The distinction in the treatment between pecuniary and nonpecuniary tax penalties reflects a fundamental policy of the Bankruptcy Code: the equal treatment of similarly situated creditors. Payment of a nonpecuniary tax penalty intended to punish the debtor inures to the benefit of only one creditor while diminishing the return and punishing other unsecured creditors. By subordinating a nonpecuniary tax penalty to the claims of general unsecured creditors and preserving priority treatment vis-a-vis the debtor, the Bankruptcy Code furthers its goal of equal treatment of comparable creditors.

[B] Distinguishing Penalties from Taxes

In determining whether a claim is a tax or penalty, the Supreme Court in *United States v. Reorganized CF & I Fabricators of Utah, Inc.* n106 employed a functional analysis test to determine whether claims by the IRS for "taxes" under *I.R.C. section 4971(a)* constituted a tax or penalty. According to the Court, a functional analysis requires an examination, behind the label placed on the exaction, of the operation of the provision in question. Behind this analysis lies the fact that a tax operates as a "pecuniary burden laid upon individuals or property for the purpose of supporting the Government" n107 whereas a penalty operates as "an exaction imposed by statute as punishment for an unlawful act." n108 In *In re Juvenile Shoe Corporation of America*, n109 the Court of Appeals for the Eighth Circuit, employing a functional analysis test, held that *I.R.C. section 4980* n110 imposed a tax, not a penalty, because the exaction was intended to compensate the Government for the tax benefit the employer received while the funds were held in a tax-exempt trust.

[C] Compensatory vs. Noncompensatory Penalties

Distinguishing between compensatory and noncompensatory penalties generally is easier than distinguishing between a tax and a penalty because most penalties imposed by the IRS (by definition) are noncompensatory in that they punish prohibited conduct such as failing to file tax returns, pay a tax or make estimated tax payments. n111 In a small number of cases though, penalties have been characterized as compensatory. n112

[D] Discharge of Tax Penalties

Pursuant to section 523(a)(7), the following penalties are dischargeable:

- (i) compensatory tax penalties; n113
- (ii) tax penalties that relate to nondischargeable taxes; and n114
- (iii) tax penalties that relate to taxes accruing more than three years before the filing of a bankruptcy petition. n115

The IRS has taken a broader and more aggressive interpretation of this provision, arguing that as long as the penalty is related to a nondischargeable tax liability it is nondischargeable. The IRS's argument, based on legislative history, would read the "or" between subsections (A) and (B) of section 523(a)(7) as "and" so as to make nondischargeable all tax penalties related to nondischargeable taxes. The majority position rejects this argument and the position of the IRS. n116

[2] Fraudulent, Unfiled or Delinquent Tax Returns**[a] Delinquent Tax Returns**

A tax liability attributable to a tax return filed after the date on which it was last due (including extensions) n117 and after two years before the date of the filing of the petition will be nondischargeable in a chapter 7, 11 or 12 case (and now pursuant to the 2005 Act, under Chapter 13), n118 if it also falls outside the three-year and 240-day rules.

For example, if a taxpayer files a delinquent 1985 return on January 1, 1991, and the tax liability reflected thereon is assessed on February 1, 1991, the 1985 tax liability initially may appear to be dischargeable because it is outside the three-year and 240-day time periods. In fact, it is nondischargeable if the chapter 7, 11 or 12 petition was filed before January 1, 1993, two years from the date the tax return was also filed.

In a special circumstance, the debtor's tax liability for those years in which the tax returns were late was discharged. n119 The situation was created where the debtor's tax Forms 1040 were deemed to be qualified tax returns was recognized in a Circuit Court case. The debtor did not file tax returns, but the IRS prepared substituted returns for the non-filed and missing returns, and the IRS assessed the tax. After the debtor filed Chapter 7, the IRS objected to the debtor's discharge and argued that the Form 1040s did not qualify as tax returns because they were filed after the IRS assessed tax. The court granted the discharge and determined that the Form 1040s qualified as missing tax returns because on their face there was sufficient information to calculate the tax. The court also held that the debtor-taxpayer made an honest and genuine attempt to comply with the tax law. The case is important because the honest and genuine attempt to satisfy the tax law is determined from the document filed and not from the taxpayer's intent or delinquency. n120

[b] Fraudulent and Unfiled Tax Returns

A tax liability attributable to a fraudulent n121 or unfiled tax return n122 will not be discharged in a chapter 7, 11 or 12 case (and now pursuant to the 2005 Act, under Chapter 13). The determination of whether the tax return is fraudulent is a question of fact based upon the totality of circumstances, including whether the debtor underpaid taxes, or knew that the tax return was false and intended to evade taxes. n123 If the IRS files a tax return for the debtor, n124 the debtor is not considered to have filed a return for purposes of section 523(a)(1)(B)(i) and any tax liability reflected on such return will be nondischargeable in a chapter 7, 11 or 12 case. n125 The courts are split regarding whether an amended return filed by the taxpayer will be considered a return for purposes of section 523(a)(1)(B)(i). n126 The IRS had previously ruled that the filing of Form 870 constituted a return for the purpose of the dischargeability provisions. n127 However,

in August 2005, the IRS revoked this ruling and held that because a Form 870 does not purport to be a return and does not contain a penalties of perjury clause, it does not constitute a return. n128 In addition, the execution of Form 4549, "Income Tax Examination Charges," is considered a return even though the income is not reported on an original or amended return. n129 Previously unfiled tax returns will be considered filed when they are completed and filed as exhibits in litigation with the United States to redetermine tax liabilities. n130 Debtors have been successful in their attempts to rely upon IRS forms as constituting filed returns when they have been cooperative with the IRS before assessment. n131

If the IRS assesses tax liabilities pursuant to *I.R.C. section 6020(a)* or *(b)* and the taxpayer subsequently files returns based on the same data used by the IRS, are those late filed tax returns and the liabilities therein dischargeable? In *United States v. Hindenlang*, the Sixth Circuit Court of Appeals concluded that a tax return filed after a section 6020(b) assessment was a nullity. n132 Two years after the date of assessment, the taxpayer sent the IRS income tax returns for the years covered by the section 6020(b) assessments. The taxpayer then filed a chapter 7 petition seeking discharge of the tax liabilities. n133 The Court of Appeals for the Sixth Circuit noted the strategy adopted by the taxpayer:

Hindenlang filed Forms 1040 for the years in question after the IRS had already made independent assessments of his tax liability. He waited the requisite two years required by section 523 before filing for bankruptcy. The government does not claim that the Forms 1040 were fraudulent in any respect. Finally, the government does not attempt to argue that the act of filing late Forms 1040, however delinquent, could be construed as an attempt to evade or defeat taxes due under section 523(a)(1)(C). The government's argument is that once a taxpayer has been assessed the deficiency, a Form 1040 submitted by the taxpayer to the IRS no longer qualifies as a return under section 523(a)(1)(B). n134 What then constitutes a "return" under *section 523(a)(1)(B) of the Bankruptcy Code*? The court referred to a four-part test to determine whether a filing with the IRS constitutes a "return" including: (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. n135

Did Hindenlang's Form 1040, filed after the IRS made a formal assessment, represent an honest and reasonable attempt to satisfy therequirements of the tax law and thereby fulfill the last prong of the four-part test for filing a "return"? n136

The Sixth Circuit concluded:

... As a matter of law ... a form 1040 is not a return if it no longer serves any tax purpose or has any effect under the Internal Revenue Code. A purported return filed too late to have any effect at all under the Internal Revenue Code cannot constitute 'an honest and reasonable attempt to satisfy the requirements of the tax law.' Once the government shows that a form 1040 submitted after an assessment can serve no purpose under the tax law, the government has met its burden... When the debtor has failed to respond to both the 30 day and the 90 day deficiency letter sent by the IRS, and the government has assessed the deficiency, then the forms 1040 serve no tax purpose, and government thereby has met its burden of showing that the debtor's actions were not an honest and reasonable effort to satisfy the tax law. n137

In the Sixth Circuit, a document purporting to be a tax return as a matter of law cannot qualify as an honest and reasonable attempt to satisfy the requirements of the tax law and is not a return for purposes of the discharge rules in the Bankruptcy Code. n138 n139

Other courts after the *Hindenlang* decision disagreed with *Hindenlang* and recognized the return filed by a taxpayer even after the assessment of a tax liability under *section 6020(b) of the IRC*. One example is a decision of the Ninth

Circuit Bankruptcy Appellate Panel which, on very similar facts, came to the opposite conclusion. In *In re Nunez*, the debtor did not timely file tax returns, the IRS prepared substitutes for returns and assessed tax liabilities for the years in question, and the debtor filed income tax returns reflecting the same wage income as the substitute returns filed by the IRS. The IRS argued for "an absolute rule that where it prepares substitute returns and assesses the taxes due, any document subsequently filed by the debtor cannot be deemed a return." n140 The Ninth Circuit B.A.P. rejected this approach first by concluding that the existence of an assessment by the IRS does not bar dischargeability. Section 523(a)(1)(B) does not state that a return must be filed prior to an assessment by the IRS to be effective for dischargeability purposes. n141 The Court noted that, under the IRS' view, "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' argument." n142 If a debtor cooperates with the IRS and takes actions that amount to adopting the substitute returns, section 523(a)(1)(B) will be satisfied and a discharge should not be prohibited. n143 Finally, the court concluded that in light of the complexity of the testing periods in section 507(a)(8) created to define dischargeability and priority, had Congress intended to condition discharge of a tax debt on whether a return was filed prior to assessment, the statute would have been written in that manner. n144

The third prong of the four part test for the filing of a "return" is the factual issue of good faith: is there an honest and reasonable attempt to satisfy the requirements of the tax laws? The Court of Appeals for the Tenth Circuit in *In re Savage* concluded this test requires the document to "appear on its face to constitute an honest and genuine endeavor to satisfy the law." n145 Under this version of the test for a "good faith" filing, a court is asked only to determine if the document in question "on its face" was filed in good faith. n146 The good faith standard for the filing of a return under section 523(a)(1)(B) was therefore narrow in scope:

The good faith inquiry under section 523(a)(1)(B) should focus on the debtor's intent at the time the returns were filed. This keeps the inquiry relevant to section 523(a)(1)(B). A focus on the delay in filing, or the number of missed years is relevant instead to an inquiry under section 523(a)(1)(C) ... The IRS has the ultimate burden of proof as to whether a return has been filed ... It has failed to present evidence raising a genuine issue as to a material fact on the issue of good faith, even under the broad scope argued for by the IRS. n147

The decision in *In re Nunez* confirms the requirement for a factual determination of the taxpayer's good faith in filing the returns, and further places the burden of proof on the existence of a filed return on the IRS. This burden is consistent with the general rule that exceptions to discharge are to be narrowly construed and the party objecting to the granting of a discharge bears the burden of proof. n148

[c] Willful Attempts to Evade or Defeat Taxes

Section 523(a)(1)(C) excepts from discharge in chapter 7, 11, 12 and 13 cases a debt for a tax with respect to which the debtor "willfully attempted in any manner to evade or defeat." In the absence of a definition in the Bankruptcy Code for "willful" and "evade or defeat," debtors have argued with success that a finding of nondischargeability requires proof of an affirmative act, beyond mere failure to file a tax return or pay taxes. n149 For a summary of the elements required for non-dischargeability where the allegation is failure to file tax returns and willful attempt to defeat and evade tax, see *Hamer v. IRS* n150

Although there may be a split among the circuits over the requirements for nondischargeability, it is a rare case indeed when the debtor has not filed or paid taxes and there is no evidence of other acts from which willful conduct can be proven. n151 The most common examples of the affirmative acts found to satisfy the willfulness standard of section 523(a)(1)(C) include fraudulent tax returns, n152 fraudulent transfers of property, n153 claiming excessive personal exemptions, n154 making false statements to the IRS, n155 transfer of assets to family trusts, n156 substantial understatements of income, n157 use of shell corporations, n158 and participation in tax protestor organizations. n159

[i] Decisions Requiring Affirmative Misconduct

In *Haas v. Internal Revenue Service*,ⁿ¹⁶⁰ the debtor filed tax returns but failed to pay income and employment taxes for nine years. He pled guilty to three counts of willfully failing to pay his income taxes and received a one-year suspended prison term and five years of probation. Haas and his wife filed a petition for relief under chapter 11; the IRS filed a proof of claim for \$704,044.25. Haas then commenced an adversary proceeding seeking a determination that his federal tax liabilities were dischargeable. The evidence showed that other than his failure to pay the tax liability, Haas did not conceal assets, engage in dubious transfers of assets, falsify or destroy records or misstate his income. Haas simply used his income to pay personal and business expenses rather than his taxes.

The IRS argued that if a debtor was aware of the duty to pay taxes and had the present ability to pay the taxes but failed to pay them, then the tax liability was nondischargeable under section 523(a)(1)(C). The Eleventh Circuit found this reading too broad, reasoning that if every knowing failure to pay taxes constituted grounds for nondischargeability, then a discharge would only be available to those very few debtors who discovered tax debts during the bankruptcy proceeding. Such a reading would have allowed the exception to swallow the rule, contravening the Bankruptcy Code's policy of providing a fresh start for honest but unfortunate debtors. The court was persuaded by the absence from section 523(a)(1)(C) and by the presence in four provisions of the I.R.C. of language addressing nonpayment of taxesⁿ¹⁶¹ that Congress intended that nondischargeability require more than the failure to pay taxes. The court concluded that the phrase "attempt in any manner to evade or defeat such tax" in section 523(a)(1)(C) did not address attempts to evade or defeat the payment of such taxes and held that the debtor's tax liability was dischargeable.

Is there a willful attempt to evade or defeat the payment of a tax liability under section 523(a)(1)(C) if there is only a failure to pay with no "badges of fraud"? The Court of Appeals for the Eleventh Circuit in *In re Griffith*ⁿ¹⁶² and *In re Haas*ⁿ¹⁶³ posed opposite ends of the factual spectrum in the application of section 523(a)(1)(C). In *Haas*, the court focused on the conduct requirement and determined that Dr. Haas' conduct did not amount to an attempt to evade or defeat his tax liability because financial pressures merely led him to pay other debts, leaving the tax debts unpaid. To the contrary, the court in *In re Griffith* dealt with a taxpayer who not only failed to pay but "engaged in a fraudulent transfer of assets in order to prevent collection of his tax debt."ⁿ¹⁶⁴ The Eleventh Circuit decision in *In re Haas* was based upon that court's determination that section 523(a)(1)(C) itself was inapplicable to attempts to avoid payment or collection; section 523(a)(1)(C) applied only to conduct constituting evasion of the assessment of the tax and not to evasion of payment of a tax.ⁿ¹⁶⁵ The court was, however, troubled by the application of *In re Haas* to the facts posed by *In re Griffith*. Because the factual consequences of the *Haas* decision were not argued in that case and because of the conflict within the circuits arising from the inconsistency between the *Haas* and *Dalton* decisions, the *Griffith* case was referred for *en banc* consideration by the Court of Appeals for the Eleventh Circuit.

Upon reconsideration *en banc*, the Court of Appeals for the Eleventh Circuit reconfirmed that nonpayment alone was insufficient to warrant nondischargeability under section 523(a)(1)(C).ⁿ¹⁶⁶ The Court reversed its decision in *In re Hass*ⁿ¹⁶⁷ and held that the debtor's tax claims were nondischargeable when the debtor willfully attempted to evade or defeat the payment of a tax claim even if there was no attempt to evade or defeat the assessment of the underlying tax claim.

In concluding that nonpayment alone does not rise to the level of tax collection avoidance that justifies the denial of a discharge for a tax claim, the Court stated:

We generally construe the statutory exceptions to discharge in bankruptcy liberally in favor of the debtor in order to ensure that the honest but unfortunate debtor is afforded a fresh start ... As we discussed in *Haas*, however, the broadest possible reading of section 523(a)(1)(C), i.e., that a tax debt is nondischargeable whenever "a debtor had both an awareness of his duty to pay his taxes and the present ability to pay them but nonetheless failed to satisfy that duty, would render virtually all tax debts nondischargeable ..." To read section 523(a)(1)(C) to render tax debts nondischargeable in cases, like

Haas, where the debtor merely failed to pay his taxes, would extinguish the general rule in favor of dischargeability of tax debts. Thus, we reaffirm our first holding from *Haas* that mere nonpayment of taxes is insufficient to establish the exception found in section 523(a)(1)(C). n168

Considering this outcome, can a debtor who knows there is a duty to file a return, knows a tax claim is owed, and knows there is a duty to pay the tax claim but simply pays other bills receive a discharge of that tax claim? The willfulness test under section 523(a)(1)(C) applied by the Courts of Appeal for the Sixth Circuit in *In re Toti* n169 or the Fifth Circuit in *In re Bruner* n170 would strictly apply the willfulness determination. Nonpayment to the IRS when there is payment to another creditor would be sufficient to lose the discharge claim. To the contrary, the *Haas* and *Griffith* decisions sanction a discharge for a debtor who does not take any affirmative action to evade collection, payment, or assessment of the tax. n171 This conclusion is consistent with the underlying theme of the discharge that only an honest debtor should receive a discharge. If there is no attempt to transfer assets, no failure to file returns, no filing of false returns, no listing assets in the names of third parties, no evading Revenue Officers and their collection efforts, or otherwise no purposefully hiding from the IRS collection system, then there should be no reason for the denial of a discharge to the taxpayer.

The *en banc* decision in *Griffith* extends itself to the situation in which the debtor does attempt to evade or defeat collection of taxes via some affirmative acts other than mere nonpayment of the taxes. The requirement for the presence of affirmative acts to evade or defeat payment or collection of the tax claim is consistent with the granting of a discharge to the honest debtor and not permitting taxpayers to use the bankruptcy system as a tax evasion device. The *en banc* decision of the Court of Appeals for the Eleventh Circuit thus reconciled its concerns regarding the facts of *Haas* and the more complicated facts of *Griffith* reflecting the more conventional badges of fraud that typically prohibit a discharge.

In *Dalton v. Internal Revenue Service*, n172 the debtor filed a petition for relief under chapter 7 that included federal income tax liabilities of over \$13 million. The debtor commenced an adversary proceeding seeking a determination that his tax liabilities were dischargeable. The IRS argued that the tax debts were nondischargeable under section 523(a)(1)(C) because the debtor had concealed assets in a willful attempt to evade or defeat the taxes.

The Court of Appeals for the Tenth Circuit found that the language "willfully attempted in any manner to evade or defeat" was unambiguous because it had a well-known judicial interpretation in cases interpreting tax provisions, including *I.R.C. section 7201*. The Tenth Circuit concurred with the Eleventh Circuit's holding in *Haas* that a debtor's failure to pay taxes, alone, does not fall within the scope of section 523(a)(1)(C) n173 and held that nonpayment is relevant evidence that a court should consider in the totality of the circumstances in determining whether the debtor willfully attempted to evade or defeat taxes. According to the court, evidence of an affirmative willful attempt may be inferred from conduct such as: keeping a double set of books, making false entries or alterations, the creation of false invoices or documents, destruction of books or records, concealment of assets or covering up sources of income and any conduct, the likely effect of which would be to mislead or to conceal. n174 Despite the court's narrow interpretation of section 523(a)(1)(C), it held that the debtor's tax liabilities were nondischargeable because there was substantial evidence that the debtor acted willfully to conceal his assets.

Section 523(a)(1)(C) includes both conduct and mental state requirements. This exception to discharge is not applicable to debtors who make mistakes as compared to those whose efforts to evade are willful and deliberate. n175 A taxpayer may also be plagued by physical or emotional disabilities that prevent the court from concluding he or she acted willfully for the purposes of section 523(a)(1)(C). For example, taxpayers with severe alcoholism that resulted in many years of unfiled returns may not be deemed capable of possessing the *mens rea* to act willfully in attempting to evade or defeat a tax claim. n176

[ii] Decisions Holding Failure to Pay Taxes Sufficient

In *In re Toti*, n177 because the debtor failed to file federal income tax returns or pay income taxes for eight years, he was convicted for willfully failing to file his returns. The debtor filed a petition for relief pursuant to chapter 7 and commenced an adversary proceeding seeking a determination of the dischargeability of his tax liabilities. The district court held that the definition of "willfully attempted to evade" was consistent with the definition found in other civil tax cases where willful meant voluntary, conscious and intentional. The Court of Appeals for the Sixth Circuit affirmed, concluding that section 523(a)(1)(C) includes both acts of commission and omission. In *Bruner v. U.S. (In re Bruner)*, n178 the debtors failed to file income tax returns for eight years. Dr. Bruner pled guilty to one count of willfully failing to file his 1981 tax return. In an adversary proceeding commenced in their chapter 7 case, the debtors sought a determination of the dischargeability of their tax liabilities. The bankruptcy court concluded that the proper test to determine if a debtor willfully attempted in any manner to evade or defeat taxes is whether the debtor (1) had a duty under the law, (2) knew of such duty and (3) voluntarily and intentionally violated that duty. Applying this test to the facts of the case, the bankruptcy court held that the debtors' tax liability was nondischargeable. The district court affirmed, concluding that the debtors did not qualify as the sort of honest debtor the Bankruptcy Code seeks to protect because they failed to file tax returns and pay their income tax liability when able to do so.

In affirming the district court, the Fifth Circuit rejected the Eleventh Circuit's reasoning in *Hass* that the Bankruptcy Code should be interpreted consistently with the I.R.C. and concurred with the Sixth Circuit's opinion in *Toti* that section 523(a)(1)(C) encompasses both acts of commission and culpable omission. n179

[d] Priority of Fraudulent, Unfiled or Delinquent Return Tax Claims

Taxes arising out of fraudulent, delinquent and unfiled tax returns are not accorded priority treatment under section 507(a)(8)(A)(iii). Although such tax liabilities are not treated as an eighth priority in chapters 7, 11, 12 and 13, the IRS does not suffer as it can pursue its claim after the bankruptcy case because its claim is nondischargeable. n180

[3] Dischargeability of Loans to Pay Tax Claims

In order to encourage the payment of tax liabilities, the IRS will allow the payment of a tax liability by credit card charge. On its face, this procedure would seem to grant the debtor an opportunity to convert a nondischargeable income tax liability into a dischargeable credit card debt. To eliminate this potential problem, the Bankruptcy Reform Act of 1994 n181 amended *section 523 of the Bankruptcy Code*. Section 523(a)(14) specifically makes nondischargeable any debt incurred to pay a tax to the United States that would be nondischargeable pursuant to section 523(a)(1) or incurred to pay fines or penalties imposed under Federal election law. Section 523(a)(14) applies to any form of loan, be it the result of a bank loan, a credit card advance, or a credit card charge the proceeds of which are used to pay a tax liability owed to the United States. Section 523(a)(14) is limited because it only applies to loans incurred to pay a tax owed to the United States. Borrowings used to pay tax liabilities owed to states, counties, and cities are not covered by section 523(a)(14).

[4] Effect of Discharge

After a discharge is entered in a title 11 case, it operates as an injunction against any act to enforce or collect any debt discharged as a personal liability of the debtor. n182 The discharge also operates as an injunction against the commencement or continuation of any action, the employment of legal process or any other action to collect or recover from or offset against property of an individual debtor that has been acquired after the commencement of the case on account of any allowable community claim. n183 The IRS, because of its status as a creditor, is bound by the injunction provisions of the Bankruptcy Code after a discharge of a tax claim has been entered in a title 11 case. n184 This general prohibition will not apply when a priority tax liability is not assessed prior to the confirmation of a plan. n185 Any debt that is nondischargeable pursuant to section 523 is nondischargeable in chapter 11 n186 and tax claims and interest on such claims are only nondischargeable when the claim is unsecured. n187

FOOTNOTES:

(n1)Footnote 1. *See* 11 U.S.C. § 523(a)(1)(A).

(n2)Footnote 2. *See* 7 Collier on Bankruptcy, P 1129.03[9] (Matthew Bender 15th Ed. Revised).

(n3)Footnote 3. 11 U.S.C. §§ 503(b)(1)(B), (C) and 507(a)(2).

(n4)Footnote 4. *Major Dynamics v. Tuchinsky*, 897 F.2d 433 (9th Cir. 1990) ; *United States v. Friendship College, Inc.*, 737 F.2d 430, 10 C.B.C.2d 1151 (4th Cir. 1984) ; *In re Mariner Enter's of Pensacola, Inc.*, 173 B.R. 771 (Bankr. N.D. Fla. 1994) .

(n5)Footnote 5. 11 U.S.C. § 503(b)(1)(B)(ii).

(n6)Footnote 6. 11 U.S.C. § 503(b)(1)(B) and (C). *See* P TX4.03 *infra* for a more detailed discussion of administrative tax liabilities.

(n7)Footnote 7. *Compare In re Weinstein*, 272 F.3d 39, 47 C.B.C.2d 334 (1st Cir. 2001) (post-petition interest on these taxes is a first priority claim); *In re Colortex Indus.*, 19 F.3d 1371, 32 C.B.C.2d 2035 (11th Cir. 1994) ; *In re Del Mission Ltd.*, 998 F.2d 756, 29 C.B.C.2d 347 (9th Cir. 1993) ; *In re Al Copeland Enters., Inc.*, 991 F.2d 233 (5th Cir. 1993) ; *In re Flo-Lizer, Inc.*, 916 F.2d 363 (6th Cir. 1990) ; *United States v. Friendship College*, 737 F.2d 430, 10 C.B.C.2d 1151 (4th Cir. 1984) ; *In re LTV Steel Company, Inc.*, 299 B.R. 863 (Bankr. S.D. Ohio 2003) , *In re Moltech Power Sys.*, 296 B.R. 63 (Bankr. N.D. Fla. 2003) ; *In re Servint Corp.*, 298 B.R. 579 (Bankr. E.D. Va. 2003) with *In re Luker*, 28 C.B.C.2d 224, 148 B.R. 946 (Bankr. N.D. Okla. 1992) , *aff'd*, 1993 U.S. Dist. Lexis 17283 (N.D. Okla. 1993) (post-petition interest on these taxes is not a first priority claim); *In re American Int'l Airways*, 77 B.R. 490 (Bankr. E.D. Pa. 1987) ; *In re Mansfield Tire & Rubber Co.*, 18 C.B.C.2d 1138, 85 B.R. 437 (Bankr. N.D. Ohio 1987) .

(n8)Footnote 8. *See* 11 U.S.C. § 503(b)(1)(D).

(n9)Footnote 9. 11 U.S.C. § 1129(a)(9)(A). *See also* 11 U.S.C. §§ 1222(a)(2) and 1322(a)(2) for similar provisions applicable to chapter 12 and 13 plans. Notably, under the 2005 Act, Chapter 12 was reenacted without a sunset date.

(n10)Footnote 10. *See* 11 U.S.C. §§ 502(f) and 507(a)(3) for the definition of these gap period claims. *See also In re Tuttle*, 291 F.3d 1238 (10th Cir. 2002) (debtor remained personally liable for the "gap interest" that accrued between her petition filing date and her plan confirmation date concerning the unsecured tax claim of the Internal Revenue Service).

(n11)Footnote 11. 11 U.S.C. § 507(a)(4). *Section 104 of the Bankruptcy Code* provides that on April 1, 1998 and at each three-year interval ending on April 1st thereafter, each dollar limitation in effect under section 507(a) will be adjusted for inflation. *See* 11 U.S.C. § 104(b)(1).

(n12)Footnote 12. *Otte v. United States*, 419 U.S. 43, 53-54, 95 S. Ct. 247, 253-54, 42 L. Ed. 2d 212, 222-23 (1974) . The *Otte* case is discussed in P TX3.04 *supra*. *See also Guy v. Terex Corp.*, 961 F.2d 1577 (6th Cir. 1992) .

(n13)Footnote 13. This dollar amount is effective for cases filed on or after Feb. 14, 2007. For cases commenced between October 17, 2005 and February 13, 2007, the amount is \$10,000. For cases commenced between April 1, 2004 and October 16, 2005, the amount is \$4,925. For cases commenced during the prior three-year period beginning April 1, 2001, the amount is \$4,650. For cases commenced between April 1, 1998 and March 31, 2001, the amount is \$4,300. For cases commenced prior to April 1, 1998, the amount is \$4,000.

(n14)Footnote 14. See 26 U.S.C. § 3111; Treas. Reg. § 31.3111-3; *Otte v. United States*, 419 U.S. 43, 53-54, 95 S. Ct. 247, 253-54, 42 L. Ed. 2d 212, 222-23 (1974) . See also chapter TX3 *supra*.

(n15)Footnote 15. *Otte v. United States*, 419 U.S. 43, 48-51, 95 S. Ct. 247, 251-53, 42 L. Ed. 2d 212, 219-22 (1974) . *In re Laub Baking Co.*, 642 F.2d 196 (6th Cir. 1981) ; *In re Main, Inc.*, 242 B.R. 574 (Bankr. E.D. Pa. 1999) . See also chapter TX3 *supra*.

(n16)Footnote 16. *Otte v. United States*, 419 U.S. 43, 48-51, 95 S. Ct. 247, 251-53, 42 L. Ed. 2d 212, 219-22 . See also *The Lane Processing Trust v. United States*, 25 F.3d 662 (8th Cir. 1994) (liquidating trust was deemed to be an "employer" for purposes of the payment of payroll taxes to the IRS); *In re Chief Freight Lines Co.*, 146 B.R. 291 (Bankr. D. Okla. 1992) ; *In re Arlan's Dep't Stores*, 3 B.R. 700, 701 (S.D.N.Y. 1981) .

(n17)Footnote 17. See chapter TX3 *supra* for a discussion of 28 U.S.C. § 960 (a trustee conducting a business must pay all tax liabilities that would have occurred in a non-title 11 case); see chapter TX15 *infra* for a discussion of 26 U.S.C. § 6672. 26 U.S.C. § 6672 imposes a 100% penalty on a responsible person who willfully fails to collect, account for and pay over withholding taxes. See also *In re White*, 266 B.R. 390 (Bankr. N.D. Ind. 2000) .

(n18)Footnote 18. *Otte v. United States*, 419 U.S. 43, 53-54, 95 S. Ct. 247, 253-54, 42 L. Ed. 2d 212, 222-23 (1974) did not consider issues related to the proper prioritization of the employer's tax liability related to priority wage claims.

(n19)Footnote 19. *U.S. v. Noland*, 517 U.S. 535 (1996) ; *In re Arlan's Dep't Stores*, 3 B.R. 700, 701 (S.D.N.Y. 1981) .

(n20)Footnote 20. *Otte v. United States*, 419 U.S. 43, 95 S. Ct. 247, 42 L. Ed. 2d 212 (1974) ; *United States v. Ennis (In re Armadillo Corp.)*, 561 F.2d 1382 (10th Cir. 1977) ; *In re Richardson Dinner Theatre*, 421 F. Supp. 423 (N.D. Tex. 1976) ; *In re Arlan's Dep't Stores*, 3 B.R. 700 (S.D.N.Y. 1981) .

(n21)Footnote 21. 419 U.S. 43, 95 S. Ct. 247, 42 L. Ed. 2d 212 (1974) .

(n22)Footnote 22. *United States v. Ennis (In re Armadillo Corp.)*, 561 F.2d 1382 (10th Cir. 1977) ; *In re Arlan's Dep't Stores*, 3 B.R. 700 (S.D.N.Y. 1981) ; *In re Richardson Dinner Theatre*, 421 F. Supp. 423 (N.D. Tex. 1976) .

(n23)Footnote 23. 561 F.2d 1382 (10th Cir. 1977) .

(n24)Footnote 24. *United States v. Ennis (In re Armadillo Corp.)*, 561 F.2d 1382 (10th Cir. 1977) ; *In re Arlan's Dep't Stores*, 3 B.R. 700 (S.D.N.Y. 1981) .

(n25)Footnote 25. *In re Chief Freight Lines Co.*, 146 B.R. 291 (Bankr. N.D. Okla. 1992) . It was undisputed in *Chief Freight Lines* that the wages accrued before the petition date were third priority claims under section 507(a)(4); thus, the section 507(a)(8)(D) definition of taxes relating to wages paid in the three years prior to the petition date was satisfied and the employer's liability was an eighth priority tax liability. The court distinguished the holding in the case of *In re Armadillo Corp.*, 561 F.2d 1382 (10th Cir. 1977) , by noting that the *Armadillo* holding interpreted the law under the former Bankruptcy Act and "does not apply and is dead in the road." *In re Chief Freight Lines Co.*, 146 B.R. 291, 293 (Bankr. N.D. Okla. 1992) .

(n26)Footnote 26. 421 F. Supp. 423 (N.D. Tex. 1976) .

(n27)Footnote 27. *In re Richardson Dinner Theatre*, 421 F. Supp. 423, 427 (N.D. Tex. 1976) .

(n28)Footnote 28. 11 U.S.C. § 1129(a)(9)(B)(i) and (ii).

(n29)Footnote 29. See the discussion of interest and penalties at PP TX4.05 and TX4.06 *infra* .

(n30)Footnote 30. 11 U.S.C. § 507(a)(8)(A)(i).

(n31)Footnote 31. 11 U.S.C. § 507(a)(8)(A)(ii).

(n32)Footnote 32. See P TX4.02[2][d][iii], [iv], [v], [vi], and P TX4.02[3] *infra* .

(n33)Footnote 33. When the taxpayer's gross or net income is the basis for the calculation of the tax, it is a tax "measured by gross receipts" for section 507(a)(8) purposes. *In re Raiman*, 32 C.B.C.2d 267, 172 B.R. 933 (B.A.P. 9th Cir. 1994) . *In re Humble*, 209 B.R. 54 (Bankr. E.D. La. 1997) . Similarly, the tax assessed on the lump-sum distribution from a 401K retirement plan is a tax measured by the debtor's income and may be nondischargeable. *Alquist v. Internal Revenue Service*, 60 F.3d 820 (4th Cir. 1995) .

(n34)Footnote 34. I.R.C. § 6081(a) provides that the IRS may grant an extension of time for filing any return required by the IRC. Such an extension may place the due date of the tax return within the three-year prepetition period thereby rendering the tax liability nondischargeable. *In re McDermott*, 286 B.R. 913, 915 (M.D. Fla. 2002) ; *In re Daniel*, 170 B.R. 466 (Bankr. S.D. Ga. 1994) ; *In re Leland*, 160 B.R. 834 (Bankr. E.D. Cal. 1993) ; *In re Gidley*, 151 B.R. 952 (M.D. Fla. 1992) .

(n35)Footnote 35. *In re Kisich*, 28 B.R. 401 (B.A.P. 9th Cir. 1983) ; *In re Carlin*, 318 B.R. 556 (Bankr. D. Kan. 2004) ; *In re McDermott*, 286 B.R. 913, 915 (M.D. Fla. 2002) ("taxes are excepted from discharge if they are for a taxable year ending on or before the date of the petition for which a return, if required, is last due, including extensions, after three years before the date of the filing of the petition"); *In re Villalon*, 253 B.R. 837 (Bankr. N.D. Ohio 2000) ; *In re Wright*, 178 B.R. 703 (Bankr. W.D. Tex. 2000) (the tax liabilities for 1994, 1995, and 1996 were nondischargeable pursuant to the three year testing period of § 507(a)(8)(A)(i)); *In re Erickson*, 172 B.R. 900 (Bankr. D. Minn. 1994) ; *In re Greco*, 164 B.R. 686 (Bankr. M.D. Fla. 1994) ; *In re Quick*, 152 B.R. 902 (Bankr. W.D. Va. 1992) .

(n36)Footnote 36. I.R.C. § 1398(d)(2)(A). See generally P TX2.05 *supra*.

(n37)Footnote 37. *Katz v. Commisioner*, 116 T.C. 5, 2001 U.S. Tax Ct. LEXIS 2 (U.S. Tax Ct. 2001) , *rev'd on other grounds*, 335 F.3d 1121 (10th Cir. 2003) ; *In re McCready*, 255 B.R. 834 (Bankr. M.D. Tenn. 1999) ; *In re Johnson*, 190 B.R. 724 (Bankr. D. Mass. 1995) ; see generally ch. TX3 *supra*.

(n38)Footnote 38. 11 U.S.C. § 348(a).

(n39)Footnote 39. *In re Lee*, 2001 Bankr. LEXIS 266 (Bankr. D. Md. Jan. 31, 2001) ; *In re Bottone*, 40 C.B.C.2d 1455, 226 B.R. 290 (Bankr. D. Mass. 1998) ; *In re Green*, 212 B.R. 160 (Bankr. N.D. Ala. 1997) ; *In re Rassi*, 140 B.R. 490 (Bankr. C.D. Ill. 1992) ; *In re Cross*, 119 B.R. 652 (Bankr. W.D. Wis. 1990) .

(n40)Footnote 39a. 535 U.S. 43 (2002) .

(n41)Footnote 40. 11 U.S.C. § 507(c).

(n42)Footnote 41. See *United States v. Frontone*, 383 F.3d 656 (7th Cir. 2004) ; *In re Jackson*, 253 B.R. 570 (M.D. Ala. 2000) .

(n43)Footnote 42. *In re Jackson*, 241 B.R. 473 (Bankr. M.D. Ala. 1999) , *rev'd and remanded*, 253 B.R. 570 (M.D. Ala. 2000) .

(n44)Footnote 43. *In re Jackson*, 253 B.R. 570 (M.D. Ala. 2000) .

(n45)Footnote 44. *In re Frontone*, 296 B.R. 184 (Bankr. C.D. Ill. 2003) , *aff'd in part, reversed in part*, 301 B.R. 290 , *rev'd*, *United States v. Frontone*, 383 F.3d 656 (7th Cir. 2004) .

(n46)Footnote 45. *Id.*

(n47)Footnote 46. *In re Frontone*, 301 B.R. 290, rev'd, *United States v. Frontone*, 383 F.3d 656 (7th Cir. 2004) .

(n48)Footnote 47. *United States v. Frontone*, 383 F.3d 656 (7th Cir. 2004) .

(n49)Footnote 48. *In re Newman*, 399 B.R. 541 (Bankr. M.D. Fla. 2008); *In re Bernicky*, 1996 Bankr. LEXIS 784 (Bankr. N.D. Ind. 1996) ; *In re Torres*, 117 B.R. 379 (Bankr. N.D. Ill. 1990) .

(n50)Footnote 49. *In re Carlin*, 328 B.R. 221 (B.A.P. 10th Cir. 2005) ; *In re Savaria*, 317 B.R. 395 (B.A.P. 9th Cir. 2004) ; *In re Lewis*, 199 F.3d 249, 43 C.B.C. 2d 650 (5th Cir. 2000) ; *In re Mulcahy*, 260 B.R. 612 (Bankr. D. Mass. 2001) ; *United States v. Gilmore*, 226 B.R. 567 (E.D. Tex. 1998) ; *In re Greco*, 30 C.B.C.2d 1429, 164 B.R. 686 (Bankr. M.D. Fla. 1994) ; *In re Callahan*, 168 B.R. 272 (Bankr. D. Mass. 1993) ; *In re Blank*, 137 B.R. 671 (Bankr. N.D. Ohio 1992) ; *In re Youngcourt*, 117 B.R. 689 (Bankr. M.D. Fla. 1990) ; *In re Kostoglou*, 74 B.R. 202 (Bankr. N.D. Ohio 1987) ; *In re Easton*, 59 B.R. 714 (Bankr. C.D. Ill. 1986) .

(n51)Footnote 50. A federal income tax is assessed for purposes of the 240-day rule on the date an IRS assessment officer signs a summary record, pursuant to I.R.C. § 6203, maintained by the IRS, adding a tax liability to a taxpayer's master file. *In re O'Connell*, 43 C.B.C.2d 1530, 246 B.R. 332 (B.A.P. 8th Cir. 2000) (determining when taxes are assessed for purposes of § 507(a)(8) is a question of federal law; the Bankruptcy Code does not define the term "assessment." Most courts have adopted the federal definition of assessment which means "the precise time an Assessment Officer of the IRS signs his summary record of assessment pursuant to 26 U.S.C. § 6202 of the Internal Revenue Code." The practical significance of this act is that it finally determines the amount of the tax due. Under the Minnesota statute applicable in this case, the "date of assessment" means the date a return was filed or the date a return should have been filed, whichever is later. Or, in the case where a tax is determined by the Commissioner, it means the date of the order assessing taxes. The critical date is when the state tax was finally determined). *In re De Jesus*, 268 B.R. 185 (Bankr. D. Minn. 2001) ; *In re Lewis*, 199 F.3d 249, 251-52, 43 C.B.C.2d 650 (5th Cir. 2000) ; 4 *Collier on Bankruptcy*, P 507.10[2][b] (Matthew Bender 15th Ed. Revised).

The assessment date is not the tax return filing date, the audit completion date, or the date that a judgment is rendered against the taxpayer. *In re Lewis*, 199 F.3d 249, 43 C.B.C.2d 650 (5th Cir. 2000) ; *In re King*, 961 F.2d 1423 (9th Cir. 1992) ; *United States v. Gilmore*, 226 B.R. 567 (E.D. Tex. 1998) ; *In re Hartman*, 110 B.R. 951 (D. Kan. 1990) ; *In re Seawright*, 1999 Bankr. LEXIS 1784 (Bankr. D.N.J.) (the 240 day period of § 507(a)(8)(A)(ii) expired prior to the petition date; the taxes from the prior chapter 7 case were dischargeable and the debtor was entitled to a refund claimed by setoff); *In re Lilly*, 194 B.R. 885 (Bankr. D. Idaho 1996) ; *In re Kostoglou*, 74 B.R. 202 (Bankr. N.D. Ohio 1987) . The assessment date may be determined by obtaining a copy of a transcript from the IRS and locating the "23C date" which is the assessment date. For easier reading, a "plain language transcript" or a Form 4340, Certificate of Assessment and Record of Payment, should be obtained. A Form 4340 is accepted by the courts as admissible evidence in the form of a certified governmental record that proves the date and the amount of the assessment. The IRS may resist the voluntary preparation of a Form 4340 because it must be requested from an IRS Service Center and may require one or more months to obtain. In the case of state tax claims, the applicable state law provisions for the determination of the assessment date must be considered. *In re Lewis*, 199 F.3d 249, 44 C.B.C.2d 1812 (5th Cir. 2000) ; *In re Bracey*, 77 F.3d 294 (9th Cir. 1996) ; *In re Williams*, 188 B.R. 331 (E.D.N.Y. 1995) .

(n52)Footnote 51. *In re Larson*, 862 F.2d 112 (7th Cir. 1988) ; *In re Howell*, 120 B.R. 137 (B.A.P. 9th Cir. 1990) . In both of these cases the courts concluded that a priority nondischargeable tax liability would not be converted to nonpriority dischargeable status when the IRS negligently provided the taxpayer the wrong assessment date and thereby caused the taxpayer to file a title 11 petition before the 240-day time period ran. However, in *In re Hollenbeck*, 166 B.R. 291 (Bankr. S.D. Tex. 1991) the court equitably estopped the IRS from collecting tax liabilities after a misrepresentation by an IRS official caused the debtor to file his chapter 7 petition too early. See also *DeSabato v. U.S.*, 538 F. Supp. 2d 422 (D. Mass. 2008) .

(n53)Footnote 52. *In re Williams*, 188 B.R. 331 (Bankr. E.D.N.Y. 1995) ("the crucial point ... is to determine the date of final assessment"); *In re Blank*, 137 B.R. 671 (Bankr. N.D. Ohio 1992) (holding that the date of the deficiency assessment would not "relate back" to the date of the original assessment which was more than 240 days and three years before the petition date); *In re Frary*, 117 B.R. 541 (Bankr. D. Alaska 1990) (same).

(n54)Footnote 53. See 11 U.S.C. § 507(a)(8)(ii)(II). The 2005 Act explicitly amended section 507(a)(8)(ii)(II) to state that the 240-day rule is tolled during any time period where there is a stay of collection proceedings (plus 90 days).

(n55)Footnote 54. 11 U.S.C. § 507(a)(8)(A)(ii)(I). See *In re Nader*, 42 C.B.C.2d 1215 (Bankr. E.D. Pa. 1999) (the 240 day testing period is tolled by the time period during which an offer in compromise is pending including the time period of any appeal of the rejection until the offer is formally withdrawn, withdrawn by the submission of an amended offer in compromise, or rejected by the IRS); *In re Genung*, 220 B.R. 505 (Bankr. N.D.N.Y. 1998); *In re Klein*, 189 B.R. 505 (C.D. Cal. 1995). An offer in compromise is not pending for purposes of § 507(a)(8)(A)(ii) once an offer in compromise is formally rejected by the IRS. *United States v. McGee*, 993 F.2d 184 (9th Cir. 1993) and *Treas. Reg. § 301.7122-1(d)*. *In re Colish*, 239 B.R. 670 (Bankr. E.D.N.Y. 1999) A subsequent appeal of the rejection of an offer in compromise does not revive the prior offer or constitute a new offer. *In re Aberl*, 78 F.3d 241 (6th Cir. 1996); *In re Emerson*, 224 B.R. 577 (Bankr. W.D. La. 1998).

(n56)Footnote 55. *In re Crist*, 85 B.R. 807 (Bankr. N.D. Iowa 1988).

(n57)Footnote 56. 11 U.S.C. § 507(a)(8)(A)(ii)(I). Care must be taken to ensure that no documents or course of communication between the taxpayer and the IRS rise to the level of an offer in compromise. For example, the IRS attempted to assert that oral and written communications between a taxpayer's representative and the IRS after rejection of an offer in compromise constituted the continuation of that offer or the filing of a new offer so that the 240-day time period was extended. *In re Aberl*, 78 F.3d 241 (6th Cir. 1996).

(n58)Footnote 57. *In re Colish*, 239 B.R. 670 (Bankr. E.D.N.Y. 1999); *In re Aberl*, 78 F.3d 241 (6th Cir. 1996) (the court rejected the IRS's attempt to include preassessment offers in compromise within the scope of 11 U.S.C. § 507(a)(8)(A)(ii)(I) because the statute and the legislative history only referred to the post assessment fact setting).

(n59)Footnote 58. 11 U.S.C. § 507(a)(8)(A)(iii); *In re Savaria*, 317 B.R. 395 (B.A.P. 9th Cir. 2004) (section 507(a)(8)(A)(iii) affords priority status to prebankruptcy income taxes which become assessable after the bankruptcy case unless they are both stale and nondischargeable because of some fault ascribed to the debtor); *In re Guillory*, 215 F.3d 1333 (9th Cir. 2000) (state tax liability was excepted from discharge by section 507(a)(8)(A)(iii) because the tax assessments made subsequent to a bankruptcy filing were excepted from discharge); *In re Brace*, 77 F.3d 294 (9th Cir. 1996); *In re Doerge*, 181 B.R. 358 (Bankr. S.D. Ill. 1995); *In re Fox*, 172 B.R. 247 (Bankr. E.D. Tenn. 1994); *In re Anderson*, 157 B.R. 104 (Bankr. N.D. Ohio 1993); *In re Crawford*, 144 B.R. 346 (Bankr. W.D. Tex. 1992); *In re Lemke*, 145 B.R. 1005 (Bankr. D. Idaho 1991); *Contra In re Doss*, 11 C.B.C.2d 764, 42 B.R. 749 (Bankr. E.D. Ark. 1984) (§ 507(a)(8)(A)(iii) applied only to unfiled, delinquent or fraudulent returns).

(n60)Footnote 59. 26 U.S.C. § 6501(a). The three-year statute of limitations for the assessment of a deficiency can be extended to six years if there is a 25% or greater omission from gross income on the examined return. 26 U.S.C. § 6501(e)(1)(A). If the six-year period applies, then the tax at issue may be a nondischargeable priority claim under 11 U.S.C. § 507(a)(8)(A)(iii). *In re Zieg*, 194 B.R. 469 (Bankr. Neb. 1996), *aff'd*, 206 B.R. 974 (D. Neb. 1997). There is no statute of limitations for the assessment of a tax liability relating to a tax return that is fraudulent. 26 U.S.C. § 6501(c)(1). Thus, it is possible that tax liabilities relating to tax returns that are substantially incorrect or fraudulent will be assessable after the petition.

(n61)Footnote 60. *Johnson v. IRS*, 301 B.R. 707 (Bankr. D.S.C. 2003); *In re Fox*, 172 B.R. 247, 249 (Bankr. E.D. Tenn. 1994); *In re Hosack*, 2006 Bankr. LEXIS 1864 (Bankr. N.D. Tex. 2006) (for a detailed discussion of tax debts which have not been assessed but are still assessable excepted from discharge and having status as an eighth priority

under Section 507(a)(8)(A)(iii)).

(n62)Footnote 61. See, e.g., *In re Martinez*, 366 B.R. 604 (Bankr. E.D. La. 2007) ; *In re Miller (Miller v. IRS)*, 300 B.R. 422 (Bankr. N.D. Ohio 2003) .

(n63)Footnote 62. See *In re Fleming*, 1999 Bankr. LEXIS 1794, 99-2 U.S. Tax. Cas. (CCH) P50,798 (Bankr. D. Mass. 1999) (execution of an extension of time within which the IRS can assess a tax liability makes the taxes assessable postpetition and therefore a priority claim which is nondischargeable); *In re Crist*, 85 B.R. 807 (Bankr. N.D. Iowa 1988) ; *In re Edwards*, 17 C.B.C.2d 509, 74 B.R. 661 (Bankr. N.D. Ohio 1987) .

(n64)Footnote 63. IRS Form 872, "Consent to Extend Time to Assess Tax," extends the assessment time to a specific date agreed upon by the IRS and the debtor. IRS Form 872-A, "Special Consent to Extend Time to Assess Tax," extends the assessment time to 90 days after (i) revocation of the extension by the debtor, (ii) revocation of the extension by the IRS, or (iii) the issuance of a statutory notice of deficiency by the IRS to the debtor. Form 872-A is terminated by the filing of a Form 872-T, notice of termination of special consent to extend the time to assess tax. If a waiver is necessary, a Form 872-A will offer a debtor more flexibility in planning for a pending filing under title 11 because it can be revoked at any time. A Form 872, on the other hand, will be deemed to be a contract to extend the assessment period to a future date and, as a result, it cannot be unilaterally revoked. See *Piarulle v. Commissioner*, 80 T.C. 1035 (1983) (contract principles apply because 26 U.S.C. § 6501(c)(4) requires the IRS and the taxpayer to agree on the extension date); *Monti v. Commissioner*, T.C. Memo 1995-73, 1995 Tax Ct. Memo Lexis 74 (U.S. Tax Ct. 1995) . See also 11 U.S.C. § 523(a) (the 2005 Act amended this section to state that a return does not include one prepared by a taxing authority, unless it is based on information received by the person required to file the return and signed by that person).

(n65)Footnote 64. Section 507(a)(8) was recently amended by the BAPCPA to substitute the word "incurred" for the word "assessed." The intent of this change was to make it clear that any property taxes incurred--whether or not they were assessed by the taxing authority--within one-year before the commencement of the bankruptcy case will be entitled to priority under section 507(a)(8).

(n66)Footnote 65. 11 U.S.C. § 507(a)(8)(B). See also *In re First Magnus Fin. Corp.*, 2009 Bankr. LEXIS 585 (Bankr. D. Ariz. Feb. 25, 2009) ; *In re Scrap Disposal, Inc.*, 38 B.R. 765 (B.A.P. 9th Cir. 1984) ; *In re Connolly*, 334 B.R. 539 (Bankr. D. Mass. 2005) ; *In re Garfinkels, Inc.*, 37 C.B.C.2d 1258, 203 B.R. 814 (Bankr. D.D.C. 1996) ; *In re Becker*, 169 B.R. 725 (Bankr. D. Kan. 1994) ; *In re Grivas*, 123 B.R. 876 (Bankr. S.D. Cal. 1991) .

(n67)Footnote 66. 11 U.S.C. § 523(a)(1)(A).

(n68)Footnote 67. *In re Handy Andy Home Improvement Ctrs., Inc.*, 144 F.3d 1125 (7th Cir. 1998) ; *In re 7003 Bissonnet, Inc.*, 153 B.R. 455 (Bankr. S.D. Tex. 1992) ; *In re Brent Explorations, Inc.*, 91 B.R. 104 (Bankr. D. Colo. 1988) .

(n69)Footnote 68. *In re Midland Indus. Serv. Corp.*, 35 F.3d 164 (5th Cir. 1994) ; *In re Members Warehouse, Inc.*, 991 F.2d 116 (4th Cir. 1993) ; *In re Western States Dist., Inc.*, 179 B.R. 666 (Bankr. D. Colo. 1995) ; *In re Grivas*, 123 B.R. 876 (Bankr. S.D. Cal. 1991) .

(n70)Footnote 69. *In re Fairchild Aircraft Corp.*, 124 B.R. 488 (Bankr. W.D. Tex. 1991) .

(n71)Footnote 70. I.R.C. § 3402.

(n72)Footnote 71. Treas. Reg. § 31.3402(f).

(n73)Footnote 72. I.R.C. § 6672(a).

(n74)Footnote 73. *Illinois Dep't of Revenue v. Hayslett/Judy Oil, Inc.*, 426 F.3d 899 (7th Cir. 2005) ; *Rosenow v. State of Illinois, Dept. of Revenue*, 715 F.2d 277 (7th Cir. 1983) ; *In re Felland*, 28 C.B.C.2d 1492, 153 B.R. 835 (Bankr. W.D. Wis. 1993) ; *In re Cain*, 145 B.R. 966 (Bankr. S.D. Ill. 1992) .

(n75)Footnote 74. *In re McDonough*, 346 B.R. 492 (Bankr. S.D. Iowa 2006) ; *Miller v. U.S.*, 363 F.3d 999 (9th Cir. 2004) (debtor's obligation to pay trust fund taxes was not dischargeable); *In re Gust*, 197 F.3d 1112 (11th Cir. 1999) (the taxpayer's obligation as a responsible party who failed to collect, account for and pay over trust fund recovery penalties assessed against him was not discharged in a chapter 7 case. The tax claims are required to be collected or withheld without regard to whether they are secured or unsecured claims; these claims are priority nondischargeable claims); *In re James Mossbrucker*, 198 F.3d 250 (8th Cir. 1999) (taxpayers could not perform a plan that included the trust fund tax liabilities because they were liable for 100 percent of the tax trust fund claim; a chapter 13 plan must provide for full payment over the course of the plan); *In re Taylor*, 132 F.3d 753 (5th Cir. 1998) ; *In re Campbell*, 242 B.R. 327 (W.D. Va. 1999) (responsible officer's tax claims assessed under 26 U.S.C. § 6672 are not "penalties" but are taxes assessed against the debtor individually and are nondischargeable priority or secured claims).

(n76)Footnote 75. *In re Toy King Dist., Inc.*, 256 B.R. 1 (Bankr. M.D. Fla. 2000) ; *In re Official Committee of Unsecured Creditors of White Farm Equip. Co.*, 943 F.2d 752, 25 C.B.C.2d 612 (7th Cir. 1991) , cert. denied, 503 U.S. 919 (1992) ; *In re R. J. Reynolds-Patrick County Mem. Hosp., Inc.*, 305 B.R. 243 (Bankr. W.D. Va. 2003) ; *In re LMS Holding Co.*, 149 B.R. 684 (Bankr. N.D. Okla. 1993) .

(n77)Footnote 76. *In re Queen*, 16 F.3d 411, 30 C.B.C.2d 752 (4th Cir. 1994) ; *In re Campbell*, 242 B.R. 327 (W.D. Va. 1999) (the court held that the tax assessment for employment taxes as a responsible officer of a corporation constituted a "tax" obligation which was nondischargeable under sections 523(a)(1)(A) and 507(a)(8). The IRS was entitled to a priority claim); *United States v. Garami*, 184 B.R. 834 (M.D. Fla. 1995) .

(n78)Footnote 77. 245 B.R. 828 (W.D. Tex. 1999) .

(n79)Footnote 78. On appeal, the Fifth Circuit, noted that the "IRS' alter ego theory is just one of several ways to pierce the corporate veil under applicable [state] law." *In re Grothues*, 226 F.3d 334, 337-38 (5th Cir. 2000) . However, the Fifth Circuit later noted that "the validity of the IRS' alter ego theory-[is] not before us." *Id.* at 340.

(n80)Footnote 79. *In re Grothues*, 226 F.3d 334 (5th Cir. 2000) .

(n81)Footnote 80. 11 U.S.C. § 507(a)(8)(D).

(n82)Footnote 81. 11 U.S.C. § 523(a)(1)(A).

(n83)Footnote 82. For cases commenced between October 17, 2005 and February 13, 2007, the amount is \$10,000. For cases commenced between April 1, 2004 and October 7, 2005, this amount is \$4,925. For cases commenced during the prior three-year period beginning April 1, 2001, the amount is \$4,650. For cases commenced between April 1, 1998 and March 31, 2001, the amount is \$4,300. For cases commenced prior to April 1, 1998, the amount is \$4,000.

(n84)Footnote 83. *Section 104 of the Bankruptcy Code* provides that on April 1, 1998, and at each three-year interval ending on April 1st thereafter, each dollar limitation in effect under section 507(a) will be adjusted for inflation. *See 11 U.S.C. § 104.*

(n85)Footnote 84. *In re Tsikouris*, 340 B.R. 604 (Bankr. N.D. Ind. 2006) ; *In re Reichert*, 138 B.R. 522 (Bankr. W.D. Mich. 1992) ; *In re Du Bose*, 22 B.R. 780 (Bankr. N.D. Ohio 1982) .

(n86)Footnote 85. *In re Pierce*, 935 F.2d 709 (5th Cir. 1991) ; *In re Graycarr, Inc.*, 330 B.R. 741 (Bankr. W.D. Ark. 2005) ; *In re Boston Regional Medical Center*, 256 B.R. 212 (Bankr. D. Mass. 2000) , *aff'd*, 265 B.R. 838 (B.A.P. 1st Cir. 2001) , *aff'd*, 291 F.3d 111 (1st Cir. 2002) ; *In re Continental Minerals Corp.*, 132 B.R. 757 (Bankr. D. Nev.

1991).

(n87)Footnote 86. *In re Pierce*, 935 F.2d 709 (5th Cir. 1991); *In re Dawson*, 43 C.B.C.2d 616, 244 B.R. 92 (Bankr. W.D. Va. 1999) (the reference in § 507(a)(8)(D) to § 507, paragraph 3 is intended to describe the kind of wages which are to be included in that section and not a time limitation during which those wages were classified as a priority claim; the 90 day period before the petition date is not a consideration in determining priority status of trust fund claims).

(n88)Footnote 87. 11 U.S.C. § 507(a)(8)(E).

(n89)Footnote 88. 11 U.S.C. § 523(a)(1)(A); *In re Marshall*, 302 B.R. 711 (Bankr. D. Kan. 2003); *In re Bliemeister*, 251 B.R. 383 (Bankr. D. Ariz. 2000), *aff'd*, 296 F.3d 858 (9th Cir. 2002) (workers compensation benefit charges are an "excise tax" that falls within the three year testing period of § 507(a)(8)(E)(ii); the testing date is not the assessment date of the claim but the date of the "transaction" which is the earlier date of the employee's injury when there was no insurance coverage).

(n90)Footnote 89. 518 U.S. 213, 116 S. Ct. 2106, 135 L. Ed. 2d 506, 35 C.B.C.2d 463 (1996).

(n91)Footnote 90. Internal Revenue Code section 4971(a) imposes a "tax" of 10% on the funding deficit of certain pension plans.

(n92)Footnote 91. 518 U.S. 213, 224, 116 S. Ct. 2106, 2113, 135 L. Ed. 2d 506, 516-17, 35 C.B.C.2d 463, 469 (1996) (quoting *New Jersey v. Anderson*, 203 U.S. 483, 492, 27 S. Ct. 137, 140, 51 L. Ed. 284, 288, (1906)).

(n93)Footnote 92. 518 U.S. 213, 224, 116 S. Ct. 2106, 2113, 135 L. Ed. 2d 506, 516-17, 35 C.B.C.2d 463, 469 (1996) (quoting *United States v. La Franca*, 282 U.S. 568, 572, 51 S. Ct. 278, 280, 75 L. Ed. 551, 555 (1931)).

(n94)Footnote 93. For a discussion of the equitable subordination of tax penalties, see P TX4.03[1][a] *infra* and 4 Collier on Bankruptcy, P 510.05[2][a] (Matthew Bender 15th Ed. Revised).

(n95)Footnote 94. *United States v. Ringley*, 985 F.2d 185, 124 O.&G.R. 637 (4th Cir. 1993); *Consolidation Coal Company v. U.S.*, 64 Fed. Cl. 718 (Fed. Cl. 2005).

(n96)Footnote 95. *In re Funk*, 1999 WL 33596475 (Bankr. S.D. Ill. Aug. 16, 1999); *In re Grynberg*, 986 F.2d 367, 28 C.B.C.2d 779 (10th Cir. 1993).

(n97)Footnote 96. *In re DeRoche*, 287 F.3d 751 (9th Cir. 2002) (when an employer fails to carry worker's compensation insurance and is required to reimburse a state's special fund for compensation to an injured employee, the required payment is an "excise tax" under Section 507(a)(8)(E)(ii) of the Bankruptcy Code); *In re Voightman*, 239 B.R. 380 (B.A.P. 8th Cir. 1999) (under either the *Lorber* or the *Suburban II* tests, the North Dakota Worker's Compensation Bureau premiums were "excise taxes" entitled to priority status as a tax because it was an involuntary burden imposed by the legislature for public purposes and under the state's taxing power); *In re Waldo*, 108 F.3d 340 (9th Cir. 1997); *In re Suburban Motor Freight, Inc.*, 998 F.2d 338, 29 C.B.C.2d 217 (6th Cir. 1993); *In re Mueller*, 43 C.B.C. 2d 982, 243 B.R. 346, 348-49 (Bankr. W.D. Wis. 1999) (unemployment insurance contributions were excise taxes entitled to priority under § 507(a)(8)(E)); *In re Olga Coal Company*, 35 C.B.C. 2d 985, 194 B.R. 741 (Bankr. S.D.N.Y. 1996). But see *In re George*, 361 F.3d 1157 (9th Cir. 2004) (state uninsured employers fund's claim for payment of workers' compensation benefits paid to employee was not an excise tax for purposes of section 507); *In re Boston Regional Medical Center Inc.*, 291 F.3d 111 (1st Cir. 2002) (debt to governmental agency for unemployment benefits was not a "tax" within the meaning of the Bankruptcy Code and should not be accorded priority under Section 507(a)(8)); *Workers Compensation Trust Fund v. Saunders*, 42 C.B.C. 2d 440, 234 B.R. 555 (D. Mass. 1999) (a tax is a pecuniary burden assessed on individuals or property for the purposes of supporting the government regardless of their consent for the purpose of defraying the expenses of government or of undertakings authorized by it; workers comp reimbursement

claims are not a "tax" because they do not possess sufficient "tax characteristics"); *In re Park*, 38 C.B.C. 2d 1183, 212 B.R. 430 (Bankr. D. Mass. 1997) (state claim for reimbursement of workers' compensation benefits did not constitute a tax); *In re Freymiller Trucking, Inc.*, 194 B.R. 914 (Bankr. W.D. Okla. 1996) (claims by Arizona for payments to uninsured workers not treated as a tax).

(n98)Footnote 97. *In re Kogut*, 325 B.R. 400 (Bankr. W.D. Ark. 2005) ; *In re Boyd*, 7 C.B.C.2d 1083, 25 B.R. 1003 (Bankr. S.D. Ohio 1982) ; *In re Tapp*, 5 C.B.C.2d 1192, 16 B.R. 315 (Bankr. D. Alaska 1981) . But see *In re McDonough*, 346 B.R. 492 (Bankr. S.D. Iowa 2006) (sales tax treated as trust fund tax liability); *In re St. Hilaire*, 135 B.R. 186 (D. Mass. 1991) (same). See P TX 4.02[1][d][vi] *supra* .

(n99)Footnote 98. *In re Groetken*, 843 F.2d 1007 (7th Cir. 1988) ; *In re National Steel Corp.*, 321 B.R. 901 (Bankr. N.D. Ill. 2005) ; *In re Templar*, 170 B.R. 562 (Bankr. M.D. Pa. 1994) .

(n100)Footnote 99. *Illinois Department of Revenue v. Haysett/Judy Oil Inc.*, 426 F.3d 899 (7th Cir. 2005) .

(n101)Footnote 100. *Williams v. Motley*, 925 F.2d 741, 24 C.B.C.2d 1188 (4th Cir. 1991) .

(n102)Footnote 101. *In re Trism, Inc.*, 311 B.R. 509 (B.A.P. 8th Cir. 2004) .

(n103)Footnote 102. *Williams v. Motley*, 925 F.2d 741, 24 C.B.C.2d 1188 (4th Cir. 1991) ; *In re Lorber Indus. of California, Inc.*, 675 F.2d 1062 (9th Cir. 1982) (sewer user fees); *In re S.N.A. Nut Co.*, 34 C.B.C. 2d 903, 186 B.R. 98 (Bankr. N.D. Ill. 1995) (assessments on walnut sales); *In re Shooters Emporium, Inc.*, 135 B.R. 701 (Bankr. S.D. Fla. 1992) (gun registration costs). But see *In re Arrow Transportation Co. of Delaware*, 229 B.R. 456 (D. Or. 1999) (the Oregon motor carrier highway use charges imposed upon a debtor qualified as "taxes" entitled to priority treatment; the assessments were made for the public purpose of maintenance operation construction and reconstruction of highways and were therefore a tax).

(n104)Footnote 103. 426 F. 3d 899 (7th Cir. 2005) .

(n105)Footnote 104. 11 U.S.C. § 507(a)(8)(G).

(n106)Footnote 105. 11 U.S.C. § 726(a)(4).

(n107)Footnote 106. 518 U.S. 213, 116 S. Ct. 2106, 135 L. Ed. 2d 506, 35 C.B.C.2d 463 (1996) .

(n108)Footnote 107. *United States v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213, 224, 116 S. Ct. 2106, 2113, 135 L. Ed. 2d 506, 516-17, 35 C.B.C.2d 463, 469 (1996) (quoting *New Jersey v. Anderson*, 203 U.S. 483, 492, 27 S. Ct. 137, 140, 51 L. Ed. 284, 288 (1906)) ; see also *In re Bolden*, 327 B.R. 657 (Bankr. C.D. Cal. Jun. 21, 2005) (noting that tax penalties were punitive in nature and not as compensation for pecuniary loss); *In re Bair*, 302 B.R. 564 (Bankr. N.D. Ohio 2003) (noting that tax penalties imposed by state taxing authority were penalties because the penalty did not appear to be compensating for the state taxing authority's actual pecuniary loss).

(n109)Footnote 108. *United States v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213, 224, 116 S. Ct. 2106, 2113, 135 L. Ed. 2d 506, 516-17, 35 C.B.C.2d 463, 469 (1996) (quoting *United States v. LaFranca*, 282 U.S. 568, 572, 51 S. Ct. 278, 280, 75 L. Ed. 551, 555 (1931)) .

(n110)Footnote 109. 99 F.3d 898 (8th Cir. 1996) . See *In re DeJesus*, 243 B.R. 241 (Bankr. D.N.J. 1999) , *aff'd sub nom*, *In re Marcucci*, 256 B.R. 685 (D.N.J. 2000) (the court, using functional analysis, held that the motor vehicle surcharge levied by the New Jersey Division of Motor Vehicles was a civil penalty and not an excise tax entitled to priority claim).

(n111)Footnote 110. Section 4980(a) imposes a 20% tax on funds reverting back to an employer from an overfunded pension plan.

(n112)Footnote 111. *United States v. Dumler*, 983 F.2d 161, 27 C.B.C.2d 1718 (9th Cir. 1992) , *aff'd*, 96 F.3d 1254, 36 C.B.C. 2d 1264 (9th Cir. 1996) (I.R.C. § 72(t) premature withdrawal from pension plan); *In re Strong*, 305 B.R. 292 (B.A.P. 8th Cir. 2004) (fine levied against debtor by taxing authority to encourage debtor to comply with environmental clean up order was penal in nature); *In re Cespedes*, 393 B.R. 403 (Bankr. E.D.N.C. 2008) (penalty stemming from premature withdrawal from IRA considered noncompensatory); *In re Hovan, Inc.*, 32 C.B.C. 2d 115, 172 B.R. 974 (Bankr. D. Wash. 1994) (delinquent return penalty); *In re Paulson*, 152 B.R. 46 (Bankr. W.D. Pa. 1992) (failure to pay penalties). *See also* *In re Suburban Motor Freight, Inc.*, 36 F.3d 484, 31 C.B.C. 2d 1539 (3d Cir. 1994) (worker compensation chargebacks); *In re TOC Assoc.*, 181 B.R. 205 (Bankr. E.D. Pa. 1995) (*ad valorem* penalty).

(n113)Footnote 112. *United States v. Unsecured Creditors Comm.*, 977 F.2d 137 (4th Cir. 1992) , *cert. denied*, 507 U.S. 1004, 113 S. Ct. 1644, 123 L. Ed. 2d 266 (1993) (10% tax on pension plan termination); *In re Hall*, 191 B.R. 814 (Bankr. D. Alaska 1995) (substantial understatement penalty under former § 6621(d)); *In re Divine*, 127 B.R. 625 (Bankr. D. Minn. 1991) .

(n114)Footnote 113. 11 U.S.C. § 523(a)(7); *In re Shin*, 306 B.R. 397 (Bankr. D.D.C. 2004) (noting that penalties on individual chapter 11 debtor's post-petition non-administrative tax debts, like the tax debts themselves, were nondischargeable); *In re Paulson*, 152 B.R. 46 (Bankr. W.D. Pa. 1992) .

(n115)Footnote 114. 11 U.S.C. § 523(a)(7)(A).

(n116)Footnote 115. 11 U.S.C. § 523(a)(7)(B); *In re Burns*, 887 F.2d 1541, 21 C.B.C. 2d 1237 (11th Cir. 1989) ; *In re Carlin*, 318 B.R. 556 (Bankr. D. Kan. 2004) ; *Xenakis v. U.S. Dep't of Treasury, IRS*, 281 B.R. 585 (W.D. Pa. 2001) ; *In re Polston*, 239 B.R. 277 (Bankr. M.D. Pa. 1999) ; *In re Pierce*, 33 C.B.C. 2d 1254, 184 B.R. 338 (Bankr. N.D. Iowa 1995) ; *In re Grassgreen*, 177 B.R. 976 (Bankr. M.D. Fla. 1995) ; *In re Leahey*, 169 B.R. 96 (Bankr. D.N.J. 1994) .

(n117)Footnote 116. *In re Hosack*, 282 Fed. Appx. 309 (5th Cir. 2008) ; *McKay v. United States*, 957 F.2d 689 (9th Cir. 1992) ; *In re Roberts*, 906 F.2d 1440 (10th Cir. 1990) ; *In re Burns*, 887 F.2d 1541 (11th Cir. 1989) ; *In re Wright*, 43 C.B.C. 2d 1312, 244 B.R. 451, 457-458 (Bankr. N.D. Cal. 2000) (the negligence penalty of Section 6653(a) of the Internal Revenue Code is dischargeable because the transactions giving rise to the liability, the income earned, was earned more than three years prior to the petition date). *Contra Cassidy v. Commissioner*, 814 F.2d 477 (7th Cir. 1987) .

(n118)Footnote 117. A tax return is deemed filed on the date of its postmark if it was deposited in the mail in the United States in an envelope, postage prepaid and properly addressed, 26 U.S.C. § 7502(a)(i), or if it was mailed by a private delivery service designated under 1997-17 I.R.B. 6, Notice 97-26 , designating, *inter alia*, Federal Express.

(n119)Footnote 118. 11 U.S.C. § 523(a)(1)(B)(ii); *In re Savage*, 218 B.R. 126 (B.A.P. 10th Cir. 1998) ; *Smith v. United States*, 186 B.R. 411 (N.D. Ohio 1995) , *aff'd*, 96 F.3d 800, 36 C.B.C. 2d 1055 (6th Cir. 1996) ; *In re Colsen*, 311 B.R. 765 (Bankr. N.D. Iowa 2004) ; *In re McTear*, 1994 Bankr. LEXIS 832, 94-1 U.S. Tax Cas. (CCH) P50,288 (Bankr. E.D. Pa. 1994) ; *In re Sonnenberg*, 148 B.R. 35 (Bankr. N.D. Ill. 1992) .

(n120)Footnote 119. *In re Colsen* 446 F.3d 836 (8th Cir. 2006) .

(n121)Footnote 120. *Beard v. Commissioner*, 82 T.C. 766 (1984) , *aff'd*, 793 F.2d 139 (6th Cir 1986) .

(n122)Footnote 121. 11 U.S.C. § 523(a)(1)(C); *In re McCoy*, 2009 Bankr. LEXIS 2542 (Bankr. S.D. Miss. Aug. 31, 2009) ; *United States v. Weiss*, 45 C.B.C.2d 130, 2000 U.S. Dist. LEXIS 16523 (E.D. Pa. 2000) , *aff'd*, 32 Fed. Appx. 32, 2002 U.S. App. LEXIS 4899 (3d Cir. 2002) ; *In re Schlesinger*, 290 B.R. 529 (Bankr. E.D. Pa. 2002) ; *In re Mastrantoni*, 2001 Bankr. LEXIS 1668, 2002-1 U.S. Tax Cas. (CCH) P50,140 (Bankr. M.D. Fla. 2001) ; *In re Rivers*, 178 B.R. 9 (S.D. Ala. 1994) ; *In re Harris*, 59 B.R. 545 (Bankr. W.D. Va. 1986) .

(n123)Footnote 122. 11 U.S.C. § 523(a)(1)(B)(i); *In re McCoy*, 2009 Bankr. LEXIS 2542 (Bankr. S.D. Miss. Aug. 31, 2009) ; *In re Carroll*, 310 B.R. 621 (Bankr. D. Minn. 2004) ; *In re Wright*, 178 B.R. 703 (Bankr. W.D. Tex. 2000) (when a tax return is admittedly unfiled, the liability reflected on that return is nondischargeable as a matter of law per the plain language of § 523(a)(1)(B)(i)); *Semenek v. Dep't of Revenue*, 166 B.R. 327 (N.D. Ill. 1994) ; *In re Cox*, 1994 Bankr. LEXIS 2117 (Bankr. W.D. Cal. 1994) .

Tax returns prepared in draft or "prototype return" format are not returns filed unless they are actually delivered for filing to the IRS. If such returns come into the possession of the IRS, they are still not filed returns unless they are signed by the debtor and delivered by the debtor to the IRS with the intent to file the document as a tax return. *In re Wright*, 43 C.B.C. 2d 1312, 244 B.R. 451, 455 (Bankr. N.D. Ca. 2000) . The returns were not signed under penalty of perjury and were not returns even though connected with a guilty plea for a willful failure to file tax returns. Prototype returns seized by the Criminal Investigation Division are therefore not "filed returns" and the tax claims thereon are nondischargeable. Signing a return or other disclosure providing income and expenses is the act which constitutes the filing of a return. Without such voluntary disclosure, a debtor cannot obtain a discharge. *But compare*, *In re Ashe*, 228 B.R. 457 (C.D. Cal. 1998) (a return is effectively filed when a stipulated Tax Court judgment is entered).

(n124)Footnote 123. *In re Jones*, 364 B.R. 118 (Bankr. M.D. Fla. 2007) ; *In re Burgess*, 199 B.R. 201 (Bankr. N.D. Ala. 1996) ; *In re Rivers*, 178 B.R. 9 (S.D. Ala. 1994) . For a discussion of the totality of the circumstantial evidence of a debtor's conduct which a bankruptcy court will review in connection with denial of discharge for willful evasion of taxes, see *In re Pisko*, 364 B.R. 107 (Bankr. M.D. Fla. 2007) ; *In re Cole*, 328 B.R. 237 (Bankr. M.D. Fla. 2005) .

(n125)Footnote 124. 26 U.S.C. § 6020(a). Failure by the debtor to properly file a tax return, such as by failing to sign, can prevent the debtor from discharging tax liabilities. *In re Waugh*, 260 B.R. 806 (W.D. Tex. 2001) ; *In re Lee*, 186 B.R. 539 (S.D. Fla. 1995) ; *In re Pierce*, 33 C.B.C. 2d 1254, 184 B.R. 338 (Bankr. N.D. Iowa 1995) .

(n126)Footnote 125. See 11 U.S.C. § 523(a) (the 2005 Act amended this section to state that a return does not include one prepared by a taxing authority, unless it is based on information received by the person required to file the return and signed by that person). Amended section 523(a) also notes that "the term 'return' means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code of 1986, or similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code of 1986, or a similar State or local law." *In re Wright*, 23 Fed. Appx. 789 (9th Cir. 2001) ; *In re Hatton*, 220 F.3d 1057, 44 C.B.C. 2d 970 (9th Cir. 2000) ; *Bergstrom v. United States*, 949 F.2d 341, 25 C.B.C.2d 1291 (10th Cir. 1991) ; *In re Brown*, 167 B.R. 249 (Bankr. S.D. Ala. 1994) ; *In re Eastwood*, 30 C.B.C. 2d 1672, 164 B.R. 989 (Bankr. E.D. Ark. 1994) ; *Lowrie v. United States (In re Lowrie)*, 162 B.R. 864 (Bankr. D. Nev. 1994) ; *Chapin v. United States*, 148 B.R. 304 (C.D. Ill. 1992) ; *United States v. D'Avanza*, 132 B.R. 462 (M.D. Fla. 1991) . *But see In re Ridgway*, 322 B.R. 19 (Bankr. D. Conn. 2005) .

For a discussion of when the failure to file an amended tax return did not bar dischargeability of a federal tax assessment, see *In re Dahmer*, 336 B.R. 784 (Bankr. W.D. Mo. 2006) .

(n127)Footnote 126. *Compare United States v. Hinderlang*, 164 F.3d 1029, 41 C.B.C.2d 351 (6th Cir.) , cert. denied, 528 U.S. 810, 120 S. Ct. 41, 145 L. Ed. 2d 37 (1999) (debtor prepared tax return after IRS prepared substitute returns and assessed taxes under the Internal Revenue Code. The Sixth Circuit held that the debtor's returns were not returns for purposes of section 523(a)(1)(B), which prohibits discharge of taxes for which the debtor did not file a return); *In re Savage*, 218 B.R. 126 (B.A.P. 10th Cir. 1998) ; *In re Vitaliano*, 178 B.R. 205 (B.A.P. 9th Cir. 1995) (state tax return); *In re Dahmer*, 336 B.R. 784 (Bankr. W.D. Mo. 2006) ("an amended tax return can constitute a required return under section 523(a)(1)(B)(i)"); *In re Colsen*, 311 B.R. 765 (Bankr. N.D. Iowa 2004) , *aff'd*, 322 B.R. 118 (2005) ; *In re Ehrig*, 308 B.R. 542 (Bankr. N.D. Okla. 2004) ; *In re Minuik*, 297 B.R. 532 (Bankr. N.D. Ill. 2003) (amended return filed by debtor taxpayer after IRS has already assessed the tax penalty was not a "return" for purposes of section

523(a)(1), and the court ruled that the taxes were not dischargeable); *In re Thompson*, 207 B.R. 7 (Bankr. M.D. Fla. 1996); *In re Blutter*, 177 B.R. 209 (Bankr. S.D.N.Y. 1995) (state tax return); *In re Lowrie*, 162 B.R. 864 (Bankr. D. Nev. 1994); *Arenson v. United States*, 145 B.R. 310 (D. Neb. 1992).

(n128)Footnote 127. *Revenue Ruling 74-203*, 74-1 C.B. 330.

(n129)Footnote 128. *Revenue Ruling 2005-59*, 2005 IRB LEXIS 312.

(n130)Footnote 129. *In re Berard*, 33 C.B.C. 2d 916, 181 B.R. 653 (Bankr. M.D. Fla. 1995). See also *In re Lamborn*, 181 B.R. 98 (Bankr. N.D. Okla. 1995), modified on other grounds, 204 B.R. 999 (Bankr. N.D. Okla. 1997) (letter to state taxing authority considered a filed return); *In re Olson*, 174 B.R. 543 (Bankr. D.N.D. 1994) (amended return not required).

(n131)Footnote 130. *In re Hetzler*, 262 B.R. 47 (Bankr. D.N.J. 2001); *Gentry v. United States*, 223 B.R. 127 (M.D. Tenn. 1998); *In re Elmore*, 165 B.R. 35 (Bankr. S.D. Ind. 1994); but see *In re Wright*, 43 C.B.C. 2d 1312, 244 B.R. 451 (Bankr. ND. Cal. 2000).

(n132)Footnote 131. *In re Gless*, 179 B.R. 646 (Bankr. D. Neb. 1995) (consent to disclosure); *In re Lowrie*, 162 B.R. 864 (Bankr. D. Nev. 1994) (Form 1902-B); *In re Carapella*, 84 B.R. 779 (Bankr. M.D. Fla. 1988) (Forms 870 and 1040). Compare *In re Hetzler*, 262 B.R. 47 (Bankr. D.N.J. 2001); *In re Gentry*, 1995 Bankr. LEXIS 1108, 76 A.F.T.R. 2d 6063 (Bankr. M.D. Tenn. 1995) (uncooperative taxpayer).

(n133)Footnote 132. *In re Hindenlang*, 164 F.3d 1029, 41 C.B.C.2d 351 (6th Cir.), cert. denied, 528 U.S. 810, 120 S. Ct. 41, 145 L. Ed. 2d 37 (1999).

(n134)Footnote 133. But for the court's decision to give no legal validity to the "returns" filed by the taxpayer, all of the testing periods for dischargeability under § 507 and § 523 of the Bankruptcy Code would have been met and the tax liabilities discharged.

(n135)Footnote 134. *In re Hindenlang*, 164 F.3d 1029, 1032, 41 C.B.C.2d 351.

(n136)Footnote 135. *In re Hindenlang*, 164 F.3d 1029, 1033 (citing *Germantown Trust Co. v. Comm.*, 309 U.S. 304, 60 S. Ct. 566, 84 L. Ed. 770); *Zellerbach Co. v. Helvering*, 293 U.S. 172, 55 S. Ct. 127, 79 L. Ed. 264 (1934); *In re Moroney*, 352 F.3d 902 (4th Cir. 2003); *In re Colsen*, 322 B.R. 118 (B.A.P. 8th Cir. 2005); *In re Izzo*, 340 B.R. 586 (E.D. Mich. 2006).

(n137)Footnote 136. *In re Hindenlang* 164 F.3d 1029, 1033, 41 C.B.C.2d 351. The Sixth Circuit determined that the forms filed were Forms 1040, the forms were filed with the IRS, the forms were executed under penalties of perjury, and the forms included all of the information needed to calculate the tax liability and, therefore, the first three prongs of the four-part test were satisfied.

(n138)Footnote 137. *In re Hindenlang*, 164 F.3d 1029, 1034-5.

(n139)Footnote 138. *In re Hindenlang*, 164 F.3d 1029, 1035, 41 C.B.C. 2d 351. See also *In re Pierchoski*, 243 B.R. 267 (W.D. Pa. 1999). In *In re Pierchoski*, the taxpayer failed to file tax returns for 1983 through 1989 and in 1992 the IRS issued a notice of deficiency. The taxpayer protested the deficiencies in tax court and decision documents agreed to by the parties were entered with the tax court and the liabilities assessed. Thereafter, the taxpayer filed Forms 1040 containing the stipulation information from the decision documents. After the running of the two-year time period for filing a late return, the taxpayer filed a chapter 7 case attempting to discharge the tax liabilities reflected on the late-filed returns. The returns filed by the taxpayer neither served as a means for self assessment nor as a trigger for the three-year statute of limitations because the tax court decision documents were already entered and the tax liabilities assessed. Therefore, the taxpayer bore the burden of proof to demonstrate that the tax returns he filed served some "tax

purpose" under the Internal Revenue Code.

(n140)Footnote 139. [Reserved]

(n141)Footnote 140. *In re Nunez*, 232 B.R. 778, 784 (B.A.P. 9th Cir. 1999) .

(n142)Footnote 141. *See also In re Savage*, 218 B.R. 126, 132 (B.A.P. 10th Cir. 1998) .

(n143)Footnote 142. *In re Nunez*, 232 B.R. 778, 781 (B.A.P. 9th Cir. 1999) ; *In re Savage*, 218 B.R. 126, 132 (B.A.P. 10th Cir. 1998) .

(n144)Footnote 143. *In re Nunez*, 232 B.R. 778, 781 (B.A.P. 9th Cir. 1999) . *But see, In re Hatton*, 220 F.3d 1057, 44 C.B.C.2d 970 (9th Cir. 2000) (installment agreement combined with the execution of substitute returns held not to be sufficient to satisfy the filing requirement).

(n145)Footnote 144. *In re Nunez*, 232 B.R. 778, 781 (B.A.P. 9th Cir. 1999) .

(n146)Footnote 145. *In re Savage*, 218 B.R. 126, 132 (B.A.P. 10th Cir. 1998) .

(n147)Footnote 146. *In re Nunez*, 232 B.R. 778, 782 (B.A.P. 9th Cir. 1999) ; *In re Colsen*, 322 B.R. 118 (B.A.P. 8th Cir. 2005) ; *In re Savage*, 218 B.R. 126, 132 (B.A.P. 10th Cir. 1998) .

(n148)Footnote 147. *In re Nunez*, 232 B.R. 778, 782 (B.A.P. 10th Cir. 1998) .

(n149)Footnote 148. *In re Nunez*, 232 B.R. 778, 782 (B.A.P. 10th Cir. 1998) ; *In re Crawley*, 244 B.R. 121, 126-27 (Bankr. N.D. Ill. 2000) (the IRS' argument and the holding in *Hindenlang* would lead to an "absurd result" because a debtor for whom the IRS prepares substitute returns could never discharge tax liabilities, a result which is inconsistent with the express language of the Bankruptcy Code in sections 507(a)(8) and 523(a); the determination of good faith in filing documents purporting to serve as "tax returns" is made based on the debtor's intent at the time the returns are filed).

Where the debtor failed to sign the substituted tax return, which was filed by the Internal Revenue Service, and did not acknowledge the return as filed as his tax return with the amount of tax due, the tax liability was nondischargeable, *see In re Ranney*, 2006 Bankr. LEXIS 762 (Bankr. S.D. Ill. 2006) .

(n150)Footnote 149. *In re Griffith*, 206 F.3d 1389 (11th Cir.) , *cert. denied*, 531 U.S. 826, 121 S. Ct. 73, 148 L. Ed. 2d 37 (2000) . *In re Meyers*, 196 F.3d 622, 623-24 (6th Cir. 1999) (11 U.S.C. § 523(a)(1)(C) exception to discharge includes acts of omission as well as acts of commission; the debtor's attempts to confess liability and make payments to the IRS does not nullify the earlier evasion of taxes; if the taxpayer knows he owes a tax liability and fails to pay it, he acts willfully); *Dalton v. Internal Revenue Service*, 77 F.3d 1297, 35 C.B.C.2d 803 (10th Cir. 1996) ; *Haas v. Internal Revenue Service*, 48 F.3d 1153, 33 C.B.C.2d 424 (11th Cir. 1995) ; *In re Jones*, 364 B.R. 118 (Bankr. M.D. Fla. 2007) ; *In re Epstein*, 303 B.R. 280 (Bankr. E.D.N.Y. 2004) ; *In re Lynch*, 299 B.R. 62 (Bankr. S.D.N.Y. 2003) ; *Rowen v. United States (In re Rowen)*, 2003-1 U.S. Tax Cas. (CCH) P50, 502 (Bankr. D. Alaska 2003) (debtor's failure to pay taxes, by itself, does not constitute a willful attempt to evade or defeat taxes under § 523(a)(1)); *Schlesinger v. United States (In re Schlesinger)*, 290 B.R. 529 (Bankr. E.D. Pa. 2002) ; *In re Crawley*, 244 B.R. 121 (Bankr. N.D. Ill. 2000) ; *In re Carnes*, 244 B.R. 435, 446 (Bankr. W.D. Mo. 2000) (the mere nonpayment of taxes, without more, will not invoke § 523(a)(1)(C) nondischargeability; however, when a debtor is aware of the duty to pay taxes, has the wherewithal to pay the taxes, and takes steps to avoid paying them, he willfully attempts to evade or defeat the tax. When a debtor files late returns, fails to pay taxes when he has income to do so, and fraudulently transfers income producing assets to his wife to avoid IRS collection, the tax claims are nondischargeable); *Gathwright v. United States*, 102 B.R. 211 (Bankr. D. Or. 1989) . *But see United States v. Fegeley*, 118 F.3d 979, 38 C.B.C.2d 451 (3d Cir. 1997) ; *In re Birkenstock*, 87 F.3d 947 (7th Cir. 1996) ; *In re Bruner*, 55 F.3d 195 (5th Cir. 1995) ; *In re Toti*,

24 F.3d 806 (6th Cir. 1994) , cert. denied, 513 U.S. 987, 115 S. Ct. 482, 130 L. Ed. 2d 395 (1994) ; *In re Guben*, 2008 Bankr. LEXIS 2581(Bankr. E.D. Pa. Aug. 14, 2008) ("affirmative conduct is not required; rather, section 523(a)(1)(C) encompasses culpable acts of omission as well as commission"); *In re Lacheen*, 365 B.R. 475 (Bankr. E.D. Pa. 2007) ; *In re Mathis*, 310 B.R. 468 (Bankr. S.D. Fla. 2004) (debtor's failure to file federal tax returns and failure to pay taxes was a willful attempt to evade or defeat taxes); *In re Krik*, 1999 Bankr. LEXIS 1288, 84 A.F.T.R.2d 99-6608 (Bankr. E.D. Pa. 1999) (the IRS bears the burden of proof of nondischargeability under section 523(a)(1)(C); there was no evidence the debtor had the ability to pay the tax or made luxury expenditures instead of paying the tax, the element of willfulness was not satisfied).

(n151)Footnote 150. *Hamer v. IRS*, 328 B.R. 825, 54 C.B.C.2d 1840 (Bankr. N.D. Ala, 2005) ; see also *In re Klayman*, 333 B.R. 695 (Bankr. E.D. PA. 2005) (dealing with whether a return was an honest and reasonable endeavor to comply with the tax law).

(n152)Footnote 151. The United States Bankruptcy Appellate Panel of the Eighth Circuit has articulated a set of factors to determine whether a debtor has willfully attempted to evade or defeat taxes under section 523(a)(1), including: debtor's understatement of income, failure to file tax returns, implausible or inconsistent behavior, failure to cooperate with taxing authority, concealment of assets, dealing in cash, shielding income and actions otherwise frustrating collection efforts. See *Roper v. Barclay (In re Roper)*, 294 B.R. 301 (B.A.P. 8th Cir. 2003) ; *May. v. Missouri Department of Revenue (In re May)*, 44 C.B.C.2d 989, 251 B.R. 714 (B.A.P. 8th Cir. 2000) ; *In re Jones*, 364 B.R. 118 (Bankr. M.D. Fla. 2007) , *aff'd*, 381 B.R. 897 (M.D. Fla. Jan. 7, 2008) ; *In re Fliss*, 339 B.R. 481 (Bankr. N.D. Iowa 2006) .

(n153)Footnote 152. *In re Wright*, 178 B.R. 703 (Bankr. W.D. Tex. 2000) , *aff'd*, 87 A.F.T.R.2d 2001-1180 (8th Cir. 2001) (tax claims for years predating the testing periods of section 507(a)(8)(A) are nevertheless nondischargeable under § 523(a)(1)(C) because the debtor was convicted of tax evasion; collateral estoppel applies to prevent the entry of a discharge for willful attempts to evade or defeat the assessment or collection of a tax if the debtor was convicted of willful tax evasion under Section 7201).

(n154)Footnote 153. *In re Tudisco*, 183 F.3d 133, 42 C.B.C.2d 810 (2nd Cir. 1999) (when the taxpayer engages in conduct rising beyond the level of mere nonpayment but produces a strategy to avoid IRS collection, the tax liability is nondischargeable under section 523(a)(1)(C)); *In re Macks*, 167 B.R. 254 (Bankr. M.D. Fla. 1994) ; *In re Pert*, 248 B.R. 659 (Bankr. M.D. Fla. 2000) ; *In re Boch*, 154 B.R. 647 (Bankr. M.D. Pa. 1993) ; *In re Lilley*, 152 B.R. 715 (Bankr. E.D. Pa. 1993) .

(n155)Footnote 154. *In re Blakeman*, 244 B.R. 100 (Bankr. N.D. Ohio 1999) (debtor was a "tax protestor," filed late returns, failed to make voluntary payments of the tax claim, and submitted false W-4 forms to reduce or eliminate tax withholding; the IRS succeeded on its motion for summary judgment because of the un rebutted factual allegations made by the IRS and the drawing of adverse self-incrimination); *In re Ketchum*, 177 B.R. 628 (E.D. Mo. 1995) ; *In re Semo*, 188 B.R. 359 (Bankr. W.D. Pa. 1995) .

(n156)Footnote 155. *United States v. Childers*, 846 F.2d 74 (4th Cir. 1988) .

(n157)Footnote 156. *In re Sumpter*, 170 B.R. 908 (E.D. Mich. 1994) , *rev'd on other grounds*, 64 F.3d 663 (6th Cir. 1995) , cert denied, 517 U.S. 1187, 116 S. Ct. 1673, 134 L. Ed.2d 777 (1996) ; *In re Birkenstock*, 171 B.R. 1008 (Bankr. E.D. Wis. 1994) , *rev'd on other grounds*, 87 F.3d 947 (7th Cir. 1996) .

(n158)Footnote 157. *In re Carapella*, 925 F.2d 1474 (11th Cir. 1991) ; *In re Krumhorn*, 249 B.R. 295, 298 (Bankr. N.D. Ill. 2000) , *aff'd*, 88 A.F.T.R. 2d 2001-6568 (N.D. Ill. 2001) (the Tax Court held that the taxpayer executed straddle transactions lacking economic substance and these transactions were an intentional trading scheme executed for the sole purpose of avoiding tax obligations; this determination collaterally estopped the taxpayer from arguing he did not act willfully in attempting to evade or defeat tax liabilities and thereby obtain a discharge); *In re Harlborg*, 177

B.R. 101 (Bankr. N.D. Ala. 1995) , *aff'd*, 76 A.F.T.R. 2d 5798 (N.D. Ala. 1995) ; *In re Freidus*, 165 B.R. 537 (Bankr. E.D.N.Y. 1994) ; *In re Berzon*, 145 B.R. 247 (Bankr. N.D. Ill. 1992) .

(n159)Footnote 158. *Rowen v. United States (In re Rowen)*, 298 B.R. 641 (Bankr. D. Alaska 2003) ; (debtor attempted to evade taxes by creating three-tiered arrangement); *United States v. Ryan (In re Ryan)*, 286 B.R. 141 (Bankr. W.D. Mo. 2002) ; *In re Teeslink*, 30 C.B.C. 2d 1770, 165 B.R. 708 (Bankr. S.D. Ga. 1994) ; *In re Griffith*, 161 B.R. 727 (Bankr. S.D. Fla. 1993) .

(n160)Footnote 159. *In re Griffith*, 174 F.3d 1222, 42 C.B.C.2d 57 (11th Cir. 1999) , *cert. denied*, 531 U.S. 826, 121 S. Ct. 73, 148 L.Ed. 2d 37 (2000) (no tax evasion was found with respect to the assessment of the tax liability, but the bankruptcy court looked to the "badges of fraud" and found the taxpayer's conduct was a willful attempt to evade or defeat the payment of the tax debt and was, therefore, nondischargeable; the 11th Circuit distinguished its prior decision *In re Haas*); *In re Brumbaugh*, 267 B.R. 800 (Bankr. S.D. Ohio 2001) ; *U.S. v. Gardner*, 2001 Bankr. LEXIS 1083 (Bankr. D. Ky. May 22, 2001) ; *In re Berning*, 244 B.R. 96 (Bankr. N.D. Ohio 1999) (debtor was a "tax protestor" who refused to file tax returns and pay income tax even though he had sufficient income to obtain return preparation and pay the tax claim; debtor was indicted and pled guilty to filing false tax returns; the tax claims were nondischargeable under § 523(a)(1)(C)); *In re Birkenstock*, 171 B.R. 1008 (Bankr. E.D. Wis. 1994) , *rev'd on other grounds*, 87 F.3d 947 (7th Cir. 1996) ; *In re Boch*, 154 B.R. 647 (Bankr. M.D. Pa. 1993) .

(n161)Footnote 160. 48 F.3d 1153, 33 C.B.C.2d 424 (11th Cir. 1995) . *But see In re Griffith*, 174 F.3d 1222, 42 C.B.C.2d 57 (11th Cir. 1999) , *cert. denied*, 531 U.S. 826, 121 S. Ct. 73, 148 L. Ed. 2d 37 (2000) (no tax evasion was found with respect to the assessment of the tax liability, but the Bankruptcy Court looked to the "badges of fraud" and found the taxpayer's conduct was a willful attempt to evade or defeat the payment of the tax debt and was, therefore, nondischargeable; the 11th Circuit distinguished its prior decision *In re Haas*).

(n162)Footnote 161. I.R.C. §§ 6531(2), 6653, 6672 and 7201. All four sections use the words "or the payment thereof."

(n163)Footnote 162. 174 F.3d 1222 (11th Cir. 1999) , *cert. denied*, 531 U.S. 826, 121 S. Ct. 73, 148 L. Ed. 2d 37 (2000) .

(n164)Footnote 163. 48 F.3d 1153, 33 C.B.C.2d 424 (11th Cir. 1994) .

(n165)Footnote 164. *In re Griffith*, 174 F.3d 1222, 1224 (11th Cir. 1999) .

(n166)Footnote 165. *In re Griffith*, 174 F.3d 1222, 1224-1225, 33 C.B.C.2d 424 (11th Cir. 1999) . *But see In re Dalton*, 77 F.3d 1297, 35 C.B.C.2d 803 (10th Cir. 1996) (the court expressly rejected the proposition adopted by the Eleventh Circuit that § 523(a)(1)(C) applies only to conduct constituting evasion of the assessment).

(n167)Footnote 166. *In re Griffith*, 206 F.3d 1389 (11th Cir.) , *cert. denied*, 531 U.S. 826, 121 S. Ct. 73, 148 L. Ed.2d 37 (2000) . *See also In re Lacheen*, 365 B.R. 475 (Bankr. E.D.Pa. Mar. 20, 2007) ; *In re Wargo*, 325 B.R. 858 (Bankr. M.D.Fla. 2005) .

(n168)Footnote 167. *In re Hass*, 48 F.3d 1153 (11th Cir. 1995) .

(n169)Footnote 168. *In re Griffith*, 206 F.3d 1389, 1394 (11th Cir.) , *cert. denied*, 531 U.S. 826, 121 S. Ct. 73, 148 L. Ed.2d 37 (2000) .

(n170)Footnote 169. 24 F.3d 806 (6th Cir.) , *cert. denied*, 513 U.S. 987, 115 S. Ct. 482, 130 L. Ed. 2d 395 (1994) .

(n171)Footnote 170. 55 F.3d 1578 (5th Cir. 1995) .

(n172)Footnote 171. *See also In re May*, 247 B.R. 786, 793 (Bankr. W.D. Mo. 2000) , *aff'd*, 251 B.R. 714 (B.A.P. 8th Cir. 2000) (when no assets are concealed from the IRS there are no grounds for the denial of the discharge). *But see In re Haesloop*, 2000 Bankr. LEXIS 1104, 86 A.F.T.R. 2d 6380 (Bankr. E.D.N.Y. 2000) (late filed returns, no payment with filed returns, and no estimated tax payments rose to the level of nondischargeability as cumulative acts that were more than mere nonpayment); *In re Gillis*, 251 B.R. 920, 922 (Bankr. S.D. Ga. 2000) (refusal by the taxpayer to permit a Revenue Officer into his home to enforce a court ordered levy was a willful act that prevented the entry of a discharge for the taxes that were evaded by such conduct); *In re Colish*, 289 B.R. 523 (Bankr. E.D.N.Y. 2002) .

(n173)Footnote 172. 77 F.3d 1297, 35 C.B.C.2d 803 (10th Cir. 1996) .

(n174)Footnote 173. *Dalton v. Internal Revenue Service*, 77 F.3d 1297, 35 C.B.C.2d 803 (10th Cir. 1996) . *See also Gathwright v. Internal Revenue Service*, 102 B.R. 211 (Bankr. D. Or. 1989) .

(n175)Footnote 174. *Dalton v. Internal Revenue Service*, 77 F.3d 1297, 35 C.B.C.2d 803 (10th Cir. 1996) ; *In re Krause*, 386 B.R. 785 (Bankr. D. Kan. 2008) ; *In re May*, 247 B.R. 786 (W.D. Mo. 2000) .

(n176)Footnote 175. *In re Rhodes*, 356 B.R. 229 (Bankr. M.D. Fla. 2006) ("nondischargeability is reserved for those whose efforts to avoid tax liability are knowing and deliberate, not those debtors who make mistakes"); *In re Krumhorn*, 249 B.R. 295, 298-99 (Bankr. N.D. Ill. 2000) , *aff'd*, 88 A.F.T.R. 2d 6568 (N.D. Ill. 2001) . *See also In re Gardner*, 360 F.3d 551 (6th Cir. 2004) ; *In re McDonald*, 249 B.R. 312 (Bankr. E.D. Mo. 1999) (the discharge exception under section 523(a)(1)(C) requires a factual determination to determine if the debtor voluntarily, consciously, and intentionally violated a known legal duty based on "objective indicia of consciousness on the part of the debtor;" the debtor claimed excess withholding exemptions on Form W4 and filed returns late, but these acts did not rise to the level of nondischargeability because the exemption claims were based upon logical tax planning by the debtor; the filing of late filed returns was consistent with the debtor's prior practice of filing returns late as refunds were always due).

(n177)Footnote 176. *In re Paige*, 196 B.R. 526 (Bankr. D. Ariz. 1996) (the debtor's failure to file returns was the result of his alcoholism, not a willful attempt to evade taxes, and therefore the debt was dischargeable). *But see In re Fretz*, 244 F.3d 1323, 45 C.B.C.2d 1437 (11th Cir. 2001) .

(n178)Footnote 177. 24 F.3d 806 (6th Cir. 1994) , *cert. denied*, 513 U.S. 987, 115 S. Ct. 482, 130 L. Ed.2d 395 (1994) . The Sixth Circuit recently revisited its ruling in *In re Toti* in *In re Gardner*, 360 F.3d 551 (6th Cir. 2004) and reaffirmed its earlier ruling in *In re Toti*.

(n179)Footnote 178. 55 F.3d 195 (5th Cir. 1995) . *See also In re Range*, 245 B.R. 266 (S.D. Tex. 1999) , *aff'd*, 256 B.R. 868 (S.D. Tex. 2000) , *aff'd*, 2002 U.S. App. LEXIS 20804, 90 A.F.T.R. 2d 6409 (5th Cir. 2002) (the taxpayers were held to have wilfully attempted to evade and defeat the payment of a tax liability under § 523(a)(1)(C) because they had adequate resources to pay the taxes, were aware of the tax liabilities as reflected on estimated income tax filings and purchased cars, planes, and a home during the tax periods 1981 through 1987. The taxpayers had a duty to file because they had income to report and knew they had a duty to file their returns and pay their taxes based on the fact they hired accountants to file extensions and file corporate tax returns. They simply chose not to pay their taxes, did not file timely returns or make estimated tax payments; requests for extensions filed during those years did not include the payment of estimated tax due. Based on the Fifth Circuit's decision in *In re Bruner*, the court concluded that the taxpayers' consistent failure to file their returns and pay their taxes is sufficient evidence of conduct that prevents the discharge of tax claims and "acts of commission" are not necessarily required for such a finding); *In re Wright*, 191 B.R. 291 (S.D.N.Y. 1995) .

(n180)Footnote 179. *In re Bruner*, 55 F.3d 195 (5th Cir. 1995) ; *accord United States v. Fegeley*, 118 F.3d 979, 38 C.B.C.2d 451 (3d Cir. 1997) ; *In re Birkenstock*, 87 F.3d 947 (7th Cir. 1996) ; *In re Schwartz*, 2009 Bankr. LEXIS 797 (Bankr. M.D. Fla. Jan. 9, 2009) ("the conduct test is satisfied when a debtor takes affirmative acts, including acts of

commission and omission, to avoid payment of taxes"); *In re Steinkrauss*, 313 B.R. 87 (Bankr. D. Mass. 2004) ; *Passavant v. United States (In re Passavant)*, 291 B.R. 879 (Bankr. M.D. Fla. 2003) (holding that failure to file tax returns when coupled with failure to pay taxes was enough to deny discharge under Section 523(a)(1)); *Brumbaugh v. United States*, 47 C.B.C.2d 39, 267 B.R. 800 (Bankr. S.D. Ohio 2001) ; *In re Crawley*, 244 B.R. 121 (Bankr. N.D. Ill. 2000) (although late filed returns may be sufficient for purposes of section 523(a)(1)(B), the taxpayer's overall intent may nevertheless fail a challenge to discharge under section 523(a)(1)(C); if the taxpayer willfully fails to pay a tax he knows to be due, the liability is nondischargeable; a debtor cannot rely upon accountant misrepresentation or negligence in the preparation of the return, and the debtor's failure to pay coupled with a 10 year pattern of failing to file prohibits discharge); *In re Carnes*, 244 B.R. 435 (Bankr. W.D. Mo. 2000) ; *In re Scarpiello*, 240 B.R. 203 (Bankr. E.D. Pa. 1999) (following *In re Fegeley*, 118 F.3d 979, 38 C.B.C.2d 451 (3d Cir. 1997) , the court applied a standard of willfulness which included evidence the debtor (i) had a duty to report additional income on his tax return, (ii) knew of the duty and (iii) voluntarily and intentionally violated that duty; the omission of income from filed returns combined with possession of the resources available to pay the liability prevented discharge under section 523(a)(1)(C)).

(n181)Footnote 180. 11 U.S.C. § 523(a)(1)(B) and (C). 11 U.S.C. § 1328(a)(2) (the 2005 Act changed existing law, which previously allowed a discharge from all taxes, whether or not fraudulent, by adding provisions in a plan to commit future income to pay any tax liabilities. However, under revised 1328, a debtor is no longer provided this "super discharge").

Indeed, under new section 1308, a chapter 13 debtor is required to file any unfiled tax returns that were required to be filed in the four years before the petition by federal, state or local law. Under amended 1307(e), if a debtor fails to file a return under section 1308, the court shall dismiss or convert the bankruptcy case, whichever is in the best interest of the creditors and the estate. *See P TX4.02[2][a]--[c] supra*.

(n182)Footnote 181. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (1994), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n183)Footnote 182. 11 U.S.C. § 524(a)(2).

(n184)Footnote 183. 11 U.S.C. § 524(a)(3).

(n185)Footnote 184. *In re Daniels*, 150 B.R. 985 (Bankr. M.D. Ga. 1992) ; *In re Moulton*, 133 B.R. 248 (Bankr. M.D. Fla. 1991) .

(n186)Footnote 185. *See In re DePaolo*, 45 F.3d 373, 32 C.B.C.2d 1675 (10th Cir. 1995) ; *In re Fein*, 22 F.3d 631 (5th Cir. 1994) ; *see also In re Grynberg*, 986 F.2d 367, 28 C.B.C.2d 779 (10th Cir. 1993) , *cert. denied*, 510 U.S. 812, 114 S. Ct. 57, 126 L. Ed. 2d 27 (1993) ; *In re Gurwitch*, 794 F.2d 584 (11th Cir. 1986) ; *In re McConahey*, 35 C.B.C.2d 453, 192 B.R. 187 (Bankr. S.D. Ill. 1996) .

(n187)Footnote 186. 11 U.S.C. § 1141(d)(2).

(n188)Footnote 187. *United States v. Victor*, 121 F.3d 1383 (10th Cir. 1997) ; *But see In re Gust*, 197 F.3d 1112 (11th Cir. 1999) ; *In re Miller*, 284 B.R. 121 (N.D. Cal. 2002) .



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Collier on Bankruptcy Taxation

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CHAPTER TX4 Priority and Dischargeability of Tax Claims

15-TX4 Collier on Bankruptcy Taxation P TX4.03

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P TX4.03 Administrative and Other Postpetition Tax Claims

[1] Taxes and Penalties

Section 507(a)(2) grants second priority treatment to unsecured administrative expenses allowed under section 503(b). Taxes, other than "of a kind" accorded an eighth priority under section 507(a)(8), and penalties related to such taxes incurred by the bankruptcy estate are allowed as administrative expenses. n1 Focusing on the language "of a kind specified in section 507(a)(8)," the debtor in *In the Matter of Lumara Foods of America, Inc.* n2 argued that postpetition sales and payroll taxes could be treated as eighth priority taxes and not as administrative expenses. After an extensive analysis of the legislative history of section 503(b)(1)(B), the court rejected the debtor's argument, holding that the only "kind" of tax excluded from a second priority distribution is a prepetition tax. n3 Prepetition taxes cannot be classified as administrative expenses because such taxes are not incurred by the estate. n4

The court in *In re Moltech Power Systems, Inc.* n5 established a two- prong test to determine if a tax can be classified as an administrative expense: (1) whether the tax was incurred by the estate; and (2) whether the tax was of the type designated by the Bankruptcy Code as eighth-level priority (for certain unsecured, prepetition claims).

Under prior law, it was not clear whether income and gross receipts taxes for the year of the bankruptcy filing must be treated partly as a pre-petition priority claim or entirely as a post-petition administrative expense, notwithstanding the fact that the filing of the petition does not terminate the corporate debtor's taxable year. Indeed, many courts had held that these claims must be bifurcated. n6

The 2005 Act amended section 507(a)(8) to limit the priority status of income and gross receipts tax claims to those for taxable years ending on or before the date of the filing of the petition. As a result, income and gross receipt taxes for the year of the bankruptcy filing are post-petition administrative expense claims that must be paid in full in the ordinary course, rather than pre-petition priority claims that are not payable until emergence from bankruptcy.

[a] Equitable Subordination of Tax Penalties

Although the Bankruptcy Code grants administrative expense status to penalties related to administrative tax liabilities, in certain circumstances, claims for tax penalties can be equitably subordinated to the claims of general unsecured

creditors. n7 In *United States v. Noland* n8 and *CF & I Fabricators of Utah, Inc.*, n9 the Supreme Court addressed the limitations on the judicial power to equitably subordinate claims and that, in the absence of inequitable conduct on the part of the creditor, the circumstances that prompt a court to order equitable subordination must not occur at the level of policy choice at which Congress itself operated in drafting the Bankruptcy Code. n10

[i] *United States v. Noland*

In *Noland*, the debtor filed for relief under chapter 11 and in the subsequent operation of its business incurred tax liabilities that it failed to discharge. After the case was converted to chapter 7, the IRS filed claims for taxes, interest and penalties. The bankruptcy court determined that the penalties were administrative expenses but equitably subordinated them to claims of general unsecured creditors under section 510(c) without making a finding of inequitable conduct on the part of the government. The bankruptcy court read section 510(c) to allow it to not only deal with inequitable conduct "but also to adjust a statutory priority of a category of claims." n11 The district court n12 and the Court of Appeals for the Sixth Circuit n13 affirmed the decision of the bankruptcy court. The court of appeals stated that it believed the claim for tax penalties to be susceptible to subordination "because of the *nature* of postpetition, nonpecuniary loss tax penalty claims in a chapter 7 case." n14

The Supreme Court reversed, holding that the courts may not apply principles of equitable subordination to achieve a result "that was directly counter to Congress's policy judgment that a postpetition tax penalty should receive the priority of an administrative expense" n15 Although the Court declined to decide whether a court must always find creditor misconduct before equitably subordinating a claim, a court may not "adjust the legally valid claim of an innocent party who asserts a claim in good faith merely because the court perceives that the result is inequitable." n16

[ii] *United States v. Reorganized CF & I Fabricators of Utah, Inc.*

In *CF & I Fabricators*, n17 the lower courts held that the 10% "tax" imposed by *I.R.C. section 4971(a)* on funding deficiencies in certain pension plans was not a tax but a penalty n18 and the claim for the penalty could be subordinated to all other general unsecured claims. n19 The Supreme Court unanimously reversed the lower courts, holding that its opinion in *Noland* was of equal force in the case of subordination amongst subgroups within a class as it was in *Noland* amongst separate classes. n20 Like its decision in *Noland*, the Court held that equitable subordination based upon the categorical reordering of priorities is beyond the scope of judicial authority under section 510(c).

The Court declined to consider the debtor's arguments made in support of subordination because: (i) the IRS's claim could not be placed in the subgroup of general unsecured claims pursuant to section 1122 because of its dissimilarity from such claims; and (ii) authority existed under section 1129(a)(7) to assign a claim the same priority it would have had in chapter 7 (where a noncompensatory prepetition penalty would be subordinated). n21

[2] Interest on Administrative Tax Claims

Section 503(b)(1)(C) provides that any fine, penalty or reduction in credit relating to a tax allowed as an administrative expense is similarly allowed as an administrative expense. Section 503(b)(1)(C) does not address the allowance of interest on a tax allowed as an administrative expense. There is a split of authority on the propriety of allowing interest on a tax allowed as an administrative priority, with the majority holding that interest on taxes allowed as an administrative expense is also an administrative expense. n22

[3] Conversion to Chapter 7

A case may be converted from Chapter 11, n23 Chapter 12 n24 or Chapter 13 n25 to Chapter 7. The conversion of a case from one chapter to another does not change the filing date of the petition but operates as an order for relief under the new chapter. n26 Administrative claims incurred during the course of a chapter 11 case are entitled to a second priority in the Chapter 7 case under 507(a)(2). n27 Administrative claims incurred prior to conversion are subordinated

to the administrative claims incurred in the Chapter 7 case. n28 When a Chapter 11 case is converted after a plan of reorganization has been confirmed, tax liabilities incurred during the postconfirmation period are not treated as administrative expenses in the Chapter 7 case; rather they are classified as prepetition tax claims and accorded only an eighth priority. n29 When a Chapter 13 case is converted to Chapter 7 more than 240 days after the taxes were assessed, the priority status of the tax claim is preserved because the time within which the tax can be collected in the Chapter 13 case is tolled. n30

[4] Dischargeability of Administrative Tax Claims

Pursuant to section 727(b), only debts arising before the entry of the order for relief are subject to discharge. Because first priority, administrative expense claims, by definition, arise after entry of the order for relief, they are nondischargeable. Nevertheless, administrative tax liabilities must be paid in full in a plan of reorganization before the plan can be confirmed. n31

[5] Abandonment of Property of the Estate

Pursuant to section 554, a trustee, after notice and a hearing, may abandon property of the estate that is burdensome or of inconsequential value to the estate, n32 and property of the estate that is not administered as of the close of the case is treated as abandoned. n33 Abandonment divests the bankruptcy estate of its interest in the property and reverts ownership in any party, typically the debtor, with a possessory interest in it. There is a distinction for tax purposes between the bankruptcy estate of an individual in a Chapter 7 or 11 case and the debtor; each is treated as a separate taxable entity. n34

Disposition of property of the estate, such as by foreclosure, during the administration of the bankruptcy case is treated as a taxable event to the bankruptcy estate and not to the debtor. Any tax liability incurred by the bankruptcy estate as a result of such a disposition is an administrative expense of the estate. Any tax liability associated with appreciated property of the estate can be avoided if the property can be disposed of during the administration of the case. On the other hand, if the property is abandoned to the debtor who then disposes of it, the debtor bears the burden of the tax liability without the ability to discharge it in bankruptcy. Abandonment can so significantly reduce the benefit of bankruptcy by shifting tax liabilities to the debtor that some courts have denied motions seeking to abandon property of the estate. n35

FOOTNOTES:

(n1)Footnote 1. 11 U.S.C. § 503(b)(1)(B) and (C). *In re Jagours*, 42 C.B.C.2d 1182, 236 B.R. 616 (Bankr. E.D. Tex. 1999) (tax claims accruing after the January 3, 1994 petition date were, by statutory definition, postpetition claims and could not be priority claims; the claims could be general unsecured claims under section 1305(a)(1)). *But see In re King*, 217 B.R. 623 (Bankr. S.D. Cal. 1998) (section 1305(a)(1) claim becomes priority); *In re Bryant*, 1998 WL 412632 (Bankr. E.D. Va. 1998) (same).

(n2)Footnote 2. 50 B.R. 809 (Bankr. N.D. Ohio 1985) .

(n3)Footnote 3. *In the Matter of Lumara Foods of Am., Inc.*, 50 B.R. 809 (Bankr. N.D. Ohio 1985) . *See also In re Hospitality Associates of Laurel*, 212 B.R. 188 (Bankr. D. N.H. 1997) ; *In re Kamstra*, 51 B.R. 826 (Bankr. W.D. Mich 1985) ; *United States v. Redmond*, 10 C.B.C.2d 1428, 36 B.R. 932 (D. Kan. 1984) .

(n4)Footnote 4. *United States v. Friendship College, Inc.*, 737 F.2d 430, 10 C.B.C.2d 1151 (4th Cir. 1984) ; *Megafoods Stores, Inc. v. Texas Comptroller of Public Accounts*, 38 C.B.C. 2d 488, 210 B.R. 351 (B.A.P. 9th Cir. 1997) , remanded in part, 163 F.3d 1063 (9th Cir. 1998) ; *In re Lee*, 184 B.R. 257 (W.D. Va. 1995) (timing of I.R.C. § 6672 penalty); *In re Mort Hall Acquisition, Inc.*, 181 B.R. 860 (Bankr. S.D. Tex 1994) (*ad valorem* taxes). *See also* chapter

TX3 *supra*; *In re Hillsborough Holdings Corp.*, 116 F.3d 1391 (11th Cir. 1997) (permitting chapter 11 debtors to divide a tax claim into administrative expense "portion" for taxes attributable to postpetition period and an eight priority portion for taxes attributable to the prepetition period).

(n5)Footnote 5. 296 B.R. 63 (Bankr. N.D. Fla 2003) .

(n6)Footnote 6. *In re Hillsborough Holdings Corp.*, 116 F.3d 1391 (11th Cir. 1997) ; *In re L.J. O'Neill Co.*, 64 F.3d 1146 (8th Cir. 1995) .

(n7)Footnote 7. 11 U.S.C. § 510(c).

(n8)Footnote 8. 517 U.S. 535, 116 S. Ct. 1524, 134 L. Ed. 2d 748, 35 C.B.C.2d 1 (1996) .

(n9)Footnote 9. *United States v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213, 116 S. Ct. 2106, 135 L. Ed. 2d 506, 35 C.B.C.2d 463 (1996) .

(n10)Footnote 10. Interest and penalties included in the IRS's claim could not be equitably subordinated. *In re Hospitality Assocs. of Laurel*, 212 B.R. 188 (Bankr. D.N.H. 1997) .

(n11)Footnote 11. *In re First Truck Lines, Inc.*, 27 C.B.C.2d 683, 141 B.R. 621, 629 (Bankr. S.D. Ohio 1992) .

(n12)Footnote 12. *Internal Revenue Service v. Noland*, 190 B.R. 827 (S.D. Ohio 1993) .

(n13)Footnote 13. *In re First Truck Lines, Inc.*, 48 F.3d 210, 32 C.B.C.2d 1658 (6th Cir. 1995) .

(n14)Footnote 14. *In re First Truck Lines, Inc.*, 48 F.3d 210, 218, 32 C.B.C.2d 1658, 1671 (6th Cir. 1995) (emphasis added).

(n15)Footnote 15. *United States v. Noland*, 517 U.S. 535, 541, 116 S. Ct. 1524, 1527-28, 134 L. Ed. 2d 748, 755, 35 C.B.C.2d 1, 6 (1996) ; *see also* *Freeland v. I.R.S.*, 264 B.R. 916 (N.D. Ind. 2001) .

(n16)Footnote 16. *United States v. Noland*, 517 U.S. 535, 538, 116 S. Ct. 1524, 1526, 134 L. Ed. 2d 748, 754, 35 C.B.C. 2d 1, 4 (1996) (quoting DeNatale & Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 Bus. Law. 417, 428 (1985)).

(n17)Footnote 17. 518 U.S. 213, 116 S. Ct. 2106, 135 L. Ed. 2d 506, 35 C.B.C.2d 463 (1996) .

(n18)Footnote 18. *In re CF & I Fabricators of Utah, Inc.*, 28 C.B.C.2d 249, 148 B.R. 332 (Bankr. D. Utah 1992) , *aff'd*, 53 F.3d 1155, 33 C.B.C.2d 613 (10th Cir. 1995) . *See* P TX4.02[1][d].

(n19)Footnote 19. *In re CF & I Fabricators of Utah, Inc.*, 148 B.R. 332 (Bankr. D. Utah 1992) .

(n20)Footnote 20. *United States v. Reorganized CF & I Fabricators of Utah, Inc.*, 518 U.S. 213, 116 S. Ct. 2106, 135 L. Ed. 2d 506, 35 C.B.C.2d 463 (1996) .

(n21)Footnote 21. For an additional discussion of equitable subordination, *see* 4 *Collier on Bankruptcy* P 510.05 (Matthew Bender 15th Ed. Revised).

(n22)Footnote 22. *Compare* *In re Weinstein*, 272 F.3d 39, 47 C.B.C.2d 334 (1st Cir. 2001) ; *In re Colortex Indus., Inc.*, 19 F.3d 1371, 30 C.B.C.2d 2035 (11th Cir. 1994) ; *In re Del Mission Ltd.*, 998 F.2d 756 , 29 C.B.C.2d 347 (9th Cir. 1993) ; *In re Al Copeland Enter., Inc.*, 991 F.2d 233 (5th Cir. 1993) ; *In re Flo-Lizer, Inc.*, 916 F.2d 430 (6th Cir. 1990) ; *United States v. Friendship College, Inc.*, 737 F.2d 430 (4th Cir. 1984) ; *In re LTV Steel Company, Inc.*, 299 B.R. 863 (Bankr. N.D. Ohio 2003) with *In re Luker*, 28 C.B.C.2d 224, 148 B.R. 946 (Bankr. N.D. Okla. 1992)

, *aff'd*, 1993 U.S. Dist. LEXIS 17283 (N.D. Ok. 1993) ; *In re American Int'l Airways*, 77 B.R. 490 (Bankr. E.D. Pa. 1987) ; *In re Mansfield Tire & Rubber Co.*, 85 B.R. 437 (Bankr. N.D. Ohio 1988) . To the extent that interest has been allowed on administrative tax claims, new section 511 provides that "[i]f any provision of this title requires the payment of interest on a tax claim or on an administrative expense tax, or the payment of interest to enable a creditor to receive the present value of the allowed amount of a tax claim, the rate of interest shall be the rate determined under applicable nonbankruptcy law."

(n23)Footnote 23. 11 U.S.C. § 1112(a).

(n24)Footnote 24. 11 U.S.C. § 1208(a).

(n25)Footnote 25. 11 U.S.C. § 1307(a).

(n26)Footnote 26. 11 U.S.C. § 348(a).

(n27)Footnote 27. 11 U.S.C. § 503(b); *In re Rocky Mountain Refractories*, 205 B.R. 307 (Bank. D. Utah 1996) ; *In re Sun Cliffe, Inc.*, 143 B.R. 789 (Bankr. D. Colo. 1992) ; *In re Mesery*, 139 B.R. 34 (Bankr. D. Wyo. 1992) .

(n28)Footnote 28. 11 U.S.C. § 726(b). *In re Resource Tech. Corp.*, 356 B.R. 435 (Bankr. N.D. Ill. 2006) ("administrative claims incurred in a chapter 11 case before conversion to chapter 7 are subordinated to the expenses of administering the case in chapter 7 after conversion"); In *In re Weinstein*, 44 C.B.C.2d 1881, 251 B.R. 174 (B.A.P. 1st Cir. 2000) , *rev'd on other grounds*, 272 F.3d 39, 47 C.B.C.2d 334 (1st Cir. 2001) (the court discussed distribution priority of interest on a Chapter 7 estate's postpetition tax liabilities. 11 U.S.C. § 503 defines administrative claims that enjoy first distribution priority among unsecured claims. 11 U.S.C. § 726(a) sets forth the overall priorities for Chapter 7 distributions. The postpetition tax liability and related penalties were § 503(b) administrative expenses. Under section 726(a)(5), interest on any claim paid under § 503(a)(1) will receive fifth priority payment. The statutory scheme is unambiguous because § 503(b)(1)(B) grants priority to tax obligations, and § 503(b)(1)(C) grants priority to the associated penalties. The interest accrued on such a liability is separately provided for at § 726(a)(5). Congress thereby specifically stated how such claims were to be handled at the time of distribution).

(n29)Footnote 29. *In re HNRC Dissolution Co.*, 343 B.R. 839 (Bankr. E.D. Ky. 2006) , *aff'd*, 371 B.R. 210, 2007 U.S. Dist. LEXIS 47865 (E.D. Ky. Jul. 02, 2007) ; *In re Patch Press, Inc.*, 71 B.R. 345 (Bankr. W.D. Wis. 1987) ; *In re Hirsch-Franklin Enter., Inc.*, 15 C.B.C.2d 672, 63 B.R. 864 (Bankr. M.D. Ga. 1986) ; *In re Westholt Mfg., Inc.*, 6 C.B.C.2d 1068, 20 B.R. 368 (Bankr. D. Kan. 1982) , *aff'd sub. nom.*, *U.S. v. Redmond*, 10 C.B.C.2d 1428, 36 B.R. 932 (D. Kan. 1984) . *But see* *In the Matter of Official Committee of Unsecured Creditors of White Farm Equipment Co.*, 943 F.2d 752, 25 C.B.C.2d 612 (7th Cir. 1991) , *cert. denied*, 503 U.S. 919, 112 S. Ct. 1292, 117 L. Ed. 2d 515 (1992) .

(n30)Footnote 30. *In re Richards*, 994 F.2d 763, 28 C.B.C. 2d 1654 (10th Cir. 1993) ; *U.S. v. Gilmore*, 226 B.R. 567 (Bankr. E.D. Tex. 1998) ; *United States v. Worthen*, 137 B.R. 1016 (D. Or. 1992) . *See* P TX4.02[1][d] *supra*.

(n31)Footnote 31. 11 U.S.C. §§ 1129(a)(9)(A), 1222(a)(2), and 1322(a)(2).

(n32)Footnote 32. 11 U.S.C. § 554(a).

(n33)Footnote 33. 11 U.S.C. § 554(c).

(n34)Footnote 34. 26 U.S.C. § 1398; *see generally* P TX3.02 *supra*.

(n35)Footnote 35. *In re Rubin*, 154 B.R. 897 (Bankr. D. Md. 1992) ; *In re A.J. Lane & Co.*, 25 C.B.C. 2d 1202, 133 B.R. 264 (Bankr. D. Mass. 1991). *Contra* *In re Terjen*, 154 B.R. 456 (E.D. Va. 1993) , *aff'd*, 30 F.3d 131 (4th Cir. 1994) .



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CHAPTER TX4 Priority and Dischargeability of Tax Claims

15-TX4 Collier on Bankruptcy Taxation P TX4.04

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P TX4.04 Secured Tax Claims and Priority of Tax Liens

[1] In General

A comprehensive discussion of tax liens is beyond the scope of this chapter, but, in addition to an overview of the law covering tax liens, this chapter will cover several recurring issues in bankruptcy cases. n1

A tax lien in favor of the United States arises by operation of law when any person liable for the tax neglects or refuses to pay it after demand for payment is made, and, in a nonbankruptcy context, need not be recorded to be effective except as against certain third parties. Thus, it is often referred to as a "secret lien." n2 The lien attaches to all property and rights to property, whether real or personal. n3 As against the taxpayer it is effective even before notice has been filed, but as against certain third parties it is not effective until notice has been filed. n4 Although effective as against the taxpayer in the absence of recordation, the IRS is required to give notice to and make demand of the taxpayer of payment of the tax liability within sixty days of the date of assessment. n5 Collection procedures are permitted after ten days following the demand for payment. n6

If a notice of tax lien has been properly filed before the petition date, the IRS will be treated as a secured creditor to the extent of the value of the property to which the lien attaches, n7 but if the notice has not been filed as of the date of the petition, then the IRS will be treated as an unsecured creditor. Tax liens are not avoidable under section 522(f) n8 but may be avoidable under section 545. n9

[2] Recordation

A tax lien is not effective as against any purchaser, holder of a security interest, mechanic's lien or judgment lien creditor until notice has been properly filed. n10 In order to perfect its lien on real or personal property, the IRS must record its notice in accordance with applicable state law. n11 If a state does not have a statutory provision designating the location for recordation of federal tax liens, the lien can be recorded with the clerk of the United States district court for the judicial district in which the property is located. n12 Tax liens arising from tax assessments independent of prior tax liens do not relate back to the date of the first tax lien; each tax lien stands on its own merits unless it is an amendment to a previously filed lien. n13

[3] Priority of Competing Liens

When the debtor's property is encumbered by multiple consensual and nonconsensual liens, the first step in determining the priority of competing lien claimants is identifying the extent of the debtor's assets. Generally, the determination of the property rights in the assets of a debtor's bankruptcy estate is a matter of state law, n14 but once a tax lien attaches to property of the debtor, the priority of competing liens is determined according to federal law. n15 The second step is to determine the identity of the lien claimant, the amount of the lien and that the lien attached to specific and identifiable property. n16 Under federal law, with certain exceptions, the first lien recorded has the highest priority. n17

As against any purchaser, holder of a security interest, mechanic's lienor or judgment lien creditor, n18 a federal tax lien is not effective until properly recorded. n19 Even though the IRS has properly recorded notice of its lien, the following are granted priority over the tax lien: (1) interests of purchasers of securities who are without actual notice of the tax lien; (2) interests of purchasers of motor vehicles who are without actual notice of the tax lien and who have retained possession of the motor vehicle; (3) purchasers of personal property purchased at retail in the ordinary course of the seller's business; (4) household goods and personal effects purchased in a casual sale for less than \$250 without knowledge of the lien; (5) personal property subject to a possessory lien under local law for repair and improvement; (6) certain real property taxes; (7) residential property subject to a mechanic's lien to the extent of \$1,000; (8) attorneys' liens for reasonable compensation for obtaining judgment; (9) certain insurance contracts; and (10) passbook loans. n20

In addition, pursuant to *I.R.C. section 6323*, commercial financing agreements are given limited protection as against previously recorded federal tax liens. A commercial lender holds a lien superior to a previously recorded tax lien if the lender's security interest: (1) came into existence after the tax lien; (2) is in qualified property n21 covered by the terms of a commercial transactions financing agreement; and (3) is protected under local law against a judgment lien arising as of the time of the filing of the tax lien. n22 A commercial transactions financing agreement is a written agreement entered into in the course of a trade or business to: (i) make a loan to be secured by commercial financing security n23 acquired in the ordinary course of the debtor's business; or (ii) purchase commercial financing security, other than inventory, acquired in the ordinary course of the debtor's business. n24

If the lending transaction is in qualifying commercial financing security, then the transaction will have priority as against a previously recorded tax lien so long as the transaction takes place before the earlier of: (i) the 46th day after the date of tax lien filing; and (ii) the time when the lender or purchaser has actual notice or knowledge of the tax lien filing. n25

[4] Dischargeability of Tax Liens

Even though the personal liability for a tax may be discharged in bankruptcy, a properly recorded tax lien rides through the bankruptcy, n26 continuing to encumber prepetition property, including exempt property under the Bankruptcy Code. n27 A tax lien related to a nondischargeable tax claim attaches to property acquired postpetition in addition to prepetition property. n28 The IRS's tax lien continues as an *in rem* claim against the debtor's assets until an amount equal to the fair market value of the assets subject to lien is paid in full.

[5] Lien Stripping

[a] In General

Pursuant to section 506(a), an allowed claim of a creditor secured by property of the estate is a secured claim to the extent of the value of the collateral and is an unsecured claim for the excess of the claim over the value of the collateral. n29 Prior to the Supreme Court's decision in *Dewsnup v. Timm*, n30 debtors could avoid (strip down) a lien to the value of the collateral because, under section 506(d), an unsecured claim was void to the extent that it exceeded the amount of the allowed secured claim. In *Dewsnup*, the Court held that in a chapter 7 case a consensual lien could not be stripped

down to the value of the collateral. Based on this holding, section 506(d) is applicable to avoid a lien in a chapter 7 case only if the underlying claim is disallowed. n31

The issue of valuation of secured claims, after being addressed by the Supreme Court in *Associates Commercial Corp. v. Rash*, was discussed in amended section 506(a)(2) of the 2005 Act, which explicitly states that if the debtor is an individual in a chapter 7 or 13, the value of the personal property securing an allowed claim shall be determined based on the replacement value of such property as of the date of the filing of the petition without deduction for costs of sale or marketing. With respect to property acquired for personal, family or household purposes, replacement value shall mean the price a retail merchant would charge the property of that kind considering the age and condition of the property at the time value is determined. n32

[b] Chapter 7 Cases

Based on the holding in *Dewsnup*, n33 a tax lien in a chapter 7 case cannot be stripped down to the value of the property to which it attaches. n34 Debtors attempting to strip down tax liens have been unsuccessful in distinguishing *Dewsnup* based on the nonconsensual nature of tax liens; nonconsensual liens have been treated no differently from consensual liens. n35

[c] Reorganization Cases

[i] Chapters 11 and 12

The vast majority of courts have held that *Dewsnup* is inapplicable to cases under chapters 11 n36 and 12. n37 Consequently, but for claims in a chapter 11 case secured only by a security interest in real property that is the debtor's principal residence, n38 liens, including tax liens, can be stripped down to the value of the collateral as of the effective date of the plan. n39 A debtor cannot, however, unilaterally misclassify tax claims and release or discharge a tax lien without contesting the claim directly. n40

[ii] Chapter 13

In a chapter 13 case, a secured creditor's lien, other than a lien on real property that is the debtor's principal residence, n41 can be stripped down to the value of the collateral as of the effective date of the plan. n42 Therefore, a tax lien in a chapter 13 case can be avoided to the extent that the value of the property to which the lien attaches is less than the amount of the tax claim. n43

[6] Allocation of Payments to Nondischargeable Claims

When a debtor has both nondischargeable and dischargeable tax claims, to the extent that the debtor can allocate payments to the nondischargeable claim, the debtor can maximize the fresh start provided by the Bankruptcy Code. n44 Of course, the IRS opposes any treatment that reduces payments allocable to dischargeable claims. The courts generally require that: (1) each lien be given a separate priority based upon the assessment date; (2) the value of the debtor's assets be allocated to each tax claim chronologically; and (3) the payments be applied first to the amount of the tax, then to interest and finally to penalties. n45

[7] *Ad Valorem* Taxes

Prior to the enactment of section 362(b)(18) as part of the Bankruptcy Reform Act of 1994, n46 a majority of courts held that local taxing authorities were prohibited by the automatic stay from creating or perfecting a statutory lien for *ad valorem* taxes that become due after the commencement of the case. Congress determined that these decisions created a windfall for creditors with a security interest in the property and impaired the revenue collecting ability of local governments. Consequently, section 362(b)(18) was enacted to overrule such decisions n47 and to allow local

governments to create and perfect statutory liens for *ad valorem* taxes in order to secure the payment of property taxes.

In addition, until recently, the general rule in chapter 7 liquidations was that, when property is sold, the claims of secured creditors must be satisfied before any payment is made to priority or general unsecured creditors, with the exception of subordination of the secured claims to the payment of administrative and certain other priority claims set forth in *section 507 of the Bankruptcy Code*. However, the 2005 Act has provided significant additional protection to taxing authorities by excepting *ad valorem* real and personal property taxes from the subordination provisions set forth in *section 507 of the Bankruptcy Code*.

FOOTNOTES:

(n1)Footnote 1. For a comprehensive analysis of tax liens, see Plumb, *Federal Tax Liens* (ALI 3d ed. 1972) and Saltzman & Saltzman, *IRS Practice and Procedure Manual: Analysis and Forms*, ch. 14 (WGL 2d ed. 1991).

(n2)Footnote 2. *I.R.C. § 6321*.

(n3)Footnote 3. *I.R.C. § 6321*. A levy is a statutorily authorized collection method by which property is seized and sold. *I.R.C. § 6331*; *Matter of Sills*, 82 F.3d 111 (5th Cir. 1996) . A levy can only be made against nonexempt assets. *I.R.C. § 6334*; *Matter of Sills*, 82 F.3d 111 (5th Cir. 1996) ; *In re Voelker*, 32 C.B.C. 2d 1690, 175 B.R. 989 (W.D. Wis. 1994) , *aff'd*, 42 F.3d 1050, 32 C.B.C.2d 873 (7th Cir. 1994) .

(n4)Footnote 4. *I.R.C. § 6323(a)*.

(n5)Footnote 5. *I.R.C. § 6303(a)*.

(n6)Footnote 6. *I.R.C. § 6331(a)*.

(n7)Footnote 7. *United States v. T.M. Building Products, Ltd.*, 231 B.R. 364, 370-371 (S.D. Fla. 1998) (the plain language of § 507(a)(8) states that its application only pertains to unsecured claims ... the presence or absence of a recorded Notice of Federal Tax Lien at the time of the petition's filing is controlling as to how a claim is treated in bankruptcy. If a notice of Federal Tax Lien is recorded before the petition date the IRS may be a "secured" creditor and the priority rules of 11 U.S.C. § 507(a)(8) do not apply to that secured claim); *In re Reichert*, 138 B.R. 522 (Bankr. W.D. Mich. 1992) .

(n8)Footnote 8. *In re Cox*, 349 B.R. 4 (E.D. Cal. 2006) ; *In re York*, 2006 Bankr. LEXIS 130 (Bankr. W.D. Ky. 2006) ; *In re Carpenter*, 2003 U.S. Bankr. LEXIS 277 (Bankr. M.D. Fla. 2003) ; *In re Deming*, 31 C.B.C.2d 1576, 94-2 U.S. Tax Cas. (CCH) P50,538 (Bankr. E.D. Pa. 1994) ; *In re Ridgley*, 81 B.R. 65 (Bankr. D. Or. 1987) .

(n9)Footnote 9. See 5 Collier on Bankruptcy, ch. 545 (Matthew Bender 15th Ed. Revised); *In re Berg*, 121 F.3d 535, 38 C.B.C.2d 836 (9th Cir. 1997) (trustee's powers under section 545 not sufficient to satisfy exceptions under § 6323); *In re Walter*, 45 F.3d 1023, 32 C.B.C.2d 1456 (6th Cir. 1995) (same); *In re Gundry Glass, Inc.*, 257 B.R. 422 (Bankr. D. Md. 2001) .

(n10)Footnote 10. *I.R.C. § 6323(a)*.

(n11)Footnote 11. *I.R.C. § 6323(f)(1)(A)(i)*.

(n12)Footnote 12. *I.R.C. § 6323(f)(1)(B)*. Many states have adopted the Uniform Federal Lien Registration Act which applies to federal tax liens. See, e.g., Cal. Civ. Pro. § 2100; N.Y. Lien Law § 240; and Tex. Prop. Code Ann. § 14.001.

(n13)Footnote 13. *In re B&B Printing Co., Inc.*, 164 B.R. 273 (Bankr. S.D. Ohio 1993) .

(n14)Footnote 14. *Butner v. United States*, 440 U.S. 48, 99 S. Ct. 914, 59 L. Ed. 2d 136 (1978) ; *In re Coleman*, 2008 Bankr. LEXIS 3080 (B.A.P. 8th Cir. Aug. 25, 2008) ; *In re Moore*, 290 B.R. 851 (Bankr. N.D. Ala. 2003) .

(n15)Footnote 15. *Aquilino v. United States*, 363 U.S. 509, 80 S. Ct. 1277, 4 L. Ed. 2d 1365 (1960) ; *Haas v. IRS*, 31 F.3d 1081 (11th Cir. 1994) , cert. denied, 515 U.S. 1142, 115 S.Ct. 2578, 132 L. Ed. 2d 828 (1995) ; *Wood v. United States*, 2004 U.S. Dist. LEXIS 6271 (E.D. La. 2004) ; *In re McTyre Grading & Pipe, Inc.*, 193 B.R. 983 (Bankr. N.D. Ga. 1996) .

(n16)Footnote 16. *United States v. Vermont*, 377 U.S. 351, 84 S. Ct. 1267, 12 L. Ed. 370 (1963) ; *United States v. Pioneer American Insurance Co.*, 374 U.S. 84, 83 S. Ct. 1651, 10 L. Ed. 2d 770 (1963) ; *Advantage Title Agency, Inc. v. Karl*, 363 F. Supp. 2d 462 (E.D.N.Y. 2005) . Liens cannot attach to after acquired property until the debtor acquires rights in such property. *United States v. McDermott*, 507 U.S. 447, 113 S. Ct. 1526 (1993).

(n17)Footnote 17. *United States v. City of New Britain*, 347 U.S. 81, 74 S. Ct. 367, 98 L. Ed. 520 (1953) ; *McGinness v. United States*, 238 F.3d 422 (6th Cir. 2000) ; *Shell Oil Co. v. Capital Financial Services*, 170 B.R. 903 (S.D. Tex. 1994) .

(n18)Footnote 18. 31 U.S.C. § 3713(a) (governing priority of governmental claims) does not require that a federal tax claim be given preference over a judgment creditor's perfected lien on real property. *United States v. Estate of Romani*, 523 U.S. 517, 118 S. Ct. 1478, 140 L. Ed. 2d 710 (1998) .

(n19)Footnote 19. I.R.C. § 6323(a).

(n20)Footnote 20. I.R.C. § 6323(b)(1)-(10). These provisions do not extend to a chapter 7 trustee's or debtor in possession's avoiding powers. *In re Walter*, 45 F.3d 1023, 32 C.B.C.2d 1456 (6th Cir. 1995) ; *In re Berg*, 121 F.3d 535, 38 C.B.C.2d 836 (9th Cir. 1997) . But see *In re Robinson*, 31 C.B.C.2d 37, 166 B.R. 812 (Bankr. D. Vt. 1994) .

(n21)Footnote 21. Qualified property includes only commercial financing security acquired by the taxpayer before the 46th day after the date of the filing of the tax lien. I.R.C. § 6323(c)(2)(B).

(n22)Footnote 22. I.R.C. § 6323(c)(1)(A) and (B); *Treas. Reg. § 301.6323(c)-1(a)*.

(n23)Footnote 23. Commercial financing security is (1) paper of a kind ordinarily arising in commercial transaction, (2) accounts receivable and (3) inventory. I.R.C. § 6323(c)(2)(C).

(n24)Footnote 24. I.R.C. § 6323(c)(2)(A).

(n25)Footnote 25. *Treas. Reg. § 301.6323(c)-1(b)*; I.R.C. § 6323(c)(2)(A). See *In re National Fin. Alternatives, Inc.*, 96 B.R. 844 (Bankr. N.D. Ill. 1989) .

(n26)Footnote 26. *In re Wrenn*, 40 F.3d 1162, 32 C.B.C.2d 987 (11th Cir. 1994) ; *In re Isom*, 901 F.2d 744 (9th Cir. 1990) ; *In re Stone*, 329 B.R. 882 (Bankr. M.D. Fla. 2005) ; *In re Green*, 310 B.R. 772 (Bankr. M.D. Fla. 2004) ; *In re Fitzmaurice*, 248 B.R. 356 (Bankr. W.D. Mo. 2000) ; *United States v. Alfano*, 34 F. Supp. 2d 827 (E.D.N.Y. 1999) ; *In re Uria*, 180 B.R. 688 (S.D. Fla. 1995) ; *In re Doerge*, 181 B.R. 358 (Bankr. S.D. Ill. 1995) .

(n27)Footnote 27. 11 U.S.C. § 522(c)(2)(B); *In re Robertson*, 2000 Bankr. LEXIS 1087 (Bankr. N.D. Tex. Sept. 6, 2000) ; *In re Demarah*, 188 B.R. 426 (E.D. Cal. 1993) , *aff'd*, 62 F.3d 1248, 33 C.B.C. 2d 1744 (9th Cir. 1995) .

(n28)Footnote 28. *Dishong v. United States Dept. of the Treasury (In re Dishong)*, 35 C.B.C.2d 223, 188 B.R. 51 (Bankr. M.D. Fla. 1995) .

(n29)Footnote 29. *See generally* 4 Collier on Bankruptcy, Ch. 506 (Matthew Bender 15th Ed. Revised).

(n30)Footnote 30. 502 U.S. 410, 112 S. Ct. 773, 116 L. Ed. 2d 903, 25 C.B.C.2d 1297 (1992) .

(n31)Footnote 31. *In re Carpenter*, 2003 U.S. Bankr. LEXIS 277 (Bankr. M.D. Fla. 2003) .

(n32)Footnote 32. *Associates Commercial Corp. v. Rash*, 520 U.S. 953, 117 S. Ct. 1879, 138 L. Ed. 2d 148, 37 C.B.C.2d 744 (1997) .

(n33)Footnote 33. *Dewsnup v. Timm*, 502 U.S. 410, 112 S. Ct. 773, 116 L. Ed. 2d 903, 25 C.B.C.2d 1297 (1992) .

(n34)Footnote 34. *In re Carpenter*, 2003 Bankr. LEXIS 277 (Bankr. M.D. Fla. March 14, 2003) ; *In re Roper*, 286 B.R. 693 (Bankr. E.D. Ark. 2002) ; *In re Walkup*, 183 B.R. 884 (Bankr. E.D. Cal. 1995) ; *In re Doviak*, 161 B.R. 379 (Bankr. E.D. Tex. 1993) ; *In re Rombach*, 159 B.R. 311 (Bankr. C.D. Cal. 1993) .

(n35)Footnote 35. *Boring v. Promistar Bank*, 312 B.R. 789 (W.D. Pa. 2004) ; *In re Hoekstra*, 45 C.B.C.2d 200, 255 B.R. 285 (E.D. Va. 2000) ; *Crossroads of Hillsville v. Payne*, 179 B.R. 486 (W.D. Va. 1995) ; *In re Doviak*, 161 B.R. 379 (Bankr. E.D. Tex. 1993) ; *In re Rombach*, 159 B.R. 311 (Bankr. C.D. Cal. 1993) .

(n36)Footnote 36. *In re Johnson*, 386 B.R. 171 (Bankr. W.D. Pa. 2008) ; *In re Weinstein*, 41 C.B.C.2d 123, 227 B.R. 284 (B.A.P. 9th Cir. 1998) ; *Wade v. Bradford*, 39 F.3d 1126, 32 C.B.C.2d 568 (10th Cir. 1994) ; *In re Regional Bldg. Systems*, 251 B.R. 274 (Bankr. D. Md. 2000) , *aff'd*, 254 F.3d 528, 46 C.B.C.2d 946 (4th Cir. 2001) ; *In re 680 Fifth Ave. Assoc.*, 29 F.3d 95, 31 C.B.C.2d 1085 (2d Cir. 1994) ; *In re Bowen*, 32 C.B.C. 2d 119, 174 B.R. 840 (Bankr. S.D. Ga. 1994) ; *In re Dever*, 164 B.R. 132 (Bankr. C.D. Cal. 1994) . *But see In re Blue Pacific Car Wash*, 150 B.R. 434 (W.D. Wis. 1992) ; *In re Taffi*, 144 B.R. 105 (Bankr. C.D. Cal.1992) , *rev'd on other grounds*, 96 F.3d 1190, 36 C.B.C.2d 1259 (9th Cir. 1996) , *cert. denied*, 521 U.S. 1103, 117 S. Ct. 2478, 138 L. Ed. 2d 987 (1997) .

(n37)Footnote 37. *Harmon v. United States*, 101 F.3d 574 (8th Cir. 1996) ; *In re Crook*, 966 F.2d 539, 27 C.B.C.2d 67 (10th Cir.) , *cert. denied*, 506 U.S. 985, 113 S. Ct. 491, 121 L. Ed. 2d 430 (1992) ; *In re Dever*, 164 B.R. 132 (Bankr.C.D. Cal. 1994) (dictum); *In re Leverett*, 27 C.B.C.2d 1232, 145 B.R. 709 (Bankr. W.D. Okla.1992) .

(n38)Footnote 38. 11 U.S.C. § 1123(b)(5). This section was added by the Bankruptcy Reform Act of 1994 and conforms treatment of residential mortgages in chapter 11 to the treatment provided in chapter 13 by § 1322(b)(2).

(n39)Footnote 39. *In re Dever*, 164 B.R. 132 (Bankr. C.D. Cal. 1994) ; *In re Bowen*, 32 C.B.C.2d 119, 174 B.R. 840 (Bankr. S.D. Ga. 1994) .

(n40)Footnote 40. *In re Haas*, 162 F.3d 1087 (11th Cir. 1998) . The debtor arbitrarily classified employment tax liabilities as a secured claim rather than their proper classification as a priority unsecured claim. This plan attempted to convert priority claims to general unsecured claims due to the lack of equity in assets. A secured or priority creditor does not forfeit the lien or statutory priority protections given to it and cannot be dealt plan classification different than that provided for in the Bankruptcy Code. The incorrect claim classifications made by the debtor in the plan were erroneous and the plan could not be confirmed.

(n41)Footnote 41. 11 U.S.C. § 1322(b)(2). *See generally* 8 Collier on Bankruptcy, P 1322.06 (Matthew Bender 15th Ed. Revised).

(n42)Footnote 42. *In re Castro*, 285 B.R. 703 (Bankr. D. Ariz. 2002) ; *In re Gray*, 285 B.R. 379 (Bankr. N.D. Tex. 2002) ; *In re Young*, 36 C.B.C.2d 1011, 199 B.R. 643 (Bankr. E.D. Tenn. 1996) ; *In re Hernandez*, 33 C.B.C.2d 146, 175 B.R. 962 (N.D. Ill. 1994) ; *In re Gibbons*, 164 B.R. 717 (Bankr. D.N.H. 1993) ; *In re Jones*, 152 B.R. 155 (Bankr. E.D. Mich. 1993) .

(n43)Footnote 43. *In re Hendrix*, 179 B.R. 519 (Bankr. E.D. Ky. 1994) ; *In re Butler*, 139 B.R. 258 (Bankr. E.D. Okla. 1992) .

(n44)Footnote 44. *United States v. Energy Resources*, 495 U.S. 545, 110 S. Ct. 2139, 109 L. Ed. 2d 580, 22 C.B.C.2d 1093 (1990) ; *In re Divine*, 127 B.R. 625 (Bankr. D. Minn. 1991) ; *In re Bolin*, 91-1 U.S.T.C. P 50,151 (Bankr. W.D. Ark. 1991). But see *In re Tillery Mech. Contractors, Inc.*, 319 B.R. 695 (Bankr. S.D. Ala. 2004) ; *In re Kaplan*, 104 F.3d 589, 37 C.B.C.2d 421 (3d Cir. 1997) (United States v. Energy Resources inapplicable).

(n45)Footnote 45. *In re Demarah*, 188 B.R. 426 (E.D. Cal. 1993) , *aff'd*, 62 F.3d 1248, 33 C.B.C.2d 1744 (9th Cir. 1995) , *cert. denied sub nom*, *City of Lockport, N.Y. v. United States.*, 499 U.S. 983, 111 S. Ct. 1640, 113 L.Ed.2d 735 (1991) ; *In re Specialty Cartage, Inc.*, 113 B.R. 484 (N.D. Ind. 1990) .

(n46)Footnote 46. Pub. L. No. 103-394, § 401 (1994), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n47)Footnote 47. E.g., *Makaroff v. City of Lockport, N.Y.*, 916 F.2d 890, 23 C.B.C.2d 1566 (3d Cir. 1990) , *cert. denied*, 499 U.S. 983, 111 S. Ct. 1640, 113 L.Ed. 2d 735 (1991) ; *In re Parr Meadows Racing Ass'n*, 880 F.2d 1540 (2d Cir. 1989) , *cert. denied sub nom*, *City of Lockport, NY v. U.S.*, 499 U.S. 983, 111 S. Ct. 1640, 113 L. Ed. 2d 735 (1991) ; *Suffolk Treasurer v. Barr*, 493 U.S. 1058 (1990)); *Alpha-Bella VI, Inc. v. Clinton Township*, 14 N.J. Tax 597 (N.J. Tax 1995) .



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Collier on Bankruptcy Taxation

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CHAPTER TX4 Priority and Dischargeability of Tax Claims

15-TX4 Collier on Bankruptcy Taxation P TX4.05

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P TX4.05 Interest on Tax Claims

[1] In General

As a general rule, the I.R.C. provides for the accrual of interest on a tax liability until it is paid n1 while the Bankruptcy Code does not authorize the payment of postpetition interest. n2 However, a secured creditor is entitled to receive postpetition interest on its claim to the extent that the collateral securing the claim exceeds the amount of the claim. n3 In addition, unsecured creditors are entitled to postpetition interest when the debtor is solvent. n4 As noted above, to the extent that interest is allowed, new section 511 provides that "[i]f any provision of this title requires the payment of interest on a tax claim or on an administrative expense tax, or the payment of interest to enable a creditor to receive the present value of the allowed amount of a tax claim, the rate of interest shall be the rate determined under applicable nonbankruptcy law." n5

[2] Secured Tax Claims

The IRS and other governmental taxing authorities are entitled to postpetition interest on oversecured claims, n6 but postpetition interest on a secured tax claim, in contrast to other tax claims that are nondischargeable, n7 is not excepted from discharge. n8 In *Ron Pair*, n9 the United States, possessing a perfected tax lien on the property of the debtor, argued that, despite the nonconsensual nature of its claim, it was entitled to postpetition interest because the value of the property securing the claim was greater than the allowed amount of the claim. The Court, after parsing section 506(b), held that the government was entitled to postpetition interest on its oversecured claim even though the government's claim was obtained nonconsensually. The appropriate rate at which interest should accrue on an oversecured tax claim is the rate provided for under applicable nonbankruptcy law. n10

[3] Undersecured Tax Claims

In *United Savings Ass'n of Tex. v. Timbers of Inwood Forest Assoc., Ltd.*, n11 the Supreme Court held that postpetition payments to an undersecured creditor could not be applied to interest because section 506(b) only permits postpetition interest to be paid to the extent that the value of the collateral exceeds the value of the claim. This holding should not be interpreted as a *per se* rule prohibiting postpetition interest to a creditor that is undersecured at the date of filing because if, at the date of confirmation, the creditor's collateral has appreciated in value, then any postpetition payments should

be applied first toward the interest on the claim. n12

[4] Unsecured Tax Claims

[a] Prepetition Interest

Prepetition interest on unsecured tax claims continues to accrue until the date the debtor commences a bankruptcy case and forms a part of the tax claim. If the tax claim is a priority or nondischargeable tax claim, then the prepetition interest on the claim is accorded the same treatment as the underlying tax liability. n13

[b] Postpetition Interest

Generally speaking, an unsecured tax claim is not entitled to postpetition interest. n14 There are, however, a couple of exceptions. The first exception is where a debtor is solvent, n15 in which case interest is payable, pursuant to new section 511, at the rate of interest determined under applicable nonbankruptcy law. The second exception is that postpetition interest on a nondischargeable tax claim is nondischargeable. Consequently, a debtor must provide for, and pay, the "gap period interest" that accrues between the petition date and the date of plan confirmation, in a plan of reorganization. Any such "gap period interest" that is not paid remains collectible and is not discharged. n16 For example, in *In re Johnson*, n17 the Court of Appeals for the Fifth Circuit confirmed that accrued postpetition interest on nondischargeable tax claims was nondischargeable. In *Johnson*, the taxpayer disputed the IRS for the years 1979 through 1984, but his chapter 11 case was converted to a chapter 7 proceeding. The claims of the IRS were not finally determined until 1996 and were not paid as distributions by the trustee in the interim. As a result of the absence of estate distributions, interest continued to accrue on the 1979 through 1984 claims. The IRS sought to collect the unpaid balance of the nondischargeable tax liabilities plus postpetition interest on the entire tax liabilities from the date of the filing of the chapter 11 petition. Postpetition interest accruing on nondischargeable tax debts is itself nondischargeable and the debtor remains personally liable for that interest following completion of bankruptcy proceedings. n18 Postpetition interest begins to accrue immediately from and after the filing of the bankruptcy petition. n19 Any amounts paid by the trustee or the debtor in the way of partial, interim payments, reduces either the accrued interest or the principal tax debt, or both, depending on the facts, and, to the extent that the principal tax debt is reduced, interest will thereafter accrue only on the remaining balance due. n20

If a taxing authority fails to object to a plan that provides for the payment of a specific tax claim with no gap period interest, the postpetition interest cannot be discharged in a chapter 11 plan. n21 In a chapter 13 plan, however, postpetition interest on a priority claim is discharged if all plan payments are made. n22

[c] Postconfirmation Interest

In chapter 11, a plan of reorganization cannot be confirmed unless the plan provides that tax claims are to receive payment in full or regular cash payments, over a period not exceeding five years from the date of the order of relief, with a value as of the effective date of the plan equal to the allowed amount of such claim (or the claimant agrees to a different treatment). n23 Accordingly, post-confirmation interest on a priority tax claim must be paid in order to meet the requirements for plan confirmation.

In chapter 13, a repayment plan cannot be confirmed unless priority tax claims receive full payment in deferred cash payments (or the claimant agrees to a different treatment). n24 Therefore, a priority tax claim in a chapter 13 case is not entitled to postconfirmation interest.

FOOTNOTES:

(n1)Footnote 1. *I.R.C. § 6601(a)*.

(n2)Footnote 2. 11 U.S.C. § 502(b)(2).

(n3)Footnote 3. 11 U.S.C. § 506(b).

(n4)Footnote 4. 11 U.S.C. § 726(a)(5).

(n5)Footnote 5. This provision of the 2005 Act will generally result in an increase in the rate of interest that debtors will pay on oversecured pre-petition tax claims or deferred tax payments made after emergence under Section 1129(a)(9)(C).

(n6)Footnote 6. *United States v. Ron Pair Enters.*, 489 U.S. 235, 109 S. Ct. 1026, 103 L. Ed. 2d 290, 20 C.B.C.2d 267 (1989) ; *Key Bank of New York v. Harko*, 211 B.R. 116 (B.A.P. 2d Cir. 1997) , *aff'd*, 141 F.3d 420, 39 C.B.C.2d 1275 (2d Cir.) , *cert. denied*, 525 U.S. 872, 119 S. Ct. 169, 142 L.Ed.2d 138 (1998) . (oversecured creditor entitled to interest at contract rate until effective date of debtor's plan and thereafter the interest rate that returns present value to creditor). *See also In re Cachu*, 321 B.R. 716 (Bankr. E.D.Ca. 2005) ; *In re Cone Constructors, Inc.*, 304 B.R. 513 (Bankr. M.D. Fla. 2003) .

(n7)Footnote 7. *United States v. Heisson*, 217 B.R. 1 (D. Mass. 1997) .

(n8)Footnote 8. *United States v. Victor*, 121 F.3d 1383, 38 C.B.C.2d 669 (10th Cir. 1997) .

(n9)Footnote 9. *United States v. Ron Pair Enters.*, 489 U.S. 235, 109 S. Ct. 1026, 103 L. Ed. 2d 290, 20 C.B.C.2d 267 (1989) .

(n10)Footnote 10. *In re Jones*, 368 B.R. 602 (Bankr. S.D. Tex. 2007) ; *In re Marfin Ready Mix Corp.*, 40 C.B.C.2d 199, 220 B.R. 148 (Bankr. E.D.N.Y. 1998) ; *Galveston Indep. Sch. Dist. v. Heartland Fed. Sav. & Loan Ass'n.*, 159 B.R. 198 (S.D. Tex. 1993) .

(n11)Footnote 11. 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740, 17 C.B.C.2d 1368 (1988) .

(n12)Footnote 12. *In re Addison Properties Ltd. Partnership*, 185 B.R. 766 (Bankr. N.D. Ill. 1995) (dual valuation approach).

(n13)Footnote 13. *In re Mosbrucker*, 227 B.R. 434 (B.A.P. 8th Cir. 1998) , *aff'd*, 198 F.3d 250 (8th Cir. 1999) (the interest accrued prepetition on a nondischargeable tax liability is also accorded priority and nondischargeability status); *Hardee v. IRS (In re Hardee)*, 137 F.3d 337, 39 C.B.C.2d 1205 (5th Cir. 1998) ; *Matter of Garcia*, 955 F.2d 16 (5th Cir. 1992) ; *Hanna v. United States*, 872 F.2d 829 (9th Cir. 1989) ; *In re Larson*, 862 F.2d 112 (7th Cir. 1988) ; *United States v. Friendship College, Inc.*, 737 F.2d 430, 10 C.B.C.2d 1151 (4th Cir. 1984) ; *In re Miller*, 300 B.R. 422 (Bankr. N.D. Ohio 2003) ; *In re Hall*, 191 B.R. 814 (Bankr. D. Alaska 1995) ; *In re Pierce*, 33 C.B.C.2d 1254, 184 B.R. 338 (Bankr. N.D. Iowa 1995) .

See also In re Moore, 307 B.R. 394 (Bankr. S.D.N.Y. 2004) (court held that interest on IRS's claim continued to accrue during pendency of taxpayer's prior chapter 13 case where the case was dismissed before the debtor was granted the superdischarge available under chapter 13).

(n14)Footnote 14. 11 U.S.C. § 502(b)(2).

(n15)Footnote 15. 11 U.S.C. § 726(a)(5); *In re D.C. Sullivan & Co., Inc.*, 929 F.2d 1 (1st Cir. 1991) .

(n16)Footnote 16. *In re Tuttle*, 291 F.3d 1238 (10th Cir. 2002) ; *In re Cousins*, 209 F.3d 38 (1st Cir. 2000) (postpetition interest on nondischargeable tax claims remains nondischargeable and collectible after the receipt of the discharge); *In re Holway*, 42 C.B.C.2d 1178, 237 B.R. 217 (Bankr. M.D. Fla. 1999) (failure to make all of the chapter 13 plan payments and thereby obtain a discharge results in continuing liability of the debtor for postpetition interest and

penalties arising from priority taxes otherwise paid in the unfunded plan; the price for the "super discharge" in chapter 13 is the payment of all plan payments and the entry of a discharge). *United States v. Ryan (In re Ryan)*, 48 C.B.C.2d 1337, 286 B.R. 141 (Bankr. W.D. Mo. 2002) .

(n17)Footnote 17. 146 F.3d 252, 40 C.B.C.2d 578 (5th Cir. 1998) .

(n18)Footnote 18. *Bruning v. United States*, 376 U.S. 358, 84 S. Ct. 906, 11 L. Ed. 2d 772 (1964) ; *In re Artisan Woodworkers*, 225 B.R. 185 (B.A.P. 9th Cir. 1998) .

(n19)Footnote 19. *Johnson v. IRS (In re Johnson)*, 146 F.3d 252, 261, 40 C.B.C.2d 578 (5th Cir. 1998) .

(n20)Footnote 20. *Johnson v. IRS (In re Johnson)*, 146 F.3d 252, 261, 40 C.B.C.2d 578 (5th Cir. 1998) .

(n21)Footnote 21. *In re Artisan Woodworkers*, 40 C.B.C.2d 1133, 225 B.R. 185 (B.A.P. 9th Cir. 1998) , *aff'd*, 204 F.3d 888 (9th Cir. 2000) (a chapter 11 plan is binding on all creditors, but a confirmed plan may not extinguish or discharge an otherwise nondischargeable debt even if a creditor fails to participate in the plan confirmation process; "GAP" interest accruing after the petition date but before the confirmation hearing is a nondischargeable claim that, if not provided for in the plan, is collectible after confirmation by the taxing authority); *In re Broadus*, 2009 Bankr. LEXIS 531 (Bankr. D. Ala. Jan. 29, 2009); *In re Stacy*, 44 C.B.C.2d 136, 249 B.R. 683 (Bankr. W.D. Va. 2000) (although the IRS was bound by the terms of the confirmed chapter 11 plan, the gap period interest accruing after the petition date to the confirmation hearing date remained nondischargeable and collectible outside the chapter 11 plan if payment was not provided for in the chapter 11 plan); *In re Minkoff*, 43 C.B.C.2d 968 (Bankr. D. Kan. 1999) (gap period interest accruing between the petition date and confirmation date is nondischargeable and remains a personal liability unless paid in the plan. The unsecured portion of a secured tax claim that is a priority unsecured claim requires the payment of gap period interest; on the other hand, if an alleged secured claim becomes unsecured due to the lack of asset value for the lien per section 506(b), and the underlying tax liability is not a priority claim, then no gap period interest is payable; postpetition interest on an IRS secured claim is payable if there is an oversecured claim pursuant to § 506(b)).

(n22)Footnote 22. See *In re Mitchell*, 38 C.B.C.2d 901, 210 B.R. 978, 983 (Bankr. N.D. Tex.) , *aff'd*, 241 B.R. 393 (N.D. Tex. 1997) ; *In re Holway*, 42 C.B.C.2d 1178, 237 B.R. 217 (Bankr. N.D. Fla. 1999) (failure to make all of the chapter 13 plan payments and thereby obtain a discharge results in continuing liability of the debtor for postpetition interest and penalties arising from priority taxes otherwise paid in the unfunded plan; the price for the "super discharge" in chapter 13 is the payment of all plan payments and the entry of a discharge).

(n23)Footnote 23. 11 U.S.C. § 1129(a)(9)(C).

(n24)Footnote 24. 11 U.S.C. § 1322(a)(2).



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CHAPTER TX4 Priority and Dischargeability of Tax Claims

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Reserved

PP TX4.06-Reserved



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CHAPTER TX5 Litigation With the IRS in Bankruptcy Court

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CHAPTER TX5 Litigation With the IRS in Bankruptcy Court

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P TX5.01 Introduction

The litigation of federal tax disputes is generally recognized as a subspecialty in both the fields of litigation and taxation. When the tax controversy being litigated involves a taxpayer which either is or has been the debtor in a case under title 11, or the title 11 estate, a third specialized field, bankruptcy law, must also be mastered. This chapter will consider the often unique and occasionally arcane issues which confront the practitioner who must synthesize knowledge of the three fields of law required to litigate tax controversies related to cases under title 11.

Prior to the enactment of the Bankruptcy Code, tax disputes in cases under title 11 were usually confined to matters associated with the collection of a tax debt as distinguished from the substantive issues related to the determination of the tax liability itself. Disputes of this type concerned "traditional" title 11 issues such as the priority and dischargeability of tax debts; n1 the applicability of the automatic stay to the IRS; n2 and actions brought pursuant to *sections 542, 547 and 553 of the Bankruptcy Code*. n3 The dramatic increase in filings under title 11 has added a new dimension to the nature of tax disputes encountered. Bankruptcy courts are now routinely called upon to determine the amount of both prepetition and postpetition tax liabilities of debtors and their estates, and the resolution of these controversies often has a profound impact upon the title 11 case itself. n4

Bankruptcy courts exercise jurisdiction which is derived from that vested in the district courts. n5 This jurisdiction over all matters related to a bankruptcy case is delegated to the bankruptcy courts as units of the district courts. Whether a matter is core or noncore limits the bankruptcy court's authority to enter a final order. n6 Most tax disputes will fall within the ambit of core proceedings and the bankruptcy court will, accordingly, have authority to issue final orders. *Section 505 of the Bankruptcy Code* provides the bankruptcy court with broad jurisdiction to determine a debtor's prepetition and postpetition tax liability. n7 There are, however, certain circumstances under which a bankruptcy court may decline to exercise this jurisdiction. n8

As the scope of tax litigation in the bankruptcy court has expanded to include substantive tax issues, the tension inherent in the usual three year audit cycle and the need for an accelerated examination of all open prepetition tax years has increased. n9 Consequently, knowledge of the various personnel representing the IRS from the beginning of the examination process through any litigation which is ultimately necessary is essential to attorneys representing parties to tax disputes in the bankruptcy court. n10 It may be advisable to encourage involvement of government counsel at an early stage and to cooperate with those individuals if resolution of a disputed tax liability will have a significant impact on the administration of the case under title 11. Such involvement may be helpful in obtaining a prompt completion of

open examinations or a decision to "survey" unexamined years. Cooperation with government counsel may also assist in developing a confirmable plan in cases under chapters 11, 12, and 13 which may include issues ranging from extended payments of tax liabilities to the unique questions arising when some, but not all, members of a group of corporations filing consolidated income tax returns file petitions under title 11.

FOOTNOTES:

(n1)Footnote 1. The priority and dischargeability of tax debts are discussed in chapter TX4 *supra*.

(n2)Footnote 2. *See P TX5.06 infra*.

(n3)Footnote 3. Turnover proceedings against the IRS are discussed in *P TX5.07 infra*; actions to avoid allegedly preferential payments to the IRS in *P TX5.09 infra* ; and motions to permit setoffs of tax debts and overpayments in *P TX5.08 infra* .

(n4)Footnote 4. In spite of the emergence of the bankruptcy court as the fourth forum for the determination of tax liabilities, proposals to consolidate all tax litigation in the Tax Court by transferring to it jurisdiction now vested in the district courts and the Court of Federal Claims over refund suits have ignored this development. The goal which these proposals hope to achieve is uniformity of substantive tax decisions. Nothing in these proposals, however, would disturb the jurisdiction of the bankruptcy courts to continue making such decisions. American Bar Association Standing Committee on Federal Judicial Improvements, 1990 Report.

(n5)Footnote 5. 28 U.S.C. § 1334.

(n6)Footnote 6. 28 U.S.C. § 157.

(n7)Footnote 7. *See P TX5.04 infra*. The other primary procedural vehicle for resolving disputes over the correct amount of tax liability, the claims objection process, is explained in *P TX5.03 infra* .

(n8)Footnote 8. *See P TX5.10 infra*.

(n9)Footnote 9. *See P TX5.13[3] infra*.

(n10)Footnote 10. *See P TX5.02 infra*.



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CHAPTER TX5 Litigation With the IRS in Bankruptcy Court

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P TX5.02 Personnel Representing the Government

Before embarking upon a detailed consideration of the types of tax litigation occurring in cases under title 11, a brief comment on some of the participants is in order.

Representing a party to a tax dispute in a case under title 11 will require familiarity with a variety of personnel within the IRS and within the Department of Justice. The following overview will introduce the primary representatives of the government who will commonly appear at various stages of tax controversies in cases under title 11. This overview is intended to be an introduction and is not exhaustive.

During the year 2000, the Internal Revenue Service implemented its most fundamental reorganization since the 1950s. Prior to this reorganization, the IRS was organized geographically into regions and districts. All of a taxpayer's affairs were handled by the Examination, Appeals, Collection, or even Criminal Division within a particular district. Each district also had a legal function in the District Counsel's office. Districts were supervised by regional offices which in turn were supervised by the national office in Washington. The reorganization eliminated the district and regional offices and replaced them with four divisions intended to focus upon specific types of taxpayers: Large and Medium Sized Businesses ("LMSB"), Small Businesses and Self-Employed ("SBSE"), Wage and Investment ("W&I"), and Tax Exempt and Government Entities ("TEGE"). The District Counsel functions also disappeared, although IRS attorneys continue to appear in title 11 cases as Special Assistant United States Attorneys ("SAUSAs"). Obviously, an undertaking this profound will produce some confusion and uncertainty during the transition.

[1] The Examination Function

Prior to the reorganization, the Examination Division of each district had the responsibility for reviewing, or "auditing," the returns that taxpayers are required to file. The IRS personnel responsible for these reviews are currently called "revenue agents." These agents are now assigned to Audit Teams within each of the four divisions: LMSB, SBSE, W&I, and TEGE. When a revenue agent determines that additional taxes are owed to the IRS, a deficiency will be proposed. If such a proposed deficiency has not been resolved by payment, agreement, or litigation when the taxpayer files a petition under title 11, the amount of the proposed deficiency, plus any applicable interest and penalties may be included on a proof of claim filed by the IRS. n1 Filing a petition under title 11 does not prevent the IRS from examining the debtor's tax liability or issuing notices of deficiencies; however, it does prevent the redetermination of such deficiencies by the Tax Court for prepetition tax periods of all debtors and for postpetition tax periods of corporate

debtors. n2 The filing of a petition under title 11 will also suspend the running of the statutes of limitation on assessing and collecting taxes, thereby obviating the need for extensions. n3

[2] The Appeals Function

Under the old structure, the Appeals Division was the component of the IRS charged with responsibility for resolving disagreements the taxpayer had with the results of an examination through an administrative review, or "appeal." Appeals are still available under the new structure, but the appeals officers are now stationed within the LMSB and SBSE Divisions. Appeals officers review the results of the examination and the contentions which the taxpayer raises to dispute them. Seeking such a review is an option available to the taxpayer which may result in a favorable outcome without resort to litigation. Because settlement of a tax dispute may be particularly attractive when the dispute arises in a case under title 11, this option should not be overlooked. n4 If a taxpayer decides to pursue an appeal, consideration should be given to the time required to complete this process. In order for this approach to be practical in a bankruptcy setting, it may be necessary for all of the parties to proceed on an expedited schedule. For a taxpayer dissatisfied with the results of the appeal as to some or all of the disputed issues, litigation remains an alternative which may still be pursued.

[3] The Collection Function

Once a tax liability has been determined and remains unpaid, the IRS has the duty to collect such a delinquent tax debt either from the taxpayer or, if necessary, from other sources. The personnel within the IRS assigned to collect unpaid taxes are called revenue officers, as distinguished from the revenue agents who conduct audits. Formerly, revenue officers were part of the Collection Division. Now, they are found within the Small Business/Self Employed ("SBSE") Division, since it has primary responsibility for collection activities. Since many debtors have become delinquent on their tax obligations prior to filing petitions under title 11, revenue officers are usually familiar with the bankruptcy process.

Until a petition under title 11 has been filed, the principal collection vehicles are filing liens to secure an unpaid tax liability and levying on property to satisfy the tax debt. In particular, the service of a notice of levy is often an event that will precipitate the filing of case under title 11 by the taxpayer. Although it is beyond the scope of this text, the reader should be aware that the Tax Reform Act of 1998 instituted significant new "collection due process rights," affording a taxpayer the opportunity for both administrative and judicial review before the IRS may proceed with either filing a lien or executing a levy. n4a

The automatic stay, of course, prevents further collection activities once a petition is filed. n5 Nevertheless, revenue officers within SBSE have the initial responsibility within the Service for monitoring the case and preparing any proofs of claim which the Service may file. Formerly, the Special Procedures Branch of the Collection Division played a significant role in discharging this responsibility. This branch of the old Collection Division included both technicians and advisors who reviewed all proofs of claim filed on behalf of the IRS, as well as many of the documents served on the IRS by debtors. The role previously played by the Special Procedures Branch is now performed by Insolvency Groups. Questions about the amount and character of a tax liability should be addressed to the appropriate Insolvency Group; personnel within a group are usually assigned to particular types of title 11 cases. Cases are frequently subdivided alphabetically based upon the debtor's name and upon the basis of the judicial district and division where they are filed. In 2005, the IRS began consolidating its administration of Chapter 7 no asset cases and Chapter 13 post confirmation cases at a central location in Philadelphia. Notice of this shift from local to national administration is provided to bankruptcy clerks and the United States Trustee on a district by district basis. Once the shift occurs, inquires, payments, etc. should be made to the Philadelphia office.

In 2006, the IRS invoked the authority on the *Bankruptcy Abuse Prevention and Consumer Protection Act of 2005* and directed that requests for prompt determination of tax liability in all types of cases should now be sent to an address in

Philadelphia. n5a Previously, these requests had been sent the Special Procedures office in the taxpayer's district.

[4] Internal Revenue Service Attorneys

Prior the reorganization of the IRS, its attorneys were stationed in district and regional offices across the country and in the Office of Chief Counsel in Washington. Attorneys in "the field" are now located within an Area Counsel's office, while the Chief Counsel's office has remained relatively unchanged with respect to title 11 matters. Attorneys in the field with title 11 responsibilities are assigned to the SBSE operation.

Traditionally, the Service's attorneys performed primarily an advisory role in title 11 matters, and litigation in the bankruptcy courts was handled by the Department of Justice. Over time, many of the Service's attorneys developed considerable knowledge in the field. With the dramatic increase in the number of cases filed under title 11 and the corresponding increase in the number of them which included tax controversies, the government found it necessary to utilize District Counsel attorneys to represent the Service in the bankruptcy court. Through the implementation of the "Houston Plan," the Service and the Department of Justice agreed that certain District Counsel attorneys would become "Special Assistant United States Attorneys" for the judicial district in which they were located. n6 Pursuant to this arrangement, certain defined types of tax litigation in the bankruptcy court were delegated to these Special Assistants, or "SAUSAs." n7 After its origin in Houston, the program was implemented in most of the other District Counsel's offices, although it was usually limited to those divisions of the judicial district in which the District Counsel's office is located. Following the reorganization, the SAUSA program was retained and transferred to Area Counsel offices in SBSE. The Department of Justice retains responsibility for all types of tax litigation in the bankruptcy court in the other divisions of each judicial district.

Attorneys in the Chief Counsel's Office in Washington do not appear in bankruptcy court; however, because of their expertise in both substantive and procedural issues arising in bankruptcy tax litigation, they play a major role in developing policy positions and in coordinating the disposition of particular cases. Especially in large cases, Chief Counsel attorneys provide a liaison which is frequently indispensable to the prompt resolution of the dispute.

[5] Department of Justice Attorneys

Representation of the Service in litigation before the bankruptcy courts was historically the task of the Tax Division of the Department of Justice. Although primary responsibility was given to the Tax Division, the various United States Attorneys' offices also played a major role because of the logistical difficulties of having Tax Division attorneys based in Washington present at the frequent hearings associated with most cases under title 11. n8 The advent of the Houston Plan has altered this arrangement with respect to the defined categories of cases delegated to the Service's attorneys under that program.

All appeals from decisions of the bankruptcy court are handled by the Department of Justice. Considerable effort is devoted to maintaining a consistent position across the country and to selecting "litigating vehicles" which offer the best opportunity for vindicating the government's position. The Department of Justice will enter a case after receiving a "referral" from the Service. A referral will usually be made after an objection to a claim filed by the Service has been received, although the referral may be made at an earlier stage if warranted by the circumstances of the case.

[6] Summary of the Role of Government Representatives

Depending upon the size and complexity of the case, an attorney representing a taxpayer in a case under title 11 may have occasion to work with some or all of the government representatives described above, either seriatim or simultaneously. Because of the time constraints often encountered in cases under title 11, the attorney may need to initiate contact with government representatives at a very early stage of the case when resolution of the tax liability will be a significant factor. Developing an understanding of which personnel represent the government at the various stages

of the examination, collection and litigation process will expedite this process. In most cases, the client should be able to provide the attorney with the status of the tax periods which are unresolved and the identity of the government personnel involved. To the extent the attorney is uncertain of the status or appropriate personnel to contact, questions should initially be directed to the appropriate IRS insolvency group.

FOOTNOTES:

(n1)Footnote 1. The claims objection process is discussed in *P TX5.03 infra*; the priority and dischargeability of taxes, interest and penalties are discussed in chapter TX4 *supra*.

(n2)Footnote 2. 11 U.S.C. § 362. In 2005, section 362(a)(8) was amended to clarify that the automatic stay applied the initiation of a redetermination proceeding in the Tax Court for prepetition tax periods of all taxpayer-debtors but only to postpetition tax periods of corporate debtors. For a discussion of the litigation of issues related to the automatic stay, see *P TX5.06 infra*.

(n3)Footnote 3. I.R.C. § 6503(h).

(n4)Footnote 4. See *P TX5.13[5] infra*. An explanation of the appeals process in cases under title 11 is provided in the Internal Revenue Manual--Administration, §§ 8(15)(31) and 8(15)(32) *et seq.* See 5 Internal Revenue Manual (C.C.H.), p. 26,251.

(n5)Footnote 4a. 26 U.S.C. § 6320 ("Notice and Opportunity for Hearing Upon Filing of Notice of Lien"); 26 U.S.C. § 6330 ("Notice and Opportunity for Hearing Before Levy").

(n6)Footnote 5. The impact of the automatic stay on collection activities is discussed in *P TX5.06[4] infra*.

(n7)Footnote 5a. *Revenue Procedure 2006-24 - 22 I.R.B. 943, 2006 IRB LEXIS 313*.

(n8)Footnote 6. The Houston Plan was implemented in 1983 through an exchange of letters between the Chief Counsel of the Internal Revenue Service and the Assistant Attorney General in charge of the Tax Division.

(n9)Footnote 7. The types of cases which may be delegated to a Special Assistant United States Attorney under the Houston Plan include:

- (1) cash collateral hearings;
- (2) motions to compel the filing of tax returns;
- (3) undisputed motions to modify the automatic stay to permit acts such as setoffs;
- (4) objections to confirmation of plan;
- (5) motions to convert or dismiss cases under chapters 11 and 13;
- (6) objections to IRS claims (except those involving responsible person liability, the merits of the debtor's tax liability, important or novel issues, or matters which will require evidentiary hearings as to disputed matters);
- (7) cases involving dischargeability (except those involving fraud or novel issues);

(8) all motions to modify the automatic stay; and

(9) turnover hearings where the government's defense is limited to adequate protection.

Even in Divisions wherein the Houston Plan has been implemented, cases usually referred to a Special Assistant may be retained by the Department of Justice if a large amount of money, a novel legal issue, or a prominent party is involved.

(n10)Footnote 8. The Tax Division's former Dallas Field Office has become the Southwestern Region-Civil Trial Section with responsibility for cases in Texas and New Mexico. In addition, the United States Attorney's offices for the Southern District of New York and the Central and Northern Districts of California have attorneys who handle most of the civil tax litigation occurring in those districts.



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CHAPTER TX5 Litigation With the IRS in Bankruptcy Court

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P TX5.03 Resolution of Tax Liabilities Through the Claims Objection Process

[1] The Claims Objection Process

The Bankruptcy Code envisions an expeditious resolution of disputes over the liability, amount and character of claims owed by the bankruptcy estate. The character of claims includes such matters as whether the claim is for a prepetition or postpetition period, what priority of payment should be accorded to the claim, and whether the claim is subject to discharge or to subordination. n1 Creditors, including the IRS, are permitted, but not required, to file proofs of claims asserting the amount of debts owed to them by the debtor in a case under title 11. n2 The proof of claim should be in writing and executed by the creditor or its authorized agent. n3 If the Service does not file a claim, the debtor, the trustee, or any other party who may also be liable for the taxes may file a claim on behalf of the Service. n4 In order to receive any payment from the title 11 case, a creditor in a case under chapter 7 or 13 must file a claim within 90 days after the first date set for the meeting of the creditors pursuant to *section 341 of the Bankruptcy Code*; however, when the creditor is a governmental unit such as the IRS, a proof of claim is timely if it is filed within 180 days after the entry of the order for relief. n5 The time for filing claims in cases under chapter 9 and 11 will be set by the bankruptcy court, but it is not necessary to file if the claim is scheduled but not listed as disputed, contingent or unliquidated. n6 If a claim is filed on its behalf, the creditor is authorized to file its own claim, which will supersede the one filed for it. n7

Proofs of claim filed by the Service will be set forth on a standard form which indicates whether the claim is secured, unsecured priority, or general unsecured. n8 Each tax period will be listed separately. The form will also indicate the amount of any prepetition interest and penalties and whether any portion of the claim is subject to being set off. A similar standard form will be used to file claims for any postpetition taxes, interest and penalties the Service asserts to be due. Whether a tax claim is classified as prepetition or postpetition depends upon when the tax liability accrues. Accordingly, if a calendar year taxpayer filed a petition under title 11 in December, then the income tax liability for that year would not yet have accrued and would constitute a postpetition or "administrative" claim. n9

Once a proof of claim has been filed, the Bankruptcy Code deems it to be allowed unless a "party in interest" files an objection to it. n10 When analyzing which parties may object to a claim, the term should be understood to include parties besides the debtor and the trustee. Depending upon the circumstances of the case, other creditors may have standing to object to a proof of claim. n11 The potential ability of parties other than the taxpayer to litigate the amount of the taxpayer's liability is a feature which distinguishes the claims objection process from tax litigation limited to the taxpayer and the government in other courts.

If the debtor, the trustee or an appropriate party in interest disputes a proof of claim filed by the Service, an "objection" to the claim may be filed. n12 Objections must be in writing, filed with the court, and served on the claimant, the debtor and the trustee. n13 The filing of an objection has been analogized to the filing of an answer to a complaint in a civil action and initiates a proceeding which empowers a bankruptcy court to determine the amount of the claim. n14 Once an objection has been filed, the party filing it may not have an absolute right to withdraw it. n14a

An objection to a claim will normally be classified as a "contested matter" and will generally proceed pursuant to *Federal Rule of Bankruptcy Procedure 9014*, which lists those Rules in Part VII of the Federal Rules of Bankruptcy Procedure (governing "adversary proceedings") which are applicable in contested matters. n15 In objecting to a proof of claim, it is prudent to serve an objection to a federal tax claim in accordance with the adversary proceeding rules upon the United States Attorney for the judicial district in which the case is pending, the Attorney General of the United States in Washington, and the IRS Special Procedures insolvency center in Philadelphia. n16 Discovery procedures will be similar to those provided for by the Federal Rules of Civil Procedure, which allow the extensive use of depositions, interrogatories and requests for the production of documents. n17 Accordingly, the potential time and expense of this type of discovery should be considered when selecting a vehicle for litigating a federal tax claim.

The Bankruptcy Code enumerates the grounds for possible objections. n18 Because a common goal in cases under title 11 is the prompt resolution of disputed claims, the grounds for the objection should be as specific as possible, and should be made clear from the beginning in order to satisfy the requirement of adequate notice pleading inherent in the adversary proceeding rules of the Federal Rules of Bankruptcy Procedure. This approach will assist in a narrowing of the issues and avoid a possible motion for more definite statement. Where a tax claim has more than one component, a determination that a single component is incorrect does not permit a bankruptcy court to reject the entire claim. n18a It should also be understood that trivial or purely technical objections which do not materially affect the ultimate validity of the creditor's claim may provoke an objection to the relevant professional's application for fees on the grounds that the needless effort did not provide any benefit to the title 11 estate. n19

Statistically, more tax disputes in cases under title 11 are resolved through the claims objection process than by any other available vehicle. Implicit in that process is the ability to litigate the amount of the tax liability without first paying the amount of the tax due in full and seeking a refund. Thus, like the Tax Court, the bankruptcy court offers a "prepayment forum." n20 Unlike in the Tax Court, even a tax which has been assessed but remains unpaid may be litigated in the bankruptcy court.

[2] Late Claims

When a debtor files a case under title 11, the Service may not immediately be able to file a claim for all of the amounts it claims to be owed. n21 If there are prior years for which the assessment and collection process has progressed to the point that liens have been filed, the task may be simple. If, however, there are prepetition years which are still under examination or which have not yet been selected for examination within the usual three year audit cycle, n22 the total amount claimed by the Service may not be easily ascertainable.

This predicament is exacerbated when the taxpayer files complex returns which may be affected by the use of tax attributes arising in other years. Indeed, in cases under title 11 involving large corporate taxpayers that file consolidated returns, it is not unusual to have numerous prepetition years still under examination by virtue of extensions agreed to by the taxpayer and the Service. For these reasons, as well as others, the Service will occasionally fail to file a timely proof of claim. In some cases under title 11, the impact of this problem may be substantial, particularly if a large tax claim will impair development of a confirmable plan of reorganization or preclude payments to junior creditors. Accordingly, parties who may be adversely affected by a tax claim need to know the maximum amount of any such claim at an early date.

If the Service fails to file a claim before the bar date because it was not given notice of the case, then its subsequently filed claim will not be barred. n23 Likewise, if the Service was unaware that it had a claim because the debtor failed to file a timely tax return, a late claim should be allowed. n24 In 2005, section 502(b)(9) was amended to provide a governmental unit a period of sixty days to file a claim in Chapter 13 cases after a tax return specified in section 1308 has been filed. Some courts have held that the scheduling of a claim by the debtor constituted the filing of a claim, n25 but other courts may disagree. One court held that a notice of deficiency did not constitute an informal claim and ruled that the Service's claim was untimely. n26 Traditionally, most courts held failure to file a timely claim would not be excused and would usually result in the claim being disallowed or being relegated to payment only after all timely filed claims, including those which would otherwise have been given lower priority, had been paid in full (which was tantamount to disallowance in most cases). n27

However, in *Pioneer Investment Services Co. v. Brunswick Associates Limited Partnership*, n28 a nontax case in which the proof of claim was filed 20 days late, the United States Supreme Court held that a flexible application of the "excusable neglect" standard with respect to a late claim was consistent with the chapter 11 goal of rehabilitating the debtor and avoiding forfeitures by creditors. The Supreme Court ruled that a court may find that a creditor's failure to file a proof of claim by the bar date was due to excusable neglect once the court has considered all of the relevant circumstances, including danger of prejudice to the debtor, the length of the delay, the reason for the delay and whether such delay was in the control of the party filing the late claim, the possible impact of the delay on the judicial proceedings, and whether the party filing the late claim acted in good faith. n29 Subsequently, a bankruptcy court allowed the IRS to file a claim twenty-one (21) months after the bar date in a chapter 11 case because no plan had been confirmed and because it determined that the *Pioneer Investments Services* excusable neglect standard had been satisfied. n30

Some lower courts had concluded that, at least in chapter 7 cases, priority of payment is more important than timeliness in filing proofs of claim. n31 In chapter 13 cases, two distinct and opposing positions had emerged with respect to whether late claims are allowable. n32 Subsequently, Congress amended section 726(a) to protect the priority status of late filed claims in chapter 7 cases. n32a The uncertainty which had resulted from the opposing lines of cases was dispelled by the Bankruptcy Reform Act of 1994 which amended section 502 to provide that a late filed proof of claim is not an allowable claim except as provided by section 726(a). This Act also added new section 509(b)(9) which provided that governmental units shall have at least 180 days after the date of the order for relief in which to file a proof of claim. n33

[3] Amended Claims

Once a proof of claim has been filed, the creditor may file an amendment which will have the effect of superseding that portion of the original claim which was the subject of the amendment. Some amendments to tax claims are made to correct clerical errors such as the computation of the amount of interest due on a claim for a prepetition year. So long as the nature of the amendment does not fundamentally change the amount or character of the claim, the Service should be accorded reasonable latitude to remedy errors. n34 From a practical standpoint, an amended claim will sometimes be filed by the Service along with the withdrawal of an objection to the original claim by the objecting party as a means of implementing a settlement of the objection.

A more serious question arises when the amended proof of claim makes a significant change in the amount or nature of the IRS's claim. For example, the IRS might add an income tax to a claim that had originally asserted only an employment or excise tax debt such as FICA or FUTA taxes. If the amended claim is filed before the bar date, there should be no ground for objection. If the bar date has passed, a dispute may occur over an increase in the amount of a tax previously included in a timely claim, or over adding a new and different kind of tax, leading to an objection that the amended claim is in reality a late claim.

Resolutions of disputes over amending claims after the bar date frequently turn on the knowledge which the

complaining party had of the claim before it was formally set forth in the amendment. n35 When it can be established that the amended claim comes as a surprise, particularly one of such magnitude that the administration of the case or the ability to reorganize will be seriously impaired, then such a new claim should be disallowed. n36 It follows that in cases where the debtor or other objecting party was aware of the claim all along, it will be much more difficult to show sufficient prejudice to prevent the amendment. n36a A corollary to the rules governing amended claims applies to amended objections. If a bar date on objections is imposed, amendments after that date which merely amplify the original objection should be allowed; those which present new arguments should not. n37

The courts will weigh the "equities" in deciding whether to allow the amendment. n38 Reliance by the other parties in the case upon the original claim as to the amounts, types, and priorities of the taxes reflected will often be critical. n39 One court of appeals has held that where a debtor filed a claim on behalf of the Service after the bar date for creditors to file had passed without a filing, the Service would be permitted to file an amended claim which increased the amount of the taxes by over 400%. n40 Although the amount increased, the type of tax and the tax period involved remained the same. The debtor's argument that the filing of the amended claim came shortly before a hearing on his proposed chapter 11 plan and imperiled his likelihood of obtaining confirmation was unavailing. Acknowledging that the purpose of bar dates was in part to define the universe of claims, the court also explained that amendments were to be freely permitted to cure defects in the claim as originally filed, to describe the claim with more particularity, or to plead new theories of recovery on the facts set forth in the original claim. n41 Adhering to the position that the equities of the case were often controlling, the court of appeals held that the bankruptcy court had not abused its discretion by allowing the amendment. It is clear that the ultimate decision on whether to permit an amendment of a claim is one committed to the discretion of the bankruptcy court and one which is to be made upon the unique facts of each case. n41a

[4] Filing Claims on Behalf of the IRS

In some cases under title 11, the Service will deliberately elect not to file a proof of claim even though the debtor may have an outstanding prepetition tax liability. The most obvious situation in which the IRS may decline to file a claim is the "no asset" case. If there will be no assets available to pay the tax claim, the Service is likely to conclude that filing a claim is a pointless exercise. It is not necessary for the Service to file a proof of claim in order that its claim survive the general discharge granted to an individual debtor. n42 The prepetition debts of a corporate debtor would not be discharged in a liquidation case; n43 because a corporate debtor with no assets would not survive the bankruptcy process, the question of discharge would normally not occur.

When the IRS either intentionally or unintentionally fails to file a proof of claim, a question may arise as to whether the debtor, the trustee or another party who may be liable to the Service along with the debtor should file a claim on the IRS's behalf. n44 Even in a no asset case, the debtor may choose to file a claim on behalf of the IRS and object to it in order to create a jurisdictional basis for the determination of its tax liability, or the dischargeability thereof, by the bankruptcy court. n45 This course is not without risk since filing a claim on behalf of the IRS may permit it to amend and substantially increase the amount of its claim. n46

Another factor which might motivate a debtor who faces the prospect of a nondischargeable tax claim to file a claim on behalf of the IRS is the desire to have the nondischargeable claim reduced by whatever payments would be available from the bankruptcy estate. In this situation, the debtor may file on behalf of the IRS even though he or she has no dispute with the amount asserted. Other circumstances that may lead to the filing of a claim on behalf of the IRS include the potential liability of another party for the same underlying tax debt that could be asserted against the debtor. Specific instances in which this strategy could be attractive would include partners of parties who file petitions under title 11, present or former spouses who are not parties to a case under title 11, n47 present or especially former members of corporate groups that filed consolidated income tax returns and are jointly liable along with the debtor corporation for prepetition years, and individuals besides the debtor who may be liable for the failure to withhold and pay over to the Service taxes as "responsible persons." n48 Here again, the strategy would be to reduce the amount of the liability which could be asserted against the nondebtor party by the amounts paid to the Service from the bankruptcy estate.

[5] Burden of Proof

The question of which party should bear the burden of proof during the litigation of objections to federal tax claims in cases under title 11 had perplexed the courts for a number of years. n48a In 2000, a unanimous Supreme Court dispositively answered the question by rejecting the notion of a unique rule in cases under title 11 which allocated the burden of proof in a manner contrary to the rules that applied in the other courts in which tax controversies could be litigated. n48b Before discussing the Supreme Court's decision, we shall first consider the background of this contentious issue. The discussion will conclude with an analysis of the statutory exception to the burden of proof rules for federal tax litigation created in 1998.

[a] Background and Prior Law

In proceedings before the Tax Court, the taxpayer, as the party seeking a redetermination of the liability asserted by the Commissioner in a notice of deficiency, has the burden of proof. n49 If the taxpayer sues for a refund in either a district court or the Court of Federal Claims, an even heavier burden is imposed. The taxpayer is required to prove that the tax liability asserted by the government is incorrect and also has to prove the correct amount of the tax liability. n50 In all three courts, the taxpayer has to discharge the burden of proof imposed on him or her by satisfying the preponderance of the evidence standard.

When an objection to a creditor's claim is adjudicated by a bankruptcy court, the general rule is that a properly filed proof of claim is deemed to be *prima facie* evidence of the validity and amount of the claim. n51 The objecting party may overcome this *prima facie* case and place the burden on the claimant, who always bears the ultimate burden, at a much lower threshold than under the preponderance of the evidence standard. n52 The threshold, however, cannot be ignored by the objecting party. n53

Historically, the issue became whether to apply the general rule placing the burden of proof on the taxpayer or the general rule placing the burden on the claimant as soon as the *prima facie* case had been rebutted. Congress did not provide an answer in the Bankruptcy Code, leaving the question open to a wide variety of often conflicting judicial answers. n54 Courts that imposed the burden of proof on the Service generally concluded that it should be treated the same as every other creditor in the claims objection process. n55 Despite the egalitarian appeal of this position, it overlooked the frequent disparate treatment of the government as tax-creditor found in the Bankruptcy Code in such matters as the priority and dischargeability of claims. n55a Those courts which imposed the burden of proof on the taxpayer frequently focused on the rationale for placing the burden of proof on the taxpayer outside the bankruptcy arena. n56 The common law rule placing the burden on the party with access to the facts was considered particularly applicable in a self-assessment system that provides for the taxpayer to make the initial determination of liability. n57

In their search for an answer to this question, some courts focused on whether the taxes which were the subject of the objection had been formally assessed by the Service. An assessment carried with it a presumption of correctness which had to be overcome by the taxpayer. n58 Some courts held that if the taxes were not assessed before the petition under title 11 was filed, there was no presumption of correctness, and the burden of proof could therefore be placed upon the Service. n59 The opinions of these courts did not address the essentially formal nature of a tax assessment and ignored the determination by the Service of the amount it contended to be due following the completion of its examination of the taxpayer's return as the fundamental basis for the presumption of correctness. More decisively, they ignored the rule in the Tax Court which placed the burden of proof on the taxpayer when the very issue to be determined was the amount of the taxes to be assessed at the conclusion of the proceeding. n60

[b] Supreme Court's Decision in *Raleigh v. Illinois Department of Revenue*

The controversy over which party had the burden of proof when a tax claim was litigated in a bankruptcy court was resolved by the Supreme Court's decision in *Raleigh v. Illinois Department of Revenue*. n61 Although the case involved

state instead of federal taxes, the Court made no distinction between them in its opinion, citing cases concerning federal and state taxes interchangeably. Noting that the courts of appeals had split four circuits to three in favor shifting the burden of proof to the taxing authority, the Court affirmed the Seventh Circuit's decision that the burden should be the same as it would have been had the proceedings taken place outside of a case under title 11. n62

The Court held that the burden of proof was a substantive aspect of a claim, and, therefore, that it was "an essential element of the claim itself." Tax law, according to the Court, was no exception to this general rule. Several rationales were offered in support of this conclusion: the government's vital interest in collecting revenue, the taxpayer's readier access to relevant information, n63 and the importance of encouraging voluntary compliance by giving taxpayers incentives to self-report and maintain adequate records. The Court acknowledged that Congress had the authority to alter entitlements in bankruptcy, including the allocation of the burden of proof, but in the absence of specific provision in the Bankruptcy Code making such an alteration, statutory silence meant that no change was intended.

Having explained its decision, the Court proceeded to consider and reject various arguments advanced by the trustee. The contention that in bankruptcy the payment of a tax debt fell not upon the original taxpayer but upon "other innocent creditors" could not overcome the lack of any authority to support an alteration of the substantive law. An apparent extension of this argument to require "a compensating equality of treatment [between creditors] when it comes to demonstrating the validity of claims" was rejected as well.

But the scope of a bankruptcy court's equitable power must be understood in the light of the principle of bankruptcy law discussed already, that the validity of a claim is generally a function of underlying substantive law. Bankruptcy courts are not authorized in the name of equity to make wholesale substitution of underlying law controlling the validity of creditors' entitlements, but are limited to what the Bankruptcy Code itself provides. n63a

The Court concluded that the "uncertainty and increased complexity" resulting from the trustee's position were another reason "to stick with the simpler rule" that in the absence of a modification expressed in the Bankruptcy Code, the burden of proof remained where substantive law put it. *Raleigh* also maintains the burden of persuasion on taxpayers in bankruptcy proceedings. n63b

[c] The Statutory Exception to the Allocation of the Burden of Proof

Although the Bankruptcy Code has made no modification of the traditional rule placing the burden of proof on the taxpayer, since 1998, the Internal Revenue Code has done so by permitting a shift to the government in certain circumstances. n63c

The IRS Restructuring and Reform Bill of 1998 n64 was signed into law on July 22, 1998, and added, among other things, a new section 7491 "Burden of Proof" to the Internal Revenue Code. This section shifts the burden to the Government in some, but not all, tax cases. This provision applies to cases involving income, estate and gift taxes in which the taxpayer is an individual or a partnership, corporation or trust with a net worth that does not exceed \$7,000,000 and that has fewer than 500 employees. Individuals and other taxpayers who satisfy the net worth requirements must also produce "credible evidence" to support their position, establish that they have complied with the Internal Revenue Code's substantiation and record keeping requirements, n65 and have "cooperated with reasonable requests by the Secretary for witnesses, information, documents, meetings, and interviews." n66 By its own language, this new provision does not apply to cases involving withholding or excise taxes, or to any cases in which the taxpayer is large partnership, corporation, or trust. The new statute also sets the stage for satellite litigation over the net worth limitation, what constitutes "credible evidence," n66a compliance with substantiation and record keeping requirements, "reasonable cooperation," n67 and net worth requirements. The statute also provides that the Government will have the burden of "production" with respect to penalty issues. n68 In light of *Raleigh's* remarks about the burden of proof remaining the same absent some modification by the Bankruptcy Code, bankruptcy courts will presumably apply the

section 7491 exception in a manner consistent with the other courts in which it may arise. n68a

FOOTNOTES:

(n1)Footnote 1. Except for the question of subordination, these issues are discussed in *P TX4.01 et seq. supra*. Subordination is discussed in *P TX5.11 infra*.

(n2)Footnote 2. 11 U.S.C. § 501(a). The authority of the IRS to file a proof of claim for taxes on behalf of the United States is predicated upon 26 U.S.C. §§ 7801, 7802(a). *In re Harrison*, 177 B.R. 564 (Bankr. S.D. Ohio 1994) ; *Schibilsky v. United States (In re Schibilsky)*, 185 B.R. 81 (Bankr. N.D. Ga. 1995) . For a consideration of situations in which the IRS might decline to file a proof of claim, see *P TX5.03[4] infra*.

(n3)Footnote 3. *Fed. R. Bankr. P. 3001(a) and (b)*. The 1991 Amendments to the Bankruptcy Rules and Official Forms amended *Bankruptcy Rule 1001* by changing the citation form of the Bankruptcy Rules to the "Federal Rules of Bankruptcy Procedure." Subsequent references to the "Bankruptcy Rules" or the "Rules" in this chapter refer to the Federal Rules of Bankruptcy Procedure. It has been held that a document may qualify as an "informal claim" if it states an explicit demand showing the nature and amount of the claim against the estate. *Sambo's Restaurants, Inc. v. Wheeler (In re Sambo's Restaurants, Inc.)*, 754 F.2d 811, 12 C.B.C.2d 173 (9th Cir. 1985) . See also *Pizza of Hawaii, Inc. v. Shakey's, Inc. (In the Matter of Pizza of Hawaii, Inc.)*, 761 F.2d 1374, 12 C.B.C.2d 1227 (9th Cir. 1985) .

(n4)Footnote 4. *Taylor v. Internal Revenue Service (Matter of Taylor)*, 132 F.3d 256, 262 (5th Cir. 1998) , citing the *Treatise*. 11 U.S.C. § 501(c) and *Fed. R. Bankr. P. 3004* permit the debtor, or a trustee, if one has been appointed, to file a claim on behalf of a creditor who fails to file one. Similar rights for other parties who may be liable for the same debt are provided by 11 U.S.C. § 501(b) and *Federal Rule of Bankruptcy Procedure 3005*. A creditor is allowed a period of an additional 30 days after the bar date to file its own claim. The factors influencing the decision whether to file on the Service's behalf are discussed in *P TX5.03[4] infra*.

(n5)Footnote 5. *Fed. R. Bankr. P. 3002*. Note that the United States is expressly authorized to request an extension of time. *Fed. R. Bankr. P. 3002(c)(1)*. Notwithstanding the provisions of *Rule 3002*, the Bankruptcy Code was amended in 1994 to provide the 180-day period for governmental units to file their proofs of claim. 11 U.S.C. § 502(b)(9).

(n6)Footnote 6. *Fed. R. Bankr. P. 3003*. *In re Oxford Royal Mushroom Products, Inc.*, 93 B.R. 390, 394-5 (Bankr. E.D. Pa. 1988) . It is not necessary for a creditor to file a claim if the claim is correctly scheduled by the debtor unless the claim is scheduled as disputed, contingent or unliquidated.

(n7)Footnote 7. *Fausett v. Murner*, 402 F.2d 961 (5th Cir. 1968) . The limitations upon a creditor's right to file superseding claims are considered in *P TX5.03[3] infra* .

(n8)Footnote 8. IRS Form 6338. It is not necessary for the IRS to have assessed the taxes prior to including them in the proof of claim; nor is the claim deficient because the IRS was forced to use an estimated amount. *In re White*, 168 B.R. 825 (Bankr. D. Conn. 1994) . The requirements of what constitutes an adequate proof of claim for the IRS were discussed by the district court in *United States v. Braunstein (In re Pan)*, 209 B.R. 152 (D. Mass. 1997) . Another district court held that failure of the IRS to sign its original proof of claim did not render it defective when a signed amended claim was filed the following day, that there was no requirement that the IRS claim be made under oath, and that the IRS claim did not require supporting documentation to accompany it since it was based upon federal statutes. *Vines v. Internal Revenue Service (In re Vines)*, 200 B.R. 940 (M.D. Fla. 1996) . The court emphasized that the debtor had not been prejudiced and had received adequate notice of the IRS claim.

The IRS is not required to obtain authorization from the Secretary of the Treasury or the Attorney General before filing a proof of claim for delinquent taxes. *Bozich v. Internal Revenue Service (In re Bozich)*, 212 B.R. 354 (Bankr. D.

Ariz. 1997) , *aff'd*, 242 B.R. 704 (D. Ariz. 1999) . Nor is the IRS required to obtain a judgment against a debtor before filing a proof of claim. *In re Larsen*, 232 B.R. 482 (Bankr. D. Wyo. 1998) . Supporting documentation is not required when the IRS files a proof of claim because the claim is based upon a statute, not a "writing" as described by *Federal Rule of Bankruptcy Procedure* 3001(c). *In re Shaver*, 43 C.B.C.2d 1150, 247 B.R. 436 (Bankr. E.D. Tenn. 1999) ; *In re Boehm*, 255 B.R. 686 (Bankr. E.D. Ky. 2000) ; *Carlisle v. U.S. Department of Justice (In re Carlisle)*, 320 B.R. 796 (M.D. Pa. 2004) .

The production by the IRS of a Form 4340 ("Certificate of Assessments and Payments") creates the presumption of a valid assessment of the taxes included on a proof of claim. *March v. Internal Revenue Service (In re March)*, 335 F.3d 1186 (10th Cir. 2003) .

(n9)Footnote 9. *See, e.g., United States v. Ripley*, 926 F.2d 440 (5th Cir. 1991) . Individual debtors in cases under chapters 7 and 11, or the trustees in such cases, have the option to terminate a tax year when a petition under title 11 is filed. 26 U.S.C. § 1398(d)(2). Several circuits have held that corporate debtors may achieve essentially the same result and pro-rate their tax liabilities between the pre- and postpetition portions of the year in which their title 11 petition is filed. *United States v. Hillsborough Holdings Corporation (In re Hillsborough Holdings Corporation)*, 116 F.3d 1391 (11th Cir. 1997) ; *Towers v. United States (In re Towers)*, 64 F.3d 1292 (9th Cir. 1995) . The results in these cases involving corporate debtors were overturned in 2005 when Section 507(a)(8) was amended to provide that it applied only to tax years ending on or before the petition date. Accordingly, the entire year during which a petition is filed will be an administrative expense.

(n10)Footnote 10. 11 U.S.C. § 502(a).

(n11)Footnote 11. 11 U.S.C. § 1109(b) grants a creditor or a creditors' committee the "right to be heard" on any issue in a case under chapter 11. Obviously a committee of unsecured creditors will have an interest in the amount of a claim with high priority, like a tax claim, which will conceivably reduce the funds available to pay claims of committee members. Whether the right to be heard under such circumstances equates to the right to participate as a litigant is less clear. Some courts have held that if the debtor in possession fails to pursue a cause of action against an insider such as the sole shareholder of a debtor corporation, then the committee may seek permission from the court for authority to pursue the cause of action on behalf of the bankruptcy estate generally. The extent of the rights of other creditors to participate has produced widely divergent answers. *Compare Official Unsecured Creditors' Committee v. Michael (In re Marin Motor Oil, Inc.)*, 689 F.2d 445, 7 C.B.C.2d 470 (3d Cir. 1982) , *cert. denied*, 459 U.S. 1207, 103 S. Ct. 1196, 75 L. Ed. 2d 440 (1983) with *Fuel Oil Supply and Terminaling v. Gulf Oil Corp.*, 762 F.2d 1283, 12 C.B.C.2d 1381 (5th Cir. 1985) . *See generally* 7 *Collier on Bankruptcy*, P 1109.05[1] (Matthew Bender 15th Ed. Revised). It can be argued that the same rationale would allow a creditors' committee to take up the mantle and object to a tax claim if the debtor or the trustee failed to do so. Stretching the rationale to permit a committee to join with the debtor or trustee in "double-teaming" the Service is a dubious proposition. *In re Industrial Commercial Electrical Inc.*, 304 B.R. 24 (Bankr. D. Mass. 2004) (an unsecured creditors' committee was permitted to prosecute an objection to an IRS claim originally filed by the debtor). It is clear that only one set of professionals can be paid from the bankruptcy estate for performing a particular service. *See* 3 *Collier on Bankruptcy* P 330.05[2][a][i] (Matthew Bender 15th Ed. Revised).

(n12)Footnote 12. *Fed. R. Bankr. P.* 3007.

(n13)Footnote 13. *Fed. R. Bankr. P.* 3007.

(n14)Footnote 14. *Simmons v. Savell*, 765 F.2d 547 (5th Cir. 1985) .

(n15)Footnote 14a. A bankruptcy court held that it would be inequitable to allow a debtor to withdraw an objection at the commencement of trial merely to avoid an adverse adjudication. *In re Wotkins*, 274 B.R. 690 (Bankr. S.D. Tex. 2002) .

(n16)Footnote 15. *Fed. R. Bankr. P. 9014*. *Fed. R. Bankr. P. 9014* enumerates which of the adversary rules (set forth in Part VII of the Federal Rules of Bankruptcy Procedure) will apply automatically and permits the bankruptcy court to invoke additional adversary rules as it sees fit. *Fed. R. Bankr. P. 1017, 1019, 2002, 2003, 3020, 3021, 4001, 4004, 4007, 6004, 6006, 7001, 7004, 7062, 9006 and 9014* of the Federal Rules of Bankruptcy Procedure, are amended, effective December 1, 1999.

(n17)Footnote 16. *Fed. R. Bankr. P. 7004(b)(4)*. *In re Morrell*, 69 B.R. 147 (N.D. Cal. 1986) ; *In re Simms*, 33 B.R. 792 (N.D. Ga. 1983) ; *In re Hernandez*, 173 B.R. 430 (N.D. Ala. 1994) ; *United States v. Keister*, 75 A.F.T.R. 2d P 95-669 (M.D. Fla. 1995) ; *Laughlin v. United States (In re Laughlin)*, 210 B.R. 659 (B.A.P. 1st Cir. 1997) . For the contrary and minority view, see *In re Hejl*, 85 B.R. 399 (Bankr. W.D. Tex. 1988) . Note, however, that on appeal *Hejl* was vacated and remanded in an unreported opinion. *Internal Revenue Service v. Hejl (In re Hejl)*, Case No. MO-88-Ca-165 (W.D. Tex. Oct. 12, 1988) (*Quoting Zapata v. Smith*, 437 F.2d 1024 [5th Cir. 1971] , "The United States cannot be sued behind its back."). Another district court reached a similar result and declined to follow the bankruptcy court's decision in *Hejl*. See *United States v. Oxyllance Corporation*, 115 B.R. 380 (N.D. Ga. 1990) . Subsequent to *Hejl*'s reversal, a different bankruptcy court in the same district held that the IRS is entitled to the statutory due process provided by the Bankruptcy Code, including notice, and permitted the filing of a claim after the bar date when notice was not given. *In re Vaughn*, 151 B.R. 87 (Bankr. W.D. Tex. 1993) . See generally: *United States v. Cardinal Mine Supply, Inc.*, 916 F.2d 1087, 1091 (6th Cir. 1990) ("implicit in the strict time requirements of the bankruptcy rules is the assumption that a creditor has received notice of the bankruptcy petition"), quoting *Merrill Lynch, Pierce, Fenner & Smith v. Dodd*, 82 B.R. 924 (N.D. Ill. 1987) . In a nontax case, a district court explained the rationale for this rule: "In light of the comparatively lenient procedure in bankruptcy, persons effecting service must provide correct notice in accordance with the rules. Thus, strict compliance with *Rule 7004* serves to protect due process rights as well as assure bankruptcy matters proceed expeditiously." *In re M & L Business Machine Co., Inc.*, 190 B.R. 111, 115-16 (D. Colo. 1995) . Failure to serve an objection to a tax claim in conformity with *Rule 7004* resulted in a bankruptcy court's overruling it, but the court went on to hold that notice of an amended plan and confirmation hearing did not have to be served pursuant to *Rule 7004* and that the IRS would be bound by the terms of the plan. *In re Swanson*, 312 B.R. 153 (Bankr. N.D. Ill. 2004) .

Following the reorganization of the IRS, the location for serving process on it was changed to a single nationwide location--Internal Revenue Service, Special Procedures--Insolvency, P. O. Box 21126, Philadelphia, PA 19114. For a consideration of the distinction between notice and service of process in bankruptcy procedure as it relates to the IRS, see *Waggoner v. United States (In re Waggoner)*, 100 A.F.T.R.2d 6426 (Bankr. N. D. Tex. 2007) .

(n18)Footnote 17. *Fed. R. Bankr. P. 7026, 7028-7037*. Note that Rules 26-37 of the Federal Rules were substantially amended in 1993.

(n19)Footnote 18. 11 U.S.C. § 502.

(n20)Footnote 18a. A bankruptcy court does not "merely sit to allow or reject" the proof of claim. Instead, under 11 U.S.C. § 502(b), it must determine the correct amount of the claim. *Neilson v. United States (In re Olshan)*, 356 F.3d 1078, 1083 (9th Cir. 2004) .

(n21)Footnote 19. The attempt to defend such practices as being required to discharge fiduciary duties to other creditors may not be persuasive if the only result is the diminution of the bankruptcy estate with unnecessary work. A benefit to the title 11 estate is the *sine qua non* which justifies the payment of expenses from the estate in the first place. *In re Watervliet Paper Co., Inc.*, 109 B.R. 733 (Bankr. W.D. Mich. 1989) ; *In re Storms*, 101 B.R. 645 (Bankr. S.D. Cal. 1989) ; *In the Matter of Zweig*, 35 B.R. 37 (Bankr. N.D. Ga. 1983) . "A bankruptcy estate is not a cash cow to be milked to death by professionals seeking compensation for services rendered to the estate which have not produced a benefit commensurate with the fees sought." *In the Matter of Saybrook Mfg. Co., Inc.*, 108 B.R. 366, 371 (Bankr. M.D. Ga. 1989) . The mere possibility that the IRS might unilaterally choose to reduce its assessment against the debtors was simply not a valid basis to object to its claim. *In re Vastag*, 345 B.R. 882 (Bankr. N.D. Ill. 2006) .

(n22)Footnote 20. The concept of a "prepayment forum" for litigating tax disputes is discussed in *P TX5.04[2] infra*.

(n23)Footnote 21. *United States v. Ripley*, 926 F.2d 440 (5th Cir. 1991) ; *In re Rasbury*, 93-1 U.S. Tax Cases (C.C.H.) P 50,351 (N.D. Ala. 1993).

(n24)Footnote 22. *I.R.C. § 6501(a)*.

(n25)Footnote 23. *In re Burruss*, 65 B.R. 407 (Bankr. D. Md. 1986) . *Burrus* held that official notice is required, and that informal notice to an unidentified revenue agent is not sufficient to bar the claim as late. *See also In re Vaughn*, 151 B.R. 87 (Bankr. W.D. Tex. 1993) (when the IRS is omitted from the list of creditors, concepts of due process demand the IRS be allowed to file a late claim); *In re Cole*, 146 B.R. 837 (D. Colo. 1992) . Fundamental fairness required that the IRS be allowed to file claims after the bar date in chapter 13 cases where it had not been given notice of the filing of the case. *Internal Revenue Service v. Hildebrand (In re Brown)*, 43 C.B.C.2d 942, 245 B.R. 287 (E.D. Tenn. 2000) , *appeal dismissed*, 248 F.3d 484 (6th Cir. 2001) . A contrary view led a district court to affirm a bankruptcy court's disallowing IRS claims filed after the bar date in two Chapter 13 proceedings even though the IRS did not receive timely notice. However, the IRS claims would not be discharged due to the lack of notice. *United States v. Meyer*, 2004 U.S. Dist. LEXIS 19399 (N.D. Ill. 2004) .

(n26)Footnote 24. *In re Sitzberger*, 65 B.R. 256 (Bankr. S.D. Cal. 1986) . The United States is expressly authorized to request an extension of time under *Fed. R. Bankr. P. 3002(c)(1)*.

(n27)Footnote 25. *In re Oxford Royal Mushroom Products, Inc.*, 93 B.R. 390, 394-5 (Bankr. E.D. Pa. 1988). *Contra In re Moro Supply Company*, 229 F. Supp. 129 (E.D. Ark. 1963) .

(n28)Footnote 26. *In the Matter of Burrell*, 85 B.R. 799 (Bankr. N.D. Ill. 1988) .

(n29)Footnote 27. *See 11 U.S.C. § 726. In re Kragness*, 82 B.R. 553 (Bankr. D. Or. 1988) ; *In re Seminole Backhoe, Inc.*, 33 B.R. 914 (Bankr. N.D. Tex. 1983) . *But see Pettibone Corporation v. United States (In re Pettibone Corporation)*, 151 B.R. 156 (Bankr. N.D. Ill. 1992) (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 granted the government's motion to enlarge the time for filing claims even though the bar date had passed). When a chapter 11 proceeding was later converted to a chapter 7 proceeding, the IRS claim for taxes incurred during the chapter 11 case was subject to the chapter 7 bar date. *In re Johnson*, 901 F.2d 513 (6th Cir. 1990) . However, in a nontax case, a bankruptcy court reached a different conclusion. *In re Pro Set, Inc.*, 193 B.R. 812 (Bankr. N.D. Tex. 1996) .

(n30)Footnote 28. 507 U.S. 380, 113 S. Ct. 1489, 123 L. Ed. 2d 74, 28 C.B.C.2d 267 (1993) .

(n31)Footnote 29. *Pioneer Investment Services Co. v. Brunswick Associates Limited Partnership*, 507 U.S. 380, 395, 113 S. Ct. 1489, 123 L. Ed. 2d 74, 28 C.B.C.2d 267, 276 (1993) . For a thoughtful application of the *Pioneer* factors in a case involving a late claim by a state taxing authority, *see In re Cable & Wireless USA, Inc.*, 338 B.R. 609 (Bankr. D. Del. 2006) .

(n32)Footnote 30. *In re Papp International*, 189 B.R. 939 (Bankr. D. Neb. 1995) . Another bankruptcy court held that the excusable neglect standard of *Fed. R. Bankr. P. 9006(b)(1)* was not available to enlarge time for creditors in chapter 7 cases to file claims. It nevertheless concluded that section 726(a) required that the tax claim maintain its priority status since no distributions had been made. *In re M.A.P. Restaurant Inc.*, 191 B.R. 519 (Bankr. D.R.I. 1996) . In a Chapter 11 case, even though no plan had been proposed, a bankruptcy court held that an IRS claim filed seven months late was prejudicial to the debtor because he had already concluded several settlements with other creditors. After balancing the *Pioneer Investments* factors, the court disallowed the claim as untimely. *Seivers v. United States (In re Seivers)*, 378 B.R. 473 (Bankr. W.D. Pa. 2007) . A postpetition tax claim filed after the bar date for claims for administrative expenses was denied as untimely, even though it was filed within three months of the filing of the return

for the period in issue and well within the 180 days the IRS would have to review a return when a section 505(b) request was made. The bankruptcy court, noting that the Second Circuit takes a "hard line" approach to the excusable neglect standard of *Pioneer Investment Services*, pointed out that the IRS could have filed a timely estimated claim and later amended it. *In re PT-1 Communications, Inc.*, 403 B.R. 250 (Bankr. E.D.N.Y. 2009) .

(n33)Footnote 31. In *Internal Revenue Service v. Century Boat Company (In re Century Boat Company)*, 986 F.2d 154 (6th Cir. 1993) , the Court of Appeals for the Sixth Circuit ruled that 11 U.S.C. § 726(a)(1) made no distinction between priority claims which are filed late and those which are filed in a timely manner. The court held that the priority regime established by the Bankruptcy Code was more important than timeliness. The other circuits generally reached the same conclusion. *In re Vecchio*, 20 F.3d 555 (2d Cir. 1994) ; *United States v. Towers (In re Pacific Atlantic Trading Co.)*, 33 F.3d 1064 (9th Cir. 1994) ; *In re Davis*, 81 F.3d 134 (11th Cir. 1996) ; and *Cooper v. Internal Revenue Service (In re Bulldog Trucking Co.)*, 167 F.3d 857 (4th Cir. 1999) . But see *United States v. Waindel (In re Waindel)*, 65 F.3d 1307 (5th Cir. 1995) . *Waindel* was described as the minority view in *Solow v. United States (In re Johnson Rehabilitation Nursing Home, Inc.)*, 239 B.R. 168 (Bankr. N.D. Ill. 1999) .

However, the rule was not held to be absolute; if distributions had already been made when the late claim was filed, the claim could lose its priority status. A similar result was reached by *In re Rago*, 149 B.R. 882 (Bankr. N.D. Ill. 1992) . The *Rago* court did note that if a priority claim is filed after the bar date, it may be appropriate to subordinate the late claim to timely filed priority claims. Typically, the IRS has been the party asserting its right to priority status for a tax claim filed after the bar date; however, individual debtors in chapter 7 proceedings may raise the same argument when the unpaid tax will become part of a nondischargeable claim. *In re Miller*, 171 B.R. 163 (Bankr. S.D. Fla. 1994) . Where a debtor had an opportunity to raise the timeliness of the filing of an IRS claim in a prior adversary proceeding and failed to do so, the doctrine of *res judicata* precluded him from asserting the issue in a subsequent objection. *In re Aggeler*, 99-2 U.S. Tax Cas. (CCH) P 50,708 (W.D. Mich. 1999).

(n34)Footnote 32. Compare *In re Hausladen*, 146 B.R. 557 (Bankr. D. Minn. 1992) (en banc) with *In re Zimmerman*, 156 B.R. 192 (Bankr. W.D. Mich. 1993) (en banc). The Court of Appeals for the Ninth Circuit distinguished its earlier decision allowing a late tax claim in a chapter 7 case, *U.S. v. Towers (In re Pacific Atlantic Trading Co.)*, 33 F.3d 1064 (9th Cir. 1994) , and refused to allow one in a chapter 13 case. *United States v. Osborne (In re Osborne)*, 76 F.3d 306 (9th Cir. 1996) . The Court of Appeals for the Fifth Circuit offered a unique response to the same question, holding that a late tax claim in a chapter 13 case should not be disallowed but should lose its first-tier priority status under section 726(a)(1). *United States v. Waindel (In re Waindel)*, 65 F.3d 1307 (5th Cir. 1995) . Note : These decisions all concerned cases which arose prior to the effective date of the Bankruptcy Reform Act.

In a case where the title 11 case was dismissed and then reinstated within the 180-day period for the filing of tax claims, the IRS was not entitled to equitable tolling for the period of the dismissal in order to extend the bar date. *Gardenhire v. United States (In re Gardenhire)*, 209 F.3d 1145 (9th Cir. 2000) .

(n35)Footnote 32a. Section 726(a) was amended again by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, reprinted in Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised), to add that when a Chapter 7 trustee mails creditors a summary of his final report before distribution commences, any tardily filed priority claim must be filed within ten days of the mailing the report.

(n36)Footnote 33. A tax claim filed after a Chapter 7 trustee filed his final report but before it had been approved by the bankruptcy court was timely since distributions could not begin until the report was approved. *In re Anderson*, 275 B.R. 922 (B.A.P. 10th Cir. 2002) .

(n37)Footnote 34. Compare *In re Kolstad*, 928 F.2d 171 (5th Cir. 1991) , reh. den., 936 F.2d 571 (5th Cir. 1991) with *In re International Horizons, Inc.*, 751 F.2d 1213, 12 C.B.C.2d 91 (11th Cir. 1985) ; *In the Matter of Stavriotis*, 977 F.2d 1202 (7th Cir. 1993) . See also *In re Jagours*, 236 B.R. 616 (Bankr. E.D. Tex. 1999) (an amended claim relates back to the filing of the original claim and, therefore, must bear a relationship to the original claim and must

simply be a correction or supplementation of that claim supported by the same operative facts that gave rise to the original claim; the addition of another income tax liability to an existing claim is not an amendment but a new claim for a new tax year); *In re Barton*, 151 B.R. 110, 115 (Bankr. W.D. Mich. 1993) (an attempt by the IRS to add a claim for a new type of tax to an existing claim after the bar date is treated as a late-filed new claim; if the IRS adds a claim for additional quarters or periods of taxes similar to those on the original claim, they may be added as an amendment to the existing claim). *But see Jackson v. IRS (In re Jackson)*, 220 B.R. 273 (Bankr. W.D. Va. 1998), allowing a substantial amendment of a timely claim after the bar date where the debtor was aware of the liability and no other party could have been surprised by the amendment. Note that the Second Circuit in the case of *In re Vecchio*, 20 F.3d 555 (2d Cir. 1994), treated the disputed claim as late-filed rather than amended. The opinion makes clear that the claim was actually an amended claim that added a different type of tax and significantly increased the amount sought by the IRS after the bar date. Accordingly, the result in *Vecchio* is contrary to *International Horizons*, at least with respect to chapter 7 cases. In *United States v. Waindel (In re Waindel)*, 65 F.3d 1307 (5th Cir. 1995), a chapter 13 case, the Fifth Circuit rejected *Vecchio* and reached a result similar to *International Horizons* when an amendment would have changed the character of the claim. In a nontax case, the Fifth Circuit held that an amendment that would have changed an unsecured claim to a priority claim constituted a new claim. *Matter of Alliance Operating Corp.*, 60 F.3d 1174 (5th Cir. 1995). Subsequently, in a tax case, a Fifth Circuit district court held that the IRS could amend its claim to assert a security interest in certain real property not scheduled by the debtor after confirmation of a Chapter 13 plan. *United States v. Johnston*, 267 B.R. 717 (N.D. Tex. 2001). As a general proposition, however, amendments to claims should be permitted unless other parties would be "unduly" prejudiced. *In re Higgins*, 8 C.B.C.2d 500, 29 B.R. 196 (Bankr. N.D. Iowa 1983).

(n38)Footnote 35. *Fausett v. Murner*, 402 F.2d 961, 963 (5th Cir. 1968): "Where there are enough facts appearing in the record to establish a claim against the bankrupt, it may, in a proper case, be a basis for amendment." *Walsh v. Lockhart Associates*, 339 F.2d 417 (5th Cir. 1964), cert. denied, 380 U.S. 953, 85 S. Ct. 1085, 13 L. Ed. 2d 970 (1965). *But see In the Matter of Paul R. Dean Co., Inc.*, 460 F. Supp. 447 (W.D.N.Y. 1978); *In the Matter of Vega Baja Lumber Yard, Inc.*, 285 F. Supp. 143 (D.P.R. 1968); *In the Matter of Appling*, 162 B.R. 43 (Bankr. M.D. Ga. 1993).

(n39)Footnote 36. *In re International Horizons, Inc.*, 751 F.2d 1213, 12 C.B.C.2d 91 (11th Cir. 1985); *In re A. M. Int'l, Inc.*, 67 B.R. 79 (N.D. Ill. 1986). See also *In re Pyramid Bldg. Co.*, 87 B.R. 38 (Bankr. N.D. Ohio 1988).

(n40)Footnote 36a. With a claims bar date approaching, the IRS filed a claim for \$584,000 and marked it "PENDING EXAMINATION." The debtor had been uncooperative and had refused to produce its books and records. The audit was completed, and an amended claim for \$2.8 million was filed after confirmation of Chapter 11 plan. Overruling an objection that the amendment was untimely, the bankruptcy court held that the amended claim should be allowed under *International Horizons*, *supra*, n.36. *In re Telephone Company of Central Florida*, 308 B.R. 579 (Bankr. M.D. Fla. 2004).

(n41)Footnote 37. *In re Eden*, 141 B.R. 121 (Bankr. W.D. Tex. 1992).

(n42)Footnote 38. *Fausett v. Murner*, 402 F.2d 961, 963 (5th Cir. 1968); *In re Barton*, 151 B.R. 110, 115-16 (Bankr. W.D. Mich. 1993) (the debtor's failure to fully assist the IRS in determining all his liabilities is more intolerable than the IRS's failure to obtain an extension of the bar date). In a case where the IRS provided sufficient and timely notice of its claim by originally filing an estimated claim, supplied the trustee with subsequently obtained information, and displayed diligence by promptly filing an amended claim following receipt of the debtor's delinquent return, the bankruptcy court should have allowed the amendment even for a substantially higher amount than the original estimated claim. *United States v. Berger (In re Tanaka Brothers Farm, Inc.)*, 36 F.3d 996 (10th Cir. 1994). The equities weighed against the IRS when it attempted to amend a claim five years after the bar date to increase the amount of the claim by ten times. *In re Best Refrigerated Express, Inc.*, 204 B.R. 44 (Bankr. D. Neb. 1996). A breakdown in IRS information processing was not sufficiently excusable neglect to permit an amendment significantly increasing the amount of the tax claim and adding more years. *In re Nalle*, 125 B.R. 164 (Bankr. W.D. Tex. 1991). After Chapter 13

debtors had failed to file income tax returns for the years in question and the IRS had filed a timely estimated claim for those years, the IRS reacted to an objection to the estimated claim by filing an amended claim after the bar date but did not file a formal response to the objection until three days after the time for such responses. The bankruptcy court held that it would be highly inequitable to provide the debtors a "windfall" based upon this procedural defect and observed that it was "ironic" for the debtors to complain since they had been delinquent in filing their tax returns for several years. The amendment was allowed. *Warner v. United States (In re Warner)*, 95 A.F.T.R. 2d 425 (Bankr. M.D. Pa. 2004) .

(n43)Footnote 39. *In re Miss Glamour Coat Co., Inc.*, 80-2 U.S. Tax Cases (CCH) P 9737 (S.D.N.Y. 1980). Note the five criteria listed by the court. These five criteria were applied by the court in the case of *In re Barton*, 151 B.R. 110 (Bankr. W.D. Mich. 1993) , which allowed the IRS to amend its claim. A debtor successfully argued that a chapter 7 trustee did not show any prejudice to the administration of the proceeding that would result from an amendment of a nondischargeable tax claim when the IRS was not given adequate notice of the bar date. *In re Mmahat*, 73 A.F.T.R.2d 829 (Bankr. E.D. La. 1993) .

(n44)Footnote 40. *In re Kolstad*, 928 F.2d 171 (5th Cir. 1991) , *reh. den.*, 936 F.2d 571 (5th Cir. 1991) .

(n45)Footnote 41. *In re Kolstad*, 928 F.2d 171, 175 (5th Cir. 1991) , *reh. den.*, 936 F.2d 571 (5th Cir. 1991) .

(n46)Footnote 41a. *In re Goodman*, 261 B.R. 415 (Bankr. N.D. Tex. 2001) .

(n47)Footnote 42. 11 U.S.C. § 523(a)(1)(A). See *In re Higgins*, 8 C.B.C.2d 500, 29 B.R. 196 (Bankr. N.D. Iowa 1983) . See also 9 Collier on Bankruptcy, ch. 3004 (Matthew Bender 15th Ed. Revised). See also *Grynberg v. United States (In re Grynberg)*, 986 F.2d 367 (10th Cir. 1993) . The IRS was permitted to pursue a claim against individual chapter 11 debtors after consummation of their plan even though it had not filed a timely proof of claim. According to the court, the debtors had only themselves to blame since they could have filed a claim on behalf of the IRS and forced a determination of its dischargeability as part of the bankruptcy case. *Grynberg* was followed by the *Fein v. United States (In re Fein)*, 22 F.3d 631 (5th Cir. 1994) .

(n48)Footnote 43. 11 U.S.C. § 727(a)(1). 6 Collier on Bankruptcy, P 727.01[3] (Matthew Bender 15th Ed. Revised). See also *In re Goodman*, 873 F.2d 598 , 131 L.R.R.M. (BNA) 2129, 22 C.B.C.2d 1159 (2d Cir. 1989) ; *In re Zamost*, 7 B.R. 859 (Bankr. S.D. Cal. 1980) .

(n49)Footnote 44. 11 U.S.C. § 501(b) and (c); *Fed. R. Bankr. P. 3004 and 3005*.

(n50)Footnote 45. For an extensive discussion of why a debtor might wish to file a claim on behalf of the IRS and then object to it to create jurisdiction for the bankruptcy court to adjudicate the claim, see *In re Kilen*, 129 B.R. 538 (Bankr. N.D. Ill. 1991) . Note that where a Chapter 13 debtor attempts to file a claim for postpetition taxes in order to subject the taxing authority to having its claim paid under the plan and without interest, the courts have typically rejected the maneuver. See, e.g., *In re Flores*, 270 B.R. 203 (Bankr. S.D. Tex. 2001) .

(n51)Footnote 46. *In re Kolstad*, 928 F.2d 171 (5th Cir. 1991) , *reh. den.*, 936 F.2d 571 (5th Cir. 1991) . When a claim is filed on behalf of a creditor, its subsequent claim supersedes the one filed for it. *Fausett v. Murner*, 402 F.2d 961 (5th Cir. 1968) ; *In re Higgins*, 8 C.B.C.2d 500, 29 B.R. 196 (Bankr. N.D. Iowa 1983) . A debtor successfully objected to a trustee's attempt to avoid paying a priority tax claim filed after the bar date in a chapter 7 proceeding, where the taxes included in the claim would have been nondischargeable. *In re Miller*, 171 B.R. 163 (Bankr. S.D. Fla. 1994) .

(n52)Footnote 47. In a decision reviewed by the full court, the Tax Court held that a wife who did not join in her husband's case under title 11 was jointly and severally liable for an income tax debt which was not fully paid in the case under title 11. Rejecting her defenses of *res judicata* and collateral estoppel, the court held that the IRS could continue to pursue the unpaid balance from her. *Kroh v. Commissioner*, 98 T.C. 383 (1992) .

(n53)Footnote 48. *I.R.C. §§ 6671, 6672.*

(n54)Footnote 48a. The burden of proof issue also occurs in determinations of tax liability pursuant to 11 U.S.C. § 505 and is discussed in that context at P 5.04[6] *infra* .

(n55)Footnote 48b. *Raleigh v. Illinois Department of Revenue*, 530 U.S. 15, 120 S. Ct. 1951, 147 L. Ed. 2d 13, 43 C.B.C.2d 869 (2000) .

(n56)Footnote 49. *Welch v. Helvering*, 290 U.S. 111, 115, 54 S. Ct. 8, 9, 78 L. Ed. 212 (1933) ; *Tax Court Rule 142*. The Commissioner does have the burden of proof as to new matters raised by the Service after the notice of deficiency is issued, increases in the notice of deficiency, affirmative defenses and fraud. The Tax Court rules regarding burden of proof have been applied by bankruptcy courts. *See, e.g., In re Kelesyan*, 153 B.R. 927 (Bankr. M.D. Fla. 1993) .

(n57)Footnote 50. *King v. United States*, 641 F.2d 253 (5th Cir. 1981) .

(n58)Footnote 51. *Fed. R. Bankr. P. 3001(f)*.

(n59)Footnote 52. *Simmons v. Savell*, 765 F.2d 547 (5th Cir. 1985) .

(n60)Footnote 53. In a case where the IRS had filed a proof of claim on its standard Form 6338(c) and the objecting debtor offered no evidence, the court held that mere objection is not enough to rebut the *prima facie* case established by the filing of the proof of claim. *In re White*, 168 B.R. 825 (Bankr. D. Conn. 1994) . Legal memoranda and oral argument were not enough to satisfy the burden on the objecting party. The court also held that the debtor had the burden of proof with respect to affirmative defenses. Merely producing tax returns is not sufficient to satisfy an objecting party's burden. *In re Spirco, Inc.*, 95-2 U.S.T.C. P 50,330 (Bankr. W.D. Pa. 1995). Submission by the IRS of a Form 4340 ("Certificate of Assessments and Payments") creates the presumption that the taxes included on a proof of claim were properly assessed. *March v. Internal Revenue Service*, 335 F.3d 1186 (10th Cir. 2003) .

(n61)Footnote 54. The Court of Appeals for the Fourth Circuit has addressed the issue and concluded that Congress did not intend to alter the burden of proof by providing for the consideration of tax claims in the bankruptcy courts. *In re Landbank Equity Corp.*, 973 F.2d 265 (4th Cir. 1992) ; *compare Resyn Corp. v. United States*, 851 F.2d 660 (3d Cir. 1988) and *In the Matter of UNECO, Inc.*, 532 F.2d 1204 (8th Cir. 1976) (Act case) with *In re Fidelity Holding Co., Ltd.*, 837 F.2d 696 (5th Cir. 1988) . Curiously, the Court of Appeals for the Eighth Circuit subsequently cited *Fidelity Holding Co.* and stated that the objecting party must rebut the *prima facie* case established by the filing of a proof of claim to shift the burden of proof to the IRS. *In re Gran*, 964 F.2d 822 (8th Cir. 1992) . No mention of the seemingly contrary rule in its earlier *UNECO* decision was made. Since *Gran* affirmed decisions by the lower courts in favor of the IRS, the burden of proof point was not decisive; it does, however, reflect the considerable confusion this issue generated. After *Gran*, the Eighth Circuit affirmed another favorable decision for the IRS, noting without comment that the bankruptcy court had placed the burden of proof upon the IRS. *In re Brown*, 82 F.3d 801 (8th Cir. 1996) . The Court of Appeals for the Tenth Circuit has also affirmed a decision in favor of the IRS after holding that it had the burden of proof. *In re Fullmer*, 962 F.2d 1463 (10th Cir. 1992) . For a thoughtful, but ultimately incomplete, consideration of the factors involved, *see In re Premo*, 116 B.R. 515 (Bankr. E.D. Mich. 1990) .

(n62)Footnote 55. *In re Fidelity Holding Co., Ltd.*, 837 F.2d 696 (5th Cir. 1988) . Although the Fifth Circuit is the only court of appeals to hold against the IRS on grounds that the burden of proof may be shifted if the *prima facie* case established by the filing of its claim is overcome, that court did so by reaffirming its earlier holding in an opinion involving state taxes which did not mention any other case considering this issue and then explicitly extending *Fidelity Holding Co.* to the IRS. *In re Placid Oil Company*, 988 F.2d 554 (5th Cir. 1993) . The IRS issued an Action on Decision ("AOD") announcing that it did not acquiesce in the *Placid* decision. Subsequently, the Ninth Circuit held that a state taxing authority must bear the burden of proof. *Franchise Tax Bd. v. MacFarlane (In re MacFarlane)*, 83 F.3d 1041 (9th Cir. 1996) , *cert. denied*, 520 U.S. 1115, 117 S. Ct. 1243, 137 L. Ed. 2d 326 (1997) . *See also, In re Forte*,

234 B.R. 607, 618 (*Bankr. E.D.N.Y.* 1999) (a filed proof of claim is *prima facie* correct until rebutted by the debtor or other party; if the claim is rebutted, the burden of proof shifts back to the claimant as it is ultimately for the claimant to prove its claim rather than the debtor to disprove the claim; in the Second Circuit, there is no specific rule, but the majority of courts conclude that if the debtor produces evidence and demonstrates facts tending to defeat the *prima facie* proof of claim, the burden of proof will ultimately rest with the IRS).

(n63)Footnote 55a. *Thinking Machines Corp. v. New Mexico Taxation & Revenue Dept.*, 211 B.R. 426, 430 (D. Mass. 1997) , quoting the *Treatise* in a state tax controversy.

(n64)Footnote 56. *In re Landbank Equity Corp.*, 973 F.2d 265 (4th Cir. 1992) ; *Resyn Corp. v. United States*, 851 F.2d 660 (3d Cir. 1988) In *Landbank Equity Corp.*, the Court of Appeals for the Fourth Circuit concluded:

[U]pon review of the code and its legislative history, we find nothing which suggests that this dispute between a taxpayer and the IRS should be decided in a manner any different from that in which the case would be determined outside the bankruptcy context. This would appear to be the view of most courts of appeals that have addressed the issue. *In re Landbank Equity Corp.*, 973 F.2d 265, 270-71 (4th Cir. 1992) .

The opinion goes on to note the contrary view of the Fifth Circuit. In affirming a bankruptcy court's decision to place the burden of proof on the debtor, a district court relied heavily upon *Landbank Equity Corporation* and rejected the Ninth Circuit's decision in *MacFarlane. Barrows v. Internal Revenue Service (In re Barrows)*, 98-2 U.S. Tax Cas. (CCH) P 50,860 (D.N.H. 1998)(quoting the *Treatise*).

In affirming a bankruptcy court's decision to place the burden of proof on the debtor, a district court relied heavily upon *Landbank Equity Corporation* and rejected the Ninth Circuit's decision in *MacFarlane. Barrows v. Internal Revenue Service (In re Barrows)*, 231 B.R. 446 (D.N.H. 1998) (quoting the *Treatise*).

(n65)Footnote 57. See the report of the National Bankruptcy Review Commission, 3.2.5., p. 816, *reprinted in*, Vol. G Collier on Bankruptcy, App. Pt. 44 (Matthew Bender 15th Ed. Revised), quoting *Treatise. United States v. Rexach*, 482 F.2d 10 (1st Cir. 1972) . A unique issue might arise when the objecting party was not the taxpayer-debtor but the trustee. The argument could be made that the trustee lacked the same access to the facts that the taxpayer had and should be relieved of the burden of proof. Such an argument overlooked the trustee's right to the relevant books and records and his or her right to receive the taxpayer's prepetition tax benefits such as the right to a refund. It could be countered that the trustee should be compelled to accept the burdens as well as the benefits of the debtor's position.

(n66)Footnote 58. See, e.g., *Psaty v. United States*, 442 F.2d 1154 (3d Cir. 1971) . The presumption of correctness that followed an assessment of taxes may no longer be applicable as a result of the addition of I.R.C. § 7491 in 1998.

(n67)Footnote 59. *United States v. Kontaratos*, 36 B.R. 928 (D. Me. 1984) . *Kontaratos* was criticized and not followed by *In re Terrell*, 75 B.R. 291 (N.D. Ala. 1987) , *aff'd without opinion*, 835 F.2d 1439 (11th Cir. 1987) . In a decision adding further confusion to an already uncertain area, another court in the same district as the *Terrell* court purported to limit situations in which the objecting party would have the burden of proof to those involving the trust fund recovery tax (26 U.S.C. § 6672) and placed the burden on the IRS in other situations. *In re Rasbury*, 141 B.R. 752 (N.D. Ala. 1992) , *aff'g*, 130 B.R. 990 (*Bankr. N.D. Ala.* 1991) . The *Rasbury* court also relied upon the superficial analysis in *Kontaratos* focusing upon whether an assessment had been made. *Kontaratos* and *Rasbury* were followed in *In re White*, 168 B.R. 825 (*Bankr. D. Conn.* 1994) . See also *In re Macagnone*, 228 B.R. 784, 786 (*Bankr. M.D. Fla.* 1998) , when the court held that the burden of proof in a dispute regarding whether the debtor is a responsible person under 26 U.S.C. § 6672 falls on the Internal Revenue Service if the assessment for that claim was not made before the petition date; all reasonable inferences regarding the facts of the dispute should be drawn in favor of the taxpayer. Another court held that an assessment was not a precondition to an allowed claim, but on remand, that bankruptcy court

held that the IRS had satisfied its burden of proof. This result was affirmed by the Court of Appeals for the Eighth Circuit. *In re Brown*, 169 B.R. 59 (Bankr. D. Iowa 1994), *aff'd*, 82 F.3d 801 (8th Cir. 1996). The significance of *Kontaratos* and its progeny should be substantially limited in the future since the 1994 amendments to the Bankruptcy Code permit the IRS to make an assessment even after the filing of a petition under title 11. 11 U.S.C. § 362(b)(9)(D).

(n68)Footnote 60. The very nature of the notice of deficiency procedure leading to litigation in the Tax Court is that no assessment can be made when a taxpayer seeks timely review before that court. I.R.C. § 6213(a).

(n69)Footnote 61. *Raleigh v. Illinois Department of Revenue*, 530 U.S. 15, 120 S. Ct. 1951, 147 L. Ed. 2d 13, 43 C.B.C.2d 869 (2000).

(n70)Footnote 62. *Raleigh* has been expressly held to require the same result when federal, as opposed to, state taxes are at issue. See *Neilson v. United States (In re Olshan)*, 356 F.3d 1078, 1083 (9th Cir. 2004). The importance of avoiding inconsistent results in different courts has been noted elsewhere. See e.g., Baird, *Loss Distribution, Forum Shopping, and Bankruptcy: A Reply to Warren*, 54 U. Chi. L. Rev. 815, 822 (1987) ("Legal rights should turn as little as possible on the forum in which one person or another seeks to vindicate them.").

(n71)Footnote 63. In a footnote, the Court disposed of the contention that a bankruptcy trustee as a party distinct from the taxpayer was entitled to avoid the burden of proof. The trustee's access to information might be less than that of a debtor with personal knowledge, but the trustee does take custody of the debtor's records. This difference was not a justification for shifting the burden of proof, especially since the government was in no better position than it ever was. See *Raleigh*, n. 61.

(n72)Footnote 63a. *Raleigh v. Illinois Department of Revenue*, 530 U.S. 15, 24-25, 120 S. Ct. 1951, 1957, 147 L. Ed. 2d 13, 22, 43 C.B.C.2d 869 (2000).

(n73)Footnote 63b. *Heilig-Meyers Co. v. United States (In re Heilig-Meyers Co.)*, 316 B.R. 866 (Bankr. E.D. Va. 2004).

(n74)Footnote 63c. See, e.g., *In re Industrial Commercial Electrical Inc.*, 304 B.R. 24 (Bankr. D. Mass. 2004). The bankruptcy court's shifting of the burden of proof to the IRS was reversed on appeal. *United States v. Official Committee of Unsecured Creditors of Industrial Commercial Electrical, Inc.*, 319 B.R. 35 (D. Mass. 2005).

(n75)Footnote 64. Pub. L. No. 105-206, 112 Stat. 685. The new burden of proof provision applies to cases arising in connection with examinations begun after its enactment. If there is no examination, then the provision applies to taxable periods or events beginning or occurring after its enactment.

(n76)Footnote 65. 26 U.S.C. § 6001.

(n77)Footnote 66. 26 U.S.C. § 7491(a).

(n78)Footnote 66a. What constitutes "credible evidence" under Section 7491 was discussed by the court in *In re Industrial Commercial Electrical Inc.*, 304 B.R. 24 (Bankr. D. Mass. 2004). On appeal, the district court held that the introduction of a tax return, without more, is insufficient to constitute credible evidence and shift the burden of proof. Other evidence such as "business records, building deeds, testimony of customers or business partners," etc. was required. *United States v. Official Committee of Unsecured Creditors of Industrial Commercial Electrical Inc.*, 319 B.R. 35, 55 (D. Mass. 2005).

(n79)Footnote 67. The Senate Report on the new burden of proof provision states:

A necessary element of cooperating with the Secretary is that the taxpayer must exhaust his or her administrative remedies (including any appeal rights provided by the IRS). The taxpayer is not required

to agree to extend the statute of limitations to be considered to have cooperated with the Secretary.

This legislative history suggests that a taxpayer in a title 11 case would have to go through the IRS appeals process before filing a claims objection or requesting a determination of tax liability if the burden of proof were to be shifted to the IRS.

(n80)Footnote 68. *26 U.S.C. § 7491(c)*.

(n81)Footnote 68a. *Raleigh* has been held to require a bankruptcy court to apply the burden of proof rules separately to each individual portion of the IRS claim and to prevent shifting the burden on all items because of an error on a single item. *United States v. Neilson (In re Olshan)*, 356 F.3d 1078, 1083 (9th Cir. 2004) .



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Collier on Bankruptcy Taxation

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CHAPTER TX5 Litigation With the IRS in Bankruptcy Court

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P TX5.04 Determinations of Tax Liability by the Bankruptcy Court

[1] Overview of Tax Liability Determinations by the Bankruptcy Court

In addition to the claims objection process which is available for the resolution of all types of disputed claims, the Bankruptcy Code provides a unique vehicle for the resolution of disputed tax claims. Section 505 vests bankruptcy courts with broad jurisdiction to determine tax liabilities arising either before or after the filing of a case under title 11. n1 Although it would seem self-evident, the existence of a case under title 11 is an essential prerequisite for the exercise of the jurisdiction provided by section 505. n1a Significantly, this jurisdiction is permissive, not mandatory, with respect to most types of tax liabilities. n2

Section 505(a) vests the bankruptcy court with authority to determine "any tax, any fine or penalty relating to a tax, or any addition to tax, whether or not previously assessed, whether or not paid." Therefore, this provision, like the claims objection process, makes the bankruptcy court a prepayment forum. Unlike that of the Tax Court, this prepayment jurisdiction even includes tax liabilities which have been previously assessed. n3

Section 505(b) creates a vehicle for trustees or debtors in possession to use in obtaining a determination of tax liability for postpetition periods in an expedited manner. To the extent that a taxing authority n4 proposes additional tax liabilities after the expedited examination procedures contained in section 505(b) have been completed, a dissatisfied trustee or debtor in possession has the opportunity to litigate the issue without first paying the proposed liability. Section 505(c) provides for the assessment of taxes determined to be due under the authority granted to the bankruptcy court by either of the other two subsections.

[2] Section 505(a)

[a] Jurisdiction of the Bankruptcy Court

As noted in the legislative history, the jurisdictional grant contained in section 505(a) is derived, with only stylistic changes, from section 2a(2A) of the former Bankruptcy Act. n5 Evidently Congress intended the language of section 505(a) to be sufficiently broad to include virtually any type of tax liability, and section 505(a) expressly includes unpaid taxes even after they have been assessed. Although the United States and its agency, the Internal Revenue Service, are immune from suit except where Congress waives that immunity, *section 505 of the Bankruptcy Code* allows the court to determine the tax liability of a debtor. n5a Section 505(a) imposes only two significant limitations on the bankruptcy

court's jurisdiction to determine federal tax liabilities. n5b They are (i) the prohibition against determining (or redetermining) a tax liability contested and adjudicated before a judicial or administrative tribunal of competent jurisdiction before the commencement of the case under title 11, n6 and (ii) the requirement that there be an actual controversy based upon a filed tax return. n7 When the Tax Court has entered a decision, even a stipulated decision, prior to the filing of a petition under title 11, bankruptcy courts lack jurisdiction to relitigate tax liabilities for the years before the Tax Court. n7a The prohibition against the relitigation of federal tax liabilities in bankruptcy court has been consistent with the practice regarding state and local taxes liabilities. n7b

With respect to a tax liability which has been determined by a court or tribunal prior to the filing of the petition under title 11 but is still subject to appeal, it is possible to argue that because the first determination is not final the bankruptcy court has jurisdiction to relitigate the dispute. Such an argument by the party disappointed with the first result is particularly unpersuasive. Besides the obvious *res judicata* concerns, there is the unnecessary diminution of the bankruptcy estate with the additional expense of a second trial to consider. Moreover, since appeals from Tax Court decisions may not be suspended by the automatic stay n8 and, unlike decisions by the bankruptcy court, n9 are directly appealable to the court of appeals, it is almost certain that the first decision would become final before any attempt to relitigate in the bankruptcy court could occur. The same rationale should apply to preclude attempts to relitigate decisions by a district court or the Court of Federal Claims. In addition, a bankruptcy court would be required to defer to a decision by a district court in its district on the same issue even though that decision was subject to appeal. n10

If a taxpayer never objects to longstanding tax liabilities in the state or local administrative or judicial systems, especially real property or ad valorem tax claims, is the bankruptcy court prohibited from litigating under section 505 the validity of the aged tax claims? State and local taxing authorities defend section 505 actions by debtors using the argument that the lapse of time from the assessment of the property tax claims results in an unfair financial harm to the taxpayers of the local community.

Although a contrary argument could be made that many debtors were so overwhelmed with financial pressures and the inability to fund litigation challenging such tax claims that timely objections to ad valorem taxes were not possible, this issue was resolved in favor of the taxing authorities in 2005. In that year, section 505(a)(2) was amended to provide that any challenge to an ad valorem tax in the bankruptcy court was timely only if the applicable period for challenging it under non-bankruptcy law had not expired. n10a Actual litigation before some judicial tribunal is necessary to preclude a bankruptcy court review of a municipal tax assessment. n10b

[b] Procedure Under section 505(a)

It is unclear whether a tax return must be filed before the bankruptcy court may hear a section 505(a) motion to determine tax liability. Section 505(a) only provides that the bankruptcy court can determine any tax liability regardless of prior assessment and/or payment, but that section is silent on the issue of whether a tax return must be filed before the determination can be made by the court.

In one case, a district court held there was no "actual controversy" to be decided between the IRS and the taxpayer debtor prior to the filing of the tax return in question, and the section 505 motion was therefore dismissed. n11 In *Grand Chevrolet*, n12 the actual controversy required by section 505(a) was not present because the trustee did not attempt to file the consolidated income tax return he proposed, and the IRS had not officially responded to the proposed return. The court noted that the potential tax liability in question was not assessed and all that existed was a belief on the part of the trustee that the IRS would reject the consolidated return. The court concluded it did not have jurisdiction to decide issues, such as the tax status on an unfiled tax return, which arise prior to the determination of tax liability.

Can the bankruptcy court make a determination of the tax liability under section 505 of the debtor's or even some third parties' tax return before the return is filed? In *In re Amoskeag Bank Shares, Inc.*, n12a the chapter 7 trustee filed a declaratory judgement action asking the bankruptcy court to determine whether he owed the IRS any tax liability for

withholding taxes on distributions of monies to former employees as a result of the payment of claims for lifetime medical benefits. An individual employee of the debtor intervened in the action contending the benefits were not wages and should not be reduced by withholding. The IRS contended there was no waiver of sovereign immunity, the employee had no standing to participate in the suit by intervention, the determination of the issue of the existence of a tax liability on the part of the employee could not be made until he filed his return, and section 505 could not be used to resolve a future dispute between a nondebtor and the IRS. The bankruptcy court's decision was reversed on appeal. n12b The district court rejected all of these jurisdictional arguments because there was a present dispute that directly involved the estate and the chapter 7 trustee and collaterally involved the employee. The dispute was ripe for decision and had to be made so that the estate and its creditors would know whether the distributions were taxable and, therefore, if the trustee would be required to pay a gross or net distribution to the employees for the benefits. The determination of the taxability of the employee benefits in issue had a direct effect on the administration of the estate and was properly resolved through the use by the trustee of section 505 with or without the participation of the employee as a party.

It should be noted that although the district court rejected the IRS's jurisdictional challenges, it ruled in favor of the IRS on the merits by holding that the payments to the intervenor were wages and were, therefore, subject to withholding. n12c In view of this reversal, the IRS was not able to continue its challenge to the bankruptcy court's jurisdiction in this case; however, it should be expected to continue litigating this issue if it were to appear in other cases.

To initiate the resolution of a disputed tax liability by means of the claims objection process, it is necessary that a proof of claim and an objection to it be filed. n13 By contrast, it is not necessary for a proof of claim to be filed to invoke the bankruptcy court's authority to determine tax liabilities pursuant to section 505. n14 Section 505(a) does not contain an explanation of the procedure which should be used to invoke it, but it is not listed in *Federal Rule of Bankruptcy Procedure 7001* as an adversary proceeding. Therefore, it is a contested matter initiated by a motion. n15 The motion should be served on the civil process clerk at the office of the United States attorney for the district in which the action is pending, the Attorney General of the United States, and the District Director of the Internal Revenue Service's district in which the case is pending. n16 Discovery will be pursuant to the adversary proceeding rules which provide for the use of depositions, interrogatories and requests for the production of documents. n17 In this respect, litigation of a disputed tax liability pursuant to either the claims objection process or section 505 should be the same.

Section 505(a) is also silent with respect to the specificity of the pleading used to invoke its provisions. It appears that, at a minimum, the pleading should identify the type of tax(es) and the particular tax period(s) which the party wishes the bankruptcy court to determine in order to comply with the requirements of notice pleading. n17a Any additional details provided in the pleading may expedite discovery as well as the ultimate resolution of the disputed tax liability. If more than one tax liability is in dispute, efficiency calls for all of them to be included in the same adjudication.

Section 505(a)(2)(B) expressly authorizes a bankruptcy court to adjudicate a claim for a tax refund relating to a prepetition tax year. n18 Moreover, the bankruptcy court may hear the matter on an expedited basis, since the Service is given only 120 days to act on the claim before it may be taken to court instead of the six month period applicable to suits in a district court or the Court of Federal Claims. n19 Even this 120 day period may be dispensed with if the refund arises from an offset or counterclaim to a claim or request for payment by the Service. n20

Another potential difference with refund suits in the Bankruptcy Court concerns the "full payment rule," which requires that the taxes asserted by the Service to be due for the period in dispute must be paid in full before a claim for refund will be permitted. n21 Section 505(a)(1) expressly permits the bankruptcy court to determine the amount or legality of any tax "whether or not paid." Section 505(a)(2)(B), which imposes certain limitations on when a suit for refund may be brought in bankruptcy court, does not alter or contradict the provisions of subsection (a)(1) in any other respect. Accordingly, in a scenario in which some, but not all, of the tax liability for a particular period had been paid, and a party contended that some or all of the amount which had been paid should be refunded, it could be argued that the full payment rule was not applicable.

Except for the shorter period for consideration of the claim for refund by the Service before resort to the bankruptcy court is permitted, and the possible implicit exception to the full payment rule, section 505(a)(2)(B) does not contain any other deviations from the general rules governing suits for refund in other courts. Since "Congress meant to make tax considerations as nearly neutral as possible with regard to whether a taxpayer should file bankruptcy," n22 in the absence of language expressly providing different rules for refund suits in bankruptcy courts, the conclusion that they should be the same as those in the district courts and the Court of Federal Claims is inescapable. Accordingly, the same forms should be used when filing the claim for refund. n23 The period of limitations on claims for refund provided by the Internal Revenue Code should also apply. n24 An attempt to circumvent the limitations period imposed upon the filing claims for tax refunds with the IRS or the subsequent filing of a refund suit in court following the denial of the claim by the IRS or after its lack of action on the claim through reliance on the "turnover" provisions of *11 U.S.C. section 542* was not successful. n24a Other significant rules which should be equally applicable in the bankruptcy court are those prohibiting "variance" from the claim as stated in the claim for refund once the dispute is taken to court, n25 and the requirement that the party claiming the refund satisfy the double burden of proving the Service's denial of the refund to be incorrect and proving the proper amount of tax liability. n26 In the case of a corporate taxpayer, the proper party to claim any refund due is the common parent of a consolidated group for the taxable period during which the claim arose. n26a Any refund of prepetition taxes which is found to be due will be property of the estate. n27

[c] Jury Trial of a section 505 Action

The right to a jury trial in bankruptcy court actions has been the subject of Congressional revision, n27a Supreme Court opinion n27b and scholarly review. Few courts have directly answered the question of whether a jury trial can be held in a tax dispute with the United States under section 505, when the issue was a refund of taxes. Disputes involving a tax deficiency have never been entitled to a jury trial. In a nonbankruptcy refund suit, a jury trial is granted to a taxpayer filing a refund suit under *Section 7422 of the Internal Revenue Code* because that suit is one for the recovery of money allegedly erroneously retained by the sovereign. n27c One bankruptcy court has, however, directly addressed this dispute in a section 505 case with the IRS. In *In re Smith*, n27d the debtor filed an adversary action against the Internal Revenue Service contesting an employment tax liability based on the reclassification of independent contractors as employees. In the English courts of the 18th Century, the bankruptcy process was equitable and not legal in nature and jury trials were not permitted. When the IRS filed its proof of claim with the Bankruptcy Court, this filing triggered the equitable jurisdiction of the court to determine the correct amount of the IRS claim if it was disputed by the debtor. n27e If a "public right" is being litigated, then there is no *Seventh Amendment* jury trial right. The dispute over the payment of taxes to the IRS and the accuracy of the IRS proof of claim is the litigation of a "public right" as opposed to a "private right" the latter being a claim for which a jury trial can be granted. n27f The court in *Smith* thus denied the debtor a jury trial in the section 505 dispute.

[3] Section 505(b)

[a] Expedited Tax Determination and Discharge

Prior to the enactment of the Bankruptcy Code in 1978, a trustee desiring to close a case under title 11 did not have the ability to obtain a prompt determination of any tax liability that might have been incurred during his or her administration. n28 This situation meant either that the case might have to remain open for several additional years until the Service's opportunity to examine the postpetition years had expired, or that the trustee who proceeded to have the case closed without waiting for limitations to expire might be faced with the possibility of personal liability for any additional taxes that were subsequently found to be due. In cases under former Chapter XI, a similar problem with respect to the potential tax liability incurred during the period of the Chapter XI case would have confronted reorganized debtors after confirmation of their plans. The Bankruptcy Code's solution to these problems was section 505(b). n29 It should be understood that section 505(b) does not provide jurisdiction for a bankruptcy court to determine a postconfirmation tax liability. n30

[b] Procedure Under section 505(b)

Section 505(b) authorizes a trustee or a debtor in possession to request a prompt determination of any postpetition tax liability which arises while the case under title 11 is open. n31 To initiate this prompt determination, the trustee must first file a return for the periods involved and pay the tax due as reflected on the return. The trustee should also specifically request a prompt determination pursuant to section 505(b). In addition to these rather elementary requirements, such a request should comply with *Revenue Procedure 2006-24*. n32 Unlike the claims objection process or actions under section 505(a), no questions about the specificity of the pleading requesting a prompt determination of the debtor's postpetition tax liability should arise since the return, payment of the tax shown, and a request for a prompt audit pursuant to section 505(b) are all that could be expected of the trustee at this point. However, the failure to comply fully with these requirements would appear to be jurisdictional. Although this subsection was envisioned as a mechanism to permit a determination of tax liability at the conclusion of the administration of an estate, *i.e.*, a single request for a prompt determination of all of the relevant tax periods, there is nothing in its language to prevent successive requests as each tax period is completed and a return filed apart from the obligation to pay the taxes shown on such returns. n33

Once it receives a request invoking the provisions of section 505(b), the Service has a period of 60 days within which to select the return(s) for examination. n34 If a return is selected, the Service will then have an additional 120 days, or a total of 180 days from the date the request for a prompt determination was made, to complete its examination. n35 Thus, section 505(b) makes it possible to reduce the effective period in which the Service may examine returns from the usual three year minimum to just 180 days. n36

If the Service decides not to examine the return, the trustee, the debtor, and any successor to the debtor are discharged from any liability for the tax period unless the return is fraudulent or contains a material misrepresentation. In the event the return is examined and an additional liability is asserted by the Service, the trustee may obtain a similar discharge by paying the additional amount. n37 Should the trustee disagree with the asserted additional liability, he or she may then request the bankruptcy court to determine the correct liability. n38 The adjudication of such a dispute, like a dispute under section 505(a), is a contested matter. n39 In 2005, section 505(b)(2) was amended to add the bankruptcy estate to the parties discharged from further tax liability if the return submitted is not selected for examination within 60 days. n40

[4] Section 505(c)

Prior to the 1994 amendments to title 11, the automatic stay prevented the assessment of any additional tax liability once a petition under title 11 had been filed. n41 Accordingly, in order for the IRS to make any such postpetition tax assessment, it was usually necessary to obtain a modification of the stay from the bankruptcy court. The 1994 amendments included a provision which now permits the IRS to make assessments of tax liabilities even after the filing of a petition under title 11. n42 Section 505(c) continues to make an exception to the old general rule and permits the immediate assessment of any liability determined pursuant to either section 505(a) or section 505(b), although its significance may now be questioned. n43 Note that although assessment is permitted after such a determination has been made, the automatic stay would continue to prevent any activity to collect on the assessment, including the filing of liens.

[5] Standing to Request a Determination of Tax Liability

Persons able to request that a bankruptcy court determine liabilities pursuant to section 505(b) are restricted by that section's language to trustees and debtors in possession, since they exercise the powers of trustees. n44 The language of section 505(a), however, is much broader and has resulted in a wide variety of answers to the question of its availability. In the years immediately following the enactment of the Bankruptcy Code, one court held that section 505(a) could be interpreted broadly enough to permit it to resolve tax disputes between the Service and other creditors of the debtor. n45 Not surprisingly, this expansive approach was not universally applied. n46

The pendulum now has swung in the direction of limiting the section 505(a) jurisdictional grant to determinations of tax liabilities of the debtor and the title 11 estate. n47 One of the most common situations in which this issue has arisen involves the attempt of individuals from whom the Service has sought collection of taxes which a corporate debtor failed to pay to use section 505(a) as a basis for asking the bankruptcy court to determine their own tax liabilities. n48 After some initial successes, these attempts have been fairly uniformly rejected. n49 Another court has refused to use section 505(a) as a jurisdictional predicate for determining the tax liabilities of the individual partners of a bankrupt partnership. n50 Attempts to stretch the provisions of section 505(a) to reach taxpayers beyond the debtor and the bankruptcy estate are also now likely to be met with the argument that even if the bankruptcy court has jurisdiction to determine such a tax liability, it should nevertheless abstain from exercising that jurisdiction. n51 Moreover, the Tax Court has held that the bankruptcy court lacks jurisdiction to determine the tax liability for a wife who is jointly and severally liable for an income tax liability when she did not join in her husband's case under title 11. n52

The bankruptcy court has determined the amount of a county tax claim for tangible personal property at the request of a liquidating trustee for the estate and the purchaser of the debtor's assets. n52a This determination under the circumstances appears to be a unique position taken by a bankruptcy court, which could possibly be explained as a fact-driven instance of the exercise of jurisdiction. On the other hand, the attempted use of section 105 to compel the Internal Revenue Service to determine tax through an offer in compromise submitted by a Chapter 13 was rejected by a bankruptcy court. n52b

[6] Burden of Proof

The issue of whether the debtor or the government bears the burden of proof in a tax dispute in bankruptcy court resulted in a large number of decisions, many of which were conflicting, as that issue developed in the claims objection process. n53 Curiously, the question does not appear to have arisen as often in adjudications pursuant to section 505. One possible explanation is that the primary reason courts placed the burden of proof on the government in claims disputes was their conclusion that the general rule governing claims objections applied to all creditors, including the government. n54

These courts held that once the *prima facie* case established by the filing of the claim had been rebutted, the burden then shifted at that relatively low threshold to the government. n55 Whatever merit this approach to the problem may have had, it clearly had no applicability outside of the claims objection process. n56

Historically, placing the burden of proof on the government in the litigation of a tax dispute in bankruptcy court was a departure from the general rule that applied in every other court in which such disputes might be litigated. In 2000, the Supreme Court held that the burden of proof does not shift to a taxing authority when an objection to its claim is litigated in a bankruptcy court. n56a The case involved a state taxing authority, but the ruling clearly applies to federal tax claims as well. Since some courts had held that the decisions shifting the burden of proof to the taxing authority in the context of a claims objection had no applicability to a determination of tax liability under section 505 even before the Supreme Court's decision, it is difficult to see how any plausible argument could now be made for placing the burden on the government in a proceeding under section 505.

In spite of the Supreme Court's decision that the burden of proof does not shift to the government when a tax liability is litigated in a bankruptcy court, there is a statutory exception to this rule which may permit the burden to be shifted to the government in certain circumstances. n56b The exception applies to income, estate and gift taxes, but not to trust fund taxes or excise taxes; and it applies only to individuals and partnerships, corporations or trusts with a net worth of less than \$7,000,000 and fewer than 500 employees. To invoke this new rule, parties to whom it applies must produce "credible evidence" to support their position, establish that they have complied with the Internal Revenue Code's substantiation and record keeping requirements, n56c and have "cooperated with reasonable requests by the Secretary for witnesses, information, documents, meetings, and interviews." n56d It is elementary that any exception to a general

rule is to be narrowly construed and, without some basis for an exception in the Bankruptcy Code or at least in the Federal Rules of Bankruptcy Procedure, none is to be implied. n57 Adherence to the general rule assigning the burden of proof to the taxpayer is also seen as consistent with the congressional intention to make tax considerations as nearly neutral as possible with regard to whether a taxpayer should file a case under title 11. n58 In many cases, however, a dispute over which party bears the burden of proof may be more apparent than actual since the outcome will not usually turn on this point unless there is a total failure to come forward with evidence.

If the burden is placed upon the taxpayer, what is the extent of that burden? Once again, no legislative answer has been provided. The most plausible approach is to compare the nature of the dispute to redetermination proceedings in the Tax Court and refund suits in the district courts and the Court of Federal Claims and then to apply the burden of proof that would be applicable to the type of proceeding that most nearly resembles the dispute. Although a direct analogy to a case in the Tax Court may not always be apparent, it should be relatively obvious whether a claim for refund is involved. Unless the matter can be characterized as a refund suit, the Tax Court burden would apply. n59 If the matter is a refund suit pursuant to section 505(a), the burden should be the same as in the district courts and the Court of Federal Claims. n60

A more subtle question arises when the party litigating the tax liability is not the taxpayer who incurred it. At first glance, it would appear that the rationale for placing the burden of proof on the party with the best access to the facts would not be applicable. n61 Indeed, one court has held that when a trustee contests a liability for a period before his or her appointment, the burden of proof will be placed upon the government. n62 This theory was subsequently advanced by the trustee in *Raleigh v. Illinois Department of Revenue* n63 and rejected by the Supreme Court. Observing that the trustee's access to information might not be as good as the debtor's, the Court pointed out that the government was still in no better position than it ever was and held that this situation was no justification for altering the burden of proof.

FOOTNOTES:

(n1)Footnote 1. Section 505 applies to all taxing authorities, not exclusively to the Internal Revenue Service. For purposes of this chapter, the discussion will be confined to issues related to tax disputes with the Service. For the effect of *Seminole Tribe of Florida v. Florida*, 517 U.S. 44, 116 S. Ct. 1114, 134 L. Ed. 2d 252, 34 C.B.C.2d 1199 (1996) on the determination of taxes owed to states, see P TX12.02[1] *infra*. See 4 Collier on Bankruptcy, ch. 505 (Matthew Bender 15th Ed. Revised), for prior law and legislative history. See generally 2 Collier on Bankruptcy, ch. 106 (Matthew Bender 15th Ed. Revised), for discussion of sovereign immunity.

(n2)Footnote 1a. In an unusual case, the Tenth Circuit held that a district court could not exercise section 505 jurisdiction in a receivership. It also rejected a novel attempt by a bankruptcy court in Massachusetts to "cede" its section 505 jurisdiction to the district court in Colorado where the receivership was pending. *Sterling Consulting Corp. v. United States*, 245 F.3d 1161 (10th Cir. 2001). The published opinions in the related title 11 proceeding may be found at *United States v. Sterling Consulting Corp. (In re Indian Motorcycle Co., Inc.)*, 259 B.R. 458 (B.A.P. 1st Cir. 1999), *vacated and remanded*, 46 C.B.C.2d 588, 261 B.R. 800 (B.A.P. 1st Cir. 2001).

(n3)Footnote 2. Section 505(a) states that a bankruptcy court "may," not "must," determine the tax liabilities described in that subsection. The use of the word "may" was decisive to one court's conclusion that its jurisdiction under this subsection was discretionary. *In re Galvano*, 116 B.R. 367, 372 (Bankr. E.D.N.Y. 1990). Section 505(b), which relates to requests by trustees or debtors in possession to determine liability, does not contain similar language, and because it is intended to address a problem unique to the bankruptcy system, it is difficult to argue that it is not mandatory. See P TX5.03[3] *supra*. The issue of when a bankruptcy court may abstain from exercising its jurisdiction to resolve a disputed tax liability is discussed in P TX5.10 *infra*. See, e.g., *Emrich v. U.S.*, 98 F.3d 1345 (9th Cir. 1996) (the court clearly had the discretion to decide whether a redetermination of a tax claim would be made in the case); *In re Lavoie*, 191 B.R. 818 (D. Ariz. 1995) (the debtor filed a section 505 determination with the bankruptcy court but also

filed a protective refund action with the district court; the bankruptcy court required the parties to proceed in district court; on appeal, the district court remanded the case with instructions to consider abstention from the determination of the tax liability. The debtor appealed and requested the district court to order the bankruptcy court to litigate the matter pursuant to 11 U.S.C. § 505); *In re St. John's Nursing Home, Inc.*, 169 B.R. 795 (D. Mass. 1994) (property tax reassessment as part of the tax determination process was subject of proper abstention by the bankruptcy court); *Eddyville Corp. v. Ulster County*, 1998 U.S. Dist. LEXIS 2735 (S.D.N.Y. 1998) (property tax contest was dismissed when filed under section 505(a) because the debtor could not use the process when it had never attempted to contest the tax claims in the past); *In re Macagnone*, 216 B.R. 668 (Bankr. M.D. Fla. 1997) (in a chapter 7 no asset case reopened to determine the debtor's tax liability, the court could refuse to hear the section 505 matter because such a determination under those facts has no bankruptcy purpose; the court could and did allow the section 505 determination where it was necessary under the circumstances to give the debtor his fresh start); *cf.* *In re Stevens*, 210 B.R. 200 (Bankr. M.D. Fla. 1997) (court would not hear section 505 action in a no asset chapter 7 case where there was no benefit to the estate or any creditors from such a proceeding); *In re Palij*, 202 B.R. 27 (Bankr. D.N.J. 1996) (same determination in no asset chapter 7 case); *In re Shapiro*, 188 B.R. 140 (Bankr. E.D. Pa. 1995) (same determination in no asset chapter 7 case); *Kohl v. Internal Revenue Service (In re Kohl)*, 397 B.R. 840 (Bankr. N.D. Ohio 2008) (same determination in no asset chapter 7 case); *In re Fankhanel*, 207 B.R. 292 (Bankr. M.D. Fla. 1997) (Congress intended the tax court to become a tax litigation forum unless it was in connection with the resolution of a tax dispute connected with the administration of the estate; thus, where the debtor had a case pending before the Tax Court, the bankruptcy court could allow the stay to be lifted to pursue the Tax Court case rather than a section 505 action). *In re American Motor Club, Inc.*, 139 B.R. 578 (Bankr. E.D.N.Y. 1991). Another bankruptcy court modified the stay to permit a Tax Court case to go forward when a debtor filed a bankruptcy petition on the eve of trial in that court, and the district court affirmed. *Beane v. United States (In re Beane)*, 404 B.R. 942 (M.D. Fla. 2008).

(n4)Footnote 3. The Tax Court may only "redetermine" deficiencies proposed by the IRS in a Notice of Deficiency prior to any assessment being made. *I.R.C.* § 6213.

(n5)Footnote 4. Section 505 applies to all taxing authorities, not exclusively to the Internal Revenue Service. For purposes of this chapter, the discussion will be confined to issues related to tax disputes with the Service. For a discussion of state and local taxes, *see* chapter TX12 *infra*.

(n6)Footnote 5. H.R. Rep. No. 595, 95th Cong., 1st Sess. 356 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 989, 95th Cong., 2d Sess. 67 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised). For detailed coverage of the pre-Code law and legislative history of § 505, *see* 4 Collier on Bankruptcy, ch. 505.LH (Matthew Bender 15th Ed. Revised).

(n7)Footnote 5a. In *United States of America v. Kearns*, 177 F.3d 706, 709-711 (8th Cir. 1999), the Internal Revenue Service argued that *section 106(c) of the Bankruptcy Code* prevented subject matter jurisdiction from accruing to the court, and the Court of Appeals for the Eighth Circuit rejected this position. *Section 505 of the Bankruptcy Code* is the specific grant of authority for the court to proceed with the determination of the debtor's tax liabilities. This jurisdictional result is true even when the tax liabilities relate to years that are not included on the Internal Revenue Service proof of claim. In the *Kearns* case, the court permitted the Service to determine a debtor/embezzler's income tax liabilities for the year of the embezzlement as well as subsequent years in which the restitution payments were made and tax deductions were claimed. *See also In re Vendell Healthcare, Inc.*, 222 B.R. 564, 568 (Bankr. M.D. Tenn. 1998) (*section 505 of the Code* gives the court jurisdiction to compute interest as part of the determination of the correct amount of a tax liability; the court has jurisdiction to determine and resolve allegations of delay or misconduct on the part of the Internal Revenue Service giving rise to an inappropriate accrual of interest in addition to the tax claim); *In re Schmidt*, 205 B.R. 394, 397 (Bankr. N.D. Ill. 1997), quoting the *Treatise*. Note, however, that section 505 does not give bankruptcy courts the authority to abate interest that would otherwise be owed on an unpaid utility liability. *Section 6404 of the Internal Revenue Code* (26 U.S.C.) gives that authority exclusively to the Internal Revenue Service, not the courts. *Karlsson v. United States*, 247 B.R. 321 (Bankr. M.D. Fla. 2000). The bankruptcy court held that under the "Tax Payer Bill of Rights," had no jurisdiction over a challenge to the legality of the *assessment* of a tax penalty as

distinguished from a challenge to the legality of the *penalty itself*. *Gurley v. United States (In re Gurley)*, 347 B.R. 312 (Bankr. W.D. Tenn. 2006) .

(n8)Footnote 5b. A state taxing authority may contend that its defense of sovereign immunity prevents a court from determining the validity of a tax claim. The provisions of the Bankruptcy Reform Act of 1994 included specific provisions for a section by section waiver of the defense of sovereign immunity including section 505, which allows for the determination of tax liabilities, and section 523, regarding the dischargeability of tax claims. *In re Willis*, 41 C.B.C.2d 966, 230 B.R. 619, 623 (Bankr. E.D. Okla. 1999) (opinion notes the cases that are split over whether section 106 is a valid waiver of a state's sovereign immunity defense and concludes the waiver was effective); *Smith v. Psychiatric Hosps. (In re Psychiatric Hospitals)*, 216 B.R. 660, 661 (M.D. Fla. 1998) (a section 505 motion is not a suit against a state that implicated the 11th Amendment and, therefore, raised the defense of sovereign immunity); *In re Ransstrom*, 215 B.R. 454, 456 (Bankr. N.D. Cal. 1997) (the court may not be able to make a monetary award against a state, but the bankruptcy court does have jurisdiction to determine if a tax claim is discharged). If a state taxing authority files a proof of claim in a case, sovereign immunity is waived per 11 U.S.C. § 106(b). In *In re Jackson*, 184 F.3d 1046 (9th Cir. 1999) (the State of California filed a proof of claim and the court discussed the sovereign immunity issue as a result of the debtor's failure to file amended state income tax returns and the dischargeability of those claims).

(n9)Footnote 6. 11 U.S.C. § 505(a)(2)(A). This subsection appears initially to be in conflict with the concluding language of section 505(a)(1) which immediately precedes it. However, when the two subsections are read together, particularly with the applicable legislative history cross-referenced in n.4 *supra*, it is clear that a bankruptcy court may not relitigate a tax liability which has been finally determined by a court or other tribunal of competent jurisdiction. See *In re Emrich*, 98 F.3d 1345 (9th Cir. 1996) (under section 505(a)(2)(A), the district court did not have jurisdiction because the amount and legality of the tax liability had previously been contested before and adjudicated by a judicial or administrative tribunal and therefore the case was dismissed). See also *In re Harker*, 357 F.3d 846 (8th Cir. 2004) (bankruptcy court lacked jurisdiction under section 505 to determine a tax liability of the debtor previously determined by the Tax Court); *In re Allison*, 232 B.R. 195, 202 (Bankr. D. Mont. 1998) (same); *In re B & B Marine Sales & Service*, 149 B.R. 465, 467 (Bankr. N.D. Ohio 1992) (the bankruptcy court had jurisdiction under section 505 to determine the debtor's tax liability even though the dispute was appealed to the state appellate tax division because there had been no final adjudication by a judicial or administrative tribunal); *In re Cohen*, 169 B.R. 759 (Bankr. S.D. Fla. 1994) (even a stipulated decision in the Tax Court was entitled to *res judicata* effect and precluded a subsequent attempt to seek a determination of the same tax liability in the bankruptcy court).

In *Hammers v. Internal Revenue Service*, 988 F.2d 32 (5th Cir. 1993) , the taxpayer had litigated her tax liability in the Tax Court prior to filing her chapter 13 petition. The court of appeals affirmed the bankruptcy court's refusal to exercise equitable authority to disallow the penalty portion of her adjudicated tax liability because of the prohibition contained in section 505(a)(2)(A). In *United States v. Wilson*, 974 F.2d 514 (4th Cir. 1992) , the bankruptcy court had modified the automatic stay to permit a previously filed Tax Court proceeding to resume. Prior to the trial in the Tax Court, the trustee and the IRS reached a settlement of the tax dispute, to which the debtor objected. The IRS then filed a complaint seeking a determination of the debtor's prepetition tax liability pursuant to section 505(a) and of the dischargeability of that liability under section 523. Affirming the courts below, the Court of Appeals for the Fourth Circuit held that a section 505 gave the bankruptcy court jurisdiction over the tax liability that was concurrent with that of the Tax Court after modification of the stay. See also *In re Schmidt*, 205 B.R. 394, 397 (Bankr. N.D. Ill. 1997) , quoting *Treatise*.

In a highly unusual case, a district court withdrew the reference to adjudicate an IRS claim based upon the debtor's participation in a purported tax shelter. Noting that Section 505(a)(2) deprived it of jurisdiction if the issue had been previously determined by a judicial or administrative tribunal, the court analyzed the debtor's failure to contest the Notice of Final Partnership Administrative Adjustment ("FPAA") issued by the IRS within the applicable time period. The court concluded that the partnership audit procedures contained in the Tax Equity and Fiscal Responsibility Act ("TEFRA"), 26 U.S.C. §§ 6221-6234, provided the debtor a full and fair opportunity to litigate the issue. Since the

partners had participated in "the proceedings described by TEFRA up to the point of the issuance of the FPAA," the court held that no default or failure to litigate was presented by the failure to contest the FPAA in court in a timely manner. Accordingly, the adjustments had been previously determined and could not be revisited in a Section 505 proceeding. *Central Valley AG Enterprises v. United States*, 326 B.R. 807 (E.D. Cal. 2005). The court of appeals reversed, holding that a failure to challenge an FPAA in a timely manner did not constitute an adjudication and that since the IRS was the party who had filed a proof of claim based upon the liability set forth in the FPAA, the debtor would be permitted to ask for a determination under section 505(a). *Central Valley AG Enterprises v. United States*, 521 F.3d 750 (9th Cir. 2008).

In another TEFRA case, a bankruptcy court held that where the Tax Court had previously adjudicated the proper treatment of certain partnership items, the IRS was equitably estopped from assessing a tax liability against a partner based upon the claimed invalidity of a loss deduction it had previously permitted. *Seay v. United States (In re Seay)*, 353 B.R. 614 (Bankr. E.D. Ark. 2006).

(n10)Footnote 7. See *In re Grand Chevrolet, Inc.*, 153 B.R. 296 (C.D. Cal. 1993); *In re Inter Urban Broadcasting of Cincinnati, Inc.*, 180 B.R. 153 (Bankr. E.D. La. 1995) (determination of the taxable status of the debtor was not ripe for determination, there was no tax controversy to be considered by the court and therefore the court lacked jurisdiction over the adversary action); cf, *In re Popa*, 218 B.R. 420 (Bankr. N.D. Ill. 1998). In *Popa*, the Court rejected the limitation suggested by the IRS that no dispute existed regarding the allowance of an income exclusion under the Internal Revenue Code. section 505(a) limits the court's determination to tax liabilities. The issue of whether the trustee is entitled to use the Section 121 exclusion determines whether the estate's tax liability is zero or taxed at the applicable capital gain rate. The court therefore exercised jurisdiction over that determination. *In re Schmidt*, 205 B.R. 394, 397 (Bankr. N.D. Ill. 1997), quoting *Treatise*.

11 U.S.C. § 505 grants the Bankruptcy Court authority to determine the amount and legality of a tax claim but the attack on the tax claim must be one based on the merits and not a challenge to the collection functions of the taxing authority, i.e., the section 505 action cannot challenge the validity of a levy or lien when the underlying amount of the tax claim is not in dispute. *In re Allison*, 232 B.R. 195, 201 (Bankr. Mont. 1998).

(n11)Footnote 7a. *Baker v. Internal Revenue Service (In re Baker)*, 74 F.3d 906 (9th Cir. 1996), cert. denied, 517 U.S. 1192, 116 S.Ct. 1683, 134 L.Ed.2d 784 (1996) (a proceeding is contested if the debtor filed a petition in the Tax Court before filing bankruptcy and the IRS filed an answer); 124 Cong. Rec. 32250, 32413 (Sept. 28. 1978) (Statement of Rep. Edwards noting that this definition has been adopted by other courts and "... we see no reason to depart from it."). Accord *United States v. Teal (Matter of Teal)*, 16 F.3d 619 (5th Cir. 1994).

A novel attempt to avoid the bar against determining tax liabilities already decided by the Tax Court was considered by the court in *Bunyan v. United States (In re Bunyan)*, 354 F.3d 1149 (9th Cir. 2004). Seven years prior to filing a Chapter 13 proceeding, the debtors had been parties to a Tax Court proceeding in which the IRS moved to dismiss their appeal as untimely. They did not dispute the motion, and the appeal was dismissed. The bankruptcy court held their attempt to challenge the resulting assessment in their later Chapter 13 proceeding was barred by res judicata. Affirming both courts below, the court of appeals held that 11 U.S.C. § 505(a)(1) "strips bankruptcy courts of jurisdiction to determine 'the amount or legality of any tax, fine, penalty, or addition to tax if such amount or legality was contested before and adjudicated by a judicial or administrative tribunal of competent jurisdiction before the commencement of the [bankruptcy] case.'" *Id.* at 1151. The debtors attempted to avoid this result by arguing that although the "amount" of the tax had been previously decided, they still could challenge the "legality" of the assessment. After examining the provisions of the Internal Revenue Code, the court held the legality of the assessment depended upon the finality of the Tax Court decision which had become final once the appeal was dismissed. *Id.* at 1152.

After confirmation of a Chapter 11 plan, an individual debtor litigated a tax dispute in the Tax Court, including an allegation the IRS had violated the automatic stay. A bankruptcy court reopened the title 11 proceeding to permit the

debtor to bring an adversary proceeding against the IRS, but it ultimately held that an attempt to relitigate the alleged stay violation was barred by collateral estoppel. *In re Wood*, 328 B.R. 880 (Bankr. S.D. Fla. 2005) .

(n12)Footnote 7b. Courts have also refused to relitigate ad valorem tax liabilities where the state or local administrative protest procedures were employed by the debtor to contest the claim. *See, e.g., In re Cody* 338 F.3d 89 (2d Cir. 2003) ; *In re Onondaga Plaza Maintenance Co., Inc.*, 206 B.R. 653 (Bankr. N.D.N.Y. 1997) ; *In re Ledgemere Land Corp.* 135 B.R. 193 (Bankr. D. Mass. 1991) ; *In re El Tropicano, Inc.*, 128 B.R. 153 (Bankr. W.D. Tex. 1991) ; *In re Ishpeming Hotel Corp.*, 70 B.R. 629 (Bankr. W.D. Mich. 1986) . *See also In re Trans State Outdoor Advertising Co.*, 140 F.3d 618 (5th Cir. 1998) , which held that the decision by an administrative agency determining a tax liability, even though it was subject to de novo review, deprived the bankruptcy court of jurisdiction to redetermine the tax liability. A similar result was reached in *In re The Railroad Street Partnership*, 255 B.R. 644 (Bankr. N.D.N.Y. 2000) . However, if the tax dispute is still pending before the state or local tribunal when the bankruptcy proceeding is filed, the bankruptcy court is not precluded from exercising jurisdiction under section 505(a). *In re Mantz*, 343 F.3d 1207 (9th Cir. 2003) . For examples of other situations where bankruptcy courts were permitted to determine state or local tax liabilities because there had been no prior adjudication, *see In re Mulberry Phosphates, Inc.*, 283 B.R. 347 (Bankr. M.D. Fla. 2002) ; and *In re Custom Distribution Services, Inc.*, 216 B.R. 136 (Bankr. D.N.J. 1997) .

(n13)Footnote 8. *Freeman v. Commissioner*, 799 F.2d 1091 (5th Cir. 1986) . *But see Delpit v. Commissioner*, 18 F.3d 768 (9th Cir. 1994) . By virtue of the contrary *Delpit* decision, this issue is now uncertain. *See P TX5.06[1] infra*. The Eleventh Circuit considered both *Freeman* and *Delpit* in *Roberts v. Commissioner*, 175 F.3d 889 (11th Cir. 1999) and decided that the Fifth Circuit's approach in *Freeman* was correct.

(n14)Footnote 9. 28 U.S.C. § 158 provides for appeals from bankruptcy courts to either the appropriate district court or to a bankruptcy appellate panel ("BAP"), if one is available. Subsequent appeals are to the appropriate court of appeals. Appeals of bankruptcy court decisions are discussed in *P TX5.12 infra*.

(n15)Footnote 10. The bankruptcy courts are units of their respective district courts and exercise jurisdiction delegated to them by the district courts. 28 U.S.C. §§ 157, 1334.

(n16)Footnote 10a. A similar result was reached a few years earlier in *City of Perth Amboy v. Custom Distribution Services, Inc.* (*In re Custom Distribution Services, Inc.*), 224 F.3d 235 (3d Cir. 2000) . This decision was followed by a bankruptcy court in the same circuit prior to the amendment of the statute. *In re ANC Rental Corporation*, 316 B.R.146 and 316 B.R. 150 (Bankr. D. Del. 2004) (Two opinions).

(n17)Footnote 10b. *City of Perth Amboy v. Custom Distribution Services, Inc.*, n.10a, *supra*, 224 F.3d at 240, n. 5 ("actual litigation necessary to trigger the application of § 505(a)(2)(A)"); *In re Buchert*, 69 B.R. 816 (Bankr. N.D. Ill. 1987) , *aff'd*, 1987 U.S. Dist. LEXIS 7550 (N.D. Ill. 1987) ; *In re Tapp*, 16 B.R. 315 (Bankr. D. Ala. 1981) . A hearing before an administrative law judge in which parties had the opportunity to subpoena and call witnesses, later approved by the state's Comptroller of Public Accounts was "quasi-judicial" and, therefore, qualified as an "administrative or judicial tribunal" under section 505(a)(2)(A) so as to preclude relitigation in the bankruptcy court. *Texas Comptroller of Public Accounts v. Trans State Outdoor Advertising Co., Inc.* (*In re Trans State Outdoor Advertising Co., Inc.*), 140 F.3d 618, 40 C.B.C.2d 105 (5th Cir. 1998) .

(n18)Footnote 11. *In re Grand Chevrolet, Inc.*, 153 B.R. 296 (C.D. Cal. 1993) . The debtor's estate was substantively consolidated with that of another debtor, and the court was requested to approve the filing of a consolidated income tax return for the two estates. *Grand Chevrolet* was followed by a court which refused to determine a corporation's tax status prior to the existence of an actual case or controversy with the IRS over a tax said to be due. *Inter Urban Broadcasting v. Lewis* (*In re Inter Urban Broadcasting*), 180 B.R. 153 A.F.T.R.2d P 95-480 (Bankr. E.D. La. 1995).

(n19)Footnote 12. 153 B.R. 296 (C.D. Cal. 1993) .

(n20)Footnote 12a. 215 B.R. 1 (*Bankr. D.N.H.* 1997) , *aff'd in part and rev'd in part*, 98-2 USTC P 50,746 (1998).

(n21)Footnote 12b. *In re Amoskeag Bank Shares, Inc.*, 98-2 USTC P 50,746 (D.N.H. 1998).

(n22)Footnote 12c. *In re Amoskeag Bank Shares, Inc.*, 98-2 USTC P 50,746 (D.N.H. 1998).

(n23)Footnote 13. See P TX5.03[1] *supra*.

(n24)Footnote 14. See *Bostwick v. United States*, 521 F.2d 741 (8th Cir. 1975) ; *In the Matter of Century Vault*, 416 F.2d 1035 (3d Cir. 1969) . Although these cases were decided under section 2a (2A) of the former Bankruptcy Act, because of the similarity of the language in section 505(a), they would probably still be accepted as good authority for this proposition. Note that once a bankruptcy court has jurisdiction over a debtor's tax liability by virtue of Section 505(a)(1), even a stipulated agreement as to the amount the liability has the effect of a final judgment. *In re Mantunas*, 261 B.R. 129 , *on reh'g*, 264 B.R. 365 (*Bankr. D.N.J.* 2001) .

(n25)Footnote 15. *Fed. R. Bankr. P.* 9014. Procedures for filing a claim for refund or credit by a bankruptcy trustee are found in *Rev. Proc.* 81-18, 1981-1 C.B. 688 ; *Taylor v. IRS (Matter of Taylor)*, 132 F.3d 256, 262 (5th Cir. 1998) . *Fed. R. Bankr. P.* 1017, 1019, 2002, 2003, 3020, 3021, 4001, 4004, 4007, 6004, 6006, 7001, 7004, 7062, 9006 and 9014 of the Federal Rules of Bankruptcy Procedure, were amended, effective December 1, 1999.

(n26)Footnote 16. *Fed. R. Bankr. P.* 7004(b)(4), (b)(5). *Fed. R. Bankr. P.* 7004 was amended by Pub. L. No. 104-204, effective as of December 1, 1996. It is suggested that the applicable office of the District Counsel of the Internal Revenue Service, the Department of Justice Tax Division; and the Special Procedures Division for the district also be served.

(n27)Footnote 17. *Fed. R. Bankr. P.* 7026-7037, 9014. (Note that the corresponding Federal Rules of Civil Procedure were substantially amended as of December 1, 1993. The implementation of these controversial amendments has been delayed in some districts.)

(n28)Footnote 17a. A tax liability may be resolved as part of the confirmation of a chapter 11 plan of reorganization pursuant to the authority granted to the bankruptcy court by section 505. If this option is utilized, however, specific notice of the intended determination of tax liability must be given to the IRS over and above serving it with a copy of the plan and disclosure statement. *Taylor v. IRS (Matter of Taylor)*, 132 F.3d 256, 262 (5th Cir. 1998) . *Taylor* was discussed and distinguished in *Puckett v. United States*, 82 F. Supp. 2d 660 (S.D. Tex. 1999) , *aff'd*, 213 F.3d 636 (5th Cir. 2000) . A result similar to *Taylor's* was reached in *Deutchman v. Internal Revenue Service (In re Deutchman)*, 192 F.3d 457 (4th Cir. 1999) . In a Chapter 13 proceeding, a bankruptcy court found insertion into the plan of a footnote with contradictory language regarding the priority of prepetition interest on a tax debt did not constitute an "offer" to treat the tax liability in a manner different than that required by the Bankruptcy Code. Insertion of the language was not reasonably calculated to inform the creditor of the impact the plan would have upon its rights and was potentially sanctionable. *In re Luarks*, 51 C.B.C.2d 737, 301 B.R. 352 (*Bankr. D. Kan.* 2003) . The Tax Court has held that without a specific determination of tax liability pursuant to section 505, the IRS could, after confirmation of a Chapter 11 plan, assert that the debtors owed additional taxes for periods that were included in the plan. *Hambrick v. Commissioner*, 118 T.C. 348 (2002) .

(n29)Footnote 18. In this respect, section 505(a) is a broader grant of jurisdiction to the bankruptcy court over tax disputes than that provided by the Bankruptcy Act which contained no refund jurisdiction. See *United States v. Kearns*, 177 F.3d 706 (8th Cir. 1999) ; *Danning v. United States*, 259 F.2d 305 (9th Cir. 1959) , *cert. denied*, 359 U.S. 911, 79 S. Ct. 587, 3 L. Ed. 2d 574 (1959) . For a discussion of the bankruptcy court's jurisdiction under section 505(a)(2)(B), see *In re Penning Trust*, 196 B.R. 389 (*Bankr. E.D. Tenn.* 1996) . There are, however, limitations to the scope of the bankruptcy court's authority to adjudicate a claim for a tax refund. Only tax refunds related to prepetition tax years fall within the scope of section 505(a)(2)(B). In the unlikely event of a refund being sought for a postpetition period, Section 505(b) would provide jurisdiction to the bankruptcy court. Thus, a bankruptcy court does not have jurisdiction

to determine a debtor's entitlement to a tax refund relating to a postconfirmation tax year, and a debtor cannot unilaterally obtain this authority by claiming it via the terms of a confirmed plan. See *In re Maley*, 152 B.R. 789 (Bankr. W.D.N.Y. 1992). A bankruptcy court could not adjudicate a claim for refund brought by a corporate affiliate since the former corporate parent was the proper party and that party was not before the court. The bankruptcy court could hear a suit by the affiliate against its former parent disputing the allocation of any refund received. *Oakridge Consulting, Inc. v. United States (In re Consolidated FGH Liquidating Trust)*, 325 B.R. 564, 95 A.F.T.R. 2d 2126 (Bankr. S.D. Miss. 2005). The bankruptcy court held that to adjudicate the claim would require it to determine the tax liabilities of non-debtors which was not allowed. See P 5.04[5], *infra*.

In a highly unusual case, a court of appeals held that tax refund suits are non-core proceedings because they do not "depend upon title 11 for their existence but instead upon 28 U.S.C. § 1346(a)(1). Therefore, this court held that the bankruptcy court was limited to hearing the case and submitting proposed findings of fact and conclusions of law to the district court. *Dunmore v. United States*, 358 F.3d 1107 (9th Cir. 2004). "Our approach treats *all tax refund claims*, whether the IRS alleges an offset or not, as non-core proceedings *entitled to an Article III adjudicator*." 358 F.3d at 1115 (emphasis added). Why the court confined its analysis to what constitutes a core proceeding and failed to consider 11 U.S.C. § 505(a)(2)(B), which expressly gives the bankruptcy courts jurisdiction over refund suits, is not clear. The conclusion that an "Article III adjudicator" is required for "all tax refund claims" is also inconsistent with the very statute relied upon by the court, 28 U.S.C. § 1346(a), which begins by stating that the district courts shall have concurrent jurisdiction with the Court of Federal Claims, another Article I court. As it stands, the decision appears to be contrary to the clear language of the Bankruptcy Code and the long-standing practice of bankruptcy courts adjudicating tax refund claims and issuing final decisions on them. This opinion would also thwart the goal of a more rapid adjudication of tax refund suits provided for by section 505(a)(2)(B)(I) which allows them to be filed on an expedited basis in bankruptcy proceedings instead of the usual six-month period that applies elsewhere, since the bankruptcy court would be restricted to trying the case and submitting proposed findings and conclusions to the district court which then review them, presumably after receiving objections and responses from the parties. See n19 *infra*. The Ninth Circuit did note that its decision was "at odds with" the Sixth Circuit's decision in *Gordon-Selway Inc. v. United States (In re Gordon-Selway)*, 270 F.3d 280 (6th Cir. 2001).

(n30)Footnote 19. Compare 11 U.S.C. § 505(a)(2)(B)(I) with I.R.C. §§ 6532(a), 7422(a). The absolute nature of the requirement that a claim for refund be filed in a bankruptcy case was recognized in *Graham v. United States (In re Graham)*, 981 F.2d 1135, 28 C.B.C.2d 78 (10th Cir. 1992) ("Simply put, no claim, no refund."). In addition, in refund suits against state and local taxing authorities, unless the debtor/trustee has complied with state procedural requirements for obtaining a refund, the bankruptcy court lacks jurisdiction. *United States v. Kearns*, 177 F.3d 706 (8th Cir. 1999) (although section 505(a) begins with broad language, permitting the bankruptcy court to determine tax liability, the grant of authority is subsequently restricted by the provision of paragraph (2), which requires the trustee, an entity which includes the debtor-in-possession, to file a claim for refund with the appropriate governmental unit. Thus, under the Bankruptcy Code, the refund procedures outlined in the Internal Revenue Code and regulations must be pursued as a condition to bankruptcy court jurisdiction over refund disputes). See also *In re Constable Terminal Corp.*, 222 B.R. 734, 737 (Bankr. D.N.J. 1998) (section 505 allows the court to make a determination of the correct amount of a debtor's tax liability; refunds can be determined by the court if the refund claim is properly claimed under applicable nonbankruptcy law; section 505(a)(2)(B) specifically provides that the debtor/trustee "properly requests" the refund and therefore the state or federal procedural rules for claiming a refund must be met before the court can grant a refund even by setoff or counterclaim); *In re Penning Trust*, 196 B.R. 389 (Bankr. E.D. Tenn. 1996); *In re EUA Power Corporation.*, 184 B.R. 631 (Bankr. D.N.H. 1995). For the effect of *Seminole Tribe of Florida v. Florida*, 517 U.S. 44, 116 S. Ct. 1114, 134 L. Ed. 2d 252, 34 C.B.C.2d 1199 (1996) on the determination of taxes owed to states, see P TX12.02 *infra*.

(n31)Footnote 20. See the discussion of legislative history in 4 *Collier on Bankruptcy*, P 505.LH (Matthew Bender 15th Ed. Revised). Senate and House comments are identical. See also 11 U.S.C. § 106(b). One court has even held that when the refund is to be used to setoff or reduce a tax liability, then the requirement of filing a claim for refund itself

does not apply. *Michaud v. United States*, 206 B.R. 1 (D.N.H. 1997) . But see *Willis v. United States*, 198 B.R. 201 (S.D. Tex. 1996) . Relying upon setoff cases, one bankruptcy court has evidently dispensed with the requirement of first filing a claim for refund even though no setoff was involved in the case before it. *Schroeder v. United States (In re Van Dyke)*, 275 B.R. 854 (Bankr. C.D. Ill. 2002) .

(n32)Footnote 21. See, e.g., *Flora v. United States*, 357 U.S. 63, 78 S. Ct. 1079, 2 L. Ed. 2d 1165 (1959) , *aff'd on rehearing*, 362 U.S. 145, 80 S. Ct. 630, 4 L. Ed. 2d 623 (1960) .

(n33)Footnote 22. The court in *United States v. Kearns*, 177 F.3d 706 (8th Cir. 1999) confirmed this neutrality when it required full compliance with nonbankruptcy law provisions regarding claims for refunds of taxes: "Under the Bankruptcy Code, a debtor, debtor-in-possession and trustee are provided means by which to contest tax liability and dischargeability. The Bankruptcy Code, however, did not abrogate all provisions relating to administrative procedures under nonbankruptcy law. Indeed, Section 505(a), while it provides for a shortened procedure with regard to administrative determination of tax refunds, expressly maintains the jurisdictional requirement found in the Internal Revenue Code, 26 U.S.C. § 7422. In order to provide for bankruptcy court jurisdiction over his claim for a federal income tax refund, the debtor was required to, but did not, file a proper claim for refund with the Internal Revenue Service. The procedures outlined in section 505(a), governing determination of refunds from governmental agencies, does not expand a debtor's right to a refund beyond that granted to every other taxpayer." H.R. Rep. No. 595, 95th Cong., 1st Sess. 274 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised). A bankruptcy court did not have jurisdiction to review the denial by the IRS of a debtor's application for a tentative carryback creating a "quickie refund" under 26 U.S.C. § 6411. *In re New Century TRS Holdings, Inc.*, 386 B.R. 11 (Bankr. D. Del. 2008) .

(n34)Footnote 23. IRS Forms 1040X and 1120X are used for individual and corporate income taxes respectively. Refunds of other types of taxes may be claimed on IRS Form 843.

(n35)Footnote 24. I.R.C. § 6511. *In re Farrell*, 211 B.R. 79 (Bankr. M.D. Fla. 1997) . See also *In re Swan*, 152 B.R. 28 (Bankr. W.D.N.Y. 1992) . The *Swan* court declined to exercise its discretionary jurisdiction when the individual debtor was the only party interested in the potential refund. The Fifth Circuit reached a contrary result in *Internal Revenue Service v. Luongo (In re Luongo)*, 259 F.3d 323 (5th Cir. 2001) . *In re Carter*, 125 B.R. 832 (Bankr. D. Kan. 1991) , held that the filing of a petition under title 11 does not extend the period of limitations for filing a claim for refund. See also *In re Dougherty*, 187 B.R. 883 (Bankr. E.D. Pa. 1995) ; *Matter of Qual Krom South, Inc.*, 119 B.R. 327 (Bankr. S.D. Fla. 1990) ; *Lynch v. Rogan*, 50 F. Supp. 356 (S.D. Cal. 1943) (Act case). Note that in some instances section 108(b) may provide an additional 60 days after the order for relief is entered in which to file the claim. The Fifth Circuit, however, has held that section 108 does not extend the period for filing. *TLL, Inc. v. United States*, 100 F.3d 424 (5th Cir. 1996) . Since a tax refund is not an action against the debtor, section 108(c) is inapplicable. *Roberts v. Commissioner*, 175 F.3d 889 (11th Cir. 1999) . See also *Firsdon v. United States*, 95 F.3d 444 (6th Cir. 1996) ; *In re Perkins*, 216 B.R. 220 (Bankr. W.D. Ohio 1997) , in which the court rejected jurisdictional arguments for a refund by setoff. It has been held that the fact that the IRS had invoked the aid of the bankruptcy court in collecting unpaid taxes does not waive its right to assert that limitations bar an untimely refund suit for the same tax periods. See *Internal Revenue Service v. Pransky*, 261 B.R. 380 (D.N.J. 2001) , *aff'd*, 318 F.3d 536 (3d Cir. 2003) .

A bankruptcy court has explained that there are actually two periods of limitations applicable to bringing a suit for the refund of federal taxes. First, the claim must be filed with the IRS within three years from the time the return was filed or two years from date the tax was paid, whichever period expires later. 26 U.S.C. § 6511. Second, the suit must be filed within two years after the claim has been denied. 26 U.S.C. § 6532. *In re Smythe*, 306 B.R. 218 (Bankr. N.D. Ohio 2004) . Of course, this second period defines the last day for filing suit after the IRS denies a claim; Section 505 shortens the period for the first possible day for filing the suit to 120 days after the claim was filed regardless of whether the IRS has acted upon it.

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refund of federal taxes. First, the claim must be filed with the IRS within three years from the time the return was filed or two years from date the tax was paid, whichever period expires later. 26 U.S.C. § 6511. Second, the suit must be filed within two years after the claim has been denied. 26 U.S.C. § 6532. *In re Smythe*, 306 B.R. 218 (Bankr. N.D. Ohio 2004). Of course, this second period defines the last day for filing suit after the IRS denies a claim; Section 505 shortens the period for the first possible day for filing the suit to 120 days after the claim was filed regardless of whether the IRS has acted upon it. Although a tax refund asserted as a setoff against another tax liability might not require the filing of a claim with the IRS, it was still subject to the same periods of limitations. *In re Rodriguez*, 387 B.R. 76 (Bankr. E.D.N.Y. 2008). Note: Some courts may disagree in so far as the filing of a claim with the IRS is required. See P TX5.08[2][c] *infra*.

(n36)Footnote 24a. The Fifth Circuit endorsed this view in an unusual case where the trustee argued that since the IRS had stipulated to the amount by which the tax was overpaid, it became a "liquidated" amount subject to turnover long after the limitations on refund suits had expired. *United States v. Neary (In re Armstrong)*, 206 F.3d 465 (5th Cir. 2000).

The Federal courts exercise jurisdiction over suits for the refund of federal taxes pursuant to 28 U.S.C. § 1346(a)(1). This section, together with 26 U.S.C. § 7422(a), constitutes a waiver by the United States of its sovereign immunity with respect to refund suits by taxpayers to recover internal revenue taxes alleged to have been erroneously or illegally assessed. The Code section provides that no refund suits shall be maintained in federal court until a claim for refund has been filed with the IRS. The taxpayer has the burden of establishing the existence of federal court jurisdiction. The plain language of § 7422(a) makes it abundantly clear that the Statute applies not only to tax refunds but also to "any sum alleged to have been in any manner wrongfully collected." I.R.C. § 7422(a). Thus, under both the plain language of the Statute the court concluded the provisions of I.R.C. § 7422(a) applied to earned income credits.

(n37)Footnote 25. I.R.C. § 7422(a); *United States v. Felt & Tarrant Mfg. Co.*, 283 U.S. 269, 51 S. Ct. 376, 75 L. Ed. 1025 (1931). *Treas. Reg. § 301.6402-2(b)(1)*, provides:

No refund or credit will be allowed after the expiration of the statutory period of limitation applicable to the filing of a claim therefor except upon one or more of the grounds set forth in a claim filed before the expiration of such period. The claim must set forth in detail each ground upon which a credit or refund is claimed and facts sufficient to apprise the Commissioner of the exact basis thereof. The statement of the grounds and facts must be verified by a written declaration that is made under the penalties of perjury. A claim that does not comply with this paragraph will not be considered for any purpose as a claim for refund or credit.

(n38)Footnote 26. The appropriate allocation of burden of proof in actions brought pursuant to section 505 is discussed in P TX5.04[6] *infra*. For present purposes, it should be understood that the double burden imposed upon parties claiming tax refunds permits the government to assert any other liabilities which would reduce or eliminate the refund. *Lewis v. Reynolds*, 284 U.S. 281, 52 S. Ct. 145, 76 L. Ed. 293, modified, 284 U.S. 599, 52 S. Ct. 264, 76 L. Ed. 514 (1932); *King v. United States*, 641 F.2d 253 (5th Cir. 1981). Note that 1998 amendments to the Internal Revenue Code now provide that in some instances the burden of proof may be shifted to the Government. See 26 U.S.C. § 7491.

(n39)Footnote 26a. *In re Consolidated FGH Liquidating Trust*, 325 B.R. 564 (Bankr. S.D. Miss. 2005). Although the bankruptcy court refused to exercise jurisdiction over claim for refund filed by a new corporate parent on behalf of a subsidiary corporation for a taxable period during which the subsidiary was owned by its former parent, it made several important qualifications. First, the former parent continued to have a duty to protect its former subsidiary's interests with respect to any refund in which it might have an interest. Second, no ruling was made on the right of the liquidating trustee to assert an interest in any such refund.

(n40)Footnote 27. 11 U.S.C. § 541. *In re Wilson*, 49 B.R. 19 (Bankr. N.D. Tex. 1985) ; *In re Guerrero*, 30 B.R. 463 (Bankr. N.D. Ind. 1983) ; *In re Nichols*, 4 B.R. 711 (Bankr. E.D. Mich. 1980) . Although they were decided under the former *Kokoszka v. Belford*, 417 U.S. 642, 94 S. Ct. 2431, 41 L. Ed. 2d 374 (1974) , and *Segal v. Rochelle*, 382 U.S. 375, 86 S. Ct. 511, 15 L. Ed. 2d 428 (1966) , are frequently cited by bankruptcy courts as authority for this proposition in cases brought under the Bankruptcy Code. See also H.R. Rep. No. 595, 95th Cong., 1st Sess. 367 (1977), reprinted in Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

Where, prior to filing a chapter 7 proceeding, a debtor had applied a prepetition tax overpayment that would otherwise have created a refund for his bankruptcy estate to satisfy a future postpetition tax liability, a bankruptcy court held that the value of this overpayment, or credit, was property of the estate and required the debtor to pay that amount to the trustee. *Birdsell v. Nichols (In re Nichols)*, 309 B.R. 41 (Bankr. D. Ariz. 2004) .

Although the courts have normally held that a taxable year during which a title 11 proceeding is filed is a post-petition tax period, absent a statutory election to split the year into two tax years, one court has held that the Earned Income Credit ("EIC") can be prorated, so that the portion of the EIC accrued before the title 11 petition is filed creates a tax refund which is property of the estate, not the debtor. *In re Ryan*, 224 F.3d 1193 (10th Cir. 2000) . The question of whether to prorate a refund generated by the federal child tax credit has produced conflicting answers. Compare *In re Schwarz*, 314 B.R. 433 (Bankr. D. Neb. 2004) (not prorated) with *In re Griffin*, 339 B.R. 900 (Bankr. E.D. Ky 2006) ; *In re Law*, 336 B.R. 780 (B.A.P. 8th Cir. 2006) (prorated). The controversy over whether a tax refund for a year in which a Chapter 11 proceeding is filed may be prorated into pre- and postpetition elements continues. A bankruptcy court's decision to prorate was affirmed in *Araj v. Kohut (In re Araj)*, 371 B.R. 240 (E. D. Mich. 2007) . After noting that the debtors had not elected to split a calendar year into separate pre- and postpetition tax years as allowed by 26 U.S.C. § 1398, a bankruptcy court ordered that a tax refund be allocated between the Chapter 7 trustee and the debtors. *In re Middendorf*, 381 B.R. 774 (Bankr. D. Kan. 2008) . Query: If a taxpayer had been in a refund posture when a Chapter 11 proceeding was filed in November but received income sufficient to extinguish the refund in December, would a proration be ordered?

(n41)Footnote 27a. See, 28 U.S.C. § 157(e) which grants the bankruptcy courts limited statutory jurisdiction to conduct jury trials if: (i) the right to a jury trial exists in a proceeding that may be heard under 28 U.S.C. § 157, (ii) the district court has specifically designated the bankruptcy court with jurisdiction to hear jury trials, and (iii) all parties consent to the jury trial in the bankruptcy court.

(n42)Footnote 27b. *Granfinanciera, S.A. v. Nordberg*, 492 U.S. 33, 109 S. Ct. 2782, 106 L. Ed. 26, 20 C.B.C.2d 1216 (1989) .

(n43)Footnote 27c. See 28 U.S.C. §§ 1346 and 2402. 26 U.S.C. § 1346 provides original jurisdiction of any civil action against the United States for the recovery of any internal revenue tax alleged to have been erroneously or illegally assessed or collected. 28 U.S.C. § 2402 provides the taxpayer a right to jury trial in any action against the United States under 28 U.S.C. § 1346 where a timely demand for jury trial is made by one of the parties.

(n44)Footnote 27d. 205 B.R. 226 (B.A.P. 9th Cir. 1997) .

(n45)Footnote 27e. See *Langekamp v. Culp*, 498 U.S. 42, 44, 111 S. Ct. 330, 331, 112 L. Ed. 2d 343, 347, 23 C.B.C.2d 973 (1990) , where the court recognized that by filing a claim against a bankruptcy estate the creditor triggers the process of "allowance and disallowance of claims" thereby subjecting himself to the bankruptcy court's equitable power.

(n46)Footnote 27f. *In re Smith*, 205 B.R.226, 229 (B.A.P. 9th Cir. 1997) .

(n47)Footnote 28. *In re Statmaster Corp.*, 465 F.2d 978 (5th Cir. 1972) .

(n48)Footnote 29. Besides enacting section 505(b), Congress also amended 28 U.S.C. § 2201 to make an exception to the general prohibition against declaratory judgments "with respect to Federal taxes." Section 505(b) is not, however, a method to invoke the court's authority to obtain a discharge of assessments for sanctions provided for in the Internal Revenue Code that are not taxes." For example, I.R.C. § 6722 provides for the assessment of a penalty for an employer's failure to provide Form W-2 to an employee. Those kinds of monetary sanctions as compared to income or excise taxes (including their related penalties) are not "taxes" which are the subject of the discharge in *section 505(b) of the Bankruptcy Code*. See, e.g., *United States v. Farm Loan Services, Inc. (In re Farm Loan Services, Inc.)*, 153 B.R. 234 (W.D. Wis. 1992) . Penalties and sanctions related to an income tax are dischargeable under the provisions of section 505(b) because the penalties and the interest are deemed under the Internal Revenue Code to be a part of the "tax."

(n49)Footnote 30. See, e.g., *In re Maley*, 152 B.R. 789 (Bankr. W.D.N.Y. 1992) ; *In re Hartman Material Handlings Systems, Inc.*, 141 B.R. 802 (Bankr. S.D.N.Y. 1992) . This subject is discussed in more detail in P TX 15.06.

(n50)Footnote 31. In an unusual situation, a creditors' committee was held to have authority to utilize section 505(b) with respect to the tax liability arising from an account created to pay their claims. *In re Goldblatt Bros., Inc.*, 106 B.R. 522 (Bankr. N.D. Ill. 1989) . An attempt to extend *Goldblatt Bros.* beyond its facts was rejected by the court in *Inter Urban Broadcasting v. Lewis (In re Urban Broadcas), Inc.*, 180 B.R. 153 (Bankr. E.D. La. 1995) . Standing to bring a request for determination of taxes owed by the debtor or the estate under section 505(b) is not restricted to trustees. *Gordon Sel-Way, Inc. v. United States (In re Gordon Sel-Way, Inc.)*, 270 F.3d 280 (6th Cir. 2001) .

(n51)Footnote 32. In 2006, the IRS revised the procedure for requesting a prompt determination of tax liability in all cases filed after the effective date of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (October 17, 2005). The contents of the request and the address in Philadelphia to which all requests of this type should be sent are provided in *Revenue Procedure 2006-24*, 24 I.R.B. 943, 2006 IRB LEXIS 313 . The address is Internal Revenue Service, Centralized Insolvency Operation, P. O. Box 21126, Philadelphia, PA 19114. The request must be post-marked "Request for Prompt Determination" and must be accompanied by an exact copy of the tax return or returns for a completed taxable period filed by the Trustee or the Debtor in Possession. This new Revenue Procedure supercedes the practice under *Revenue Procedure 81-17* .

(n52)Footnote 33. See *Kellogg v. United States (In re West Texas Marketing Corporation)*, 54 F.3d 1194, 1200 (5th Cir. 1995) , *reh'g denied*, 66 F.3d 324 (1995) , *cert. denied*, 516 U.S. 991, 116 S. Ct. 523, 113 L. Ed. 2d 430 (1996) (quoting *Treatise*).

(n53)Footnote 34. 11 U.S.C. § 505(b)(1)(A).

(n54)Footnote 35. 11 U.S.C. § 505(b)(1)(B).

(n55)Footnote 36. See I.R.C. § 6501(a), but note that section 505(b)(1)(B) authorizes the bankruptcy court to extend the 180-day period "for cause."

(n56)Footnote 37. 11 U.S.C. § 505(b)(3).

(n57)Footnote 38. 11 U.S.C. § 505(b)(2).

(n58)Footnote 39. See P TX5.04[2][b] *supra*.

(n59)Footnote 40. This amendment effectively overturned the decisions in the following cases: *Kellogg v. United States (In re West Texas Marketing Corp.)*, 155 B.R. 399 (Bankr. N.D. Tex. 1993) , *aff'd*, 94-1 U.S. Tax Cases (C.C.H.) P 50,063 (N.D. Tex. 1993), *aff'd*, 54 F.3d 1194, 1200 (5th Cir. 1995) , *reh. denied*, 66 F.3d 324 (1995) , *cert. denied*, 516 U.S. 991, 116 S. Ct. 523, 113 L. Ed. 2d 430 (1996) ; *In re Fondiller*, 125 B.R. 805 (N.D. Cal. 1991) ; *In re Rode*, 119 B.R. 697 (Bankr. E.D. Mo. 1990) ; *Kellogg v. United States (In re Southwestern States Marketing Corp.)*, 179 B.R. 813 (N.D. Tex. 1994) , *aff'd without pub op.*, 82 F.3d 413 (5th Cir. 1996) ; *In re Vale*, 204 B.R. 716 (Bankr. N.D. Ind.

1996) ; *In re Edwards*, 92 A.F.T.R.2d 6119 (Bankr. E.D. Pa. 2003) ; *United States v. Grassgreen (In re Grassgreen)*, 221 B.R. 975, 977 (M.D. Fla. 1998) .

(n60)Footnote 41. *See P TX5.06[1] infra.*

(n61)Footnote 42. 11 U.S.C. § 362(b)(9)(D).

(n62)Footnote 43. 11 U.S.C. § 505(c).

(n63)Footnote 44. 11 U.S.C. § 1107(a).

(n64)Footnote 45. *In re Major Dynamics, Inc.*, 14 B.R. 969 (Bankr. S.D. Cal. 1981) . *See also In re Jon Co., Inc.*, 9 C.B.C.2d 1, 30 B.R. 831 (D. Colo. 1983) . *In re Datair Systems Corporation*, 10 C.B.C.2d 255, 37 B.R. 690 (Bankr. N.D. Ill. 1983) .

(n65)Footnote 46. *In re Booth Towing Services, Inc.*, 53 B.R. 1014 (W.D. Mo. 1985) ; *In re County Wide Garden Center, Inc.*, 25 B.R. 203 (Bankr. S.D.N.Y. 1982) .

(n66)Footnote 47. *In re Brandt-Airflex Corp.*, 843 F.2d 90 (2d Cir. 1988) (debtor cannot use section 505(a) to request a bankruptcy court to determine tax liability of another party who might also be liable for the same taxes as the debtor); *In re LaSalle Rolling Mills, Inc.*, 832 F.2d 390, 17 C.B.C.2d 650 (7th Cir. 1987) (section 505(a) does not authorize a bankruptcy court to enjoin collection of taxes from a responsible officer of the debtor corporation). *LaSalle Rolling Mills* was followed by the district court in *United States v. Plainwell, Inc. (In re Plainwell, Inc.)*, (D. Del. 2004), . *But see Quattrone Accountants, Inc. v. Internal Revenue Service*, 895 F.2d 921, 22 C.B.C. 2d 427 (3d Cir. 1990) . For a general discussion of the issue, see G.M. Buechlein, Annotation, *Jurisdiction of Bankruptcy Court to Determine Tax Liability of Individuals or Entities Other than Debtor Under 11 U.S.C. § 505(a)* , 97 A.L.R. Fed. 160 (1990) .

Opinions like *Brandt-Airflex* continue to be good law after the Supreme Court's decision in *United States v. Energy Resources Co., Inc.*, 495 U.S. 545, 110 S.Ct. 2139, 109 L.Ed.2d 580, 22 C.B.C.2d 1093 (1990) . Nothing in that opinion suggests that bankruptcy courts have jurisdiction to determine the tax liabilities of non-debtors. *United States v. Prescription Home Health Care, Inc. (Matter of Prescription Home Health Care, Inc.)*, 316 F.3d 542 (5th Cir. 2002) . In an unusual case, a chapter 7 debtor brought a tax refund suit for prepetition years in district court after receiving his discharge in bankruptcy and that court transferred the case to the bankruptcy court where the trustee abandoned any interest in the claims. The bankruptcy court proceeded to adjudicate the claims. Ultimately, the court of appeals held that these tax refund claims by the discharged debtor did not constitute a core proceeding and that the bankruptcy court was limited to submitting proposed findings of fact and conclusions of law to the district court. *Dunmore v. United States*, n18, *supra*

The limitations on the jurisdiction granted by section 505(a) were considered in the context of a request by proponents of a Chapter 11 plan for a determination that post-confirmation payments to employees would not be wages subject to federal taxes. Noting that the courts have "balked" at "unbounded interpretations" of section 505(a) in cases like *Brandt-Airflex* and *Prescription Home Health Care*, the bankruptcy court concluded there was a consensus as to whose taxes could be determined but not as to when the tax issue must arise to be subject to adjudication. It then proceeded to hold that nothing in section 505(a) authorized a declaratory judgment of the type sought by the plan proponents and distinguished the jurisdiction granted by section 1146(d) as limited to state and local taxes. *In re UAL Corporation*, 336 B. R. 370 (Bankr. N.D. Ill. 2006) . For discussion, see *P TX15.06 infra.*

(n67)Footnote 48. I.R.C. §§ 6671, 6672 provide for the "100 percent" penalty permitting the Service to hold responsible persons liable for taxes which the corporation failed to withhold, collect and pay over to the Service. This topic is treated in more detail in chapter TX15 *infra* .

(n68)Footnote 49. *See, e.g., In re Proactive Technologies, Inc.*, 39 C.B.C.2d 482, 215 B.R. 796 (Bankr. N.D.

Okla. 1997) (the court refused to determine the validity of the 26 U.S.C. § 6672 liability of a corporate officer of the debtor because the benefits of 11 U.S.C. § 505 were only available to the corporate debtor); *In re Malone Properties*, 28 C.B.C.2d 569, 150 B.R. 160 (Bankr. S.D. Miss. 1993) ; *Wright v. Butz (In re Buildwright Homes, Inc.)*, 75 A.F.T.R.2d P 95-429 (Bankr. S.D. Ohio 1994) . *But compare In re Acme Music Co., Inc.* 196 B.R. 925 (Bankr. W.D. Pa. 1996) , where the court concluded it could determine the tax liability of a nondebtor third party where that determination was required as part of the administration of the estate. The fact that the liability of a third party was also determined was not a violation of the scope of the jurisdictional limitations of 11 U.S.C. § 505.

(n69)Footnote 50. *American Principals Leasing Corp. v. United States*, 904 F.2d 477 (9th Cir. 1990) . It has also been held that a general partner who was a debtor in a case under title 11 could not force the IRS to collect unpaid federal withholding taxes from the partnership before seeking collection from him. *In re Norton*, 158 B.R. 834 (Bankr. D. Idaho 1993) .

(n70)Footnote 51. *See P TX5.10 infra*. A bankruptcy court abstained from determining the tax liability of an officer of a corporation which had sought relief under title 11. *In re American Motor Club, Inc.*, 139 B.R. 578 (Bankr. E.D.N.Y. 1991) .

(n71)Footnote 52. *Kroh v. Commissioner*, 98 T.C. 383 (1992) .

(n72)Footnote 52a. *In re Litestream Techs., LLC*, 337 B.R. 705, 2006 Bankr. LEXIS 222 (Bankr. M.D. Fla. 2006) . *See 11 U.S.C. § 505(a)(1)(C)*.

(n73)Footnote 52b. *In re Uzialko*, 339 B.R. 579, 2006 Bankr. LEXIS 918 (Bankr. E.D. Pa. 2006) .

(n74)Footnote 53. *See P TX5.03[5] supra*. *Walters v. United States (In re Walters)*, 176 B.R. 835 (Bankr. N.D. Ind. 1994) citing *Treatise* at 867-68).

(n75)Footnote 54. *Fed. R. Bankr. P. 3001(f)*. *See, e.g., In re Fidelity Holding Co., Ltd.*, 837 F.2d 696 (5th Cir. 1988) .

(n76)Footnote 55. *See, e.g., In re Fidelity Holding Co., Ltd.*, 837 F.2d 696 (5th Cir. 1988) .

(n77)Footnote 56. Five years after its decision in *Fidelity Holding Co.*, the Court of Appeals for the Fifth Circuit reaffirmed its position that objections to tax claims were to be governed by the same burden of proof rules as other claims objections. *In re Placid Oil Company*, 988 F.2d 554 (5th Cir. 1993) . This case arose after a request for prompt determination of tax liability had been made pursuant to section 505(b). Subsequent to that request and the examination, the IRS filed an administrative claim, and an objection was filed. It is clear from the bankruptcy court's opinion, 140 B.R. 122 (Bankr. N.D. Tex. 1990) , that the burden of proof issue was decided solely upon rules relevant to the claims objection process. In its discussion, the court of appeals merely cited its earlier decision in *Fidelity Holding Co.* without any discussion of the contrary view of other courts of appeals. *See, e.g., In re Landbank Equity Corp.*, 973 F.2d 265 (4th Cir. 1992) ; *Resyn Corp. v. United States (In re Resyn Corp.)*, 851 F.2d 660 (3d Cir. 1988) . The distinction between the traditional burden of proof rules in claims objections and in motions to determine tax liability was noted by a bankruptcy court that concluded that the debtor should bear the burden of proof. *Walters v. United States (In re Walters)*, 176 B.R. 835 (Bankr. N.D. Ind. 1994) (citing *Collier* at 867-68). A similar result was reached in *Matter of Carden*, 1998 Bankr. LEXIS 1024 (Bankr. E.D. La. 1998) .

(n78)Footnote 56a. *Raleigh v. Illinois Department of Revenue*, 530 U.S. 15, 120 S. Ct. 1951, 147 L. Ed. 2d 13, 43 C.B.C.2d 861 (2000) . The Court's decision is discussed in detail in *P TX5.03[5] supra*.

(n79)Footnote 56b. Pub. L. No. 105-206, 112 Stat. 685. The burden of proof provision, 26 U.S.C. § 7491, applies to cases arising in connection with examinations begun after its enactment on July 22, 1998. If there is no examination, then the provision applies to taxable periods beginning or occurring after its enactment.

(n80)Footnote 56c. 26 U.S.C. § 6001. Although the bankruptcy court did state in its order whether the debtor had offered "credible evidence," it was clear that no credible evidence had been offered, and there was no error in refusing to shift the burden of proof. *Steffen v. United States (In re Steffen)*, 349 B.R. 734 (M.D. Fla. 2006) .

(n81)Footnote 56d. 26 U.S.C. § 7491(a)(2)(B). Note that the Senate Report states "A necessary element of cooperating with the Secretary is that the taxpayer must exhaust his or her administrative remedies (including any appeal rights provided by the IRS). The taxpayer is not required to agree to extend the statute of limitations to be considered to have cooperated with the Secretary." This legislative history suggests that a taxpayer in a title 11 proceeding would have to go through the IRS appeals process before the burden of proof could be shifted to the government in a determination of tax liability by a bankruptcy court.

(n82)Footnote 57. In this connection, consider the Supreme Court's literalist interpretation of the Bankruptcy Code. See *United States v. Ron Pair Enterprises, Inc.*, 489 U.S. 235, 109 S. Ct. 1026, 103 L. Ed. 2d 290, 20 C.B.C.2d 267 (1989) .

(n83)Footnote 58. See H.R. Rep. No. 595, 95th Cong., 1st Sess. 274 (1977), reprinted in Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised). "For policy reasons, the burden should not necessarily vary from one forum to another." *Walters v. United States (In re Walters)*, 176 B.R. 835 (Bankr. N.D. Ind. 1994) (citing *Collier at 867-68*). The applicability of the provision of the Internal Revenue Code regarding burden of proof to tax disputes litigated in bankruptcy courts would appear to follow from its language that it governs to "any court proceeding" without including a limitation to the Tax Court, the Court of Federal Claims, and the district courts. 26 U.S.C. § 7491(a)(1) "General Rule." (emphasis added).

(n84)Footnote 59. *Welch v. Helvering*, 290 U.S. 111, 115, 54 S. Ct. 8, 9, 78 L. Ed. 212 (1933) ; *Tax Court Rule 142*. The Commissioner will have the burden of proving new matters raised by the Service after issuance of the Notice of Deficiency, increases in the amount of tax after its issuance, affirmative defenses and fraud. Except for allegations of fraud, the preponderance of the evidence standard applies to whichever party has the burden of proof.

(n85)Footnote 60. The appropriate allocation of burden of proof in actions brought pursuant to section 505 is discussed in P TX5.04[6] *infra*. Without discussing the conflicting rules regarding which party bears the burden of proof in a title 11 case, one court of appeals held that an individual debtor bore the burden to disprove his liability for trust fund taxes pursuant to 26 U.S.C. § 6672. *United States v. Charlton*, 2 F.3d 237 (7th Cir. 1993) , *aff'g*, 144 B.R. 845 (E.D. Wis. 1992) . The court based its decision on a rule that applied in a district court proceeding. Compare *In re Terrell*, 75 B.R. 291 (N.D. Ala. 1987) , *aff'd without opinion.*, 835 F.2d 1439 (11th Cir. 1987) ; P TX5.03[5]. A district court in the Eleventh Circuit reached a similar conclusion by relying upon later circuit precedent in a nonbankruptcy case which held that once a party has been shown to be a "responsible person" under 26 U.S.C. § 6672, that party has the burden to prove that failure to pay the taxes was not willful. *United States v. Macagnone (In re Macagnone)*, 240 B.R. 444 (M.D. Fla. 1999) , *rev'g*, 228 B.R. 784 (Bankr. M.D. Fla. 1998) .

(n86)Footnote 61. See P TX5.03[5] *supra*.

(n87)Footnote 62. *In re Fidelity America Financial Corp.*, 91-1 U.S. Tax Cas. (CCH) P 50,161 (Bankr. E.D. Pa. 1990). The Court of Appeals for the Fourth Circuit has implicitly rejected such a distinction in the context of a claims objection. *In re Landbank Equity Corp.*, 973 F.2d 265 (4th Cir. 1992) .

(n88)Footnote 63. *Raleigh v. Illinois Department of Revenue*, 530 U.S. 15, 120 S. Ct. 1951, 147 L. Ed. 2d 13, 43 C.B.C.2d 869 (2000) .



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CHAPTER TX5 Litigation With the IRS in Bankruptcy Court

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P TX5.05 Estimation of Tax Claims

The claims objection process and determinations of tax liabilities under section 505 are the two primary jurisdictional vehicles for resolving disputed tax liabilities in the bankruptcy court. In certain situations, the Bankruptcy Code offers an interim solution to claims disputes in the form of a claims estimation proceeding. Although it has not been authoritatively decided whether a claims estimation proceeding is applicable to a disputed tax claim, n1 the uses and limitations of this option should be understood.

[1] Overview of the Bankruptcy Court's Authority to Estimate Claims

The Bankruptcy Code provides that a bankruptcy court "shall" estimate for purposes of allowance: "any contingent or unliquidated claim, the fixing or liquidating of which, as the case may be, would unduly delay the administration of the case." n1a A disputed tort claim against the debtors is the type of claim which would typically be subject to estimation. n2 Although the bankruptcy court appears to have some latitude in deciding whether the fixing or liquidating of the claim would unduly delay the administration of the case, once it has determined that an undue delay would result, estimation becomes mandatory. n3

Estimation was envisioned as a means for expeditiously determining the maximum amount of a claim which must be paid from the bankruptcy estate. n4 The particular procedures to be employed in an estimation proceeding are not provided by the Bankruptcy Code, and courts have held that the bankruptcy court has broad discretion in devising procedures appropriate to the demands of individual cases. n5 In most cases in which a bankruptcy court embarks upon an estimation proceeding, it will be a summary affair which makes extensive use of offers of proof and provides little opportunity for the presentation of evidence through live testimony. n6 Implicit in the nature of an estimation proceeding is the recognition that it is intended to be something more abbreviated than a traditional trial on the merits. n7 No particular form of pleading is required to request a bankruptcy court to estimate claims.

In a claims estimation proceeding in a case under title 11, the party dissatisfied with the result is presented with a difficult problem. Although a claims estimation proceeding is not intended to deny a party the right to a full and fair hearing on the merits of his or her claim, n8 an estimation of the maximum amount of the claim which must be paid from the title 11 estate may very well be the only hearing the claimant receives. Once distributions are made based upon the estimated value of the claim, it may be impossible for the claimant to seek a larger distribution at a later date if it is ultimately determined that the claim had a higher value than the one placed upon it in the estimation proceedings.

Obviously, this situation raises serious due process questions. n9 Conversely, if the claim is liquidated in time for the claimant to receive a larger share of the bankruptcy estate, then actions taken in reliance upon the lower estimated amount, such as the treatment of classes of claims in a proposed plan of reorganization, may be invalidated. Accordingly, the risks to all concerned require parties to proceed cautiously.

[2] Issues Related to the Estimation of Tax Claims

The issues which arise when a bankruptcy court is requested to estimate a federal tax claim are whether such a claim is "contingent" and whether it is "unliquidated." If the claim is not contingent or unliquidated, then it is not subject to estimation under the terms of section 502(c)(1). What constitutes a contingent or an unliquidated claim for purposes of section 502(c)(1) is not specified in the Bankruptcy Code. One bankruptcy court has defined a contingent claim as one based upon a future event, and such a claim is not considered to be contingent merely because it is disputed by the debtor. n10 Whether a claim is unliquidated and susceptible to estimation is sometimes said to depend upon whether the amount of the claim can be calculated. n11 In a more frequently encountered situation, the courts have consistently held that a debtor's dispute of a claim does not make it contingent or unliquidated when determining the amount of noncontingent and liquidated unsecured debt required to qualify as a chapter 13 debtor under *11 U.S.C. section 109(e)*. n11a The argument can be made that when the Service has conducted an examination and asserted a deficiency, the nature of its claim is fundamentally different from a disputed tort claim. There can be no dispute about the legal duty to pay the tax, but only a dispute as to the amount that must be paid. Likewise, once the Service has determined a deficiency, the amount of its claim has obviously been calculated. n12 The issue becomes more clouded, however, when the Service has not completed examinations for prepetition tax periods. n13

The procedural uncertainties encountered in estimation proceedings generally, coupled with the doubts as to whether tax claims in particular are susceptible to estimation, make section 502(c) a questionable tool for the resolution of tax disputes in cases under title 11. n14 It may be for these reasons that estimations of tax claims are relatively rare. Although some bankruptcy courts have been willing to estimate disputed tax claims, the practitioner representing a debtor should carefully consider all procedural alternatives before pursuing this one.

FOOTNOTES:

(n1)Footnote 1. *United States v. Sterling Consulting Corp. (In re Indian Motorcycle Co., Inc.)*, 46 C.B.C.2d 588, 261 B.R. 800, 809 (B.A.P. 1st Cir. 2001) (quoting the Treatise).

(n2)Footnote 1a. *11 U.S.C. § 502(c)(1)*. The Code also authorizes a bankruptcy court to estimate, or place a dollar value on, "any right to payment arising from a right to an equitable remedy for breach of performance." *11 U.S.C. § 502(c)(2)*. However, since tax claims are not equitable in nature, this consideration of claims estimation will focus exclusively on section 502(c)(1).

(n3)Footnote 2. *See, e.g., Bittner v. Borne Chemical Company*, 691 F.2d 134, 7 C.B.C.2d 376 (3d Cir. 1982) .

(n4)Footnote 3. *A.H. Robbins Co. v. Piccinin*, 788 F.2d 944 (4th Cir. 1986) , *cert. denied*, 479 U.S. 876, 107 S. Ct. 251, 93 L. Ed. 2d 177 (1986) ; *Addison v. Langston (In re Brints Cotton Marketing, Inc.)*, 737 F.2d 1338, 11 C.B.C.2d 588 (5th Cir. 1984) ; *In re Continental Airlines, Inc.*, 57 B.R. 842 (Bankr. S.D. Tex. 1985) ; *In re Nova Real Estate Investment Trust*, 7 C.B.C.2d 87, 23 B.R. 62 (Bankr. E.D. Va. 1982) .

(n5)Footnote 4. For a detailed discussion of the origin and purposes of section 502, *see 4 Collier on Bankruptcy, P 502.04* (Matthew Bender 15th Ed. Revised).

(n6)Footnote 5. *Bittner v. Borne Chemical Company*, 691 F.2d 134, 7 C.B.C.2d 376 (3d Cir. 1982) :

Despite the lack of express direction on the matter, we are persuaded that Congress intended the procedure to be undertaken initially by the bankruptcy judges, using whatever method is best suited to the particular contingencies at issue. *Bittner v. Borne Chemical Company*, 691 F.2d 134, 135, 7 C.B.C.2d 376 (3d Cir. 1982) .

(n7)Footnote 6. The right of a committee to intervene in a claims estimation proceeding and upon what terms was addressed by the court in the case of *In re Continental Airlines, Inc.*, 57 B.R. 839 (Bankr. S.D. Tex. 1985) .

(n8)Footnote 7. *In the Matter of Baldwin-United Corporation*, 13 C.B.C.2d 1369, 55 B.R. 885 (Bankr. S.D. Ohio 1985) .

(n9)Footnote 8. *The Court of Appeals for the Third Circuit in Bittner v. Borne Chemical Company*, 691 F.2d 134, 7 C.B.C.2d 376 (3d Cir. 1982) , makes repeated references to the "temporary" disallowance of the creditor's claim until the final resolution of the state court action.

(n10)Footnote 9. A discussion of the due process aspects of this problem may be found in *In the Matter of Baldwin-United Corporation*, 13 C.B.C.2d 1369, 55 B.R. 885, 896-902 (Bankr. S.D. Ohio 1985) . The bankruptcy court denied a due process challenge to its estimation proceeding by holding that since the claims were contingent, the claimants had no *present* property rights which entitled them to due process under the *Fifth Amendment*. Acknowledging the "hardship" which the claimants might suffer, the court concluded that the rights of these claimants had to give way in order to achieve what it considered to be the greatest good for the greatest number of parties in the case. Whether this utilitarian approach to constitutional law will ultimately find favor with the appellate courts remains to be seen. For a general discussion of this problem, see Kauffman, *Procedures for Estimating Contingent or Unliquidated Claims in Bankruptcy*, 35 *Stan. L. Rev.* 153 (1982).

(n11)Footnote 10. See *In re All Media Properties, Inc.*, 5 B.R. 126 (Bankr. S.D. Tex. 1980) , *aff'd per curiam*, 646 F.2d 193 (5th Cir. 1981) :

A claim is contingent as to liability if the debtor's legal duty to pay does not come into existence until triggered by the occurrence of a future event and such future occurrence was within the actual or presumed contemplation of the parties at the time the original relationship of the parties was created. On the other hand, if a legal obligation to pay arose at the time of the original relationship, but that obligation is subject to some future event or occurrence, the claim is not *contingent* as to liability, although it may be *disputed* as to liability for various reasons. 5 B.R. 126, 133 (emphasis added).

But see Bittner v. Borne Chemical Company, 691 F.2d 134, 7 C.B.C.2d 376 (3d Cir. 1982) :

The Rolfite stockholders assert that the claims are not contingent since they are not dependent on some future event that may never occur. In as much as the very existence of the claims in the reorganization proceeding is dependent on a favorable decision by the state court, the Rolfite stockholders are clearly mistaken. 691 F.2d 134, 137, n. 5 .

It would appear that the *Bittner* footnote makes any claim the debtor chooses to dispute a contingent one subject to estimation. Such a result would be difficult to support. The rule announced in *All Media Properties* was followed by *In re Dill*, 731 F.2d 629, 10 C.B.C.2d 1119 (9th Cir. 1984) . See also *In re Andrews*, 78 B.R. 420 (Bankr. E.D. Pa. 1987) . The Court of Appeals for the Fifth Circuit subsequently reaffirmed its position in *All Media Properties* and refused to make a distinction between "contingent as to liability" and "contingent as to collectability." In reaching its decision, the court recognized that the refusal to permit estimation of the claim appeared "to frustrate Section 502(c)(1)'s goal of accelerated payout to creditors." *First City Beaumont v. Durkay (In the Matter of Ford)*, 967 F.2d 1047 (5th Cir. 1992)

(n12)Footnote 11. *In re Vaughan*, 36 B.R. 935 (N.D. Ala. 1983) , *aff'd*, 741 F.2d 1383 (11th Cir. 1984) ; *In re Sylvester*, 6 C.B.C.2d 586, 19 B.R. 671 (B.A.P. 9th Cir. 1982) ; *In re Madison*, 168 B.R. 986 (D. Haw. 1994). *Contra In re Lambert*, 11 C.B.C.2d 693, 43 B.R. 913 (Bankr. D. Utah 1984) .

(n13)Footnote 11a. *In re Sivertsen*, 180 B.R. 513 (Bankr. N.D. Ill. 1994) . Subsequently, a court of appeals agreed, observing that the contention that a dispute was enough to make a tax debt "unliquidated" was against the "overwhelming body of precedent." A notice of deficiency had been issued to the taxpayer in this case. *United States v. Verdunn (Matter of Verdunn)*, 89 F.3d 799 (11th Cir. 1996) , *rev'g*, 160 B.R. 682 (Bankr. M.D. Fla. 1993) and 187 B.R. 996 (M.D. Fla. 1995) . *Verdunn* was followed by the Court of Appeals for the Second Circuit, which held that a debtor's pending disputes in an adversary proceeding brought pursuant to sections 505 and 523 did not make an unassessed liability for trust fund taxes contingent or unliquidated. *Mazzeo v. United States (In re Mazzeo)*, 131 F.3d 295, 39 C.B.C.2d 38 (2d Cir. 1997) . *Accord*, *In re Berenato*, 226 B.R. 819 (Bankr. E.D. Pa. 1998) . It would be anomalous if a decision by a debtor to dispute a tax claim resulted in the claim becoming contingent and unliquidated for permitting a claims estimation under section 502(c) but not for chapter 13 eligibility under section 109(e). *Verdunn* has been followed by bankruptcy courts both within and without the Eleventh Circuit. *See In re Newman*, 259 B.R. 914 (Bankr. M.D. Fla. 2001) ; *In re Vaughn*, 276 B.R. 323 (Bankr. D. N.H. 2002) . In a chapter 11 case, another bankruptcy court cited *Verdunn* in concluding that a claim was neither contingent nor unliquidated and refusing to estimate it under the authority of section 502(c). *In re Southern Cinemas, Inc.*, 45 C.B.C.2d 567, 256 B.R. 520 (Bankr. M.D. Fla. 2000) . A district court in the Eleventh Circuit affirmed a bankruptcy court's rejection of a debtor's contention that a notice of deficiency issued by the IRS was necessary before a tax debt became contingent and unliquidated. *Hounsom v. United States (In re Hounsom)*, 325 B.R. 319 (M.D. Fla. 2005) . Reversing a bankruptcy court, a district court in the Ninth Circuit relied upon *Verdunn* and explained that, if tax debts can be calculated, they are liquidated - especially if a notice of deficiency has been issued or an assessment has been made. *United States v. Ahmed (In re Ahmed)*, 362 B.R. 445 (C. D. Cal. 2006) .

When presented with a variation on this theme, a bankruptcy court rejected the contention of an individual debtor in a chapter 13 proceeding that the possibility the corporate employer might pay employees' trust fund taxes in its Chapter 11 proceeding made the derivative liability of the individual under 26 U.S.C. § 6672 for failure to withhold and pay the trust fund taxes a contingent liability. *In re Brown*, 302 B.R. 913, 92 A.F.T.R.2d 6000 (Bankr. D. Or. 2003) .

(n14)Footnote 12. *Cf. Williams v. United States*, 92-1 U.S. Tax Cas. (CCH) P 50,160 n.1 (N.D. Ala. 1992).

(n15)Footnote 13. As to any postpetition tax periods, it would appear that 11 U.S.C. § 505(b) provides a remedy which makes estimation unnecessary. *See P TX5.04[3] supra*.

(n16)Footnote 14. *United States v. Sterling Consulting, Corp. (In re Indian Motorcycle Co., Inc.)*, 46 C.B.C.2d 588, 261 B.R. 800, 809 (B.A.P. 1st Cir. 2001) .



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CHAPTER TX5 Litigation With the IRS in Bankruptcy Court

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P TX5.06 Litigation Related to the Automatic Stay

[1] The Effect of the Automatic Stay on the Internal Revenue Service

The filing of a title 11 petition invokes the automatic stay provision of the Bankruptcy Code. n1 The automatic stay prevents actions from being taken by creditors which might otherwise "dismember" the debtor to the detriment of the creditor body. The automatic stay thus provides for the orderly treatment of all creditor claims pursuant to the regime of classifications and priorities established in the Bankruptcy Code. n2

The automatic stay prohibits the IRS and other creditors from taking actions which are detrimental to the bankruptcy estate or which result in a creditor changing the nature or priority of a claim after the bankruptcy petition is filed. The provisions of *Bankruptcy Code section 362* that are the most relevant to a debtor's relationship with the Internal Revenue Service are:

1. Section 362(a)(1)--the Internal Revenue Service cannot commence or continue any judicial, administrative, or other action or proceeding against the debtor to recover a prepetition claim against the debtor;
2. Section 362(a)(2) and (6)--the Internal Revenue Service cannot attempt to enforce any prepetition judgment against the debtor;
3. Section 362(a)(3)--the Internal Revenue Service cannot take any action to obtain possession of property of the estate or to obtain control over property of the estate; n2a
4. Section 362(a)(4) and (5)--the Internal Revenue Service cannot take any action to create, perfect, or enforce any Notice of Federal Tax Lien against any property of the estate;
5. Section 362(a)(7)--the Internal Revenue Service cannot exercise its statutory right of setoff n3 to satisfy any prepetition debt against the debtor; and
6. Section 362(a)(8)--The debtor cannot commence, and neither the debtor or the Internal Revenue Service can continue, the litigation of a Tax Court petition after the title 11 petition has been filed.

These provisions of the Bankruptcy Code impose restrictions on the Internal Revenue Service at almost every level of its operations and relationships with taxpayers who have filed a petition under title 11. n3a The automatic stay thus affects the examination and collection functions of the Internal Revenue Service as well as the tax litigation branches of the Internal Revenue Service and the Tax Division of the Department of Justice. Under the right, albeit unusual, circumstances the automatic stay may also affect the criminal investigation division of the Internal Revenue Service. n4

It cannot be disputed that when a debtor has incurred an unpaid tax liability, the Internal Revenue Service will be a creditor in a case filed under title 11 and will be subject to the provisions of section 362(a). n5 The most notable issues relating to the litigation of the automatic stay against the Internal Revenue Service relate to the effect of the bankruptcy filing on Internal Revenue Service examination, postconfirmation collection activities by the Internal Revenue Service, the effect of the bankruptcy filing on a prepetition Tax Court petition, and, if the Internal Revenue Service violates the protective stay, to what extent the bankruptcy court can impose sanctions against the Internal Revenue Service.

[2] The Effect of the Stay on the Examination Process

The Internal Revenue Service is required to conduct civil and criminal tax investigations as may be necessary to enforce the provisions of the Internal Revenue Code. n6 If an examination or audit of tax returns is begun by the Internal Revenue Service before or after a petition under title 11 is filed, that audit can generally be continued after the petition is filed. It might be argued that the commencement or continuation of an Internal Revenue Service examination is a violation of section 362(a)(1) because the civil audit is an administrative process the final result of which is the recovery of a prepetition tax debt. As a rule, however, the institution or continuation of an Examination Division audit should not constitute a violation of the protective stay when the Internal Revenue Service is only attempting to calculate a tax liability, and is not actually attempting to assess or collect a calculated tax liability. n7 It is also not a violation of the automatic stay for any taxing authority to issue a Statutory Notice of Deficiency. n8 However, a taxing authority's postpetition assessment of a tax liability absent a court ordered modification or lifting of the stay was, prior to the enactment of section 362(b)(9)(D) in 1994, a violation of the automatic stay. n9 The Internal Revenue Service's delivery of correspondence to a debtor which is a prelude to the issuance of a Statutory Notice of Deficiency is not a violation of the automatic stay. n10 The Internal Revenue Service will also not violate the automatic stay when it completes an audit and changes the taxable status of an entity, even if that conclusion results in a fundamental change in the economic nature of the entity and the assessment of a tax liability. For example, the Employee Plan/Exempt Organization ("EPEO") Division of the Internal Revenue Service may investigate a debtor that claims to be tax-exempt, and it may determine that the debtor is in fact not a tax-exempt entity. The completion of this examination and determination is not a violation of the automatic stay because the revocation of an entity's tax-exempt status is not an act to collect, assess or recover a prepetition tax liability. n11

The Bankruptcy Reform Act of 1994 permits the postpetition assessment of a tax liability. n11a Section 362(b)(9)(D) also permits a taxing authority to issue a notice and demand for payment of the assessed tax. Where a tax assessment is void because it predates section 362(b)(9)(D), the statute of limitations for assessment may expire and the tax liability becomes unenforceable. n11b

The Criminal Investigation Division of the Internal Revenue Service may also be conducting an investigation of a debtor before or after the petition date. The commencement or continuation of a criminal tax investigation should generally not be prohibited by the automatic stay because the Bankruptcy Code specifically authorizes "the commencement or continuation of a criminal action or proceeding against the debtor." n12 Most criminal tax investigations are begun after the referral of a fraud allegation from the Examination Division to the Criminal Investigation Division. After the Criminal Investigation Division begins to participate in an audit investigation, it will continue to work with the Examination Division to complete the audit in order to ensure the calculation of a tax deficiency, which is required in order to prosecute some tax crimes. It may therefore be difficult to argue that a criminal investigation should not continue, because that process may also be necessary to the calculation of the taxpayer's tax liability.

If, however, a taxpayer discovered exceptional circumstances and were able to show that the asserted Criminal Investigation Division investigation was merely a means to collect a civil tax liability, then the automatic stay provisions might be invoked to prohibit that investigation. n13 Absent compelling facts which clearly prove an improper motive on the part of the Internal Revenue Service investigators, the great weight of authority indicates that most courts will probably refrain from interfering with the completion of any state or federal criminal tax investigation.

It is unclear to what extent the Internal Revenue Service's discovery procedures are affected by the automatic stay even if such actions are conducted only as a part of a civil tax determination. For example, may a bankruptcy court limit the scope of the Internal Revenue Service's investigative summons powers? Recent litigation has indicated that some courts may limit the scope of the Internal Revenue Service's audit investigative powers after a title 11 petition has been filed. n14 In civil, collection, and criminal tax proceedings, the Internal Revenue Code allows the Internal Revenue Service to issue summons to collect information from taxpayers and third parties. n15 There appears to be a division of authority concerning whether the issuance of a civil investigative summons is a violation of the automatic stay. At least one court has held that the automatic stay of section 362(a) prohibits any Internal Revenue Service inquiry into the business records of the debtor taxpayer. n16 Other courts have generally allowed the IRS to continue its examination (but not collection) investigations which includes the issuance of one or more summonses to gather any information relevant to the determination of the taxable income and allowable deductions of a debtor taxpayer. n17

It can be argued that the view which forbids the issuance of a summons is an overextension of the protective scope of the automatic stay. Cases such as *In re Spencer* n18 run contrary to authority concerning the Internal Revenue Service's investigative power, the protectible interests that a taxpayer has in business records held by a third party, and the purpose behind the automatic stay. n19

An adversary proceeding concerning the ability of the Internal Revenue Service to issue a summons to calculate a tax liability may do more strategic harm to the debtor than might be readily apparent. The Internal Revenue Service may not be able to complete its examinations without the records requested from the debtor or a third party. Any delay resulting from a dispute over the validity of a postpetition summons may result in delays in the approval of net operating losses, tax refunds, or other tax attributes which may be necessary to the successful confirmation of a plan. n20

A balancing of the two lines of authority concerning the validity of a postpetition summons, however, must be made on a case by case basis. The debtor should also make sure that mounting an opposition to an administrative summons will not cause it harm due to unanticipated delays.

[3] The Effect of the Stay on the Internal Revenue Service's Ability to Assess a Tax Liability

The Bankruptcy Code prohibits any acts by any creditor to collect, assess or recover a prepetition claim against the debtor. n21 The "assessment" of a tax liability by the Internal Revenue Service is the formal recording of a taxpayer's tax liability in the records or tax rolls of the Internal Revenue Service. n22 After assessment, the tax liability becomes fully collectible by the Internal Revenue Service, interest and penalties can be assessed, and Notices of Federal Tax Liens can be filed to perfect the tax liability as against third parties. n23 After assessment of a tax liability, the procedures for contesting a tax liability through litigation are also significantly altered because only a refund suit can be filed to contest a liability after it has been assessed. n24 The assessment of a tax liability alters the debtor-creditor relationship that exists between the Internal Revenue Service and a debtor. n25 Prior to the Bankruptcy Reform Act of 1994, n26 the postpetition assessment of prepetition tax liabilities was prohibited.

An exception to this general prohibition against the postpetition assessment of a prepetition tax liability was, however, created in section 116 of the Bankruptcy Reform Act of 1994. n27 Section 116 of the 1994 Act amends *section 362(b)(9) of the Bankruptcy Code* to permit postpetition tax assessments, so that the section 362(a) stay against

postpetition tax assessments is terminated. Under *section 362(b)(9)(D) of the Bankruptcy Code* as amended, the IRS can make "an assessment for any tax" asserted against the debtor taxpayer. Section 116 of the Bankruptcy Reform Act of 1994 also allows the Internal Revenue Service to issue a notice and demand for the payment of such an assessment. *section 362(b)(9)(D)* does not, however, appear to allow the Internal Revenue Service to collect a tax liability while the general provisions of the *section 362(a)* automatic stay otherwise prohibit the collection of a debt against the debtor during the course of the title 11 case. The ability of the IRS to collect a tax liability that is assessed postpetition is not, however, unlimited. *Section 362(b)(9)(D) of the Bankruptcy Code* as amended may permit the postpetition tax assessment, but it also prohibits, with one exception, the tax lien from attaching to any property owned by the debtor. A postpetition tax assessment and lien will attach to property of the debtor taxpayer if: (i) the underlying income tax liability is nondischargeable, and (ii) the assets otherwise subject to the lien are distributed from the debtor's section 541 bankruptcy estate and revert in the debtor such as by abandonment by the trustee or the claiming of assets as exempt under the Bankruptcy Code or applicable state law. Thus, a tax lien validly assessed under *section 362(b)(9)(D) of the Bankruptcy Code* will not attach to any assets of the Debtor that are administered by a trustee as property of the estate under *section 541 of the Bankruptcy Code*.

There are a few statutory exceptions to the rule that the Internal Revenue Service cannot assess a tax liability against the debtor without the lifting or modification of the section 362 stay. *Section 6871 of the Internal Revenue Code* authorizes the assessment of tax liabilities when (i) the tax assessment relates to an income tax liability incurred by the bankruptcy estate or (ii) a tax liability of the debtor is determined by the bankruptcy court pursuant to *Bankruptcy Code section 505*.ⁿ²⁸ The IRS may also contend that it can assess a prepetition income tax liability which was reported by the taxpayer and which has not been paid in full prior to the filing of the title 11 case.ⁿ²⁹ The result of the application of *I.R.C. section 6871* is to allow the immediate assessment of a tax liability in the two circumstances in which Congress felt there was no necessity for the issuance of a Statutory Notice of Deficiency.ⁿ³⁰ Beyond these two exceptions, however, prepetition tax liabilities cannot be assessed after the filing of the title 11 petition absent prior relief as allowed by the Bankruptcy Code.ⁿ³¹

The timing of a tax assessment is also important because the existence of the assessment allows the Internal Revenue Service to assess penalties and interest and begin attempts to collect those liabilities; it also begins the running of the statute of limitations on collection, and allows the Internal Revenue Service to record a Notice of Federal Tax Lien. As a result, the debtor's "fresh start" may be impaired by the overstatement of the penalties assessed in violation of the stay which are calculated from an earlier assessment date.ⁿ³² Similarly, the assessment of a tax and the recording of a tax lien in violation of the stay may also prevent a taxpayer from obtaining post-discharge financing, which would also interfere with the debtor's fresh start.

If a tax is assessed by the Internal Revenue Service in violation of the stay, the status of that assessment will depend upon the bankruptcy court's determination of whether the assessment is "void" or "voidable." There is a split of authority whether collection actions such as a tax assessment made in violation of the stay are void or voidable. Some courts have concluded a tax assessment made in violation of the automatic stay is void *ab initio*.ⁿ³³ Other courts, however, have concluded that a tax assessment in violation of *section 362(a)* is merely voidable.ⁿ³⁴ It is reasonable to expect the Internal Revenue Service to argue that any assessment made in violation of the stay is only voidable because the assessment will not expose the Internal Revenue Service to the continued running of the statute of limitations on the assessment of the tax liability and nondischargeable penalties and interest will continue to accrue based upon an earlier assessment date.

If an assessment is void but is never abated, the tax liability may be successfully attacked in litigation after the bankruptcy case is closed. In one case, a tax assessment was made in violation of the stay, and the statute of limitations for the filing of a valid assessment of the tax liability by the IRS expired after the bankruptcy case had closed. The court held that the assessment was void, not voidable, that the statute of limitations for the filing of a valid assessment had run, and that the taxpayer was therefore entitled to summary judgment on the issue of liability in the subsequent tax refund action.ⁿ³⁵

[4] The Effect of the Stay on the Collection Division

The automatic stay is extremely broad in scope, and applies to almost any type of collection action against the debtor or the property of the bankruptcy estate. n36 Thus, the functions of the Collection Division of the IRS are those which are the most severely curtailed by the filing of a case under title 11.

The Internal Revenue Service acknowledges the limitations of the stay on its Revenue Officers and instructs them to refrain from conducting postpetition investigations concerning the location of assets which are subject to seizure. n37 Like the Examination Division, the Collection Division also conducts investigations, but the sole purpose of its work is to locate assets which are subject to seizure and sale to satisfy an assessed tax liability. Collection Division investigative procedures which are carried out to locate assets for seizure seek to accomplish the following goals: the collection of an assessed tax liability against the property of the taxpayer, the exercise of control over property of the taxpayer, the obtaining of possession by seizure of property of the taxpayer, or the obtaining of possession by seizure of property formerly owned by the taxpayer which is subject to a tax lien. n38 Revenue Officers should thus be prohibited by the automatic stay from conducting investigations concerning the location of assets which are subject to seizure.

The Internal Revenue Service uses many methods which are implemented by both Revenue Officers and the Internal Revenue Service's computer system to collect unpaid tax liabilities. Violations of the stay by the Collections Division or the Automated Collections Division ("ACS") are frequent and may take many different forms. n39 The mailing of any letters by the Internal Revenue Service giving notice, for example, of its intent to levy or seize assets of the debtor or the issuance of demand letters for a delinquent tax liability will constitute a violation of the automatic stay even if there is no conversion of assets by the government. n40 The IRS is also not permitted to mail postpetition Notices of Intent to Levy any assets of the debtor, and the IRS may not sell any seized assets to satisfy a debt owed by the debtor after the petition is filed. n41 The computerized or manual execution of the United States' statutory right of setoff n42 to satisfy a prepetition debt may constitute a violation of the stay. n43 The recording of a Notice of Federal Tax Lien after the petition date is also a violation of the stay, n44 and the Internal Revenue Service is also barred from foreclosing on any tax lien held against a debtor. n45

However, the refiling of a Notice of Federal Tax Lien is not a stay violation. n46 The Internal Revenue Service can also issue and execute on a Notice of Intent to Levy on a bankruptcy trustee or to a debtor to secure the collection of amounts owed by the debtor to a creditor who owes taxes to the United States government. n47 An action complaining that the IRS violated the automatic stay through its collection activity should be brought in the bankruptcy court, not a subsequent collection due process proceeding appealable to the Tax Court. n47a

[5] Postconfirmation Stay Violations

In chapter 13 cases, the Internal Revenue Service has been charged with violating the section 362(a) stay as a result of the postconfirmation collection of a prepetition nondischargeable tax liability or a new postconfirmation tax liability.

In these cases, debtors have asserted that their postconfirmation wages were property of their bankruptcy estates and were protected by the automatic stay because they were necessary for the funding and successful completion of the confirmed plan. n48

There is a split of authority concerning whether the postconfirmation collection of a nondischargeable tax liability is a stay violation under such circumstances. Some courts have agreed with the debtor and held that the debtor's bankruptcy estate remains open until the time the case is dismissed, converted or closed. These courts have then concluded that postconfirmation wages were property of the estate, were critical to the consummation of the plan, and therefore were protected by the automatic stay. n49

An extension of these postpetition levy cases has been adopted by the Tax Court. If a chapter 13 debtor obtains

confirmation of a plan, does the section 362 stay terminate to allow Tax Court litigation to proceed? The Tax Court has concluded that the bankruptcy estate remains open until the case is closed, the case is dismissed, or a discharge is granted. Thus, the section 362(a) stay remains in effect and the taxpayer debtor cannot litigate a prepetition tax liability in the Tax Court while the chapter 13 plan is still in effect.

On the other hand, the majority of courts have held the bankruptcy estate terminates upon the confirmation of the chapter 13 plan and all of the assets of the debtor, including any interest in postpetition wages, revert in the debtor and are subject to levy to pay a nondischargeable or new postpetition tax liability. n50 The problems raised by this split of authority may be easily resolved by the retention in the chapter 13 estate of assets, including wages, sufficient to satisfy the terms of the confirmed plan. If the assets or wages in question are not reverted in the debtor upon confirmation, there is authority which confirms that those assets and wages are protected by the automatic stay and cannot be the subject of a postpetition levy. n51

The Internal Revenue Service has recently been successful in collecting prepetition tax debts after confirmation of a Chapter 11 plan when the tax obligations were not discharged by the plan, or were nondischargeable. In one instance, the tax collection efforts were permitted because the bankruptcy court determined that the automatic stay was lifted when the confirmation order was entered and a discharge was granted to the debtor. n51a In another instance, the bankruptcy court permitted collection because the taxes were not discharged pursuant to section 1141(d). n51b

[6] The Effect of the Stay on Pending Tax Court Litigation

When a bankruptcy petition is filed, the automatic stay prohibits the commencement or continuation of a proceeding before the Tax Court concerning the debtor. Absent the lifting or modification of the stay, the Tax Court may not determine a tax liability asserted against an individual debtor for a taxable period ending before the filing of the bankruptcy petition, or for a corporate debtor for any taxable period the bankruptcy court may determine. n52 A title 11 proceeding instituted by the shareholders of a corporation, including limited liability companies ("LLCs"), does not invoke the automatic stay with respect to a notice of deficiency issued to the corporation. n52a If the automatic stay is modified after the issuance of the Statutory Notice of Deficiency, the debtor is then able to file a petition with the Tax Court. n53

Unless modified, the automatic stay remains in effect until the bankruptcy case is either closed, dismissed, or the debtor is granted or denied a discharge. n54 The point at which the automatic stay will be terminated and a resumption of litigation in the Tax Court allowed depends upon the chapter of the Bankruptcy Code under which the case was filed. If the case was filed under chapter 11, the confirmation of a plan of reorganization is the event which terminates the stay because confirmation results in the debtor's being granted a discharge. n55 By contrast, in a chapter 13 case, confirmation of a plan does not terminate the stay regarding prepetition tax liabilities because the debtor does not receive a discharge until the debtor successfully completes the confirmed plan. n56 In a chapter 7 case, the debtor will generally receive a discharge at a relatively early stage, which typically occurs before the trustee has completed the administration of the bankruptcy estate. Consequently, it should be possible for the debtor who received a discharge but still faces nondischargeable tax liabilities to proceed with litigation in the Tax Court. n57 Conversely, a taxpayer will not be able to reopen a closed title 11 case, attempt to reimpose the automatic stay, and thereby avoid litigation before the Tax Court. n58

Although most questions concerning the impact of the automatic stay on Tax Court litigation arise in connection with redetermination proceedings following the issue of a notice of deficiency, other situations occur from time to time. In a case of first impression, the Tax Court held that section 362(a)(8) denied it jurisdiction over a Chapter 13 debtor's "stand-alone" proceeding brought pursuant to 26 U.S.C. section 6015 seeking a determination that she was not jointly liable for her spouse's tax debts. n58a The automatic stay also prevented the Tax Court from exercising jurisdiction it would have otherwise had over a taxpayer/debtor's petition for review of lien or levy actions brought pursuant to 26 U.S.C. section 6320 (the "Collection Due Process" procedures). n58b In both cases, the court noted that unlike the

tolling provision applicable to proceedings to redetermine tax liabilities asserted in notices of deficiency, 26 U.S.C. section 6213(f), the periods of time available to seek relief under these provisions continued to run during bankruptcy proceedings.

If the debtor completes litigation with the Internal Revenue Service in the Tax Court and then files a bankruptcy petition, an appeal may be filed by either the United States or the taxpayer debtor. Whether such an appeal is precluded by the automatic stay depends upon its characterization as a judicial action or proceeding "against the debtor." There is a split of authority with respect to appeals from the Tax Court being subject to the automatic stay. n59

[7] IRS Defenses to Stay Violations

The United States asserts a variety of defenses to complaints filed against it as a result of its violations of the automatic stay. These defenses include the United States' claim of sovereign immunity, the lack of willfulness associated with the stay violation, and limitations on the nature and amount of damages that can be asserted against the United States.

[a] Sovereign Immunity Defense

The Bankruptcy Code contains a waiver of the United States' and other governmental entities' defense of sovereign immunity as substantially amended by the Bankruptcy Reform Act of 1994. n61 Prior to the 1994 amendments to section 106, there was substantial judicial disagreement regarding the application of section 106 and the court's ability to impose monetary sanctions against the United States and other governmental entities as a result of actions taken by governmental entities against a debtor taxpayer. n62 Two Supreme Court cases placed limitations on the application of the pre-1994 version of section 106 and the alleged waiver of sovereign immunity in favor of a debtor taxpayer. In *Hoffman v. Connecticut Department of Income Maintenance*, n63 the Court held that a trustee could not recover a money judgment from a state notwithstanding the provisions of section 106(c). Notwithstanding the existence of the predicate "trigger words" in section 547, the Court held the provision could only bind the state, but section 547 did not create a mechanism for the recovery of a monetary judgment against a state under section 547. The Supreme Court confirmed this result in *United States v. Nordic Village, Inc.*, n64 when it held a trustee could not recover a postpetition payment by a chapter 11 debtor to the Internal Revenue Service because there was no unmistakably clear waiver of sovereign immunity in the provisions of section 105 that would permit an award of monetary damages. The waiver of sovereign immunity in section 106, as amended by the Bankruptcy Reform Act of 1994, n65 is significant because section 106 now contains the "unmistakenly clear" waiver of sovereign immunity in a broad set of circumstances now defined in the statute. Debtors may now more easily contend they can recover monetary sanctions in the form of attorneys fees, costs, and actual damages pursuant to the provisions of the Bankruptcy Code that create causes of action for both monetary and nonmonetary remedies. n66

[i] Section 106(a) Amended by the Bankruptcy Reform Act of 1994

In the Bankruptcy Reform Act of 1994, n66a Congress completely revised the statutory scheme for the waiver of governmental sovereign immunity through the rewriting of *section 106 of the Bankruptcy Code*. The most notable of these amendments was the creation of section 106(a) which eliminates the "guess work" involved in locating a waiver of sovereign immunity before many of the provisions of the Bankruptcy Code against governmental entities can be enforced. Under this new scheme for the waiver of sovereign immunity, Congress provided a specific list of Bankruptcy Code sections under which governmental sovereign immunity is deemed waived to allow for both monetary recoveries as well as declaratory and injunctive relief. The Bankruptcy Code sections include the following:

1. Section 105 which allows the Bankruptcy Court to enter injunctive relief and other orders to enforce the terms of the Bankruptcy Code;
2. Section 106 containing the waiver of sovereign immunity provisions;

3. Section 107 relating to the public access to records filed in title 11 cases;
4. Section 108 which extends the statute of limitations for causes of action as a result of the application of the automatic stay;
5. Section 303 controlling the filing of involuntary title 11 cases;
6. Section 346 regarding special tax provisions applicable to state and local taxing authorities;
7. Section 362 providing for the automatic stay and the awarding of damages under section 362(h) for the willful violation of the stay; n67
8. Section 363 allowing the debtor to use property of the estate in the ordinary course of business and allowing the use of collateral under certain circumstances;
9. Section 364 allowing the debtor to borrow money during the course of the title 11 case;
10. Section 365 regarding executory contracts;
11. Section 366 regarding utility services provided to the debtor;
12. Sections 502 and 503 regarding the allowance and objection to creditors' general and administrative claims;
13. Section 505 which gives the Bankruptcy Court jurisdiction to determine tax liabilities of debtors;
14. Section 506 controlling the determination of the amount of secured claims;
15. Section 510 which gives the Bankruptcy Court the authority to subordinate claims filed in the title 11 case;
16. Section 522 which defines exempt property for purposes of title 11 cases;
17. Sections 523, 524, and 525 defining exceptions to discharge, defining the effect of the discharge, and protecting the debtor from discriminatory treatment;
18. Sections 542 and 543 authorizing turnover actions against third parties and custodians to recover property of the estate; n67a
19. Sections 544, 545, 546, 547, 548, 549, 550, 551, 552, and 553 providing for avoidance actions by the debtor or its trustee against third parties;
20. Sections 722, 724, 726, 728, 744, 749, and 764 which defines the debtor's redemption rights, the treatment of certain liens, the order of distribution of assets from the bankruptcy estate, executory contracts in stockbroker cases, voidable transfers in stockbroker cases, and voidable transfers in commodity broker liquidations;
21. Sections 901, 922, 926, 928, 929, and 944 relating to cases involving the adjustment of debts of a municipality;

- 22. Section 1107 concerning the rights and duties of a debtor in possession;
- 23. Sections 1141, 1142, 1143, and 1146 regarding the effect of confirmation, the implementation of the plan, distributions under the plan, and special tax provisions regarding the confirmation of chapter 11 plans;
- 24. Sections 1201, 1203, 1205, 1206, 1227, and 1231 relating to chapter 12 family farmer cases; and
- 25. Sections 1301, 1303, 1305, and 1327 relating to chapter 13 wage earner cases.

The specific waiver of sovereign immunity is effective by the combined application of sections 106(a)(1), which creates the list of bankruptcy causes of action in which sovereign immunity is deemed waived, and 106(a)(2). Section 106(a)(2) specifically allows the bankruptcy and appellate courts to assert jurisdiction over governmental entities and apply the section 106(a)(1) specified sections of the Bankruptcy Code to governmental entities. These provisions apply to create specifically authorized bankruptcy causes of action in which governmental entities must participate as parties to allow the debtor to reorganize its creditor relationships with all creditors including governmental entities. Disputes regarding the existence of a waiver of sovereign immunity against any governmental entity in cases involving these code sections should now be easily resolved in favor of the existence of the waiver.

The new provisions of amended section 106 that define the waiver of sovereign immunity are not, however, without their limitations. Section 106(a)(1) lists the bankruptcy related causes of action for which sovereign immunity is waived, but that waiver does not allow the debtor to pursue other prepetition or postpetition causes of action against a governmental entity that are property of the estate. Therefore, any prepetition cause of action that accrues in favor of the debtor against the Internal Revenue Service under the Internal Revenue Code must satisfy the waiver of sovereign immunity requirements under applicable nonbankruptcy law and will not fall within the jurisdiction of the bankruptcy court unless it also falls within one of the code sections listed in section 106(a)(1). Two other limitations contained in sections 106(a)(4) and (5) ensure that courts will not be permitted to extend the waiver of sovereign immunity beyond the scope intended by Congress. Under section 106(a)(4), any order, process, or judgment issued as a result of the section 106(a)(1) waiver of sovereign immunity must be consistent with appropriate nonbankruptcy law applicable to such governmental unit. For example, a bankruptcy court should not be able to exercise its injunctive powers under section 105, one of the section 106(a)(1) included statutes, to enjoin the Internal Revenue Service's collection of a tax liability against a corporate officer under *Section 6672 of the Internal Revenue Code*. This is true because *Section 7421 of the Internal Revenue Code*, the Anti-Injunction Act, prevents the granting of such equitable relief; this applicable nonbankruptcy law should control. Finally, section 106(a)(5) provides that section 106 as amended does not create any substantive claim for relief or cause of action not otherwise existing under title 11, the Federal Rules of Bankruptcy Procedure, or applicable nonbankruptcy law. n68

[ii] Section 106(b)

The Bankruptcy Reform Act of 1994 n69 moved the provisions of former section 106(a) to new section 106(b) and more specifically provided that a governmental entity waives its sovereign immunity defense if it actually files a claim in a title 11 case. Section 106(b) now provides that a governmental entity that has filed a proof of claim in the case is deemed to have waived sovereign immunity with respect to a claim against that entity that is property of the estate and arose out of the same transaction or occurrence out of which the government claim arose. Many of the answers to issues provided by Bankruptcy Courts interpreting old section 106(a) will still apply to the interpretation of new section 106(b) including whether (i) sovereign immunity is waived if a proof of claim is filed, (ii) whether a claim is property of the bankruptcy estate, and (iii) whether the debtor's and the government's claim arise out of the same transaction and occurrence. Congress made one significant change to section 106(b) with the specific intent to overturn certain opinions of various the Courts of Appeals that found a waiver of sovereign immunity if the governmental entity had a claim

against the debtor but did not file the claim in the title 11 case. As discussed more fully below, section 106(b) specifically now provides that it will apply only if the governmental entity actually files a proof of claim in the case, and cases holding to the contrary are now overruled by the amendment to section 106(b).

Even before the amendments to *section 106(a) and (b) of the Bankruptcy Code* by the Bankruptcy Reform Act of 1994, courts generally found that governmental entities waive the defense of sovereign immunity if that entity files a proof of claim in the debtor's title 11 case. n70 Must a governmental entity actually file a proof of claim in the title 11 case before the section 106(b) waiver is complete? Before the Bankruptcy Reform Act of 1994, n71 some courts concluded that the ministerial act of filing a proof of claim was not a predicate to a valid waiver of sovereign immunity under old section 106(a). Therefore, when a governmental entity holds a claim against the debtor, that claim can constitute a waiver of sovereign immunity even if the entity does not file a proof of claim. n72 The amendments to section 106(b) by the Bankruptcy Reform Act of 1994 now make it unmistakably clear that a proof of claim must be filed for a waiver to occur under that provision of section 106. This amendment to section 106(b) was made to specifically overrule cases such as *Sullivan v. Town & Country Nursing Home Services, Inc.* n73 and *In re Craftsman, Inc.* n74 in which those courts found a waiver of sovereign immunity to apply if the governmental entity owned a claim against the debtor but did not file the claim in the title 11 case.

Regardless of whether a claim is filed by the Internal Revenue Service, the Internal Revenue Service's claims and the debtor's claims against the Internal Revenue Service must nevertheless arise out of the same transaction or occurrence before sovereign immunity is waived under section 106(b). The answer to this question is usually decided by reference to the compulsory counterclaim rule of Rule 13 of the Federal Rules of Civil Procedure, made applicable in bankruptcy cases by *Federal Rule of Bankruptcy Procedure 7013*. Although the Internal Revenue Service has, in some cases, successfully argued that the existence of an assessed tax liability and a stay violation resulting from attempts to collect that liability are not compulsory counterclaims, the trend of recent cases concludes that the tax assessment and the invalid collection of that tax are compulsory counterclaims arising out of the same facts and circumstances and that a waiver of immunity under section 106(b) exists when the Internal Revenue Service attempts to collect the tax claim. n75

[iii] Section 106(c)

The Bankruptcy Reform Act of 1994 n76 also moved the provisions of former section 106(b) to new section 106(c) and continued the "permissive counterclaim" rule set forth in the Supreme Court's *Nordic Village* decision. n77 Thus, to the extent a taxpayer has any valid claim against the United States which is property of the debtor's estate, sovereign immunity is waived to the extent necessary to allow the setoff of that claim against any claim asserted by the United States against the debtor. The Supreme Court has also held that this section is not one under which monetary damages can be awarded against the United States. n78 The cap on the waiver of the United States' sovereign immunity is the amount of the United States' allowed claim against the debtor. Thus, if the allowed claim of the United States is reduced to zero, the recovery on a stay violation action against the United States will also be reduced to zero if section 106(c) is the applicable sovereign immunity waiver provision. n79 Section 106(c) does not permit any affirmative recovery of monetary damages. n80

[iv] Internal Revenue Code section 7430

Internal Revenue Code section 7430 applies generally to all cases involving the litigation of tax liabilities and establishes predicates for the award of attorney's fees and costs against the United States. Several recent decisions imply that compliance with the provisions of section 7430 serves as a separate basis for the waiver of sovereign immunity for the award of attorney's fees in stay violation litigation. n81

In *Graham*, the bankruptcy court had assessed attorney's fees against the Internal Revenue Service as a result of its handling of tax litigation. The Court of Appeals for the Tenth Circuit reversed the bankruptcy court award finding that

the predicates of *section 7430 of the Internal Revenue Code* had not been met and that *section 106 of the Bankruptcy Code* did not warrant the award of attorney's fees. Based upon the holding in *Graham*, the court in *Shafer* concluded:

The Tenth Circuit effectively held that no waiver of sovereign immunity as to attorneys fees against the Internal Revenue Service in bankruptcy cases exists unless either *11 U.S.C. section 106(a)* or *(b)* applies or the requirements of *26 U.S.C. section 7430* are met.

The court in *Shafer* specifically concluded contempt actions in the bankruptcy court were civil proceedings falling within the scope of section 7430. n82 Congress specifically provided for the award of attorney's fees via section 7430 against the Internal Revenue Service. Section 7430 may, based on the analysis in *Graham* and *Shafer*, represent the unequivocal waiver of sovereign immunity for the award of monetary sanctions against the Internal Revenue Service in contempt proceedings. Such an award would, however, be limited to attorney's fees and costs subject to the limits of *I.R.C. section 7430*. Section 7430 would not, therefore, serve as a means to recover punitive or other forms of damages against the Internal Revenue Service. In 1998, Congress amended section 7433 to provide that a bankruptcy court may award up to \$1,000,000 in damages against the Internal Revenue Service for wilfully violating the automatic stay. n83 Note, however, that even if other bankruptcy courts are inclined to accept *Shafer's* conclusion that contempt actions are civil proceedings that permit the use of section 7430 as a waiver of sovereign immunity, the question of whether bankruptcy courts possess civil contempt powers in the first place is unresolved. n84

[b] The Absence of Willfulness

Section 362(h) allows the awarding of damages for the "willful violation" of the automatic stay. A willful violation of the stay means a deliberate and intentional act done with the knowledge that the act is in violation of the stay. n85 In many cases, a stay violation by the IRS may only be a technical violation of the stay which does not result in any monetary harm to the debtor. n86 In other cases, an actual levy may take place, a tax may actually be assessed, or a tax lien may be recorded which in fact causes some actual harm to the debtor or at least alters the debtor-creditor relationship with the IRS. In such cases, the United States will argue the violation was a technical one that has been remedied and for which no further harm can be attributed to the debtor. n87

A violation of section 362(a) will not support a finding of contempt in all cases. n88 Each stay violation must be considered in its entirety, with due consideration given to the underlying facts. n89 A finding of willfulness on the part of the Internal Revenue Service has, however, been found if only one employee of the IRS had actual notice of the filing of a petition under title 11. The bureaucratic size of the IRS is no defense to the charge of willfulness. n90 Notwithstanding this broad definition of willfulness, courts have tempered the application of section 362(h) against the Internal Revenue Service to limit its use to cases where deliberate action has been taken by the IRS n91 rather than to cases of inadvertent or clerical errors which may have caused a stay violation. n92 Some bankruptcy courts have also been willing to modify the stay retroactively to authorize a step previously taken by the IRS. n92a

[c] Defenses to the Form of Damages Awarded

The Internal Revenue Service will also defend a section 362(h) action by attacking the form of damages a taxpayer debtor may attempt to recover. Section 362(h) allows a debtor to recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, punitive damages. n93 The United States will resist an award of punitive damages on several grounds. First and foremost, section 113 of the Bankruptcy Reform Act of 1994. n94 created section 106(a)(3) which specifically prohibits the entry of any order, process, or judgment for punitive damages against a governmental entity. Thus, for cases governed by the revisions to section 106, an entry of punitive damages cannot be made by a Bankruptcy Court because there is no unequivocal waiver of sovereign immunity for these kinds of damages. n95 For cases falling within the old version of section 106, the United States will continue to assert a variety of defenses to such claims.

The Federal Tort Claims Act contains a statutory bar against the award of punitive damages against the United States. n96 An award of punitive damages under section 362(h) would be in direct conflict with this statute created before the Bankruptcy Code's enactment and which evidences Congressional intent that punitive damages cannot be awarded against the United States. Several opinions have also confirmed that punitive damages cannot be awarded against the United States. n97 A few courts have, however, awarded punitive damages against the IRS. n98 The waiver of sovereign immunity under section 106 was intended to be a limited waiver of immunity in bankruptcy cases, and was designed to achieve approximately the same result in a bankruptcy case as would prevail in a nonbankruptcy case. n99 The United States will thus argue that a debtor should not be able to recover punitive damages in any nonbankruptcy forum and therefore should not be able to do so in a bankruptcy case.

The United States may also defend against an award of attorneys' fees by asserting that the debtor is required to satisfy the predicates of new *section 106(a)(3) of the Bankruptcy Code* and *I.R.C. section 7430*. n100 In awarding fees or costs under the Bankruptcy Code or under the Federal Rules of Bankruptcy Procedure, the award against any governmental entity, not just the United States, is subject to the hourly rate limitations contained in the Equal Access to Justice Act, *section 2412(d)(2)(a) of Title 28 of the United States Code*. Under *I.R.C. section 7430*, before attorneys' fees can be awarded to a taxpayer, (i) all administrative remedies must have been exhausted n101 (ii) the taxpayer must be the prevailing party (iii) the position of the United States must not have been substantially justified and (iv) the taxpayer must not have unjustifiably prolonged the litigation. If all of these steps are not satisfied, the IRS may contend that *I.R.C. section 7430* bars the recovery of attorneys' fees as a result of the violation of the stay by the IRS. *I.R.C. section 7430* also places a \$75 per hour dollar limitation on the hourly fees which can be awarded to a prevailing party, n102 and the United States will likely rely upon that limitation to reduce any award asserted against it for attorneys' fees. It must also be remembered that, under the terms of section 362(h), attorney's fees for violations of the automatic stay may only be awarded to individual debtors, not to corporations. n103

On September 25, 1998, the Internal Revenue Service announced a new program intended to minimize inadvertent violations of the Bankruptcy Code and to provide for the prompt correction of any violations which do occur. This new program will allow debtors to elect to file claims for damages with the IRS in lieu of seeking damages from the bankruptcy court. The claims will have to be in writing and include supporting documentation. They should be filed with the Special Procedures Function (SPF) of the Internal Revenue Service Collection Division for the appropriate Internal Revenue Service district. n104

FOOTNOTES:

(n1)Footnote 1. *11 U.S.C. § 362*.

(n2)Footnote 2. *See, e.g., Laughlin v. United States*, 912 F.2d 197, 198, 23 C.B.C.2d 736 (8th Cir. 1990), cert. denied, 498 U.S. 1120, 111 S. Ct. 1073, 112 L. Ed. 2d 1179 (1991).

(n3)Footnote 2a. The Omnibus Consolidated Emergency Supplemental Appropriations Act, 1999, Pub. L. No. 105-277, effective October 21, 1998, deleted sections 362(b)(4) and (b)(5) (the exceptions to the automatic stay for exercises of the police and regulatory power) and supplied a new section 362(b)(4). The 1998 amendment substantially broadens the police and regulatory exception to the automatic stay by its introductory reference to paragraphs (3) and (6) of section 362(a), but the expansion appears limited by the history of the provision. *See 3 Collier on Bankruptcy, P 362.05* (Matthew Bender 15th Ed. Revised).

(n4)Footnote 3. *I.R.C. § 6402(a)* provides:

(a) General Rule.--In the case of any overpayment, the Secretary, within the applicable period of

limitations, may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall, subject to subsections (c) and (d), refund any balance to such person.

I.R.C. § 6402(c) and (d) requires the Internal Revenue Service to give a taxpayer notice prior to a setoff with respect to past-due child support payments and debts owed to Federal agencies other than the IRS. *See P TX5.08 infra* for a discussion of the IRS's setoff rights in title 11 cases.

(n5)Footnote 3a. In addition to the automatic stay provided by *11 U.S.C. § 362*, there is a codebtor stay applicable to consumer debts in chapter 13 cases. *11 U.S.C. § 1301*. Federal taxes are not consumer debts subject to the codebtor stay. *Internal Revenue Service v. Westberry (In re Westberry)*, 215 F.3d 589 (6th Cir. 2000) .

(n6)Footnote 4. The automatic stay will probably not prevent the Internal Revenue Service from proceeding with a criminal investigation or prosecution. The presence of a criminal investigation, however, may, in very unusual circumstances, be a guise for a civil collection proceeding the continuation of which may constitute a stay violation under *11 U.S.C. § 362(a)*. *See* the discussion at *P TX5.02[2] supra*.

(n7)Footnote 5. *See, e.g., In re Greene*, 13 C.B.C.2d 129, 130, 50 B.R. 785 (Bankr. S.D.N.Y. 1985) .

(n8)Footnote 6. *I.R.C. §§ 7601-7611*.

(n9)Footnote 7. Section 362(b)(9)(D) specifically permits the IRS to complete an audit to determine a tax liability and to demand the filing of tax returns. *See, e.g., In re Larsen*, 232 B.R. 482, 483 (Bankr. D. Wyo. 1998) (there is no stay violation as a result of the continuation of an audit by the IRS, the recording of an assessment, or the issuance of a notice of deficiency); *H&H Beverage Distributors v. Department of Revenue of the Commonwealth of Pa.*, 850 F.2d 165, 167 (3d Cir. 1988) ; *In re Neary*, 220 B.R. 864 (Bankr. E.D. Pa. 1998) . In a complex case, a bankruptcy court outside of the Third Circuit followed *H & H Beverage Distributors* and held that an audit of a debtor's postpetition tax returns did not violate the automatic stay. The bankruptcy court additionally held that the debtor's prior assertion of this contention before the Tax Court invoked collateral estoppel. *Wood v. Internal Revenue Service (In re Wood)*, 328 B.R. 880 (Bankr. S.D. Fla. 2005) (the court also noted the United States, not the IRS, was the proper party to the suit.) In cases that are filed before the enactment of the Bankruptcy Reform Act of 1994 (Pub. L. No. 103-394 (enacted on October 22, 1994)), which amended section 362(b)(9)(D) to permit postpetition tax assessments, postpetition tax assessments will still be void or voidable depending upon the jurisdiction involved.

The ability of the IRS to continue with the examination function can also be labeled as part of the governmental police and regulatory power which is part of the blanket exceptions to the automatic stay. *11 U.S.C. § 362(b)(4)*. *See, e.g., Universal Life Church v. United States (In re Universal Life Church, Inc.)*, 128 F.3d 1294 (9th Cir. 1997) (the debtor asserted the revocation postpetition of its tax exempt status was a stay violation; the determination whether the debtor met the test for a charitable organization was fell within the scope of the "general welfare purposes" of the government and the policing of those tax exemptions and the revocation of granted exemptions was not subject to the automatic stay); *Yellow Cab Coop. Ass'n v. Metro Taxi (In re Yellow Cab Coop Ass'n)*, 132 F.3d 591 (10th Cir. 1997) (same result regarding cab company operating certificates).

The Omnibus Consolidated Emergency Supplemental Appropriations Act, 1999, Pub. L. No. 105-277, effective October 21, 1998, deleted sections 362(b)(4) and (b)(5) (the exceptions to the automatic stay for exercises of the police and regulatory power) and supplied a new section 362(b)(4). The 1998 amendment substantially broadens the police and regulatory exception to the automatic stay by its introductory reference to paragraphs (3) and (6) of section 362(a), but the expansion appears limited by the history of the provision. *See 3 Collier on Bankruptcy*, P 362.05 (Matthew Bender 15th Ed. Revised).

(n10)Footnote 8. *11 U.S.C. § 362(b)(9)(B)*. A Statutory Notice of Deficiency is authorized by *I.R.C. § 6212(a)* and the IRS cannot assess an income, estate or gift tax until at least 90 days, and in some cases up to 150 days, after the date of that required notice. *I.R.C. § 6213(a)*. Other taxes such as the *I.R.C. § 6672* penalty assessment and excise taxes can, however, be assessed without the issuance of a Statutory Notice of Deficiency. The issuance of a Statutory Notice of Deficiency will not generally occur until several steps are completed by the IRS. After the completion of an audit, the IRS will send a "30-day letter" to the taxpayer. This letter gives a taxpayer notice of the calculation of a deficiency liability and allows the taxpayer a 30-day period within which he or she must file a written protest with the IRS's Appeals Division. If after the passage of this 30-day period no response is made by the taxpayer, a "90-day letter" or the Statutory Notice of Deficiency will be mailed by the IRS. The 90-day letter must be mailed to the "last known address" of the taxpayer before the tax deficiency reflected thereon can be assessed. After 90 days from the date of the 90-day notice, the IRS will assess the tax deficiency reflected on the notice. The issuance of the 90-day letter does not, however, in and of itself reflect an attempt by the IRS to actually assess a tax or to affect the assets of the debtor's estate. Therefore, the Bankruptcy Code specifically allows the 90-day letter to be issued without violating the stay. *11 U.S.C. § 362(b)(9)*.

(n11)Footnote 9. [Reserved.]

(n12)Footnote 10. See *Riley v. United States*, 118 F.3d 1220 (8th Cir. 1997) (the debtor received a letter from the IRS giving him notice the IRS was unable to collect all of the payroll taxes associated with a corporation of the debtors and that the 100% penalty of *26 U.S.C. § 6672* was to be assessed against him; the fact this notice of the IRS's intent to make the assessment under *26 U.S.C. § 6672* was sent to the debtor after the petition date was not a stay violation and was not a defense to the assessment in a subsequent refund suit); *In re Hardy*, 39 B.R. 64, 66 (Bankr. E.D. Pa. 1984) (issuance of a "30-day letter" is not a stay violation). It is thus also not a violation of the automatic stay for the IRS to solicit and obtain extensions of the statute of limitations for assessment or collection of a tax liability during the pendency of a title 11 case. The IRS is authorized by *section 362(b)(8) of the Bankruptcy Code* to assess a tax liability notwithstanding the automatic stay's application. The statute waiver forms are an integrated part of the procedure for determining tax deficiencies, and they therefore fall within the scope of permitted action under *section 362(b)(8)*. *Richmond v. United States*, 172 F.3d 1099, 1103 (9th Cir. 1999) .

(n13)Footnote 11. *In re Heritage Village Church and Missionary Fellowship, Inc.*, 87 B.R. 401, 404-405 (D.S.C. 1988) , *aff'd*, 851 F.2d 104 (11th Cir. 1988) . See also *United States v. Universal Life Church*, 114 B.R. 246 (Bankr. E.D. Cal. 1990) , in which the bankruptcy court held the IRS did not violate the automatic stay provisions by terminating the tax-exempt status of a debtor church. The logic of these cases is that the tax-exempt status of an entity is not an asset of the estate and is thus not protected by the stay. Tax-exempt status is more like a "rule" that does not lose or change its characteristics when applied to various fact situations from taxpayer to taxpayer.

(n14)Footnote 11a. *11 U.S.C. § 362(b)(9)(D)*. See also, *In re Innovation Instruments, Inc.*, 41 C.B.C.2d 161, 228 B.R. 313, 314 (Bankr. N.D. Fla. 1998) (the automatic stay is not violated by the assessment of a tax postpetition as a result of the application of *11 U.S.C. § 362(b)(9)(D)* and interest and penalties are included in the tax that may be assessed postpetition).

(n15)Footnote 11b. The delivery or production of a tax return is a common element of civil and criminal investigations to determine a taxpayer's liability. If an assessment is void but is never abated, the tax liability may be successfully attacked after the bankruptcy case is closed. In one case, a tax assessment was made in violation of the stay, and the statute of limitations for the filing of a valid assessment of the tax liability by the IRS expired after the bankruptcy case had closed. The court held that the assessment was void, not voidable, that the statute of limitations for the filing of a valid assessment had run, and that the taxpayer was therefore entitled to summary judgment on the issue of liability in the subsequent tax refund action. *H&H Beverage Distributors v. Department of Revenue of the Commonwealth of Pennsylvania*, 850 F.2d 165, 168 (3d Cir. 1988) ; see, e.g., *In re Ungar*, 104 B.R. 517, 520 (Bankr. N.D. Ga. 1989) ; *1983 Western Reserve Oil & Gas Co. v. Commissioner*, 95 T.C. 51 (1990) .

(n16)Footnote 12. 11 U.S.C. § 362(b)(1).

(n17)Footnote 13. Some courts have held that pursuant to 11 U.S.C. § 105(a) the bankruptcy courts may, in very exceptional circumstances, enjoin as a stay violation a criminal action for the passing of a bad check. *See, e.g., In re Davis*, 691 F.2d 176, 7 C.B.C.2d 861 (3d Cir. 1982) (the court acknowledged the ability of the court to prevent the prosecution but agreed that the debtor failed to prove the requisite irreparable injury); *In re Padgett*, 37 B.R. 280 (Bankr. W.D. Ky. 1983) (the institution of a criminal action for the sole purpose of gaining restitution was a stay violation); *In re Milone*, 16 C.B.C.2d 1502, 73 B.R. 452 (Bankr. D.N.H. 1987) (criminal action could be enjoined as a stay violation if it was proved that the motivation for the action was collection of the check). Compare these cases with those which hold that state court criminal actions can absolutely not be enjoined: *In re Taylor*, 44 B.R. 548 (D. Md. 1984); *Lare v. Norton*, 24 B.R. 959 (D. Md. 1982). Compare these cases still further with those which hold that if irreparable harm can be proved [and it usually was not proved] by the debtor, the criminal action could be a stay violation: *Barnette v. Evans*, 673 F.2d 1250, 1252, 6 C.B.C.2d 475 (11th Cir. 1982); *In re Gates*, 75 B.R. 535 (Bankr. W.D. Pa. 1987); *Munroe v. Lasch*, 73 B.R. 909 (E.D. Wis. 1987); *In re Anoai*, 61 B.R. 918 (Bankr. D. Conn. 1986); *In re Klawson*, 50 B.R. 776 (N.D. Ind. 1985); *In re Frances*, 44 B.R. 1016 (Bankr. S.D. Fla. 1984); *In re Richardello*, 28 B.R. 344 (Bankr. D. Mass. 1983).

(n18)Footnote 14. Compare *In re Spencer*, 123 B.R. 858 (Bankr. N.D. Cal. 1991) with *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322, (D. Mass. 1979), appeal dismissed, 623 F.2d 720 (1st Cir. 1980), *aff'd*, 623 F.2d 725 (1st Cir. 1980), cert. denied, 449 U.S. 1021, 101 S. Ct. 588, 66 L. Ed. 2d 483 (1980); *In re Greene*, 13 C.B.C.2d 129, 50 B.R. 785 (Bankr. S.D.N.Y. 1985); *United States v. Cadalso*, 83-1 U.S. Tax Cas. (CCH) P 9335 (Bankr. N.D.N.Y. 1982).

(n19)Footnote 15. I.R.C. §§ 7602 and 7609. A summons served upon a bank, accountant, attorney or other person or entity who retains records relating to a debtor taxpayer is allowed only pursuant to the limiting provisions of the third party recordkeeper summons statute. I.R.C. § 7609.

(n20)Footnote 16. *In re Spencer*, 123 B.R. 858 (Bankr. N.D. Cal. 1991).

(n21)Footnote 17. *See, e.g., United States v. Arthur Andersen & Co.*, 474 F. Supp. 322 (D. Mass. 1979), appeal dismissed, 623 F.2d 720 (1st Cir. 1980), *aff'd*, 623 F.2d 725 (1st Cir. 1980), cert. denied, 449 U.S. 1021, 101 S. Ct. 588, 66 L. Ed. 2d 483 (1980) (third-party recordkeeper summons was enforced even though the taxpayer was a debtor in possession in a case filed under the former Bankruptcy Act); *In re Greene*, 13 C.B.C.2d 129, 50 B.R. 785 (Bankr. S.D.N.Y. 1985) (same result); *United States v. Cadalso*, 83-1 U.S. Tax Cas. (CCH) P 9335 (Bankr. N.D.N.Y. 1982) (Bankruptcy Code does not affect the issuance or enforcement of a summons issued for the purpose of determining the debtor taxpayer's income tax liability).

(n22)Footnote 18. Compare *In re Spencer*, 123 B.R. 858 (Bankr. N.D. Cal. 1991) with *United States v. Arthur Andersen & Co.*, 474 F. Supp. 322, (D. Mass. 1979), appeal dismissed, 623 F.2d 720 (1st Cir. 1980), *aff'd*, 623 F.2d 725 (1st Cir. 1980), cert. denied, 449 U.S. 1021, 101 S. Ct. 588, 66 L. Ed. 2d 483 (1980); *In re Greene*, 13 C.B.C.2d 129, 50 B.R. 785 (Bankr. S.D.N.Y. 1985); *United States v. Cadalso*, 83-1 U.S. Tax Cas. (CCH) P 9335 (Bankr. N.D.N.Y. 1982).

(n23)Footnote 19. A taxpayer generally has no protected constitutional or other privacy interest in records held by a third party if those records are commercial documentation for transactions entered into by a debtor. Examples of such documents would include bank statements, lending agreements and related documents, and any other records in the possession of third parties which prove the existence or nonexistence of income and deductions attributable to the debtor taxpayer. *See, e.g., United States v. Miller*, 425 U.S. 435, 442-444, 96 S. Ct. 1619, 48 L. Ed. 2d 71 (1976). Similarly, a taxpayer generally has no *Fifth Amendment* claim against self-incrimination with respect to business or other commercial records that are held by a third party. *See, e.g., United States v. Doe*, 465 U.S. 605, 610-611, 104 S. Ct. 1237, 79 L. Ed. 2d 552 (1984). It should be expected that the IRS will assert that a debtor has no interest in these

kinds of commercial documents which is protected by the automatic stay of section 362(a). The production of commercial records to assist any taxing entity in the determination of a tax liability chargeable against the estate or which is nondischargeable may not constitute the taking of or interference with possession of property of the estate which was contemplated by the automatic stay.

(n24)Footnote 20. *See, e.g., In re Prudential Lines, Inc.*, 928 F.2d 565, 24 C.B.C.2d 1503 (2d Cir. 1992) , in which the court sustained the conclusion of the two lower courts that had held a debtor's net operating losses were an asset of the bankruptcy estate protected by the automatic stay. The net operating losses were to be used to offset future income and thereby indirectly increase the debtor's postconfirmation cash flow. A delay in the calculation, verification or approval of the net operating loss carryover of Prudential Lines might have impeded its ability to confirm its plan.

(n25)Footnote 21. 11 U.S.C. § 362(a)(6); *In re Coleman American Cos., Inc.*, 26 B.R. 825, 831 (Bankr. D. Kan. 1983) ; *In re Twomey*, 24 B.R. 799, 804 (Bankr. W.D.N.Y. 1982) .

(n26)Footnote 22. The assessment is essentially a bookkeeping notation made when the IRS establishes an account against the taxpayer. *Laing v. United States*, 423 U.S. 161, 96 S. Ct. 473, 46 L. Ed. 2d 416 (1976) .

(n27)Footnote 23. Interest and penalties will accrue from the due date of the tax return. Although these additions to a tax liability may accrue, they may not be assessed until a later date after the filing of a title 11 petition. The assessment or non-assessment of these amounts is relevant for several reasons. For example, the interest and penalties cannot be collected unless assessed. From the perspective of the potential settlement of a dispute with the IRS, it is possible the IRS or the Department of Justice will, in the right case, consider the waiver of unassessed interest and penalties as part of a settlement proposal.

(n28)Footnote 24. *See I.R.C. §§ 6213 and 7421*; Saltzman & Saltzman, *IRS Practice and Procedure Manual*, P 17.01 (WGL 2d ed. 1991).

(n29)Footnote 25. An assessment is a formal discrete act with specific legal consequences. The assessment gives rise to a "secret" federal tax lien that attaches to the taxpayer's property upon failure to pay after notice and demand. *In re Carlson*, 580 F.2d 1365, 1368 (10th Cir. 1978) . The assessment also triggers the statute of limitations for collection of the taxes by levy or court proceeding. The statute of limitations on collection is, however, tolled during the time that a case under title 11 is pending.

(n30)Footnote 26. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat 4106 (1994), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n31)Footnote 27. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n32)Footnote 28. *I.R.C. § 6871(b)* provides:

(b) Immediate Assessment With Respect to Certain Title 11 Cases.--Any deficiency (together with all interest, additional amounts, and additions to the tax provided by law) determined by the Secretary in respect of a tax imposed by subtitle A or B or by chapter 41, 42, 43, 44 or 45 on--

(1) the debtor's estate in a case under title 11 of the United States Code, or

(2) the debtor, but only if liability for such tax has become res judicata pursuant to a determination in a case under title 11 of the United States Code, may, despite the restrictions imposed by Section 6213(a) on assessments, be immediately assessed if such deficiency has not theretofore been assessed in accordance with law. The reference to *I.R.C. § 6213(a)* refers to the issuance of a Statutory Notice of Deficiency which must occur before the IRS can assess a tax liability. As a result of *I.R.C. § 6871(b)*, an assessment may be made without the issue of the required notice in the two instances noted in the statute. It should be noted that the ability to assess a tax liability after a determination by the bankruptcy court is only proper after a determination made under *11 U.S.C. § 505*. The resolution of a claims objection between the IRS and a debtor does not, however, allow the IRS to immediately assess a tax under *I.R.C. § 6871*.

(n33)Footnote 29. The Internal Revenue Manual, Legal Reference Guide For Revenue Officers, § 57(16)(0), P 918 states:

Section 362(a)(6) stays an act to assess a prepetition tax only for which a proof of claim is warranted, *i.e.*, a tax liability for which the Government has a right to payment. Thus, the assessment of the amount shown as tax on a return by the taxpayer-debtor is not stayed if payment of the tax has been remitted.

There are generally two forms of assessments, and these forms of assessments cannot generally be assessed while the automatic stay is in effect. The assessment of a tax liability under *I.R.C. § 6871* is the only permitted circumstance under which the IRS can assess a tax liability while the automatic stay is in effect. Voluntary assessments are made by the IRS after a taxpayer voluntarily files a tax return and reports a tax liability admittedly owed to the IRS. Deficiency assessments are made by the IRS after an audit is conducted, a tax deficiency is calculated, a Statutory Notice of Deficiency is mailed, and the additional deficiency liability is assessed. *11 U.S.C. § 362(a)* does not, however, differentiate between a voluntary and deficiency assessment, so the statute would not literally appear to condone the position assumed by the IRS in the Internal Revenue Manual quoted above. In the case of a voluntary assessment, although there may be a technical violation of the stay, the practical effect is probably that no harm accrues to the debtor because the tax liability may already have been paid in full by withholding taxes and estimated income tax payments paid before the petition date. A deficiency assessment, on the other hand, asserts a new income tax liability against the debtor, and if that tax liability relates to a prepetition tax period, it should be treated as such and should not be assessed in violation of the stay. See *11 U.S.C. § 502(I)* which deems certain tax liabilities to be prepetition liabilities even if they were calculated or determined postpetition. Such tax liabilities would be payable through a confirmed chapter 11 or 13 plan, and should not be assessed because that would alter the debtor-creditor relationship between the IRS and the debtor to the potential detriment of the debtor, the estate, and the other creditors. On the other hand, in a chapter 7 case, the assessment of such a tax liability would not appear to result in any actual, compensable harm to the debtor, and this is especially true if the tax liability is nondischargeable.

(n34)Footnote 30. Saltzman & Saltzman, *IRS Practice & Procedure Manual*, P 17.06 (WGL 2d ed. 1991) and S. Rep. No. 1035, 96th Cong., 2nd Sess. 49 (1980), reprinted in Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n35)Footnote 31. *11 U.S.C. § 362(d)*.

(n36)Footnote 32. If a tax liability is nondischargeable, any accrued interest, penalties and other statutory additions will also be nondischargeable. See *PP TX4.05* and *TX4.06 supra*. Because the statutory additions related to a tax liability are also nondischargeable, those liabilities can continue to accrue even during the period the automatic stay is in effect. See, e.g., *In re Hanna*, 872 F.2d 829 (8th Cir. 1989).

(n37)Footnote 33. See, e.g., *Raymark Industries, Inc. v. Lai*, 973 F.2d 1125 (3d Cir. 1992); *In re Schwartz*, 954 F.2d 569, 572, 26 C.B.C.2d 649 (9th Cir. 1992) and the cases cited therein; *In re Coleman American Cos., Inc.*, 26 B.R.

825, 831 (*Bankr. D. Kan.* 1983) ; *In re Formisano*, 148 B.R. 217, 223-24 (*Bankr. D.N.J.* 1992) (there is no difference between the concepts of "void" and "voidable" for purposes of characterizing an action in violation of the automatic stay; all acts violating Section 362 are void, and have no force and legal effect from the beginning); *In re Fingers*, 28 C.B.C.2d 484, 148 B.R. 586 (*Bankr. S.D. Cal.* 1993) ; *In re Olson*, 101 B.R. 134, 145-146 (*Bankr. D. Neb.* 1989) ; *Anglemyer v. United States*, 115 B.R. 510 (*D. Md.* 1990) ; *In re Fasgo, Inc.*, 58 B.R. 99 (*Bankr. E.D. Pa.* 1986) ; *Phoenix Bond & Indemnity Co. v. Shamblin*, 890 F.2d 123, 125 (9th Cir. 1989) (a tax sale in violation of the stay is void *ab initio*).

(n38)Footnote 34. See, e.g., *Sikes v. Global Marine, Inc.*, 881 F.2d 176, 178-79 (5th Cir. 1989) ; *In re Clark*, 79 B.R. 723, 725 (*Bankr. S.D. Ohio* 1987) ; *In re Fuel Oil Supply and Terminaling, Inc.*, 8 C.B.C.2d 989, 991, 30 B.R. 360 (*Bankr. N.D. Tex.* 1983) . The Third and Federal Circuits have indicated their agreement with the Court of Appeals for the Fifth Circuit on the void-voidable issue. *In re Siciliano*, 13 F.3d 748 (3d Cir. 1994) ; *Bronson v. United States*, 46 F.3d 1573 (*Fed. Cir.* 1995) . The Court of Appeals for the Fifth Circuit has restated its adherence to the "voidable" rule even after acknowledging it to be the minority view. *In re Jones*, 63 F.3d 411 (5th Cir. 1995) . A bankruptcy court in the First Circuit has reached the same conclusion. *In re Thunderbolt Realty Trust*, 190 B.R. 11 (*Bankr. D. Mass.* 1995) . Now that the IRS may make assessments after a title 11 petition has been filed by virtue of 11 U.S.C. § 362(b)(9)(D), the continuing significance of the "void"/"voidable" distinction is doubtful.

(n39)Footnote 35. See *Anglemyer v. United States*, 115 B.R. 510 (*D. Md.* 1990) .

(n40)Footnote 36. See, e.g., *In re Zurich*, 88 B.R. 721, 724 (*Bankr. W.D. Pa.* 1988) .

(n41)Footnote 37. The Internal Revenue Manual, Legal Reference Guide for Revenue Officers, § 57(16)(0), PP 918 and 942 instructs Revenue Officers that their collection investigations and seizure activities should be suspended when a petition is filed under title 11. This was confirmed by the United States' failure on appeal to challenge the finding of one lower court that held that the execution of a collection information statement from the debtor was a willful violation of the stay. See *United States v. McPeck*, 910 F.2d 509, 23 C.B.C.2d 863 (8th Cir. 1990) .

(n42)Footnote 38. Collection investigative procedures are prohibited by the automatic stay under either of 11 U.S.C. § 362(a)(1), (2), (3) or (5). 11 U.S.C. § 541 defines the property of the debtor's estate. At the beginning of a bankruptcy case all of the debtor's legal and equitable interests in property will be included in the estate. 11 U.S.C. § 541(a)(1)-(7). As a result, the automatic stay will protect all of the debtor's property, rights to property, or other property interests owned by the debtor in possession until the stay is modified or terminated as provided for in 11 U.S.C. § 362(d). A postpetition demand for payment made on a bank, as distinguished from the debtor, for funds that were the subject of a prepetition levy did not violate the stay. It was held that the levy effectively severed any interest had in the money in the account prior to the filing of the title 11 petition. *In re Smiley*, 189 B.R. 338 (*Bankr. E.D. Pa.* 1995) .

(n43)Footnote 39. The frequency of stay violations by the ACS Division of the IRS is usually attributable to a lack of communication between the computer systems and personnel between various branches of the IRS that would result in the placement of the appropriate "freeze code" or other computer code on a debtor's accounts to prevent the continuation of computerized collection actions.

(n44)Footnote 40. Compare *Jove Engineering, Inc. v. IRS*, 92 F.3d 1539 (11th Cir. 1996) (the issuance of a payment demand letter and a notice of intent to levy postpetition combined with an onsite appointment with a Revenue Officer were stay violations); *In re Hanna Coal Co., Inc.*, 198 B.R. 672 (*W.D. Va.* 1996) (levy on corporate assets and issuance of notice of intent to levy); *Headrick v. Georgia (In re Headrick)*, 200 B.R. 963 (*Bankr. S.D. Ga.* 1996) (collection letters sent by the state of Georgia); *In re Gault*, 136 B.R. 736 (*Bankr. E.D. Tenn.* 1991) (Notice of Federal Tax Lien); *In re Fasgo, Inc.*, 58 B.R. 99, 100-01 (*Bankr. E.D. Pa.* 1986) ; *In re Wallingford's Fruit House*, 8 C.B.C.2d 1138, 1143, 30 B.R. 654 (*Bankr. D. Me.* 1983) ; *In re Covington*, 256 B.R. 463 (*Bankr. D.S.C.* 2000) ; with *In re Hardy*, 39 B.R. 64 (*Bankr. E.D. Pa.* 1984) (preassessment correspondence not barred by the stay).

(n45)Footnote 41. 11 U.S.C. § 362(a)(1), (2), (3) and (5). Compare *In re Holden*, 217 B.R. 161 (D. Vt. 1997) (application of the Code's freeze on the debtor's tax accounts to prevent the processing of a refund to coerce the payment of a prepetition debt is a stay violation); *In re Fernandez*, 125 B.R. 317 (Bankr. M.D. Fla. 1991) (a postpetition levy is a stay violation and the government has an obligation to ensure that a prepetition levy is not executed upon postpetition thereby creating a stay violation); *In re Garcia*, 109 B.R. 335 (Bankr. N.D. Ill. 1989) (postpetition sale of the debtor's assets to satisfy prepetition tax claim is a stay violation); *In re Lile*, 103 B.R. 830 (Bankr. S.D. Tex. 1989), *aff'd*, 161 B.R. 788 (S.D. Tex. 1993), *aff'd in part w/o op.*, 43 F.3d 668 (5th Cir. 1994) (the IRS violated the stay when it levied postpetition on leasehold property owned by the debtor; the court imposed sanctions on the government even though the debtor's actual damages were less than \$500); *In re Miller*, 98 B.R. 110 (Bankr. N.D. Ga. 1989) (levy); *In re Greer*, 89 B.R. 757 (Bankr. S.D. Ill. 1988); *In re Carlsen*, 63 B.R. 706 (Bankr. C.D. Cal. 1986) (levy); *In re Spencer*, 45 B.R. 1 (Bankr. Mo. 1983); *In re Young*, 14 B.R. 809 (Bankr. N.D. Ill. 1981); *In re Byrne*, 5 B.R. 556 (Bankr. W.D. Pa. 1980) (levy); with *In re Chastang*, 116 B.R. 833 (Bankr. M.D. Fla. 1990) (a stay violation does not occur, however, if the IRS fails to return levied monies received postpetition in response to a prepetition levy); *In re Smith*, 2 B.R. 417 (Bankr. D. Mo. 1979); *In re Stewart*, 253 B.R. 51 (Bankr. E.D. Ark. 2000) (IRS could retain tax refund pending timely motion for relief from stay for setoff). *Holden* had a long and complex history after the initial decision. See *United States v. Holden*, 226 B.R. 809 (Bankr. D. Vt. 1998) (denying IRS motion to exclude evidence of mental suffering); 236 B.R. 156 (Bankr. D. Vt. 1999) (awarding debtor's damages for pain, suffering, and mental anguish); *aff'd*, 258 B.R. 323 (D. Vt. 2000). Another bankruptcy court has held that a prepetition levy on a bank effectively severed the debtor's interest in them prior to the filing of the title 11 petition. *In re Smiley*, 189 B.R. 338 (Bankr. E.D. Pa. 1995).

(n46)Footnote 42. I.R.C. § 6402.

(n47)Footnote 43. 11 U.S.C. § 362(a)(7). See, e.g., *United States v. Reynolds*, 764 F.2d 1004, 13 C.B.C.2d 239 (4th Cir. 1985) (retention of refund by the IRS was a setoff); *United States v. Norton*, 32 B.R. 698 (Bankr. E.D. Pa. 1982), *aff'd in part, rev'd in part*, 717 F.2d 767, 9 C.B.C.2d 336 (3d Cir. 1983) (the setoff was a stay violation but the court refused to impose sanctions because the issue was undecided in that district and the IRS was not on notice that it would be in violation of section 362 if the setoff was made); *In re Davidson*, 120 B.R. 777 (Bankr. D.N.J. 1990); *In re Ferguson*, 83 B.R. 676 (Bankr. E.D. Mo. 1988); *In re Greene*, 13 C.B.C.2d 129, 50 B.R. 785 (Bankr. S.D.N.Y. 1985); *In re Warden*, 36 B.R. 968 (Bankr. D. Utah 1984); *In re Burrow*, 36 B.R. 960 (Bankr. D. Utah 1984) (imposition of a "freeze code" on the taxpayer's tax accounts which prevented issuance of tax refunds was setoff); *In re Smith*, 35 B.R. 451 (Bankr. N.D. Ga. 1983). Some judicial districts have, however, amended their local rules to allow the IRS to execute a setoff of prepetition tax liabilities against refunds payable to the taxpayer. See, e.g., *In re Dominguez*, 67 B.R. 526 (Bankr. N.D. Ohio 1986). Therefore, before a complaint is filed against the IRS concerning a setoff, it must be determined if a setoff is allowed under the local bankruptcy rules.

More recently, a court of appeals has held that a debtor's claim to a tax refund is property of the estate, but that a debtor is only entitled to a refund to the extent that the overpayment exceeds unpaid tax liabilities. When the IRS used its authority under 26 U.S.C. § 6402 to offset the overpayment, which was the basis of the claim for refund to satisfy other tax liabilities, the overpayment was consumed and the debtor was not entitled to a refund. Accordingly, the tax refund did not become property of the estate. *Internal Revenue Service v. Luongo (In re Luongo)*, 259 F.3d 323 (5th Cir. 2001). If the refund never became property of the estate, then it is arguable that the IRS's actions should not be subject to the automatic stay.

(n48)Footnote 44. *In re Avis*, 178 F.3d 718, 721-723 (4th Cir. 1999) (the debtor's ancestor created a spendthrift trust that was a contingent interest on the petition date; the court determined that the attachment of the Notice of Federal Tax Lien to the debtor's interest in the trust was inchoate on the petition date and was stayed by the petition from actually attaching to the interest, and, therefore, the lien did not attach to the property postpetition due to the operation of the automatic stay); compare however *In re Orr*, 180 F.3d 656, 659 (5th Cir. 1999) (the Notice of Federal Tax Lien attaches to the proceeds of a spendthrift trust that accrued before the petition date and after the recording of the tax lien and the tax lien and the interests to which it attached before the petition date survive the filing and the automatic stay is

never applicable).

In re Pinkstaff, 974 F.2d 113 (9th Cir. 1992) (because the IRS had knowledge of the pending bankruptcy case and nevertheless filed a postpetition notice of federal tax lien, the IRS was guilty of willfully violating the automatic stay); *In re Guterl Special Steel Corp.*, 111 B.R. 107 (Bankr. W.D. Pa. 1990), *aff'd*, *Makoroff v. City of Lockport*, 916 F.2d 890, 23 C.B.C.2d 1566 (3d Cir. 1990), *cert. denied*, 499 U.S. 983, 111 S. Ct. 1640, 113 L. Ed. 2d 735 (1990); *In re Erie Hilton Joint Venture*, 125 B.R. 140, 148 (Bankr. W.D. Pa. 1991); *In re Chateaugay Corp.*, 115 B.R. 760, 780-781 (Bankr. S.D.N.Y. 1990); *In re Pointer*, 22 C.B.C.2d 1452, 1458, 113 B.R. 285 (Bankr. N.D. Tex. 1990); *In re Isley*, 104 B.R. 673, 677 (Bankr. D.N.J. 1989). A Notice of Federal Tax Lien mailed prepetition but recorded postpetition is, notwithstanding the timing argument, a stay violation. *In re Carlsen*, 15 C.B.C.2d 1191, 63 B.R. 706 (Bankr. C.D. Cal. 1986). After a Chapter 7 debtor had received his discharge, the automatic stay no longer applied to him and a lien filed at that point to secure a nondischargeable tax debt would reach his property that was not part of the bankruptcy estate. *Pullman v. United States (In re Pullman)*, 319 B.R. 443 (Bankr. E.D. Va. 2004). Similarly, a tax lien filed against property that previously had been exempted by the debtor in a Chapter 7 case without objection did violate the automatic stay. *Owens v. United States*, 379 B.R. 558 (Bankr. W.D. Pa. 2007), *aff'd*, 390 B.R. 808 (W. D. Pa. 2008).

(n49)Footnote 45. See, e.g., *In re Alta Industries, Inc.*, 53 B.R. 567 (Bankr. W.D. Tex. 1985).

(n50)Footnote 46. See, e.g., *In re Morton*, 866 F.2d 561, 564, 20 C.B.C.2d 465 (2d Cir. 1989); *In re Stuber*, 142 B.R. 435, 438 (Bankr. D. Kan. 1992); *United States v. Sayres*, 43 B.R. 437 (W.D.N.Y. 1984). The refiling of a Notice of Federal Tax Lien is not a stay violation because the Bankruptcy Code only prevents acts that create, perfect, or enforce a lien against property of the estate; because the Bankruptcy Code does not prohibit the extension, continuation, or renewal of a lien that validly existed prepetition, the refiling is not a stay violation. The refiling of a federal tax lien during a title 11 proceeding did not violate section 362 because the action merely preserved the status quo. *In re O'Callaghan*, 342 B.R. 364 (Bankr. M.D. Fla. 2006).

(n51)Footnote 47. See, e.g., *Laughlin v. United States (In re Laughlin)*, 912 F.2d 197, 23 C.B.C.2d 736 (8th Cir. 1990), *cert. denied*, 498 U.S. 1120, 111 S. Ct. 1073, 112 L. Ed. 2d 1179 (1991); *In re Root*, 61 B.R. 984 (Bankr. D. Colo. 1986).

(n52)Footnote 47a. *Meadows v. Commissioner*, 405 F.3d 949 (11th Cir. 2005).

(n53)Footnote 48. 11 U.S.C. § 1306(a) provides in relevant part:

(a) Property of the estate includes, in addition to the property specified in Section 541 of this title

*

(b) earnings from services performed by the debtor after the commencement of the case but before the case is closed, dismissed, or converted ... whichever occurs first.

(n54)Footnote 49. See *In re Aneiro*, 16 C.B.C.2d 1070, 1076, 72 B.R. 424 (Bankr. S.D. Cal. 1987) (the only relevant dates are the dates of closing, dismissal or conversion; the confirmation date does not remove the debtor's wages from the estate); *In re Clark*, 71 B.R. 747, 750 (Bankr. E.D. Pa. 1987); *In re Root*, 61 B.R. 984, 985 (Bankr. D. Colo. 1986) (postconfirmation estate of the taxpayer would include only assets which were necessary to fund the plan); *In re Adams*, 4 C.B.C.2d 1054 (Bankr. D. Utah 1981) (same result as *Root*; assets are protected from collection only to the extent needed to fund a plan). Under the rationale of the court in *Root*, if the debtor was required to make a \$500 per month payment to the trustee, then at least \$500 of postconfirmation wages would be protected by the automatic stay as

that amount would continue to be property of the estate.

(n55)Footnote 50. *See, e.g., In re Mason*, 45 B.R. 498 (Bankr. D. Or. 1984), *aff'd*, 51 B.R. 548 (D. Or. 1985); *In re Johnson*, 36 B.R. 958, 959 (Bankr. D. Utah 1983); *In re Dickey*, 64 B.R. 3, 4 (Bankr. E.D. Va. 1985); *In re Petruccelli*, 22 C.B.C.2d 1519, 113 B.R. 5 (Bankr. S.D. Cal. 1990).

(n56)Footnote 51. *See, e.g., In re Walker*, 67 B.R. 811, 812, n.3 (Bankr. C.D. Cal. 1986). In this case, the debtor's counsel provided in the plan that "property of the estate shall revert in the debtor at such time as a discharge is granted or the case is dismissed." The reversion of the property of the estate in the debtor is discussed in 8 *Collier on Bankruptcy*, P 1327.03 (Matthew Bender 15th Ed. Revised). The court therefore concluded the section 362(a) stay remained in effect with respect to the postconfirmation default on a mortgage.

The consequences of a stay violation resulting from the filing of a notice of federal tax lien against a chapter 13 debtor for tax periods after the confirmation of his or her plan in a prior case were considered by the district court in *United States v. Sanderfer* (*In re Sanderfer*), 93 A.F.T.R.2d 677 (E.D. Tenn. 2004). The court accepted the minority view and agreed that the lien filing was a stay violation in the first case, but it also held that the dismissal of the first case after this violation made the lien voidable but not void *ab initio*. Since no action had been taken to void the lien, the IRS claim was secured in the subsequent case.

(n57)Footnote 51a. *In re Gill*, 343 B.R. 732, 2006 Bankr. LEXIS 880 (Bankr. M.D. Fla. 2006); *United States v. White*, 466 F.3d 1241 (11th Cir. 2006). A similar result occurred following the granting of discharge in a Chapter 7 proceeding. *McGuirl v. United States*, 349 B.R. 759 (D. D.C. 2006).

(n58)Footnote 51b. *In re Wood*, 341 B.R. 804, 2006 Bankr. LEXIS 567 (Bankr. S.D. Fla. 2006).

(n59)Footnote 52. 11 U.S.C. § 362(a)(8) was amended in 2005 to make this distinction between individual and corporate debtors. Cases like *McClamma v. Commissioner*, 76 T.C. 754, 757 (1981); *Wahlstrom v. Commissioner*, 92 T.C. 703, 706-707 (1989); *Ever Clean Serv. Inc. v. Commissioner*, 45 T.C.M. (CCH) 349, 350 (1982), remain good law. However, *Halpern v. Commissioner*, 96 T.C. 895 (1996), where the Tax Court rejected a individual Chapter 7 debtor's argument that it had jurisdiction over his postpetition tax liabilities, is effectively overruled. There are very strict prerequisites to obtaining proper jurisdiction before the Tax Court. In each of these cases, the prior filing of a case under title 11 caused each of these courts to conclude that there was no jurisdiction in the Tax Court. The automatic stay does not, however, prohibit the IRS from assessing a tax liability against the debtor for taxable years after the petition date. *In re Carter*, 74 B.R. 613 (Bankr. E.D. Pa. 1987).

(n60)Footnote 52a. The Tax Court has held that an limited liability company (LLC) is a separate legal entity from its shareholders and that the automatic stay does not apply to the adjudication of its tax liability. *People Place Auto Hand Carwash, L.L.C. v. Commissioner*, 26 T.C. 359, 2006 U.S. Tax Ct. LEXIS 19 (2006).

(n61)Footnote 53. A taxpayer is allowed only 90 days from the date the Statutory Notice of Deficiency is mailed to his or her last known address within which to file a Tax Court petition or the tax deficiency reflected on the notice will be assessed. I.R.C. § 6213. This 90-day jurisdictional time limitation is tolled by the automatic stay. 11 U.S.C. § 108(a)(1). If the stay is modified, however, the 90-day jurisdictional time limitation for the filing of a Tax Court petition begins to run again. Care must be observed to ensure that the 90-day jurisdictional time period does not expire or use of the Tax Court as a forum will be lost.

(n62)Footnote 54. 11 U.S.C. § 362(c)(2).

(n63)Footnote 55. *Moody v. Commissioner*, 95 T.C. 655, 660-664 (1990). Bankruptcy courts have reached the same conclusion as the Tax Court did in *Moody*. *See, e.g., In re Fortner Oilfield Services, Inc.*, 49 B.R. 9, 10 (Bankr. N.D. Tex. 1984). In *Zimmerman v. Commissioner*, 105 T.C. 220 (1995), the Tax Court held that the automatic stay was terminated as of the date the order of discharge was entered by the bankruptcy court, not the date notice of the

discharge was sent to creditors. Accordingly, the period during which the taxpayer could have filed a timely petition with the Tax Court to redetermine the asserted tax liability had expired.

(n64)Footnote 56. *Wahlstrom v. Commissioner*, 92 T.C. 703 (1989) . The stay would, however, be terminated as to postpetition liabilities after confirmation.

(n65)Footnote 57. See *Reagoso v. Commissioner*, T.C. Memo 1993-450; 1993 Tax Ct. Memo LEXIS 461; 66 T.C.M. (CCH) 850 (1993). A notice of deficiency was issued while the debtors were in a chapter 7 case. Prior to their discharge, they filed a petition with the Tax Court. That court subsequently held that the petition was invalid because it was filed in violation of the automatic stay. After they received their discharge, the period within which the debtors could have filed a valid petition had started to run and expired. The Commissioner's motion to dismiss was granted. After a bankruptcy court entered an order of discharge in a chapter 7 proceeding, it was possible for the IRS to proceed with previously filed litigation in the Tax Court against the taxpayers individually, as distinguished from the chapter 7 estate. *Bigelow v. Commissioner*, 65 F.3d 127 (9th Cir. 1995) .

(n66)Footnote 58. In *Allison v. Commissioner*, 97 T.C. 544 (1991) , a chapter 7 debtor received a discharge and the case was closed. Subsequently, the IRS issued a Statutory Notice of Deficiency for a year prior to the bankruptcy petition date. The debtor responded by timely filing a petition with the Tax Court and also obtained an order from the bankruptcy court reopening his bankruptcy case pursuant to 11 U.S.C. § 350. In the absence of any explicit language in the stay provisions of the Bankruptcy Code, the Tax Court held the automatic stay was not in effect when the case was reopened and denied the debtor's attempt to stay the Tax Court proceeding in deference to the bankruptcy case. *Accord Roth v. Commissioner*, T.C. Memo 1993-229; 1993 Tax Ct. Memo LEXIS 227; 65 T.C.M. (CCH) 2778 (1993) . In a subsequent case involving similar facts, the Tax Court followed *Allison* and held that the automatic stay was not "reinstated" when a bankruptcy court later vacated an earlier order denying a discharge in a chapter 7 case in the absence of language in that order explicitly reimposing the stay. *Kieu v. Commissioner*, 105 T.C. 387 (1995) . See also *Guerra v. Commissioner*, 110 T.C. 271 (1998) . After receiving a notice of deficiency, taxpayers initiated a title 11 proceeding and then filed a petition in the Tax Court to challenge an accuracy-related penalty reflected in the notice. The Tax Court held the petition was filed in violation of the automatic stay and dismissed it for lack of jurisdiction. *Cassel v. Commissioner*, T.C. Memo. 2006-132 (2006) .

(n67)Footnote 58a. *Drake v. Commissioner*, 123 T.C. 320 (2004) . Subsequently, the bankruptcy court held that the IRS had violated the automatic stay by issuing the debtor a notice of deficiency during her bankruptcy proceeding. For this reason, it held that limitations did not prevent the debtor from pursuing the matter in the Tax Court and abstained from hearing her objection. *In re Drake*, 336 B.R. 155 (Bankr. D. Mass. 2006) .

(n68)Footnote 58b. *Prevo v. Commissioner*, 123 T.C. 326 (2004) .

(n69)Footnote 59. See *Freeman v. Commissioner*, 799 F.2d 1091 (5th Cir. 1986) (debtor's appeal from a Tax Court decision was not a proceeding "against the debtor" for purposes of the automatic stay of 11 U.S.C. § 362 because the debtor was the plaintiff in the original proceeding and the application of the stay to a pending appeal is determined from an examination of the posture of the case at the initial proceeding). The Fifth Circuit's view has been rejected by the *Court of Appeals for the Ninth Circuit*. *Delpit v. Commissioner*, 18 F.3d 768 (9th Cir. 1994) .

Compare, *Cathey v. Johns-Manville Sales Corp.*, 711 F.2d 60, 61, 8 C.B.C.2d 1179 (6th Cir. 1983) (appeals filed by asbestos plaintiffs against favorable rulings in favor of the debtor were actions against the debtor and therefore were stayed pursuant to the automatic stay of section 362; the automatic stay is applicable at both the trial and appellate levels if the proceeding is one against the debtor). It is possible that the IRS may assert counterclaims in a Tax Court determination or in a refund suit filed in the district court or Claims Court. If the Commissioner or the United States were to appeal a final judgment on its counterclaim, then, on the basis of the opinions noted above, the section 362 automatic stay should apply to stay the appeal filed by the government. See also *Computer Programs Lambda, Ltd. v. Commissioner*, 89 T.C. 198 (1987) (filing of a petition under title 11 by the tax matters partner prevented him from

acting as such; automatic stay prevented a previously filed proceeding with respect to the partnership for which he was the tax matters partner from going forward in the Tax Court; the other nonfiling partners would be unaffected by the outcome of the case under title 11, but they would have to wait until it was completed or the automatic stay was modified before their rights could be adjudicated). The Court of Appeals for the Eleventh Circuit considered the conflicting views of the Fifth Circuit in *Freeman* and the Ninth Circuit in *Delpit* and decided to follow *Freeman*. *Roberts v. Commissioner*, 175 F.3d 889 (11th Cir. 1999) .

(n70)Footnote 61. 11 U.S.C. § 106.

(n71)Footnote 62. See 2 *Collier on Bankruptcy*, P 106.LH (Matthew Bender 15th Ed. Revised), for a discussion of the legislative history of section 106(c) as it existed prior to revision by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 (enacted on October 22, 1994).

(n72)Footnote 63. *Hoffman v. Connecticut Department of Income Maintenance*, 492 U.S. 96 (1989), 109 S. Ct. 2818, 106 L. Ed. 2d 76 (1989) .

(n73)Footnote 64. *United States v. Nordic Village, Inc.*, 503 U.S. 30, 112 S. Ct. 1011, 117 L. Ed. 2d 181, 26 C.B.C.2d 9 (1992) ("Nordic Village").

(n74)Footnote 65. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994), reprinted in Vol. E *Collier on Bankruptcy*, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n75)Footnote 66. For example, 11 U.S.C. § 362(h) provides:

An individual injured by any willful violation of a stay provided by this section shall recover actual damages, including costs and attorneys' fees, and, in appropriate circumstances, may recover punitive damages.

Two points should be noted with respect to this statute. Section 362(h) only offers remedial relief to individuals, so corporations and partnerships cannot recover the noted sanctions in stay litigation against the United States or any other creditor. Additionally, there must be a finding of willfulness before the sanctions may be awarded. As discussed below, courts disagree over the level of activity and conscious action which will rise to the level of willfulness on the part of the IRS in this statute. Finally, punitive damages are not awarded in every case, and as discussed below, there must be a finding of bad acts and a flaunting of the court's jurisdiction before this form of punishment is imposed.

(n76)Footnote 66a. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994), reprinted in Vol. E *Collier on Bankruptcy*, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n77)Footnote 67. The Omnibus Consolidated Emergency Supplemental Appropriations Act, 1999, Pub. L. No. 105-277, effective October 21, 1998, deleted sections 362(b)(4) and (b)(5) (the exceptions to the automatic stay for exercises of the police and regulatory power) and supplied a new section 362(b)(4). The 1998 amendment substantially broadens the police and regulatory exception to the automatic stay by its introductory reference to paragraphs (3) and (6) of section 362(a), but the expansion appears limited by the history of the provision. See 3 *Collier on Bankruptcy*, P 362.05 (Matthew Bender 15th Ed. Revised).

(n78)Footnote 67a. *In re Pansier*, 212 B.R. 950 (Bankr. E.D. Wis. 1997) (section 106(a)(3) of the Bankruptcy Code waived the IRS defense of sovereign immunity for damages for failing to abide by a court order to turnover levied property).

(n79)Footnote 68. It should be remembered that the foregoing discussion of sovereign immunity relates to litigation of federal tax disputes only. In *Seminole Tribe of Florida v. Florida*, 517 U.S. 44, 116 S. Ct. 1114, 134 L.

Ed. 2d 252, 34 C.B.C.2d 1199 (1996) , the Supreme Court appears to have opened the way for state taxing authorities to assert that any attempt by the Bankruptcy Reform Act of 1994 would be unconstitutional.

(n80)Footnote 69. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n81)Footnote 70. 11 U.S.C. § 106(b), as amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, represents the compulsory counterclaim rule referred to in *United States v. Nordic Village, Inc.*, 503 U.S. 30, 112 S. Ct. 1011, 117 L. Ed. 2d 181, 26 C.B.C.2d 9 (1992) and *Davis v. IRS*, 136 B.R. 414, 420 (E.D. Va. 1992) . For cases in which the sovereign immunity defense was waived due to the filing of a proof of claim, *see, e.g., In re Pinkstaff*, 974 F.2d 113, 114-5 (9th Cir. 1992) ; *In re Fernandez*, 132 B.R. 775, 780 (M.D. Fla. 1991) ; *In re Pullman Construction Industries, Inc.*, 27 C.B.C.2d 707, 142 B.R. 280 (Bankr. N.D. Ill. 1992) , *aff'd*, 153 B.R. 539 (N.D. Ill. 1993) , *appeal dismissed*, 23 F.3d 1166 (7th Cir. 1994) ; *In re Long*, 142 B.R. 234 (Bankr. S.D. Ohio 1992) ; *In re Price*, 130 B.R. 259 (Bankr. N.D. Ill. 1991) ; *In re Bryant*, 23 C.B.C.2d 337, 116 B.R. 272 (Bankr. D. Kan. 1990) . For a very expansive view of the former section 106(a) waiver, *see In re Mohawk Industries, Inc.*, 55 B.R. 284 (Bankr. D. Mass. 1985) , in which the court held that the sovereign immunity of the United States was waived by the IRS's pursuit of the I.R.C. § 6672 100% penalty against the officers and directors of the debtor. If, as the Supreme Court stated in *Nordic Village*, waivers of sovereign immunity are required to be unequivocal, it is difficult to imply a waiver of the defense when the IRS is attempting to collect the separate and independent tax liability of I.R.C. § 6672 from nondebtor individuals who have been classified as responsible persons who willfully failed to collect, account for, and pay over trust fund tax liabilities. The separate and independent tax status of the I.R.C. § 6672 assessment has been confirmed by many courts. *See, e.g., Howard v. United States*, 711 F.2d 729 (5th Cir. 1989) . The collection of the I.R.C. § 6672 liability from nondebtors should not therefore affect the status of the corporate debtor or its relationship with IRS To the contrary, when a proof of claim has not been filed, some courts have refused to find a waiver of sovereign immunity. *See, e.g., In re Nichols*, 143 B.R. 104, 106 (Bankr. S.D. Ohio 1992) ; *In re Dillon*, 148 B.R. 852, 854 (Bankr. E.D. Tenn. 1992) (the absence of a filed proof of claim resulted in a finding of no waiver in a turnover action); *Kincaid v. United States Veterans Admin.*, 148 B.R. 844, 845 (Bankr. E.D. Ky. 1992) (same result in case involving the IRS and its postpetition setoff of a tax refund); *In re Pettis*, 146 B.R. 653, 655 (E.D. Pa. 1992) . *See also In re Unroe*, 144 B.R. 85 (Bankr. S.D. Ind. 1992) . In *Unroe*, the chapter 13 taxpayer's plan paid the IRS's prepetition claim in full. The IRS attempted to collect a postpetition tax liability, and the debtor moved to have the IRS held in contempt for violating the stay. The court held sovereign immunity was not waived in the contempt action because the prepetition "claim" required for the operation of section 106(a) did not exist, having been satisfied through the chapter 13 plan. As a result, the waiver of sovereign immunity that may exist at the start of a bankruptcy case may be lost if the tax claims asserted by the United States are paid.

(n82)Footnote 71. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n83)Footnote 72. *Sullivan v. Town & Country Home Nursing Services, Inc.*, 963 F.2d 1146, 26 C.B.C.2d 1446 (9th Cir. 1992) (the clear terms of section 106(a) do not compel the filing of a proof of claim to waive immunity because immunity is waived by the mere existence of the claim); *Mims v. United States (In re Craftsmen)*, 163 B.R. 88 (Bankr. W.D. Tex. 1994) ; *In re Taylor*, 148 B.R. 361, 364 (S.D. Ga. 1992) ; *In re Fingers*, 28 C.B.C.2d 484, 148 B.R. 586 (Bankr. S.D. Cal. 1993) ; *In re Boldman*, 148 B.R. 874, 876-77 (Bankr. C.D. Ill. 1993) ; *Rakozy v. Diversified Turnkey Constr. Co.*, 145 B.R. 661, 666-67 (Bankr. D. Idaho 1993) . The court in *Western States Drywall* concluded that an informal claim was filed when the United States wrote a letter to the court outlining the claims asserted by the United States. That letter, although not a "claim" was sufficient to waive sovereign immunity under prior section 106(a).

(n84)Footnote 73. *Sullivan v. Town & Country Home Nursing Services, Inc.*, 963 F.2d 1146, 26 C.B.C.2d 1446 (9th Cir. 1992) .

(n85)Footnote 74. *Mims v. United States (In re Craftsmen, Inc.)*, 163 B.R. 88 (Bankr. W.D. Tex. 1994) .

(n86)Footnote 75. In some instances the IRS has successfully argued that 11 U.S.C. § 106(a) will not waive sovereign immunity as a result of its collection activities if the IRS has not filed a proof of claim because the collection functions do not arise from the same transaction or occurrence that created the income tax liability that forms the basis for the IRS's claim. *See, e.g., Davis v. IRS*, 136 B.R. 414, 422 (E.D. Va. 1992) ; *Ashbrook v. Block*, 917 F.2d 918 (6th Cir. 1990) . *But see In re Taborski*, 141 B.R. 959 (Bankr. N.D. Ill. 1992) (a claim for taxes and a claim for damages arising from a stay violation to collect those taxes satisfy the same transaction or occurrence test); *In re Matravers*, 149 B.R. 204 (Bankr. D. Utah 1993) ; *In re Adams*, 152 B.R. 1021 (Bankr. M.D. Ga. 1993) ; *In re Fingers*, 28 C.B.C.2d 484, 490, 148 B.R. 586 (Bankr. S.D. Cal. 1993) (the IRS's claim arose out of unpaid prepetition taxes and the debtor's stay violation claim arose from the IRS's attempt to collect those same tax liabilities; these claims arose out of the same transaction or occurrence for purposes of section 106(a)); *In re Lile*, 103 B.R. 830 (Bankr. S.D. Tex. 1989) , *aff'd in part w/o op.*, 161 B.R. 788 (S.D. Tex. 1993) , *aff'd in part w/o op.*, 43 F.3d 668 (5th Cir. 1994) ; *In re Bulson*, 117 B.R. 527 (B.A.P. 9th Cir. 1990) .

(n87)Footnote 76. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n88)Footnote 77. *See United States v. Nordic Village, Inc.*, 503 U.S. 30, 112 S. Ct. 1011, 117 L. Ed. 2d 181, 26 C.B.C.2d 9 (1992) ("Nordic Village"); *Davis v. IRS*, 136 B.R. 414, 420 (E.D. Va. 1992) .

(n89)Footnote 78. Any award against the United States under 11 U.S.C. § 106(c) can only be set off against or used to reduce the claims of the United States against the debtor. *United States v. Nordic Village, Inc.*, 503 U.S. 112 S. Ct. 1011, 117 L. Ed. 2d 181, 26 C.B.C.2d 9 (1992)

(n90)Footnote 79. *See Davis v. IRS*, 136 B.R. 414, 423 (E.D. Va. 1992) .

(n91)Footnote 80. S. Rep. No. 989, 95th Cong., 2d Sess. 29 (1978), *reprinted in*, Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised).

(n92)Footnote 81. *See, e.g., In re Germaine*, 152 B.R. 619 (B.A.P. 9th Cir. 1993) ; *In re Graham*, 981 F.2d 1135, 28 C.B.C.2d 78 (10th Cir. 1992) ; *In re Shafer*, 148 B.R. 617 (D. Kan. 1992) . A district court held that a cause of action under sections 7430 and 7433 accrued when the IRS sent a notice of levy to the debtor and that she had waited too long to bring her adversary proceeding alleging a violation of the discharge injunction. *Kovacs v. United States*, 391 B.R. 820 (E.D. Wis. 2008) .

(n93)Footnote 82. *See In re Shafer*, 148 B.R. 617, 619 (D. Kan. 1992) , in which the court concluded:

It seems beyond serious dispute that a proceeding to hold the IRS in contempt for attempting to collect on taxes and penalties discharged in bankruptcy is a "civil proceeding ... brought ... against the United States in connection with the ... collection ... of any tax, ... or penalty. The relationship or connection arises from the act triggering the civil contempt proceeding is the collection of a tax or penalty.

(n94)Footnote 83. 26 U.S.C. § 7433(e). Actions under this provision are the exclusive remedy for recovering damages from such actions except for actions under 11 U.S.C. § 362(h). No damages can be awarded under section 7433 unless the claimant has exhausted administrative remedies within the IRS. *In re Lowthorp*, 332 B.R. 656 (Bankr. M.D. Fla. 2005) ; *In re Graycarr, Inc.*, 330 B.R. 741 (Bankr. W.D. Ark. 2005) .

(n95)Footnote 84. Compare *In re Continental Airlines, Inc.*, 61 B.R. 758 (S.D. Tex. 1987) with *Kellog v. Chester*, 71 B.R. 36 (N.D. Tex. 1987) .

(n96)Footnote 85. *See, e.g., In re Zurich*, 88 B.R. 721, 724 (Bankr. W.D. Pa. 1988) , *In re Mullarkey*, 81 B.R.

280, 284 (*Bankr. D.N.J. 1987*) ; *In re Forty-Eight Insulations, Inc.*, 54 B.R. 905, 909 (*Bankr. N.D. Ill. 1985*) . This definition of willfulness has been applied very broadly by some courts to impute the actual knowledge of one Revenue Agent or Revenue Officer to the entire IRS as an entity. *See, e.g., In re Shafer*, 63 B.R. 194, 198 (*Bankr. D. Kan. 1986*) . In *Shafer*, the taxpayers moved from one IRS district to another, and the IRS agents in the prior district had knowledge of the title 11 case filing. They did not, however, communicate that fact to the IRS in the new district. The stay was violated by the IRS agents in the new district, and the court held that there was a willful stay violation based upon the actual knowledge of the agents in the old district. *But see Crispell v. Landmark Bank (In re Crispell)*, 73 B.R. 375, 379 (*Bankr. E.D. Mo. 1987*) (willfulness means "deliberate" or "intentional"); *Augustino Enterprises Inc. v. Amgro, Inc.*, 13 B.R. 210, 212 (*Bankr. D. Mass. 1981*) (inadvertent violations of the stay will not be punished; there must be a showing of "bad faith" which is action taken "with actual knowledge of the petition and with deliberate intent to violate the stay").

(n97)Footnote 86. Examples of such cases include the mailing of demand letters, notices of intent to levy, or the issuance of any other correspondence which is connected to the IRS's collection functions.

(n98)Footnote 87. Where the IRS had inadvertently mailed a computer-generated demand for payment to a debtor and the only harm to the debtor was the cost of seeking sanctions from the bankruptcy court, no damages were allowed. The court noted that the debtor had not bothered to telephone the IRS to resolve the matter before bringing its action for damages. *In re Brock Utilities & Grading, Inc.*, 185 B.R. 719 (*Bankr. E.D.N.C. 1995*) . It has also been held that debtors have a duty to mitigate their damages before seeking relief from violations of the stay that they could have prevented. *In re Belcher*, 189 B.R. 16 (*Bankr. S.D. Fla. 1995*) .

(n99)Footnote 88. *See, e.g., In re Aponte*, 82 B.R. 738 (*Bankr. E.D. Pa. 1988*) ; *Ramage v. Ramage*, 39 B.R. 37, 39 (*Bankr. E.D. Pa. 1984*) .

(n100)Footnote 89. *In re McCullough*, 63 B.R. 97, 99 (*Bankr. E.D. Pa. 1986*) ; *In re Rasbury*, 24 F.3d 159 (11th Cir. 1994) (The court of appeals affirmed the district court's determination that the IRS would not be subjected to an award of attorneys fees because of the uncertainty over which party would bear the burden of proof on the merits of the tax claim); *In re Sammon*, 253 B.R. 672 (*Bankr. D.S.C. 2000*) (the court found no proximate cause between the IRS's actions and the damages alleged by the debtors, particularly because the debtors failed to contact the IRS during the time the events said to cause the damages occurred).

(n101)Footnote 90. *See, e.g., Shaddock v. Rodolakis*, 221 B.R. 573, 585-586 (*D. Mass. 1998*) (the filing of a tax lien and levy were deliberate actions taken by the IRS to collect a prepetition tax claim and the knowledge of one employee of the IRS that the debtors filed a title 11 case was imputed to the entire IRS so that its actions in violation of the stay were willful violations of the stay); *In re Santa Rosa Truck Stop, Inc.*, 74 B.R. 641 (*Bankr. N.D. Fla. 1987*) .

(n102)Footnote 91. *See, e.g., In re Lile*, 103 B.R. 830 (*Bankr. S.D. Tex. 1989*) , *aff'd*, 161 B.R. 788 (*S.D. Tex. 1993*) , *aff'd in part w/o op.*, 43 F.3d 668 (5th Cir. 1994) .

(n103)Footnote 92. *See, e.g., Allen v. IRS*, 83 B.R. 678, 681 (*Bankr. E.D. Mo. 1988*) (IRS levy on debtor's wages was not deliberate and therefore did not warrant punitive damages); *In re Conti*, 42 B.R. 122, 127-128 (*Bankr. E.D. Va. 1984*) (inadvertent wage levy resulting from a clerical error was not willful so as to hold the IRS in contempt).

(n104)Footnote 92a. *Compare In re Kramer*, 95 A.F.T.R.2d 324 (*Bankr. N.D. Iowa 2004*) with *In re Pleasant*, 320 B.R. 889 (*Bankr. N.D. Ill. 2005*) . Observing that retroactive relief should be granted sparingly and only in compelling circumstances, the bankruptcy court in *Kramer* refused to modify the stay retroactively where the IRS had secured the entry of a judgment granted before the filing of the title 11 petition. The record indicated that the debtor had sent notice of the filing of his petition to the wrong address and contained indications of the debtor's bad faith. In a different case where a debtor sent notice of the filing of his petition to the IRS at the wrong address, the court in *Pleasant* retroactively modified the stay to permit a setoff the IRS had made two weeks prior to receiving actual notice

of the filing.

(n105)Footnote 93. *In re Holden*, 226 B.R. 809 (Bankr. D. Vt. 1998) (it was proper for the court to hear evidence on the issue of emotional distress arising from conduct of the IRS in violating the automatic stay; damages for emotional distress from violation of the stay are available due to the embarrassment, humiliation, and shame occasioned by a levy and its consequences).

(n106)Footnote 94. Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, 108 Stat. 4106 (1994), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised).

(n107)Footnote 95. Some debtor's counsel might make a claim for and litigate punitive damages against a governmental entity to increase the debtor's claim for purposes of setoff against the governmental claim under new section 106(c). On the face of new section 106(a)(3), it appears that Congress terminated this strategy because the Bankruptcy Court has no authority to enter any order awarding punitive damages against a governmental entity.

(n108)Footnote 96. 28 U.S.C. § 2674(b) which provides: The United States shall be liable, respecting the provisions of this title relating to tort claims, in the same manner and to the same extent as a private individual under like circumstances, but shall not be liable for interest prior to judgment or for punitive damages.

(n109)Footnote 97. *See, e.g., Missouri Pacific Railroad Co. v. Ault*, 256 U.S. 554, 564, 41 S. Ct. 593, 65 L. Ed. 1087 (1921); *Edelman v. Jordan*, 415 U.S. 651, 668, 94 S. Ct. 1347, 39 L. Ed. 2d 662 (1974), *reh'g denied*, 416 U.S. 1000, 94 S. Ct. 2414, 40 L. Ed. 2d 777 (1974); *Painter v. Tennessee Valley Authority*, 476 F.2d 943 (5th Cir. 1973).

(n110)Footnote 98. *See, e.g., In re Gault*, 136 B.R. 736 (Bankr. E.D. Tenn. 1991) (\$2,500 punitive damages); *In re Lile*, 103 B.R. 830 (Bankr. S.D. Tex. 1989), *aff'd*, 161 B.R. 788 (S.D. Tex. 1993), *aff'd in part w/o op.*, 95-1 U.S. Tax Cas. (CCH) P50,031 (5th Cir. 1994).

(n111)Footnote 99. S. Rep. No. 989, 95th Cong., 2nd Sess., pp. 29-30 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised).

(n112)Footnote 100. There is a split of circuit court opinions regarding the award of attorneys fees in bankruptcy cases pursuant to *Section 7430 of the Internal Revenue Code*. The majority of the decisions considering this issue, however, agree that the bankruptcy court should apply Section 7430 to determine the amount of attorneys fees to be awarded to a successful litigant. *See, e.g., In re Brickell Investment Corp.*, 922 F.2d 696 (11th Cir. 1991) (the bankruptcy court was not the court authorized to award attorneys fees under section 7430); *In re Sneller*, 153 B.R. 343, 345 (Bankr. M.D. Ala. 1993) (adopting reasoning of *Brickell*). Compare the *Brickell* decision to the majority of decisions, including *In re Yochum*, 89 F.3d 661 (9th Cir. 1996); *In re Lilly*, 76 F.3d 568 (4th Cir. 1996); *In re Grewe*, 4 F.3d 299 (4th Cir. 1993), *cert. denied*, 510 U.S. 1112, 114 S. Ct. 1056, 127 L. Ed. 2d 377 (1994); *In re Germaine*, 152 B.R. 619 (B.A.P. 9th Cir. 1993); *O'Connor v. United States*, 942 F.2d 771 (10th Cir. 1991); *Volpert v. Volpert* (*In re Volpert*), 186 B.R. 240 (N.D. Ill. 1995); *In re Chambers*, 140 B.R. 233 (N.D. Ill. 1992); *In re Milto*, 210 B.R. 687 (Bankr. D. Md. 1997); *In re Acme Music Co.*, 208 B.R. 838 (Bankr. W.D. Pa. 1997); *In re Matthews*, 184 B.R. 594 (Bankr. S.D. Cal. 1995); *In re Evans*, 188 B.R. 598 (Bankr. D. Neb. 1995); *Williams v. IRS*, 179 B.R. 929, 934 (Bankr. D. Mont. 1995); *In re Brooks*, 175 B.R. 409 (Bankr. S.D. Ala. 1994); *In re Abernathy*, 150 B.R. 688 (Bankr. N.D. Ill. 1993). *Abernathy* was followed by a bankruptcy court which also refused to award damages for mental anguish without some basis in fact or proof of damages with reasonable certainty. *Baird v. United States* (*In re Baird*), 319 B.R. 686 (Bankr. M.D. Ala. 2004). A district court held that damages for emotional distress were not available under section 362(h) and that punitive damages and attorneys' fees were an adequate remedy. *United States v. Harchar*, 331 B.R. 720 (N.D. Ohio 2005). On remand, the bankruptcy court held that the imposition of an administrative freeze on a tax refund did not constitute a stay violation. *Harchar v. United States*, 102 A.F.T.R.2d 2008-5274 (Bankr. N.D. Ohio 2008). Although a violation of the discharge injunction, not the automatic stay, was at

issue, a court of appeals discussed the split between the circuits regarding the reach of section 362(h) and held that damages for emotional distress were not available in this situation either. *United States v. Torres (In re Torres)* 432 F.3d 20 (1st Cir. 2005) .

(n113)Footnote 101. *In re Lilly*, 1995 U.S. Dist. LEXIS 3567 (S.D. W. Va. Feb. 27, 1995) (failure to exhaust administrative remedies within the IRS before filing a complaint in the bankruptcy court precluded an award of attorneys fees.) *Accord Klauer v. United States*, 100 A.F.T.R.2d 2007-6858 (M.D. Fla. 2007) . The failure to exhaust administrative remedies before seeking attorneys fees for a stay violation was a fatal jurisdictional flaw that could be raised for the first time on appeal. *Kuhl v. United States*, 467 F.3d 145 (2d Cir. 2006) .

(n114)Footnote 102. I.R.C. § 7430(c)(1).

(n115)Footnote 103. *In re Manlon*, 168 B.R. 594 (Bankr. E.D. Ky. 1994) ; *Johnson Envtl. Corp. v. Knight (In re Goodman)*, 991 F.2d 613 (9th Cir. 1993) . One court of appeals has held, in a nontax case, that chapter 7 trustees do not qualify as "individuals" under section 362(h) and may not seek damages for stay violations on behalf of the estate. *Havelock v. Taxel (In re Pace)*, 67 F.3d 187 (9th Cir. 1995) . The Court of Appeals for the Ninth Circuit did hold that the chapter 7 trustee could be awarded damages as a sanction for civil contempt under section 105(a), but this remedy would not be available against the IRS. A debtor's claim for damages resulting from emotional distress was dismissed since it was barred by section 362(k). *King v. United States (In re King)*, 396 B.R. 242 (Bankr. D. Mass. 2008) .

(n116)Footnote 104. The details of this new program, which were not available as of November, 1998, are to be published in the next version of the *Internal Revenue Manual, Part V, Bankruptcy Handbook. Announcement 98-89* , Internal Revenue Bulletin, 1998-40 (September 25, 1998).



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Collier on Bankruptcy Taxation

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CHAPTER TX5 Litigation With the IRS in Bankruptcy Court

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P TX5.07 Turnover Litigation Against the IRS

[1] Overview of Turnover Litigation Against the IRS

Prior to and, subject to the limitations of the automatic stay of section 362, during the course of a case filed under title 11, the Internal Revenue Service may seize assets of a taxpayer to satisfy a tax liability. If a taxpayer files a title 11 petition after an asset seizure by the Internal Revenue Service, many questions arise concerning the ability of the debtor or a trustee to recover the property and whether an action to recover seized assets can even be filed against the Internal Revenue Service. These issues include, for example, whether the Internal Revenue Service can be a defendant in a turnover action, what kind of property can be recovered after seizure, the Internal Revenue Service's defenses to a turnover action, and the status of prepetition levies that continue postpetition.

[2] The IRS as a Defendant in a Turnover Action

The Bankruptcy Code requires anyone holding property of the estate on the date of the filing of the petition, or property that the debtor may use, sell or lease under the Bankruptcy Code to turn over that property to the trustee or the debtor in possession. n1 The legislative history of section 542(a) states that any entity, other than a custodian, is required to deliver property of the estate to the trustee or the debtor in possession. n2 The term "entity" includes a "governmental unit" which in turn includes the United States and its agencies and states. n3 Accordingly, the turnover provisions of section 542(a) apply to the United States and other governmental entities.

The Internal Revenue Service has attempted to avoid liability under section 542 by asserting that the United States has not waived its defense of sovereign immunity. n4 In one case, the United States asserted that it could not be sued in a turnover action because section 542 is not a "determination" for the purposes of the sections of the Bankruptcy Code that contain a waiver of sovereign immunity. n5 Despite its arguments to the contrary, the United States, on behalf of its agency the Internal Revenue Service, is a proper defendant in a section 542 turnover action and the defense of sovereign immunity is waived by the terms of *section 106(a) of the Bankruptcy Code*. n6 In addition, amended section 106(a) specifically mentions sovereign immunity is abrogated with respect to section 542. n6a

[3] Assets Subject to Turnover From the IRS

The most prominent case involving the Internal Revenue Service and a taxpayer's turnover demand is *United States v. Whiting Pools, Inc.* n7 The Supreme Court n8 and the Internal Revenue Service have taken the position that turnover

actions against the United States cannot be asserted to recover any assets other than tangible assets. n9 This position is based, in part, upon the Court's opinion in *Whiting Pools*. Taxpayers have argued that, to the contrary, the opinion in *Whiting Pools* does not appear to be limited to any particular form of assets held by or owned by the debtor by reference to the following language in the opinion:

... section 541(a)(1) provides that the "estate is comprised of all the following property, wherever located; ... all legal or equitable interest of the debtor in property as of the commencement of the case." ... section 541(a)(1)'s scope is broad. Most important, in the context of this case, section 541(a)(1) is intended to include in the estate any property made available to the estate by other provisions of the Bankruptcy Code Several of these provisions bring into the estate property in which the debtor did not have a possessory interest at the time the bankruptcy proceedings commenced. n10

Section 542(a) is such a provision. It requires an entity (other than a custodian) holding any property of the debtor that the trustee can use under section 363 to turn that property over to the trustee.

The interpretation of this passage from the *Whiting Pools* opinion can be read to extend the scope of the section 542(a) remedial power to all forms of assets, both tangible and intangible. n11 This particular issue of the application of the turnover power to intangible assets has not, however, been specifically resolved by the Supreme Court although it has been considered by lower courts. n12

The assets which are most commonly the focus of a section 542(a) conflict are cash, accounts receivable, or any other intangible assets which are "cash equivalents" n13 and thereby readily converted into cash. The IRS takes the position that upon the service of a levy, n14 any interest asserted by a debtor in intangible property such as cash or cash equivalents is terminated, and that those assets are therefore not subject to turnover. n15 This result is based upon the IRS's position that after a levy upon intangibles such as cash or cash equivalents, the ownership of such assets is "virtually transferred to the government," and there is therefore no ownership interest retained by the debtor which can be included in the bankruptcy estate. n16

Many courts have, however, rejected the IRS position that a levy results in the transfer of the ownership of an asset and have held that a taxpayer retains an ownership interest in intangible assets such as cash and accounts receivable and that such assets are subject to turnover under section 542(a). n17 The Internal Revenue Code may also be interpreted to support the conclusion that ownership of assets is not transferred by a levy. n18

[4] Limitations on the Turnover Remedy

[a] Necessity for Reorganization

The turnover remedy sanctioned by the Supreme Court in *Whiting Pools* has its limitations. In *Whiting Pools*, the lower court specifically found the property seized by the Internal Revenue Service was "essential to Whiting's reorganization effort." n19 The focus of the Supreme Court's logic in allowing the turnover of the assets seized by the Internal Revenue Service was the fact that those assets were necessary to the successful reorganization of the debtor. n20 Other courts have agreed that turnover is only appropriate in a reorganization context and not if there is a liquidation in a chapter 7 or chapter 11 case. n21 It can, however, be argued that the turnover of seized assets is appropriate in a liquidation case in order to ensure the proper liquidation of the debtor's assets in conformity with the priority scheme of the Bankruptcy Code. n22

[b] Necessity for Adequate Protection

If a turnover request is made against the IRS, the trustee will be required to provide adequate protection for the IRS's lien interest n23 in the property remitted or conveyed to the title 11 estate. n24 This adequate protection requirement was confirmed by the Supreme Court in *Whiting Pools* n25 and has been reconfirmed by many lower courts ordering

the turnover of both tangible and intangible assets. n26

[c] Necessity for Status as an Asset of the Estate

Section 542 of the Bankruptcy Code allows a court to order the turnover of assets that are part of the estate. Therefore, if it can be established that an asset is not property of the estate, a trustee may be unable to recover that asset, to the benefit of the taxpayer debtor and the Internal Revenue Service. n26a For example, a taxpayer may have overpaid taxes with respect to one taxable period, which overpayment he or she elects to carry over as an estimated tax payment to a subsequent taxable period as allowed by *Sections 6402(b) and 6513(d) of the Internal Revenue Code*. Trustees have attempted to recover such overpayments by arguing that they are tax refunds that are assets of the estate. n27 After a taxpayer debtor makes the election to apply an overpayment to a later taxable year as an estimated tax payment, that election is irrevocable and that overpayment is not an asset of the estate. n28 As a result, the overpayment is not a tax refund that is subject to recovery by a trustee pursuant to *Bankruptcy Code section 542*. If a taxpayer anticipates the filing of a bankruptcy petition, it is beneficial to the taxpayer to elect to apply any income tax overpayments to a subsequent tax period in order to preserve the taxpayer's ability to use those funds in future periods to satisfy postpetition, nondischargeable tax liabilities. n29

FOOTNOTES:

(n1)Footnote 1. *11 U.S.C. § 542(a)*.

(n2)Footnote 2. 124 Cong. Rec. H11096, H11907 (daily ed. Sept. 28, 1978).

(n3)Footnote 3. *11 U.S.C. § 101*.

(n4)Footnote 4. *See, e.g., In re R&L Refunds, 12 C.B.C.2d 207, 45 B.R. 733 (Bankr. W.D. Ky. 1985)*.

(n5)Footnote 5. *In re R&L Refunds, 12 C.B.C.2d 207, 45 B.R. 733 (Bankr. W.D. Ky. 1985)*; *11 U.S.C. § 106(c)*.

(n6)Footnote 6. Prior to its amendment in 1994, *11 U.S.C. § 106(c)* provided that any provision of title 11 which contained the terms "entity" or "governmental unit" applied to governmental units such as the IRS and the United States. Because section 542(a) incorporates the specified "trigger language" of section 106(c), the waiver of sovereign immunity should be effective against the United States in a section 542(a) action. *See, e.g., United States v. Whiting Pools, Inc., 462 U.S. 198, 103 S. Ct. 2309, 76 L. Ed. 2d 515, 8 C.B.C.2d 710 (1983)* (the Court stated the IRS "is bound by § 542(a) to the same extent as any other secured creditor"); *In re Great Western Coal, Inc., 146 B.R. 702 (Bankr. S.D. Tex. 1992)*; *In re R&L Refunds, 12 C.B.C.2d 207, 45 B.R. 733 (Bankr. W.D. Ky. 1985)*; *In re Ray Heid, Inc. 13 B.R. 171 (Bankr. D.N.M. 1981)* (the IRS is included in the definition of the term entity and therefore falls within the scope of § 542); *In re Bush Gardens, 10 B.R. 506 (Bankr. D.N.J. 1979)* (the IRS is not immune from the provisions of section 542 because the United States and the IRS are included in the definition of the term entity). Compare, however, *In re Dillon, 148 B.R. 852, 854 (Bankr. N.D. Ill. 1992)*, a turnover contempt action, in which the court observed that the debtor could not obtain monetary relief absent a waiver of immunity under section 106(a) or (b). The *Dillon* court concluded that section 106(c) applied in this case, permitting the court to grant only declaratory or injunctive relief but not to award a monetary judgment. In *Nordic Village* the Court held the section 106(c) waiver of sovereign immunity could not be implied because section 106(c) was too ambiguous to provide the necessary waiver. Section 106(b) does result in a waiver of sovereign immunity, but that waiver can only result in damages that the taxpayer can set off against a liability owed to the IRS. Notwithstanding this analysis, the Court's opinion in *Whiting Pools* was very specific in concluding the United States was a proper defendant in a turnover action and should therefore continue to be controlling precedent on the sovereign immunity issue because of Congress's inclusion of the triggering language in section 542(a).

(n7)Footnote 6a. *In re Pansier, 225 B.R. 657 (Bankr. E.D. Wis. 1998) (section 106(a)(3) of the Bankruptcy Code*

waived the IRS defense of sovereign immunity for damages for failing to abide by a court order to turnover levied property).

(n8)Footnote 7. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 103 S. Ct. 2309, 76 L. Ed. 2d 515, 8 C.B.C.2d 710 (1983) . On the day before the debtor filed its title 11 petition, the IRS levied upon and seized all of the debtor's tangible personal property including equipment, vehicles, inventory and office supplies valued at \$35,000 but having a going concern value of \$162,876. The Court required the assets to be returned to the debtor because it specifically found they were necessary to the reorganization of the debtor. The *quid pro quo* extracted from the debtor in return for the benefit of the turnover remedy was, however, that the taxpayer was required to pay adequate protection to the IRS for the use by the debtor of the assets returned.

(n9)Footnote 8. *See Phelps v. United States*, 421 U.S. 330, 95 S. Ct. 1728, 44 L. Ed. 2d 201 (1975) .

(n10)Footnote 9. *See, e.g., Phelps v. United States*, 421 U.S. 330, 95 S. Ct. 1728, 44 L. Ed. 2d 201 (1975) (the debtor's assets were converted into cash by an assignee for the benefit of creditors; a levy was served by the IRS on the assignee, and the debtor was placed into an involuntary bankruptcy under the former Bankruptcy Act; the levy created a custodial relationship between the assignee and the IRS and reduced the cash proceeds to the IRS's constructive possession and the debtor and the assignee could not assert any interest in the cash proceeds); *Cross Electric Co. v. United States*, 664 F.2d 1218, 5 C.B.C.2d 1273 (4th Cir. 1981) (after the issuance of an IRS levy, the taxpayer's interest in an intangible asset (such as an account receivable) was transferred to the IRS; the taxpayer did not retain any interest in the intangible asset; and the intangible asset was not therefore included in the debtor's bankruptcy estate and was not subject to turnover).

(n11)Footnote 10. *See United States v. Whiting Pools, Inc.*, 462 U.S. 198, 204-05, 103 S. Ct. 2309, 76 L. Ed. 2d 515, 8 C.B.C.2d 710 (1983) .

(n12)Footnote 11. On the other hand, the IRS can refer to language in the *Whiting Pools* opinion that appears to justify its position that cash or cash equivalents are transferred to the IRS upon the issuance of a levy: "Of course, if a tax levy or seizure transfers ownership of the property seized, § 542(a) may not apply." *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 199, 103 S. Ct. 2309, 76 L. Ed. 2d 515, 8 C.B.C.2d 710 . The Court continued, however, and concluded that the collection or enforcement provisions of the Internal Revenue Code at §§ 6321-6326 "do not transfer ownership of the property to the IRS" The only interest the IRS has in seized property is its lien under I.R.C. § 6321. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 199, 103 S. Ct. 2309, 76 L. Ed. 2d 515, 8 C.B.C.2d 710 (1983) .

(n13)Footnote 12. *See In re Challenge Air*, 952 F.2d 384 (11th Cir. 1992) .

(n14)Footnote 13. Certain types of property may be so closely related to cash that they are viewed by courts as the equivalent of cash. *See, e.g., Silverman v. Johnson Controls, Inc.*, 139 B.R. 765 (Bankr. E.D.N.Y. 1992) (account receivable was a chose in action; money is an intangible asset, title to which follows possession; the title to both intangibles and choses in action is determined by possession of the asset); *In re Brown*, 126 B.R. 767 (Bankr. N.D. Ill. 1991) (bank account the debtor held in trust but over which the debtor held signature authority was cash levied on by the IRS); *Altman v. Commissioner of Internal Revenue Service*, 83 B.R. 35 (D. Haw. 1988) (IRS levy on debtor's interest in spendthrift trust composed of cash accounts at banks transferred ownership to the IRS and trust interest was not asset of the debtor's estate).

In an unusual case, the IRS had stipulated in litigation with a chapter 7 debtor that he had overpaid his taxes for a prepetition year. The debtor was not entitled to the overpayment because it was property of the estate. Although the trustee failed to file a timely refund suit, the bankruptcy court held that the IRS's stipulation with the debtor converted this overpayment into a "liquidated amount" subject to turnover under section 542 regardless of the requirements for a refund suit. Ultimately, this novel theory was rejected by the court of appeals. *United States v. Neary (In re Armstrong)*, 206 F.3d 465 (5th Cir. 2000) .

(n15)Footnote 14. For all levies issued after July 1, 1989, the IRS is required to give the taxpayer 30 days notice of its intent to levy. *I.R.C. § 6331(d)(2)*. Because of this extended notice period (the former notice period was only 10 days), it is possible that more taxpayers may turn to relief under title 11 before the IRS seizes any property in which the debtor has any interest. This result could limit the applicability of the turnover provisions to the IRS

(n16)Footnote 15. The IRS asserts that upon the levy of an intangible asset, it does not have to take any further action under the Internal Revenue Code to sell that asset. *See I.R.C. § 6335 (Sale of Seized Property); § 6337 (Redemption of Property)*. *See In re Caldwell*, 111 B.R. 836 (Bankr. C.D. Cal. 1990) and *In re Paul*, 85 B.R. 850 (Bankr. E.D. Cal. 1988) for examples of this same argument asserted by a state taxing authority. Thus, the seizure of cash or other intangibles that do not have to be sold to be liquidated transfers the ownership of that asset to the IRS and terminates all rights of the taxpayer in that asset. *See, e.g., Cross Electric Co. v. United States*, 664 F.2d 1218, 5 C.B.C.2d 1273 (4th Cir. 1981). *But see United States v. Whiting Pools, Inc.*, 462 U.S. 198, 199, 103 S. Ct. 2309, 76 L. Ed. 2d 515, 8 C.B.C.2d 710 (1983) (accounts receivable subject to prepetition levy were virtually transferred to the IRS; the debtor had a right to redeem the property but that redemption would also require the debtor to pay the tax liability in order to recover its property, so a turnover was not the appropriate remedy); *Silverman v. Johnson Controls, Inc.*, 139 B.R. 765 (Bankr. E.D.N.Y. 1992) (account receivable was a non-possessory chose in action; after the levy, title to the receivable vested in the IRS due to its possession of the receivable, and the debtor's interest in the chose in action was terminated; intangible asset was not asset which could be used, sold or leased and was not therefore within the scope of 11 U.S.C. § 542(a)); *In re Brown*, 126 B.R. 767 (Bankr. N.D. Ill. 1991) (cash in savings accounts held by debtor for himself and as trustee for minor children was subject to levy; funds held for children were regularly drawn upon by debtor for his use; debtor retained no saleable rights after the levy which could be protected by *I.R.C. § 6335*); *In re Rose*, 112 B.R. 12 (Bankr. E.D. Tex. 1989); *Rose* was followed by *In re Fandre*, 167 B.R. 837 (Bankr. E.D. Tex. 1994); *In re Caldwell*, 111 B.R. 836 (Bankr. C.D. Cal. 1990) (under state tax laws, the debtor did not have any right to redeem property levied upon by the state and, therefore, the levy converted all ownership in the asset to the state and section 542(a) could not be used to recover the seized assets); *In re Paul* 85 B.R. 850 (Bankr. E.D. Cal. 1988) (same result as *Caldwell*); *In re Professional Technical Services*, 71 B.R. 946 (Bankr. E.D. Mo. 1987); compare *In re Debmar Corp.*, 6 C.B.C.2d 1290, 21 B.R. 858 (Bankr. S.D. Fla. 1982) (although the levy upon an intangible did not divest the debtor of ownership of the intangible account receivable, the payment of the receivable to the IRS by a company owing funds to the debtor taxpayer terminated the existence of the receivable and the cash could not be subjected to turnover) with *In re Dunne Trucking Co.*, 9 C.B.C.2d 464, 32 B.R. 182 (Bankr. N.D. Iowa, 1983) (prepetition notice of levy was issued but the debtor's cash was not actually taken into possession by the IRS; the levy did not terminate all of the taxpayer's interest in the cash and it was subject to turnover). Another bankruptcy court focused not upon the distinction between tangible and intangible property, but rather upon whether the property was "saleable" or "non-saleable." This distinction was based upon the debtor's right to redeem saleable property and the right to any excess proceeds following sale. When the IRS had made a prepetition levy upon funds in a bank account, that act was sufficient to sever any interest the debtor had in this non-saleable asset. *In re Ruggeri Electrical Contracting, Inc.*, 185 B.R. 750 (Bankr. E.D. Mich. 1995). The court relied upon *In re Rose*, 112 B.R. 12 (Bankr. E.D. Tex. 1989), and the district court's decision in the case of *In re Brown*, 126 B.R. 767 (Bankr. N.D. Ill. 1991).

(n17)Footnote 16. *See, e.g., Cross Electric Co. v. United States*, 664 F.2d 1218, 1220-1, 5 C.B.C.2d 1273 (4th Cir. 1981) (although the debtor retained the right to redeem the levied assets, the levy transferred the ownership of the accounts receivable to the IRS). As discussed *infra* the Supreme Court granted certiorari in the *Whiting Pools* case as a result of the division between the circuit courts. This split in authority was based upon the conflict between the results in the *Whiting Pools* and the *Cross Electric* cases. Many courts have concluded that the *Cross Electric* decision has continuing validity even after the Court's opinion in *Whiting Pools* based on the nature of the asset seized. When there is a levy on a non-saleable asset like cash then the transfer of ownership is complete, and the *Whiting Pools* decision did not deal with non-saleable assets but tangible, saleable assets. *See, e.g., In re Coghlan*, 227 B.R. 304, 306-307 (D. Ariz. 1998) (the levy and collection by the IRS on accounts receivable payable to the debtor terminates the debtor's interest in the asset and there is thus no asset subject to turnover from the IRS; had the accounts receivable been subject to levy but not been paid to the IRS, the debtor might have an argument in favor of turnover, but the prepetition payment of the

funds eliminated the right of turnover); *In re Valentino's Restoration & Cleaning Service*, 215 B.R. 153 (Bankr. N.D. Ill. 1997) (a levy by the state on the debtor's funds is subject to a state law period within which the levy or tax debt can be protested or contested; after this permissible protest period passes, the debtor's interest in the cash is terminated and the court cannot order turnover); *In re Smiley*, 189 B.R. 338 (Bankr. E.D. Pa. 1995) (a levy on non-saleable assets, specifically cash or cash equivalents, is different than a levy on saleable assets; after a levy on cash or a cash equivalent, the property owner no longer retains any significant interest in the cash or cash equivalent as there is no interest to redeem); *In re Faith Missionary Baptist Church*, 174 B.R. 454 (Bankr. E.D. Tex. 1994) (because the funds are an asset that need not be sold in order to be applied against the tax liabilities, the IRS acquired complete ownership of the funds seized upon possession); *In re Eisenbarger*, 160 B.R. 542 (Bankr. E.D. Va. 1993) (notice of levy on intangibles is tantamount to actual physical seizure of tangible property; once notice of levy has been served on cash or a cash equivalent, nothing more is required to transfer ownership to the government, and the taxpayer's interest in the levied property will have been extinguished); *In re Abercrombie*, 156 B.R. 782 (Bankr. N.D. Tex. 1993).

(n18)Footnote 17. See, e.g., *In re Challenge Air*, 952 F.2d 384 (11th Cir. 1992) (IRS levied on cash fund held by American Express; difference between tangible and intangible property is insufficient to depart from the ruling in *Whiting Pools*; prepetition levy does not terminate the debtor's interest in the asset; turnover to facilitate the debtor's reorganization outweighs the interest of the IRS); *Century Hotels v. United States*, 952 F.2d 107 (5th Cir. 1992) (in a case involving a prepetition levy on debtor's cash, the district court's opinion was reversed because the district court did not address the question of the title 11 estate's interest in the seized cash; the opinion seems to imply that turnover would be proper if the title 11 estate had any interest in the cash); *Cross Electric Company, Inc. v. United States*, 512 F. Supp. 511 (W.D. Va. 1980), rev'd, 664 F.2d 1218, 5 C.B.C.2d 1273 (4th Cir. 1981) (a levy issued by the IRS does not transfer full legal rights in property to the IRS; the levy only gives the IRS an adverse claim to the intangible assets and does not transfer ownership to the IRS); *In re Giaimo*, 194 B.R. 210 (E.D. Mo. 1996), judgment vacated, 202 B.R. 691 (E.D. Mo. 1996) (the bankruptcy court judgment recognizing the levied monies as property of the estate and subject to turnover was vacated because of the conversion of the case to a chapter 7 liquidation); *Gouveia v. IRS (In re Quality Health Care)*, 215 B.R. 543 (Bankr. N.D. Ind. 1997) (in a chapter 7 case, the trustee has exclusive control over all assets of the estate, including causes of action; absent the IRS lien and the levy, the cash levied would be included in the section 541 bankruptcy estate; seizure of the cash transferred possession but not ownership to the IRS; a levy does not transfer title but only brings the debtors assets into the control of the IRS); *In re Creel*, 214 B.R. 838 (Bankr. E.D. La. 1997) (all of the debtors interests in the levied cash are not terminated by possession by the IRS as the enforcement provisions of the Internal Revenue Code do not transfer ownership to the IRS upon levy); *In re Sanchez*, 96-2 U.S. Tax Cas. (CCH) P 50,590 (Bankr. N.D. Cal. 1996) (cash levied was subject to turnover; the court relied on the line of decisions following *Challenge Air*); *In re HDI Partners*, 202 B.R. 524 (Bankr. S.D. Fla. 1996); *In re Hunter*, 201 B.R. 959 (Bankr. E.D. Ark. 1996); *In re Boutillier*, 196 B.R. 323 (Bankr. W.D. Va. 1996) (IRA subject to levy is not an intangible which immediately is transferred to the IRS upon levy; the investments in the account are tangible, saleable assets and the debtor retains an interest therein which is property of the bankruptcy estate); *In re Wolensky's Ltd. Partnership*, 163 B.R. 629 (Bankr. D.D.C. 1994); *In re Nation Center For Employment of Disabled*, 157 B.R. 291 (Bankr. W.D. Tex. 1993); *In re Hooper*, 152 B.R. 309 (Bankr. D. Colo. 1993) (prepetition wage levy on wages paid postpetition does not transfer the right or ownership to those wages to the IRS; the IRS obtains a secured interest in the wages, but the IRS must turn over those wages to the estate if adequate protection is provided); *In re Metro Press, Inc.*, 139 B.R. 763 (Bankr. D. Mass. 1992) (follows the opinion in *Challenge Air*); *In re Anaheim Electric Motor, Inc.*, 137 B.R. 791 (Bankr. C.D. Cal. 1992) (account receivable was property of the debtor's estate and title was not transferred to the IRS at the date of levy; no distinction can be drawn between intangible and tangible property; the prepetition levy may so frustrate the reorganization process that turnover is required to give the debtor the opportunity to reorganize; receivables are capable of sale and title therefore will not pass upon levy); *In re Flynn's Speedy Printing, Inc.*, 136 B.R. 299 (Bankr. M.D. Fla. 1992) (court ordered IRS to return cash levied two days before the filing of the debtor's title 11 petition; court refused to distinguish the Supreme Court's opinion in *Whiting Pools* as between tangible and intangible property); *In re Hebermehl*, 132 B.R. 651, 656 (Bankr. D. Colo. 1991) (issuance of a tax levy was only "tantamount to a lien in favor of the IRS"); *Kirk v. United States*, 100 B.R. 85 (Bankr. M.D. Fla. 1989) (levy on a disability benefits contract and its payments was subject to turnover action); *In re AIC Industries, Inc.*, 83 B.R. 774 (Bankr. D. Colo.

1988) (levy on accounts receivable does not extinguish all interests of the debtor; turnover is proper if adequate protection provided); *In re Cleveland Graphic Reproduction, Inc.* 78 B.R. 819 (Bankr. N.D. Ohio 1987) (IRS levy did not extinguish the "equitable" title in the cash and turnover was proper for any form of property if that property was essential to the rehabilitation of the debtor); *In re All Way Services, Inc.*, 73 B.R. 556 (Bankr. E.D. Wis. 1987) (levy on cash accounts did not transfer ownership to IRS when bank retained the funds subject to further determination of ownership; IRS was oversecured creditor entitled to recovery of adequate protection); *In re Davis*, 35 B.R. 795 (Bankr. W.D. Wash. 1983) (same result as *All-Way Services*); *In re Health America of Florida, Inc.*, 22 B.R. 268 (Bankr. M.D. Fla. 1982) (court rejected distinction between tangible and intangible assets for post-levy determination of rights).

(n19)Footnote 18. The Internal Revenue Code allows the IRS to levy on and seize property of taxpayers to be applied to outstanding tax liabilities. *I.R.C.* §§ 6331 and 6632. These sections are special procedural devices available to the IRS to protect and satisfy its liens against the assets of a taxpayer. As the Court in *Whiting Pools* stated: [*I.R.C.* §§ 6331 and 6332] are provisional remedies that do not determine the Service's rights to the seized property, but merely bring the property into the Service's legal custody At no point does the Service's interest in the property exceed the value of the lien. ... Ownership of the property is transferred only when the property is sold to a bona fide purchaser at a tax sale In fact, the tax sale provision itself refers to the debtor as the owner of the property after the seizure but prior to the sale. Until such a sale takes place, the property remains the debtor's and thus is subject to the turnover requirement of § 542(a). *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 211-12, 103 S. Ct. 2309, 76 L. Ed. 2d 515, 8 C.B.C.2d 710 (1983) .

(n20)Footnote 19. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 201, 103 S. Ct. 2309, 76 L. Ed. 2d 515, 8 C.B.C.2d 710 (1983) .

(n21)Footnote 20. The Court discussed the purposes of the Bankruptcy Code as the foundation for its ruling: In proceedings under the reorganization provisions of the Bankruptcy Code, a troubled enterprise may be restructured to enable it to operate successfully in the future. Until the business can be reorganized pursuant to a plan under [the Bankruptcy Code], the trustee or debtor-in-possession is authorized to manage the property of the estate and to continue the operation of the business By permitting reorganization, Congress anticipated that the business would continue to provide jobs, to satisfy creditors' claims, and to produce a return for its owners Congress presumed that the assets of the debtor would be more valuable if used in a rehabilitated business than if "sold for scrap." The reorganization effort would have small chance of success, however, if property essential to running the business were excluded from the estate Thus, to facilitate the rehabilitation of the debtor's business, all the debtor's property must be included in the reorganization estate. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203, 103 S. Ct. 2309, 76 L. Ed. 2d 515, 8 C.B.C.2d 710 (1983) .

(n22)Footnote 21. See, e.g., *In re Giaimo*, 203 B.R. 696 (E.D. Mo. 1996) (the judgment of the district court recognizing the levied monies were property of the estate and subject to turnover was vacated because of the conversion of the case to a chapter 7 liquidation); *In re Hoffman*, 51 B.R. 42 (Bankr. W.D. Ark. 1985) (turnover denied in a chapter 7 liquidation case); *In re Barnes Freight Line, Inc.*, 29 B.R. 664 (Bankr. N.D. Ga. 1983) (turnover denied in a chapter 11 liquidation case).

(n23)Footnote 22. See, e.g., *Southern Rock, Inc. v. B&B Auto Supply*, 711 F.2d 683 (5th Cir. 1983) . In a nonbankruptcy case, the Court of Appeals for the Fifth Circuit held the levy on an account receivable did not entitle the Internal Revenue Service to priority over competing claimants to those assets because that result would not give any recognition to secured creditors with priority under *I.R.C.* § 6323. The court's opinion in *Southern Rock* indicates concern with the legal priorities of competing claimants to a limited fund of assets. Based upon this decision, the necessity for the existence of a reorganization effort can be argued to be irrelevant if there is nevertheless a need to recognize and prioritize all creditors' interests in the debtor's property within the limits of the Bankruptcy Code. See also *In re Hawkins*, 224 B.R. 334, 338-339 (Bankr. E.D. La. 1998) (the debtor filed a chapter 13 case after the issuance of an IRS levy but before the payment of money to the IRS which was done after the petition date; the levy was not a continuing levy and on the date of the levy nothing was earned by the debtor so that the levy did not attach to any

property even though the party receiving the levy paid money after the petition date; the property was subject to turnover even if there was no benefit to creditors and the only payments to be distributed would be for the payment of administrative claims) and *Gouveia v. IRS (In re Quality Health Care)*, 215 B.R. 543 (Bankr. N.D. Ind. 1997), in which the court rejected the IRS's attempts to distinguish each of the *Whiting Pools* and *Challenge Air* decisions by pointing out that this was a chapter 7 liquidation and not a reorganization. The court noted that the trustee's strong arm powers are found in chapter 5 of the Bankruptcy Code, the provisions of chapter 5 apply to any case commenced under Title 11, and *section 103(a) of the Bankruptcy Code* applies chapter 5 to any case under chapter 7, 11, 12, or 13. Therefore, the Internal Revenue Service argument that turnover in a liquidation was improper was incorrect and turnover was ordered. *In re HDI Partners*, 202 B.R. 524 (Bankr. S.D. Fla. 1996) (same result using the same argument).

(n24)Footnote 23. The Court in *Whiting Pools* characterized the IRS's post-levy interest in the seized property as a "lien on that property." *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 210, 103 S. Ct. 2309, 76 L. Ed. 2d 515, 8 C.B.C.2d 710 (1983).

(n25)Footnote 24. 11 U.S.C. § 363(e).

(n26)Footnote 25. The Court compared the position of secured creditors whose collateral would be used by the debtor to the IRS whose seized assets would also be used by the debtor in the reorganization process. The Bankruptcy Code contains the adequate protection provision in order to protect such secured interests: Although Congress might have safeguarded the interests of secured creditors outright by excluding from the estate any property subject to a secured interest, it chose instead to include such property in the estate and to provide secured creditors with "adequate protection" for their interests At the secured creditor's insistence, the bankruptcy court must place such limits or conditions on the trustee's power to sell, use, or lease property as are necessary to protect the creditor. The creditor with a secured interest in property included in the estate must look to this provision for protection, rather than to the nonbankruptcy remedy of possession. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203-04, 103 S. Ct. 2309, 76 L. Ed. 2d 515, 8 C.B.C.2d 710 (1983).

(n27)Footnote 26. See, e.g., *In re Creel*, 214 B.R. 838 (Bankr. E.D. La. 1997) (even if the court agrees the levied cash is property of the bankruptcy estate, the cash will not be returned to the bankruptcy estate absent the payment of adequate protection for its use, thereby giving recognition to the secured position of the IRS in the asset; levied cash is "cash collateral" and the debtor must obtain court permission for its recovery and use in the postpetition business of the debtor; adequate protection is only required if the creditor demands its payment); *In re Anaheim Electric Motor, Inc.*, 137 B.R. 791 (Bankr. C.D. Cal. 1992); *In re Metro Press, Inc.*, 139 B.R. 763 (Bankr. D. Mass. 1992) (follows the opinion in *Challenge Air*); (IRS entitled to adequate protection under 11 U.S.C. § 363(e) before turnover will be ordered); *In re Dunne Trucking Co.*, 9 C.B.C.2d 464, 32 B.R. 182 (Bankr. N.D. Iowa 1983) (same result). A bankruptcy court refused to require the IRS to turn over funds it received from a prepetition levy on the debtor's wages because of the debtor's inability to provide adequate protection. The court rejected the argument that the debtor's proposed chapter 13 plan offered adequate protection since administrative claims would have to be paid before the IRS received any payment. It also noted that the debtor could simply dismiss his title 11 case once the funds were turned over to him. Since cash instead of tangible personal property was involved, it was "very difficult" for the court "to find that a promise to pay the cash in the future is adequate protection for a creditor with the cash in hand at present." *Hooper v. United States (In re Hooper)*, 152 B.R. 309 (Bankr. D. Colo. 1993). The court relied heavily upon *In re Hebermehl*, 132 B.R. 651 (Bankr. D. Colo. 1991). But see *In re Merida Tiles Corp.*, 144 B.R. 550 (Bankr. S.D. Fla. 1992), in which the court ruled on the effect of the IRS's Notice of Federal Tax Lien on cash held by the debtor taxpayer's customer. As a result of the application of Florida law, the court ruled the IRS held only an unperfected interest in the cash in question. The cash was therefore ordered to be turned over to the debtor's estate without provision for adequate protection for the IRS. If the IRS had completed a prepetition levy on the cash, the postpetition turnover would have been authorized only if adequate protection was provided. The bankruptcy court was reversed on appeal. *Hefltler Realty Co. v. Merida Tiles Corporation*, 72 A.F.T.R.2d 6477 (S.D. Fla. 1993). The district court held that the notice of levy was sufficient to give the IRS an interest in the funds that required adequate protection. It remanded to the bankruptcy court for a determination of whether the debtor could meet this burden. In a lengthy opinion, a bankruptcy

court held that funds remitted to the IRS postpetition in response to a prepetition levy remained property of the estate; however, the IRS did not violate the stay by failing to advise the bank not to honor the levy after the case under title 11 had been filed or by retaining funds in spite of the trustee's demand that they be turned over to him. The court ordered that the IRS need not turn over the funds until the trustee provided it with adequate protection. *Goveia v. United States (In re Quality Health Care)*, 215 B.R. 543 (Bankr. N.D. Ind. 1997) .

(n28)Footnote 26a. Stock in a corporation, which later filed a title 11 petition, was issued to the child of the individual then in control of the corporation. Subsequently, but still before the title 11 petition was filed, the stock was sold and a portion of the proceeds were paid to the IRS as a deposit for the parents' income tax liability for the current year. The bankruptcy court rejected the efforts of the reorganized corporation to recover the funds paid to the IRS, since they were not property of the bankruptcy estate. *Trinity Gas Corporation v. IRS (In re Trinity Gas Corporation)*, 242 B.R. 344 (Bankr. N.D. Tex. 1999) (the court also denied recovery under sections 544 and 548). The district court affirmed the decision (*Trinity Gas Corporation v. IRS (In re Trinity Gas Corp.)*, 2000 U.S. Dist. LEXIS 8940 (N.D. Tex. May 24, 2000) . In an action brought by the trustee for turnover of a federal tax refund paid to the debtor, a bankruptcy court considered the conflicting authorities before holding that under Illinois law a spouse who was not in bankruptcy and who had not contributed to the earnings that were subject to taxation had no interest in the refund. Accordingly, no portion of the refund was exempt from turnover on the theory that it was not property of the estate. *In re Lock*, 329 B.R. 856 (Bankr. S.D. Ill. 2005) .

Note that since a tax refund is property of the estate, a debtor may be compelled to turn it over to the trustee. A split of authority exists as to whether a debtor's claim that the funds have been spent is a defense against a turnover action. *Bailey v. Suhr (In re Bailey)*, 380 B.R. 486 (B.A.P. 6th Cir. 2008) .

(n29)Footnote 27. See *In re Block*, 141 B.R. 609, 610-11 (N.D. Tex. 1992) .

(n30)Footnote 28. See *In re Block*, 141 B.R. 609, 610-11 (N.D. Tex. 1992) . *Block* distinguished *Gibson v. United States (In re Russell)*, 927 F.2d 413, 24 C.B.C.2d 1526 (8th Cir. 1991) , since there was no allegation that the actions in *Block* had been fraudulent. The Eighth Circuit had held that an individual debtor's election to carryforward a net operation loss ("NOL") was avoidable under 11 U.S.C. § 548 even though it was irrevocable under the Internal Revenue Code. A similar result was reached by the *United States v. Sims (In re Feiler)*, 218 F.3d 948 U.S. Tax Cas. (CCH) P 50,579 (9th Cir. 2000). Both of the courts of appeals appear to have been more concerned about preventing individuals from depriving their creditors of the benefit of what would otherwise have been tax refunds belonging to the bankruptcy estates than reading the Codes in harmony. Nothing is said about whether the IRS paid tax refunds to both the debtors and the bankruptcy estates by virtue of these decisions.

The distinction between an action brought against the IRS and one brought against the debtor was discussed by a bankruptcy court in *Birdsell v. Nichols (In re Nichols)*, 309 B.R. 41 (Bankr. D. Ariz. 2004) , where the court held the debtor had to pay the trustee the value of the tax credit created by applying a prepetition tax overpayment to a postpetition tax liability prior to filing a title 11 proceeding.

Shortly after its *Sims* decision, the Ninth Circuit considered this issue again. On this occasion, it held in favor of the IRS, because the trustee had not brought her avoidance action within the time limits imposed upon section 549. Agreeing with the dissent in the Eighth Circuit's *Gibson* decision, the court held that because success in the section 549 action was a condition precedent to bringing the refund suit, the shorter limitations period for section 549, rather than the longer period for refund suits, controlled. *United States v. Shaltry (In re Home America T.V.- Appliance Audio, Inc.)*, 232 F.3d 1046 (9th Cir. 2000) .

(n31)Footnote 29. The court in the case of *In re Block*, 141 B.R. 609 (N.D. Tex. 1992) , further concluded that the application of a tax overpayment is not property of the estate for purposes of the turnover rules of section 542 even if the tax overpayment is refunded to the taxpayer debtor after the bankruptcy petition is filed, because the taxpayer had no right to recover the overpayment on the petition date, which is the date on which property of the estate is determined.

In re Block, 141 B.R. 609 (N.D. Tex. 1992) .



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Collier on Bankruptcy Taxation

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CHAPTER TX5 Litigation With the IRS in Bankruptcy Court

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P TX5.08 Setoff of Claims by the IRS

[1] Overview of Setoff of Claims

The Bankruptcy Code authorizes the setoff of claims in certain circumstances, and these rules are generally applicable to the Internal Revenue Service-taxpayer relationship. n1 The Internal Revenue Code grants the Internal Revenue Service a general statutory right of setoff with respect to tax overpayments, n2 and this right is implicitly recognized in title 11 cases by section 553(a). The right of setoff is not, however, unlimited. As a general rule, the Bankruptcy Code provides that the setoff provisions of section 553 are subject to the operation of the automatic stay of section 362(a). n3 In 2005, section 362 was amended to remove the IRS from this general rule in certain instances. n3a Prior to that amendment, most bankruptcy courts that had discussed the setoff of tax claims and overpayments between the IRS and a debtor had focused on the setoff in the context of an alleged violation of the automatic stay provisions of section 362(a). n4 The determination of whether a setoff is permitted will also involve the analysis of the "mutuality" rule of section 553 with respect to the nature of the claims being offset and the timing of the claims with respect to the petition date.

[2] General Rules Regarding the IRS's Right of Setoff

There are several procedural aspects to the setoff of claims between the Internal Revenue Service and a taxpayer that must be observed even if the taxpayer is not a debtor in a title 11 case.

[a] Requirement for Claim for Refund

The Internal Revenue Code requires that a claim for refund be filed before a taxpayer can set off tax liabilities asserted by the Internal Revenue Service against monies owed to the taxpayer. n5 A taxpayer cannot therefore unilaterally assert an unliquidated overassessment and overpayment for a taxable year and use that asserted overpayment to set off a tax liability assessed against the taxpayer. A claim for refund can be filed in different ways and the method chosen will depend on the kind of tax that is to be refunded. n6 For example, a claim for refund of income taxes will be made when a tax return is filed if there is an overpayment reflected thereon and the taxpayer instructs the Internal Revenue Service to refund that overpayment. n7 If a refund claim is filed after the filing of the original tax return, that claim must be filed on a Form 1120X or Form 1040X [for corporate and personal income taxes respectively]. n8 A claim filed for any other form of tax overpayment must be made on Internal Revenue Service Form 843. n9 The claim for refund, whether in the original or an amended return, must set forth in detail each ground upon which a credit or refund is claimed and

facts sufficient to inform the Internal Revenue Service of the exact basis thereof. n10

[b] Statute of Limitations for Filing Claim for Refund

There is a statute of limitations within which a taxpayer must file a claim for refund and thereby assert his or her right to an overpayment. A claim for refund must be filed within three years of the date the return in question was filed or within two years of the date the tax in question was paid. n11

[c] Effect of IRS Application of Overpayment

Absent a claim for refund and setoff instructions from the taxpayer, the Internal Revenue Service has unlimited discretion concerning which tax liabilities will be set off with an overpayment. n12 After the Internal Revenue Service has applied an overpayment to a tax liability assessed against a debtor, that refund cannot be the subject of a refund claim. n13 Thus, after application of an overpayment to an assessed tax liability, the taxpayer may not be able to file a claim for refund to reallocate the overpayment to other tax liabilities.

[d] Necessity for an Assessed Tax Liability and Notice of Administrative Setoff

The Internal Revenue Service cannot set off an overpayment payable to a taxpayer unless a tax liability has been assessed against which the overpayment can be applied. n14 Some taxpayers have attempted to avoid an *I.R.C. section 6402* setoff by equating the setoff to a levy under *I.R.C. section 6331* and contending there is a notice requirement before the execution of a setoff by the Internal Revenue Service. n15 The Internal Revenue Service can, however, exercise its administrative setoff authority without any prior notice issued to a taxpayer. n16

[3] Procedural Aspects

Taxpayers have contended that the Internal Revenue Service must file a proof of claim before it can set off any claim against tax refunds owed to a taxpayer. Because the setoff rights of the Internal Revenue Service and a debtor do not differ under the Bankruptcy Code and the common law, courts have determined it is not necessary for the Internal Revenue Service to file a proof of claim before it can exercise its setoff rights. n17

[4] Setoff When a Debtor Claims an Overpayment as Exempt Property

Although section 553(a) does not refer to the exempt property provisions of section 522 to place a limit on its application, some courts have nevertheless prevented a setoff by the Internal Revenue Service of prepetition overpayments claimed as exempt property by the debtor. n18 This result has been justified based upon the observation that an asset cannot be made exempt from all prepetition debts in one instance and then subject to setoff in another instance. Congress intended the exemption provisions of the Code to be read broadly to allow the debtor a fresh start, and as a result, the setoff provisions are often interpreted to prevent the setoff of a claim against exempt assets. n19 A growing minority of courts, however, hold that the exemption provisions will not defeat the government's right of setoff. n19a

[5] The Requirement of Mutuality

Mutuality is a requirement for any right of setoff, and this element of the law of setoff is strictly construed under section 553. The basic test of mutuality is not the similarity of the obligation but whether debts are owed by both sides. The debts to be set off need not be of the same character or have arisen from the same transaction. n20

Setoff rights of the United States under *I.R.C. section 6402* will include the setoff of any claims owed to the United States and not just to the Internal Revenue Service. Thus, if a debtor has a tax refund receivable from the Internal Revenue Service, but is indebted to another agency or branch of the United States government, that refund will be

subject to setoff to satisfy the non-IRS claim. n21

[6] The Requirement of Timing

[a] Prepetition Versus Postpetition Setoffs

Another requirement for or limitation on the setoff power of the Internal Revenue Service is the issue of the timing of the overpayment and the liability that may be set off under section 553. Section 553 does not affect any right of setoff of a prepetition debt owed to the debtor against a prepetition claim against the debtor. n22 Thus, to be eligible for setoff, the mutual claims of the creditor and the debtor must have arisen before the commencement of the title 11 case. n23 Claims or refunds that arise postpetition lack the requisite mutuality for setoff against prepetition claims or refunds because the postpetition trustee or debtor in possession is a different entity from the prepetition debtor. n24

The Internal Revenue Service will only be able to set off prepetition tax liabilities owed by the debtor to the Internal Revenue Service against prepetition overpayments owed by the Internal Revenue Service to the debtor. n25 It would logically seem to follow that mutual, postpetition debts can also be set off under section 553. This is not always true. Section 553 does not permit the setoff of postpetition debts against postpetition overpayments after the conversion of a chapter 11 case to a chapter 7 case. n26 On the other hand, the setoff of mutual postpetition debts in a case under title 11 that is not converted should be permissible as long as the mutuality test is satisfied.

[b] Proration of Overpayments

The timing of an overpayment creates a potential proration problem that may have to be resolved before the extent of the Internal Revenue Service's setoff right can be determined. As discussed above, the Internal Revenue Service can only set off its prepetition tax liabilities against prepetition overpayments. Thus, subject to the discussion of *I.R.C. section 1398* below, an allocation may be required to divide an overpayment into prepetition and postpetition elements to determine the overpayment that qualifies for setoff treatment. n27

The timing of the accrual of a tax refund will control its classification as an asset of the debtor's bankruptcy estate and will determine if the refund is subject to setoff as a prepetition asset of the debtor. Taxpayers have attempted to classify tax overpayments as postpetition refunds to avoid the *I.R.C. section 6402* setoff rights of the Internal Revenue Service. n28 A tax refund for a prepetition tax period is, however, property of the bankruptcy estate, n29 and tax refunds accrue as of the end of the taxable year. n30 The fact that a tax refund may be contingent or incapable of determination as of the petition date does not remove the tax refund from the debtor's bankruptcy estate. n31

If a debtor files a petition under title 11 of the *Bankruptcy Code* after the end of a calendar year, any refund attributable to the preceding calendar year will be a prepetition tax refund and will be subject to the IRS right of setoff against prepetition tax claims. n32 Applying this prepetition setoff rule in the negative, any refund accruing or vesting at the end of the taxable year in which the petition is filed is a postpetition overpayment not subject to setoff against prepetition tax liabilities. Any tax overpayment attributable to a postpetition period will not be subject to the Internal Revenue Service's prepetition setoff rights because of the absence of mutuality. n33

Under one opinion rendered in a bankruptcy case filed before the enactment of *I.R.C. section 1398*, the court concluded that any refund attributable to the year in which the title 11 petition was filed must be allocated between the prepetition and the postpetition periods. n34 An argument in favor of allocation of a tax refund during the petition year based upon the *In re Wilson* opinion may have limited or no application after the enactment of *I.R.C. section 1398*. Under *I.R.C. section 1398*, n35 certain debtors may elect to terminate their taxable year on the date when the title 11 petition is filed. n36

If the election to terminate the taxable year on the petition date is not made, the filing of the title 11 petition has no

effect on the determination of the debtor's taxable year for the petition year. n37 If the *I.R.C. section 1398* election is made, the bankruptcy estate succeeds to and takes account of the debtor's prepetition tax attributes, including any withholding payments, estimated tax payments, and overpayments. n38 Thus, if the election is not made, the debtor's taxable year will not be terminated, any tax liability or overpayment will accrue as of the end of the taxable year, and any tax liability or overpayment will be a postpetition liability or overpayment for purposes of section 553. On the other hand, if the election is made, the overpayment attributable to the short taxable year created by the *I.R.C. section 1398* election will be a prepetition tax liability or overpayment, and any liability or overpayment accrued after the petition date to the debtor's new, short taxable year will be a postpetition liability or overpayment.

[7] Effect of the Automatic Stay on the Right of Setoff

The section 362(a) automatic stay does not defeat the right of setoff; setoff is merely stayed pending an "orderly examination of the debtor's and creditor's rights." n39 In general, when a creditor seeks to exercise a postpetition setoff, it must first obtain relief from the automatic stay. n40

Prior to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, the IRS had been required to obtain a modification of the automatic stay before making a setoff. In that year, Congress added a new section 362(b)(26) that permits the IRS to setoff a prepetition income tax liability against a prepetition income tax overpayment without first obtaining relief from the stay. n41 The amendment also provides that if a pending action to determine the amount or the legality of a tax liability prevents the setoff, the IRS may then hold the refund to be setoff, *i.e.*, "freeze it," until the resolution of the action. n42 n43-45

This right would continue to apply to the IRS in situations not covered by the amendment. After notice and hearing a bankruptcy court may order the IRS to release the refund, if it grants adequate protection to the IRS. Note that the amendment refers only to setoffs involving income tax overpayments and underpayments; presumably the IRS would be required to obtain relief from the stay before making a setoff involving other types of taxes. Likewise, a setoff of any kind of tax overpayment or underpayment against a debt to or from another governmental agency would be unaffected by the amendment.

In the years before this amendment, some judicial districts had entered standing orders allowing the Internal Revenue Service to exercise its statutory setoff power, and this was especially true in chapter 13 cases. In those districts, a setoff of a prepetition overpayment against a prepetition tax liability could be completed and would not be a stay violation under section 362(a). n46 To the extent that these orders remain in place after the amendment, they potentially may permit setoffs in situations not covered by it, *e.g.*, taxes other than income taxes.

[8] Effect of Setoff on Priority of Competing Creditors

A secured creditor will generally have a priority over an unsecured creditor with respect to distributions from the debtor's estate and from the proceeds of the sale of assets serving as collateral for the secured claim. Notwithstanding this observation, a subordinate creditor holding a right of setoff can exercise that right of setoff before any monies or assets are made available to the senior secured creditor. n47

[9] Status as Secured Claimant

If the IRS has an otherwise unsecured tax claim against the debtor, that claim may nevertheless be secured because of the Internal Revenue Service's setoff rights. This result is confirmed by the language of *Bankruptcy Code section 506(a)* that includes as an allowed secured claim a claim that is subject to setoff under section 553(a). n48

[10] Failure to Assert Setoff Rights

[a] Waiver of Setoff Rights by IRS

If the Internal Revenue Service pays a tax refund to the debtor or to a trustee, the section 553 setoff remedy probably will be lost. If the setoff remedy is to be claimed by the United States or any of its agencies, that claim must be made before the delivery of a tax refund to the debtor or the trustee, or the right to setoff will be waived. n49 Additionally, if the IRS files a proof of claim and does not assert its right of setoff, that right of setoff may also be waived. n50 Noting that the cases addressing waiver of setoff rights are "in tension," one court of appeals, in a case involving the IRS, listed a series of criteria to be considered. It held that a waiver could be made expressly as in a written statement or that it could be implied from conduct if the creditor's intent to waive was fairly demonstrated. n50a The court remarked that a waiver was "seldom, if ever" to be implied from "mere silence." In addition, the court held that either an expressed or implied waiver could be rescinded if another party had not acted to its detriment in reliance upon the waiver. n50b

[b] Effect of Confirmation of a Plan

If a debtor's plan is confirmed, an issue is raised regarding the setoff rights of a creditor if that creditor will be fully paid under the terms of the confirmed plan. It has been argued by the Internal Revenue Service that upon confirmation of a chapter 11 or 13 plan, all of the assets of the debtor's estate vest in the debtor and those assets are then subject to setoff. n51 Some courts have, however, rejected the IRS's position and have prohibited the postconfirmation setoff because the IRS was bound by the terms of the confirmed plan. n52

For example, in a chapter 11 case not involving taxes, *United States v. Continental Airlines*, the Third Circuit distinguished *De Laurentis* and followed its earlier *Norton* decision in a chapter 13 case. n52a Although *Norton* and *Continental Airlines* were followed by a bankruptcy court outside of the Third Circuit, the district court reversed, in part due to its concerns of a windfall to the debtor. n52b A bankruptcy court in the Third Circuit held that it would permit the IRS to make a setoff after a Chapter 13 plan had been confirmed, notwithstanding *Norton* and *Continental Airlines*, because the debtors' erratic history of making payments meant the IRS did not have adequate protection from the confirmed plan. n52c This result has been justified because the tax refund may be used under the terms of the confirmed plan to pay all creditors, and the setoff of an asset of the estate revested in the debtor would result in a preferential payment to one creditor to the detriment of creditors who do not possess setoff rights. n53

An issue may remain whether the postconfirmation setoff rights of the IRS are different in cases under chapters 11 and 13. In a chapter 13 case, all of the property of the debtor's bankruptcy estate is vested in the debtor free and clear of liens, and the terms of the plan are binding on all of the debtor's creditors even if they are not provided for under the plan. n54 The Bankruptcy Code contains almost identical provisions for chapter 11 cases. n55 Courts which have addressed this issue have reached a variety of conflicting results. n56

FOOTNOTES:

(n1)Footnote 1. 11 U.S.C. § 553(a). See, e.g., *In re Medina*, 205 B.R. 216 (B.A.P. 9th Cir. 1996) ; *In re Jones*, 212 B.R. 680 (Bankr. M.D. Ala. 1997) . In 2005, Congress added a new provision to the Bankruptcy Code, 11 U.S.C. § 362(b)(26), that exempts the IRS, in certain circumstances, from the necessity of securing a modification of the automatic stay prior to making a setoff. This unique treatment of setoffs made by the IRS is discussed in P 5.08[7], *infra*.

(n2)Footnote 2. I.R.C. § 6402 provides: (a) General Rule.--In the case of any overpayment, the Secretary, within the applicable period of limitations, may credit the amount of such overpayment, including any interest allowed thereon, against any liability in respect of an internal revenue tax on the part of the person who made the overpayment and shall, ... refund the balance to such person. See, e.g., *Cherry Cotton Mills v. United States*, 327 U.S. 536, 66 S. Ct. 729, 90 L. Ed. 835 (1946) (it has long been established that the departments, agencies and subdivisions of the U.S. Government constitute a single creditor for purposes of setoff); *In re Whimsy*, 221 B.R. 69 (S.D.N.Y. 1998) (same result specifically

relying on the *Cherry Mills* decision; the courts cannot apply setoffs equitably as the courts cannot ignore the right of setoff when they think the result would be unjust; the unaltered right of setoff has been embodied in every bankruptcy act the nation has had, and creditors have long acted in reliance upon it); *In re Lazar*, 39 C.B.C.2d 586, 219 B.R. 212 (Bankr. N.D. Ohio 1998) (even though the debtor may have needed the tax refund for household costs and necessary costs, including curtains and other personal expenses, the court could not equitably deny the IRS its right to setoff); *In re Sedlock*, 39 C.B.C.2d 589, 219 B.R. 207 (Bankr. E.D. Pa. 1998) (same conclusion by the same court as in *Lazar*); *In re Burton*, 1998 Bankr. LEXIS 302 (Bankr. E.D. Pa. 1998) (there is no equitable basis for refusing to execute the setoff rights of the government under section 553). The distinction between the "doctrines" of setoff and recoupment as they relate to the rights of the IRS under section 6402 was considered by one bankruptcy court. *In re Coastal Bus and Equipment Sales, Inc.*, 330 B.R. 328 (Bankr. D. Mass. 2005) .

(n3)Footnote 3. 11 U.S.C. § 553 provides: (a) Except as otherwise provided in this section and in Sections 362 and 363 of this title, this title does not affect any right of a creditor to offset a mutual debt owing by such creditor to the debtor that arose before the commencement of the case under this title against a claim of such creditor against the debtor that arose before the commencement of the case.

(n4)Footnote 3a. 11 U.S.C. § 362(b)(26) is discussed at P 5.08[7], *infra*.

(n5)Footnote 4. See P TX5.06 *supra* for a detailed discussion of litigation of the section 362(a) stay with the Internal Revenue Service.

(n6)Footnote 5. *Treas. Reg. § 301.6402-2* provides that credits or refunds of overpayments may not be allowed or made after the expiration of the statutory period of limitations for claiming those creditor refunds. See also *Vishnevsky v. United States*, 430 F. Supp. 648 (E.D. Wis. 1977) ; *Acker v. United States*, 519 F. Supp. 178 (N.D. Ohio 1981) .

(n7)Footnote 6. *I.R.C. § 6511*. See also *In re Swan*, 152 B.R. 28 (Bankr. W.D.N.Y. 1992) . The *Swan* court declined to exercise its discretionary jurisdiction when the individual debtor was the only party interested in the potential refund. *In re Carter*, 125 B.R. 832 (Bankr. D. Kan. 1991) , held that the filing of a petition under title 11 does not extend the period of limitations for filing a claim for refund. See also *In re Dougherty*, 187 B.R. 883 (Bankr. E.D. Pa. 1995) ; *Matter of Qual Krom South, Inc.*, 119 B.R. 327 (Bankr. S.D. Fla. 1990) ; *Lynch v. Rogan*, 50 F. Supp. 356 (S.D. Cal. 1943) (Act case). Note that in some instances Section 108(b) may provide an additional 60 days after the order for relief is entered in which to file the claim.

(n8)Footnote 7. *Treas. Reg. § 301.6402-3(5)*.

(n9)Footnote 8. *Treas. Reg. § 301.6402-3(2) and (3)*.

(n10)Footnote 9. *Treas. Reg. § 301.6402-2(c)*.

(n11)Footnote 10. *Treas. Reg. § 301.6402-2(b)(1)*.

(n12)Footnote 11. *I.R.C. § 6511(a)*.

(n13)Footnote 12. See *Acker v. United States*, 519 F. Supp. 178 (N.D. Ohio 1981) . Thus, a taxpayer must act via a claim for refund if the taxpayer wants to apply an overpayment in a manner that is most advantageous to that taxpayer. Even a demand by the taxpayer may not be conclusive. A bankruptcy court has held that the IRS was entitled to apply a tax refund to its unsecured claim in spite of the debtor's demand that the refund be applied to a priority (and nondischargeable) tax claim. *In re Lawson*, 187 B.R. 6 (Bankr. D. Idaho 1995) . Subsequently, a bankruptcy court rejected the argument that 11 U.S.C. § 105(a) and *United States v. Energy Resources Co.*, 495 U.S. 545, 110 S. Ct. 2139, 109 L. Ed. 2d 580 (1990) , gave it the authority to compel the IRS to apply a tax overpayment to the priority portion of its claim in a Chapter 13 proceeding. *In re Lybrand*, 338 B.R. 402 (Bankr. W.D. Ark. 2006) . See also *Internal Revenue Service v. Pransky (In re Pransky)*, 318 F.3d 536 (3d Cir. 2003) (where a taxpayer had failed to file a

timely claim for refund for a particular tax period, there was nothing available to setoff). Although a tax refund asserted as a setoff against another tax liability might not require the filing of a claim with the IRS, it was still subject to the same periods of limitations. *In re Rodriguez*, 387 B.R. 76 (Bankr. E.D.N.Y. 2008) . Note: Some courts may disagree in so far as the filing of a claim with the IRS is required.

(n14)Footnote 13. See *Smith v. Director of Internal Revenue Service*, 77-2 U.S. Tax Cas. (C.C.H.) P 9599 (S.D. Fla. 1977).

(n15)Footnote 14. See, e.g., *Close v. United States*, 79-1 U.S. Tax Cas. (C.C.H.) P 9143 (Ct. Cls. 1978) (if the taxpayer did not receive a statutory notice of deficiency as required by the Internal Revenue Code, the assessment could be invalid and the application of the overpayment to that liability could be void).

(n16)Footnote 15. See *Fulgoni v. United States*, 91-1 U.S. Tax Cas. (C.C.H.) P 50,256 (Claims Ct. 1991).

(n17)Footnote 16. See *Fulgoni v. United States*, 91-1 U.S. Tax Cas. (C.C.H.) P 50,256 (Cls. Ct. 1991).

(n18)Footnote 17. See, e.g., *Turner v. United States (In re G.S. Omni Corp.)*, 835 F.2d 1317, 17 C.B.C.2d 1429 (10th Cir. 1987) , in which the Court of Appeals for the Tenth Circuit held that even though a proof of claim may be required to participate in the distributions from the estate, a proof of claim is not required as a predicate to the IRS's setoff rights under I.R.C. § 6402. Until a discharge is ordered, a creditor is not required to file a proof of claim as a prerequisite to asserting a section 553 setoff.

(n19)Footnote 18. See, e.g., *In re Jones*, 230 B.R. 875, 878 (M.D. Ala. 1999) (the IRS possesses a nonbankruptcy right of setoff pursuant to 26 U.S.C. § 6402 which is preserved by 11 U.S.C. § 553(a); the monies payable to the debtor for the 1995 tax year were subject to setoff against tax claims for the years 1990 through 1992 even though the tax claims were otherwise dischargeable but the claimed exemption of the refund prevented the setoff of the refund because the debtor's exemption claim overrides the right of setoff absent an objection by the IRS; See also *In re Miel*, 134 B.R. 229 (Bankr. W.D. Mich. 1991) ; *In re Monteith*, 7 C.B.C.2d 498, 23 B.R. 601 (Bankr. N.D. Ohio 1982) (tax refund exempt under 11 U.S.C. § 522(c) cannot be subject to setoff; the exemption provisions take priority over the setoff provisions of 11 U.S.C. § 553). See, however, *In re Eggemeyer*, 75 B.R. 20 (Bankr. S.D. Ill. 1987) (11 U.S.C. § 542(b) provides that an entity that owes a matured debt to the debtor shall pay that debt to the debtor subject to any right of setoff under 11 U.S.C. § 553; the claim by the taxpayer that the tax refund is exempt property does not affect the right to execute the setoff). In light of the Supreme Court's later decision in *United States v. Rodgers*, 461 U.S. 677, 103 S. Ct. 2132, 76 L. Ed. 2d 236 (1983) , which held, in part, that state law homestead exemptions did not prevent the United States from executing a levy on a debtor's homestead to satisfy a tax liability, the validity of the *Miel* and *Monteith* opinions may be suspect

A district court reversed a bankruptcy court's decision that section 522 could be used to exempt assets from setoff by the United States to satisfy a tax debt in *United States v. Luongo*, 255 B.R. 424 (N.D. Tex. 2000) , relying in part on *Runnels v. Internal Revenue Service (In re Runnels)*, 134 B.R. 562 (Bankr. E.D. Tex. 1991) . The district court was affirmed on further appeal. *Luongo v. Internal Revenue Service (In re Luongo)*, 259 F.3d 323 (5th Cir. 2001) . The court of appeals reasoned that although a claim for refund predicated upon the claim of an exemption might be property of the estate, by virtue of 26 U.S.C. § 6402, the IRS had a prior right to apply any overpayment of taxes first to satisfy other unpaid tax liabilities. Because the application of this overpayment resulted in its elimination, there was no property that became part of the estate, and, accordingly, the debtor had no property to exempt. This issue continues to be contentious. One bankruptcy court held that setoff rights must yield to exemption rights in section 522. *In re Pace*, 45 C.B.C.2d 948, 257 B.R. 918 (Bankr. W.D. Mo. 2000) . Another bankruptcy court cited *Luongo* for the proposition that section 553 preserves a party's right of setoff, but then reached a contrary result by holding the refund to be subject to the debtor's claim of exemption. *In re Sharp*, 286 B.R. 627 (Bankr. E.D. Ky. 2002) . A district court, however, relied upon *Luongo* to affirm a bankruptcy court's decision that the IRS may first net over- and under-payments before there is any refund subject to exemption. *In re Beaucage*, 342 B.R. 408 (D. Mass. 2006) , *aff'g*, 334 B.R. 353 (Bankr. D. Mass.

2005). Noting that the decisions on this point increasingly have concluded that the IRS may first net over-payments against under-payments pursuant to section 6402, a bankruptcy court followed *Luongo and Beaucauge*. *Jones v. Internal Revenue Service* (*In re Jones*), 359 B.R. 837 (Bankr. M.D. Ga. 2006). Accord *In re Emery*, 379 B.R. 688 (Bankr. W. D. Ky. 2007). A district court reached a similar conclusion in *United States v. White*, 365 B.R. 457 (M. D. Pa. 2007), and reversed a contrary conclusion by a bankruptcy court. However, another bankruptcy declined to follow this decision as well as *Luongo*, *Sharp* and other similar decisions. *In re Gould*, 389 B.R. 105 (Bankr. N. D. Calif. 2008). On appeal, this decision was reversed and *Luongo* was followed. *United States v. Gould* (*In re Gould*), 401 B.R. 415 (B.A.P. 9th Cir. 2009).

(n20)Footnote 19. Compare *In re Haffner*, 12 B.R. 371 (Bankr. M.D. Tenn. 1981), with *In re Eggemeyer*, 75 B.R. 20 (Bankr. S.D. Ill. 1987) (the claimed exemption of a tax refund does not alter the IRS's statutory setoff rights).

(n21)Footnote 19a. See, e.g., *In re Bourne*, 262 B.R. 745 (Bankr. E.D. Tenn. 2001); *In re Allen*, 47 C.B.C.2d 218, 266 B.R. 713 (Bankr. N.D. Iowa 2001). *In re Baucom*, 339 B.R. 504 (Bankr. W.D. Mo. 2006) (discussing the divergent opinions on this subject and following *Bourne*); *In re Pigott*, 330 B.R. 797 (Bankr. S.D. Ala. 2005) (no refund available for exemption until IRS has netted over- and under-payments per 26 U.S.C. § 6402).

(n22)Footnote 20. See 5 *Collier on Bankruptcy*, P 553.03[3] (Matthew Bender 15th Ed. Revised), for a detailed discussion of the elements of the mutuality requirement for the setoff of claims. See also *In re Visiting Home Services, Inc.*, 643 F.2d 1356 (9th Cir. 1981); *In re Blake*, 235 B.R. 568, 569 (Bankr. D. Md. 1998) (the setoff of a postpetition tax refund payable by the IRS to the debtor by the Department of Education to be applied to a prepetition student loan claim was a violation of automatic stay as there was not a mutual debt payable between the debtor and the Department of Education); *In re Parrish*, 75 B.R. 14 (Bankr. N.D. Tex. 1987); *In re Braniff Airways, Inc.*, 12 C.B.C.2d 610, 42 B.R. 443 (Bankr. N.D. Tex. 1984). Although it would appear elementary, before a debtor can assert a setoff to reduce a tax obligation, he must possess a money judgment or some other sort of liquidated claim against the government. *In re Wrubleski*, 380 B.R. 635 (Bankr. S. D. Fla. 2008) (denying setoff sought by tax protestor).

(n23)Footnote 21. See, e.g., *In re Inland Waterways*, 71 F. Supp. 134 (D. Minn. 1947) (debtor had contracts with the United States Navy and filed a bankruptcy petition under the Bankruptcy Act; the United States' tax claims were set off against the amounts due the debtor from the Navy Department); *In re HAL, Inc.*, 122 F.3d 851 (9th Cir. 1997) (the various agencies of the federal government constitute a single governmental unite for purposes of the application of setoff); *In re Turner*, 84 F.3d 1294 (10th Cir. 1996) ("because we hold that the United States is a unitary creditor in bankruptcy, it, like any other single creditor, should be entitled to offset any mutual debts it has involving multiple agencies in accordance with section 553"); *In re Rush-Hampton Industries, Inc.* 98 F.3d 614 (11th Cir. 1996); *Doe v. United States*, 58 F.3d 494 (9th Cir. 1995); *In re Whimsy*, 221 B.R. 69 (S.D.N.Y. 1988) (governmental agencies are a single unitary creditor entitled to setoff under section 553); *In re Burton*, 1998 Bankr. LEXIS 302 (Bankr. E.D. Pa. 1998) (mutuality exists between two agencies of the United States when the debtor has a claims against the IRS and the D.O.E.); *In re Hanssen*, 203 B.R. 149 (Bankr. E.D. Ark. 1996) (mutuality of parties existed between Army and Air Force Exchange Service and the IRS to permit AAFES' setoff of federal income tax refund against debt owed to AAFES); *In re Lopes*, 211 B.R. 443 (D.R.I. 1997) (mutuality existed between the debtor on one side and the IRS and HUD on the other); *In re Pyramid Industries, Inc.*, 210 B.R. 445 (N.D. Ill. 1997); *In re Sacred Heart Hospital of Norristown*, 199 B.R. 129 (Bankr. E.D. Pa. 1996), rev'd on other grounds, 204 B.R. 132 (E.D. Pa. 1997), aff'd, 133 F.3d 237 (3rd Cir. 1998); *In re Buckner*, 165 B.R. 942 (D. Kan. 1994), appeal dismissed, 66 F.3d 263 (10th Cir. 1995); *In re Lykes Steamship Co., Inc.*, 217 B.R. 304 (Bankr. M.D. Fla. 1997); *In re Reed*, 179 B.R. 353 (Bankr. S.D. Ga. 1995); *In re Bison Heating & Equipment, Inc.*, 177 B.R. 785 (Bankr. W.D.N.Y. 1995); *In re Medina*, 177 B.R. 335 (Bankr. D. Or. 1994); *In re Kalenze*, 175 B.R. 35 (Bankr. D.N.D. 1994); *In re Bennett Company, Inc.*, 118 B.R. 564 (Bankr. M.D. Tenn. 1990) (state tax refunds payable to the debtor could be set off against the debtor's liabilities owed to other state agencies); *Defense Servs. v. United States* (*In re Defense Services, Inc.*), 104 B.R. 481 (Bankr. S.D. Fla. 1989) (debtor's right to payment from the United States for services rendered was subject to setoff by the IRS to liquidate unpaid tax claims; the debts were mutual because the United States was owed by the debtor and owed money to the debtor); *Small Business Administration v. Rinehart*, 88 B.R. 1014 (D.S.D. 1988), aff'd in part, rev'd in part, 887

F.2d 165, 21 C.B.C.2d 917 (8th Cir. 1990); *In re Thomas*, 84 B.R. 438 (Bankr. N.D. Tex. 1980), *aff'd in part, rev'd in part*, 91 B.R. 731 (N.D. Tex. 1988); *In re IML Freight, Inc.*, 15 C.B.C.2d 1473, 65 B.R. 788 (Bankr. D. Utah 1986) (monies owed to the debtor for shipping charges would be set off against the debtor's tax liabilities); *In re Sound Emporium, Inc.*, 48 B.R. 1 (Bankr. W.D. Tex. 1984), *aff'd*, 17 C.B.C.2d 253, 70 B.R. 22 (W.D. Tex. 1987) (debtor's claim for goods sold to the United States Army would be set off against the debtor's tax liability for unpaid payroll taxes); *In re Nuclear Imaging Systems, Inc.*, 260 B.R. 724 (Bankr. E.D. Pa. 2000). Compare, however, the following decisions in which the courts found mutuality did not exist between agencies of the same governmental body: *Westamerica Bank v. United States*, 178 B.R. 493 (N.D. Cal. 1995); *Shugrue v. Fischer*, 164 B.R. 839 (Bankr. S.D.N.Y. 1994); *In re Julien Co.*, 116 B.R. 623 (Bankr. W.D. Tenn. 1990); *In re Lakeside Community Hospital*, 151 B.R. 887, 890-891 (N.D. Ill. 1993). In this case, the Department of Revenue for the state of Illinois attempted to set off its tax claims against refunds owed to the debtor by other state agencies. The court agreed that the various agencies represented the "state" for statutory and regulatory purposes, but that conclusion did not control for bankruptcy purposes. Because the respective debts arose "between parties acting in different capacities" there was no mutuality of claims. The fact that the state agencies were related did not satisfy the mutuality test because the claims could not be aggregated for setoff purposes. Because each "entity" holding a claim includes each separate governmental unit, the court concluded Congress intended those units to be treated as distinguishable and therefore not the same creditor with respect to the provisions of the setoff statute. In an unusual case, an attempt by the Government Accounting Office to have a judgment owed by the United States to a title 11 estate setoff against a tax debt owed to the IRS was disallowed because of the inequitable conduct by the Forest Service which led to the judgment. The setoff had been sought pursuant to 31 U.S.C. § 7328(a). *United States v. Arkison (In re Cascade Roads, Inc.)*, 34 F.3d 756 (9th Cir. 1994). A bankruptcy court applied this principle in a case involving an setoff of a tax refund to satisfy a foreclosure deficiency owed to Rural Housing Development, an agency of the federal government. *In re Baucom*, 339 B.R. 504 (Bankr. W.D. Mo. 2006).

Besides the Ninth, Tenth, and Eleventh Circuits, two other courts of appeals have now held that agencies of the United States government constitute a unitary creditor for purposes of section 553. *Aetna Casualty & Surety Co. v. LTV Steel Co. (In re Chateaugay Corp.)*, 94 F.3d 772 (2d Cir. 1996); *United States v. Maxwell*, 157 F.3d 1099, 40 C.B.C.2d 1423 (7th Cir. 1998).

Agencies of the federal government are authorized to "intercept" tax refunds and apply them to debts they are owed. 31 U.S.C. § 7320. The statute requires that the agency give the debtor notice of its intent to intercept any tax refunds and allow 60 days for the debtor to present evidence that the debt is not owed. The agency must also notify the Treasury at least once a year of the amount of the debt. A district court held that the annual notice requirement related only to the notice to the Treasury and did not to include an annual notice to the debtor in a Chapter 7 proceeding. The interception of a prepetition refund occurred after the bankruptcy petition had been filed. *In re Huff*, 343 B.R. 136 (W.D. Pa. 2006), *reversing* 317 B.R. 679 (Bankr. W.D. Pa. 2004). An overpayment of taxes that was setoff by the Department of Agriculture Rural Housing Service, after proper notice to the debtors but prior to the filing of their bankruptcy petition, could not be challenged as an improper setoff when they later filed their Chapter 7 case. *Harrison v. Department of Agriculture*, 383 B.R. 398 (Bankr. W.D. Ky. 2008).

(n24)Footnote 22. 11 U.S.C. § 553. The only limitation that may apply in such a case is the automatic stay of section 362(a) that should prevent the postpetition setoff without the approval of the bankruptcy court.

(n25)Footnote 23. 5 Collier on Bankruptcy, P 553.03[1] (Matthew Bender 15th Ed. Revised). See *In re Alvstad*, 223 B.R. 733, 741 (Bankr. D.N.D. 1998) (the claims of the Rural Housing Service and the monies payable to the debtor by the Farm Service Agency were both prepetition claims and refunds and thus were mutual obligations subject to setoff as preserved by section 553); *In re Okwukwu*, 210 B.R. 194 (Bankr. N.D. Ala. 1997) (setoff is permitted under section 553 of the Bankruptcy Code only if the debt owed by the creditor to the debtor arose prior to the commencement of the case, the creditor's claim against the debtor arose before commencement of the case, and there are mutual or reciprocal obligations).

When does a refund or liability accrue for purposes of setoff? Consider this example: the debtor files a chapter 13 petition on April 9, 1998; he files his income tax return for the 1997 tax year on May 1, 1998 (after the case is filed). Is the refund claimed on that 1997 income tax return subject to setoff for any IRS prepetition tax claims? The issue here is when the refund or a tax liability becomes payable by the parties to the setoff. The majority of courts considering this issue agree that the refund or tax liability accrues at the end of the taxable year in question and not later on the date when the return is filed by the debtor. *See, e.g., In re Dixon*, 218 B.R. 150 (B.A.P. 10th Cir. 1998); *In re Pettibone Corp.*, 161 B.R.960, 963 (N.D. Ill. 1993), *aff'd in part, remanded on other grounds*, 34 F.3d 536 (7th Cir. 1994); *Harbaugh v. United States*, 1989 Dist. LEXIS16506 (W.D. Pa. 1989), *aff'd*, 902 F.2d 1560 (3d Cir. 1990); *In re Durant*, 1998 WL 887471 (Bankr. N.D. Ala. 1996) (return filed on April 15, 1996 for the 1995 tax year; the February 20, 1996 petition reflected prepetition refunds which were subject to setoff); *In re Breder*, 199 B.R. 207 (Bankr. SD. Fla. 1996) (returns signed prepetition but filed postpetition nevertheless reflected prepetition refunds or liabilities); *In re Franklin Savings Corp.*, 177 B.R. 356 (Bankr. D. Kan. 1995); *In re Whitaker*, 173 B.R.359 (Bankr. S.D. Ohio 1994); *In re Martin*, 167 B.R. 609, 613 (Bankr. D. Or. 1994); *In re Thorvund-Statland*, 158 B.R. 837, 838-839 (Bankr. D. Idaho 1993); *In re Johnson*, 136 B.R. 306, 309 (Bankr. M.D. Ga. 1991); *In re Runnels*, 134 B.R.562, 564 (Bankr. E.D. Tex. 1991); *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); *In re Eggemeyer*, 75 B.R. 20, 21-22 (Bankr. S.D. Ill. 1987); *In re W.L. Jackson Mfg. Co.*, 50 B.R. 506, 508 (Bankr. E.D. Tenn. 1985). Compare, however, *In re Glenn*, 198 B.R. 106 (Bankr. E.D. Pa. 1996). In the *Glenn* decision, the court referred to 26 U.S.C. § 6407 which provides "The date on which the Secretary first authorizes the scheduling of an overassessment in respect of any internal revenue tax shall be considered as the date of allowance of refund or credit in respect of such tax." Based on this provision of the Internal Revenue Code, the court concluded the refund was not authorized and did not therefore exist until it was finally determined to be due, *i.e.*, after the return was actually filed and the refund was claimed on a tax return. Thus, the "date that a tax return is authorized, rather than the conclusion of the tax year for which it is filed, constitutes the date that a federal income tax return is deemed to be allowed." The result of this decision was that the refund was considered a prepetition refund and was not subject to setoff for a postpetition tax liability. The Sixth Circuit, however, has held that a postpetition overpayment of a prepetition tax could be used to setoff other prepetition tax debts. *Gordon Sel-Way, Inc. v. United States (In re Gordon Sel-Way, Inc.)*, 270 F.3d 280 (6th Cir. 2001). The court held that the IRS's prepetition claim became a postpetition claim after confirmation of a liquidating Chapter 11 plan." A postpetition abatement of penalties paid prepetition created a credit which the IRS could setoff against other prepetition tax debts; *Harris v. United States (In re American Payroll Network, Inc.)*, 98-2 U.S. Tax Cas. (CCH) P 50,680 (Bankr. N.D.N.Y. 1998).

(n26)Footnote 24. 5 *Collier on Bankruptcy*, P 553.03[1] (Matthew Bender 15th Ed. Revised). *See also In re Braniff Airways, Inc.*, 12C.B.C.2d 610, 42 B.R. 443, 449 (Bankr. N.D. Tex. 1984).

(n27)Footnote 25. *In re Braniff Airways, Inc.*, 12 C.B.C.2d 610, 42 B.R. 443, 449-50 (Bankr. N.D. Tex. 1984); *In re W.L. Jackson Manufacturing Company*, 50 B.R. 506 (Bankr. E.D. Tenn. 1985); *In re Lawrence*, 19 B.R. 627 (Bankr. E.D. Ark. 1981). An overpayment of taxes accruing before the bankruptcy petition was filed could be setoff against a prepetition debt, but an overpayment accruing after the petition date could not. *In re Bryant*, 399 B.R. 477 (Bankr. W.D. Ky. 2009).

(n28)Footnote 26. *See, e.g., In re W.L. Jackson Manufacturing Company*, 50 B.R. 506 (Bankr. E.D. Tenn. 1985). The court noted that in a chapter 11 case, the setoff of mutual postpetition debts would not be permitted if the case was converted to a chapter 7 liquidation because a creditor's postpetition claim is converted to a prepetition claim under 11 U.S.C. § 348(d) when the case is converted. As a result, the prepetition/postpetition estates are created and the mutuality required by 11 U.S.C. § 553 is lost.

(n29)Footnote 27. *See 5 Collier on Bankruptcy*, P 553.06[3][b] (Matthew Bender 15th Ed. Revised).

(n30)Footnote 28. *See, e.g., In re Harbaugh*, 99 B.R. 671 (Bankr. W.D. Pa. 1989), *rev'd*, 902 F.2d 1560 (3d Cir. 1990), (a refund until the tax return had been filed and the IRS had authorized the refund; the district court rejected this

argument and held the right to the refund accrued at the end of the taxable year even if the tax return had not yet been filed and the refund actually claimed); *In re Wilson*, 29 B.R. 54 (Bankr. W.D. Ark. 1982) (debtor asserted that the tax liability and the overpayment liability were not mutual because the debtor's entitlement to the tax refund did not arise or vest until after the November 19, 1980 petition date because the amount of the tax refund was not determinable on the petition date or until the date in 1981 when the tax return was filed).

(n31)Footnote 29. 11 U.S.C. § 541(c).

(n32)Footnote 30. See *In re Rozel Industries, Inc.*, 120 B.R. 944 (Bankr. N.D. Ill. 1990) (the right to a refund arises at the end of the tax year to which the refund relates); *In re Harbaugh*, 99 B.R. 671 (Bankr. W.D. Pa. 1989), rev'd, 89-2 U.S. Tax Cas. (C.C.H.) P 9608 (W.D. Pa. 1989); *In re Mason*, 79 B.R. 786 (Bankr. N.D. Ill. 1987) (debtor was entitled to receive 1986 income tax refund as of January 1, 1987 after the end of the 1986 taxable year; the setoff right was unaffected by the title 11 petition but only to the extent of funds the debtor was entitled to receive prepetition); *In re Ferguson*, 83 B.R. 676 (Bankr. E.D. Mo. 1988) (tax refund accrued at the end of the taxable year); *In re Eggemeyer*, 75 B.R. 20 (Bankr. S.D. Ill. 1987) (for purposes of 11 U.S.C. § 553, income tax refunds are "absolutely owing" on the last day of the taxable year); *In re Dominguez*, 67 B.R. 526 (Bankr. N.D. Ohio 1986) (the obligation of the IRS to refund tax payments arose as of the end of the 1985 taxable year; although the debtor received notice of the refund and the setoff postpetition, the right to the refund accrued prepetition and the debtor only had to comply with the procedural steps to obtain the refund); *In re Conti*, 12 C.B.C.2d 1472, 50 B.R. 142 (Bankr. E.D. Va. 1985) (tax refund accrued at the end of the taxable year; the date of allowance of a tax refund pursuant to I.R.C. § 6407 is not the same as the date the obligation arose for purposes of 11 U.S.C. § 553). *Rozel Industries*, *Eggemeyer*, and *Conti* were followed by the bankruptcy court in *In re Pleasant*, 320 B.R. 889 (Bankr. N.D. Ill. 2005).

(n33)Footnote 31. See, e.g., *In re Mason*, 79 B.R. 786 (Bankr. N.D. Ill. 1987); *In re Wilson*, 29 B.R. 54 (Bankr. W.D. Ark. 1982); *In re Barfknecht*, 15 B.R. 463 (Bankr. D. Minn. 1981) (income tax refund was due to the debtor as a result of income tax withholding during the taxable year 1980; the right to a refund was unliquidated and contingent until a return was filed, but that right nevertheless existed). Even if the refund is not claimed and received until two years after the close of the taxable year, the refund will nevertheless be a prepetition refund for section 553 purposes because the right to the refund vested in the debtor at the end of the taxable year. *In re Conti*, 12 C.B.C.2d 1472, 50 B.R. 142 (Bankr. E.D. Va. 1985) (refund related to the 1982 tax year was not claimed and paid until after the petition date in 1984; refund was still a prepetition asset subject to setoff).

(n34)Footnote 32. For example, if the title 11 petition was filed on January 2, 1992, any tax refunds attributable to the 1991 or earlier tax years would be prepetition assets included in the debtor's bankruptcy estate which would be subject to the setoff remedy of 11 U.S.C. § 553. This would be true even if the refund was not claimed until after the filing of the title 11 petition. The claiming of a tax refund and its payment by the IRS after the filing of the title 11 petition does not convert the refund into a postpetition refund for purposes of 11 U.S.C. § 553. See the cases cited in n.31 *supra* and *In the Matter of Firestone*, 179 B.R. 148 (Bankr. D. Neb. 1995).

(n35)Footnote 33. [Reserved]

(n36)Footnote 34. See 5 *Collier on Bankruptcy*, P 553.06[3] (Matthew Bender 15th Ed. Revised); *In re Rozel Industries, Inc.*, 120 B.R. 944 (Bankr. N.D. Ill. 1990); *In re Wilson*, 29 B.R. 54 (Bankr. W.D. Ark. 1982). In *Wilson* the debtor filed his title 11 petition on November 19, 1980. The bankruptcy court allocated the debtor's overpayment for the year between the periods before and after the petition date on a *pro rata* basis because there was no evidence provided of when the debtor's income was earned. This case supports the idea that an overpayment attributable to any period before the petition date is subject to setoff as a prepetition obligation of the IRS to the debtor. *Wilson* also seems to approve the admission of evidence to allocate the earnings and corresponding income tax overpayment or liability to periods before or after the petition date.

(n37)Footnote 35. For a complete discussion of I.R.C. § 1398, see P TX2.05 *supra*.

(n38)Footnote 36. *I.R.C. § 1398(d)(2)*. Note the restrictions in the statute upon which debtors are eligible to make the election to terminate a taxable year.

(n39)Footnote 37. *I.R.C. § 1398(d)(1)*.

(n40)Footnote 38. *I.R.C. § 1398(g)*.

(n41)Footnote 39. See 5 *Collier on Bankruptcy*, P 553.06[1] (Matthew Bender 15th Ed. Revised).

(n42)Footnote 40. See 5 *Collier on Bankruptcy*, P 553.06[5] (Matthew Bender 15th Ed. Revised).

(n43)Footnote 41. Following passage of the amendment, one bankruptcy court refused to apply it prior to its effective date: October 17, 2005. *In re Shultz*, 325 B.R. 197 (Bankr. N.D. Ohio 2005) . For periods after the effective date, the IRS may proceed with a setoff and provide the debtor with a notice of "Overpaid Tax Applied to Other Taxes Owed." *Ewing v. United States (In re Ewing)*, 400 B.R. 913 (Bankr. N.D. Ga. 2008) .

(n44)Footnote 42. The right of a creditor to freeze an amount subject to a setoff was recognized by the *Supreme Court in Citizens Bank of Maryland v. Strumpf*, 516 U.S. 16, 116 S. Ct. 286, 133 L. Ed. 2d 258 (1995) .

(n45)Footnote 43-45. [Reserved]

(n46)Footnote 46. See, e.g., *In re Ferguson*, 83 B.R. 676 (Bankr. E.D. Mo. 1988) ; *In re Dominguez*, 67 B.R. 526 (Bankr. N.D. Ohio 1986) .

(n47)Footnote 47. See, e.g., *Rochelle v. United States*, 521 F.2d 844, 855 (5th Cir. 1975) , modified, 526 F.2d 405 (5th Cir. 1975) , cert. denied, 426 U.S. 948, 96 S. Ct. 3168, 49 L. Ed. 2d 1185 (1976) ; *In re Sound Emporium, Inc.*, 48 B.R. 1 (Bankr. W.D. Tex. 1984) , aff'd, 17 C.B.C.2d 253, 70 B.R. 22 (W.D. Tex. 1987) . In *Sound Emporium*, a bank held a security interest in the debtor's assets, and the debtor owed the IRS several tax liabilities. The United States Army owed money to the debtor, and the IRS set off those funds against the mutual tax debt. The IRS was allowed to set off the debt owed by the Army against the debt owed to the IRS even though the bank had a senior lien against the amounts owed by the Army to the debtor. See also *In re Nuclear Imaging Systems, Inc.*, 260 B.R. 724 (Bankr. E.D. Pa. 2000) . The right of the IRS to setoff Medicare payments owed to a healthcare provider against unpaid employment taxes was not affected by the debtor's assignment of the payments to another creditor. *United States v. Cherry Street Partners, LP (In re Alliance Health Care of Fort Worth, Inc.)*, 240 B.R. 699 (N.D. Tex. 1999) , aff'd, 200 F.3d 816 (5th Cir. 1999) .

(n48)Footnote 48. See, e.g., *In re Northeastern International Airways, Inc.*, 99 B.R. 487 (Bankr. S.D. Fla. 1989) , in which the court concluded there was a right of setoff and a corresponding secured claim with respect to a security deposit paid to the New York Transit Authority.

(n49)Footnote 49. See, e.g., *In re Wilson*, 49 B.R. 19 (Bankr. N.D. Tex. 1985) ; *In re Archer*, 34 B.R. 28 (Bankr. N.D. Tex. 1983) . Note, however, that the IRS may setoff of an overpayment for one tax year against an amount it claims to have refunded erroneously to a debtor for another prepetition year. *In re Franklin Savings Corp.*, 177 B.R. 356 (Bankr. D. Kan. 1995) . In an unusual case, the United States Customs Service objected to a settlement between a chapter 11 trustee and the IRS, asserting that it had a right to setoff the tax refund which was to be paid to the trustee against its own claim. The objection was unsuccessful because the court held the Customs Service had waived its setoff rights by its own prior settlement with the trustee. *In re Holder*, 182 B.R. 770 (Bankr. M.D. Tenn. 1995) . But see *McCarty v. National Bank, N.A. (In re United Marine Shipbuilding, Inc.)*, 158 F.3d 997 (9th Cir. 1998) .

(n50)Footnote 50. See 5 *Collier on Bankruptcy*, P 553.07[2] (Matthew Bender 15th Ed. Revised). *In re Custom Center, Inc.* 163 B.R. 309 (Bankr. E.D. Tenn. 1994) ; *Apex International Management Services, Inc.*, 155 B.R. 591 (Bankr. M.D. Fla. 1993) , aff'd, 77 A.F.T.R. 2d 1026 (M.D. Fla. 1996) . Compare *In re Whimsy*, 221 B.R. 69 (S.D.N.Y.

1998) (the debtor contended the IRS waived the right of setoff when it executed a settlement agreement involving tax liabilities at a time when it was entitled to a refund of customs duties; the settlement agreement was silent regarding setoffs so neither the IRS or the Customs Service did anything to manifest an intent to waive the setoff rights). This waiver is not, however, without its limitations. See *In re Sound Emporium, Inc.*, 17 C.B.C.2d 253, 70 B.R. 22 (W.D. Tex. 1987), in which the district court affirmed the bankruptcy court's ruling allowing the IRS to amend its proof of claim to assert its right of setoff when the original claim was filed in error due to a "good faith mistake" of fact and the debtor was not prejudiced as a result of the amendment. See also *In re Northeastern International Airways, Inc.*, 99 B.R. 487 (Bankr. S.D. Fla. 1989), in which the court allowed the amendment of the claim to formally claim the setoff rights of the creditor because the original claim gave sufficient notice of the right of setoff.

(n51)Footnote 50a. An issue related to waiver may arise if the IRS pays the refund to the debtor or the trustee while the issue of a setoff is being litigated. The courts have split on whether such a payment would render an appeal by the IRS from an adverse ruling moot. Compare *Internal Revenue Service v. Ealy* (*In re Ealy*), 396 B.R. 20 (B.A.P. 8th Cir. 2008) (moot) to *United States v. Gould* (*In re Gould*), 401 B.R. 415 (B.A.P. 9th Cir. 2009) (not moot).

(n52)Footnote 50b. *United States v. Fleet Bank of Massachusetts* (*In re Calore Express Company, Inc.*), 288 F.3d 22 (1st Cir. 2002). The Court of Appeals also cautioned bankruptcy courts about the limits on their discretion to allow or disallow a setoff. One bankruptcy court held that the confirmation of a Chapter 11 plan could not affect the setoff rights of the IRS but concluded that, in light of *Calore Express*, it should conduct an evidentiary hearing on the issue of a possible waiver of those rights. *In re Ronnie Dowdy, Inc.*, 314 B.R. 182 (Bankr. E.D. Ark. 2004).

(n53)Footnote 51. *In re Crabtree*, 76 B.R. 208 (Bankr. M.D. Fla. 1987) (debtor contended that the confirmation of the plan bound the IRS to its payment terms, and IRS contended it retained its I.R.C. § 6402 setoff rights even after confirmation); *In re Sedlock*, 219 B.R. 207 (Bankr. N.D. Ohio 1998) (confirmation of the chapter 13 plan had no effect on the right of setoff, so long as all of the other tests for a proper setoff under section 553 were met); *In re Okwukwu*, 210 B.R. 194 (Bankr. N.D. Ala. 1997); *In re Tillery*, 179 B.R. 576 (Bankr. W.D. Ark. 1995); *In re Warwick*, 179 B.R. 582 (Bankr. W.D. Ark. 1995); *In re Orlinski*, 140 B.R. 600 (Bankr. S.D. Ga. 1991).

(n54)Footnote 52. See *United States v. Reynolds*, 764 F.2d 1004, 13 C.B.C.2d 239 (4th Cir. 1985) (plan provided for the full payment of the IRS claim and IRS was thus adequately protected; no setoff rights were permitted); *United States v. Norton*, 717 F.2d 767, 9 C.B.C.2d 336 (3d Cir. 1983) (chapter 13 plan was confirmed before refund was payable; IRS had knowledge of the plan and could have objected; IRS was bound by the terms of the confirmed plan and would be paid under the plan; IRS could not also claim setoff rights to postpetition tax refunds); *In re Johnson*, 136 B.R. 306 (Bankr. M.D. Ga. 1991) (payment of IRS claim in plan, if the IRS was adequately protected, would result in the loss of setoff right held by the IRS); *In re Alexander*, 9 C.B.C.2d 111, 31 B.R. 389 (Bankr. S.D. Ohio 1983) (IRS's setoff right was barred upon confirmation of the chapter 13 plan and the right to the refund vested in the debtor free and clear of any liens and encumbrances); *In re Hackney*, 20 B.R. 158 (Bankr. N.D. Idaho 1982) (scheme of chapter 13 prevails over setoff attempt after confirmation of the plan; IRS is bound by the terms of the plan); *In re Vargas*, 342 B.R. 762 (Bankr. N.D. Ohio 2006); *In re Wellman*, 322 B.R. 298 (B.A.P. 6th Cir. 2004). But see *In re Orlinski*, 140 B.R. 600 (Bankr. S.D. Ga. 1991), rejecting the analysis in *Norton supra*, in a chapter 13 case; and *In re Whitaker*, 173 B.R. 359 (Bankr. S.D. Ohio 1994) holding that a valid prepetition right of setoff takes precedence over the *res judicata* effect of a confirmed chapter 13 plan. Note, however, that in chapter 11 cases a different result may obtain. One court of appeals has held that section 553 explicitly provides that "this title does not affect any other right of a creditor to offset" mutual prepetition debts. Accordingly, in the event of a conflict, the setoff right under section 553 takes precedence over the discharge provisions of section 1141 and will survive confirmation of a chapter 11 plan. *In re DeLaurentiis Entertainment Group, Inc.*, 963 F.2d 1269, 26 C.B.C.2d 1435 (9th Cir. 1992). The court declined to follow the approach of the Third Circuit in *Norton* although it noted that the language in sections 1141 and 1327 was virtually identical. *De Laurentiis Entertainment* was followed by the district court in *Pettibone Corporation v. United States* (*In re Pettibone Corporation*), 23 B.C.D. 1384 (Bankr. N.D. Ill. 1992), *aff'd*, 161 B.R. 960 (N.D. Ill. 1993), *aff'd*, 34 F.3d 536 (7th Cir. 1994). See also *Weems v. United States* (*In re The Custom Center, Inc.*), 163 B.R. 309 (Bankr. E.D. Tenn. 1994).

In an unusual case, the Sixth Circuit allowed a setoff of a prepetition tax claim against a claim for refund that arose postpetition. It held that the prepetition claim was transformed into a postpetition claim under the terms of the confirmed Chapter 11 plan. *Gordon Sel-Way, Inc. v. United States (In re Gordon Sel-Way, Inc.)*, 239 B. R. 741 (E.D. Mich. 1999) , *aff'd*, 270 F.3d 280 (6th Cir. 2001) .

(n55)Footnote 52a. *United States v. Continental Airlines (In re Continental Airlines)*, 134 F.3d 536 (3d Cir. 1998) , *cert. denied*, 525 U.S. 929, 119 S. Ct. 336, 142 L. Ed. 2d 277 (1999) .

(n56)Footnote 52b. *In re Munson*, 241 B.R. 410 (Bankr. C.D. Ill. 1999) , *rev'd*, 43 C.B.C.2d 1883, 248 B.R. 343 (C.D. Ill. 2000) . The district court's decision was followed in *In re Bare*, 49 C.B.C.2d 1142, 284 B.R. 870 (Bankr. N.D. Ill. 2002) .

(n57)Footnote 52c. *In re Stienes*, 49 C.B.C.2d 179, 285 B.R. 360 (Bankr. D.N.J. 2002) .

(n58)Footnote 53. *See In re Crabtree*, 76 B.R. 208 (Bankr. M.D. Fla. 1987) .

(n59)Footnote 54. 11 U.S.C. § 1327(a), (b) and (c).

(n60)Footnote 55. 11 U.S.C. § 1141(a), (b) and (c).

(n61)Footnote 56. *Compare In re Womack*, 188 B.R. 259 (Bankr. E.D. Ark. 1995) (IRS retained prepetition setoff rights after confirmation of chapter 13 plan); *In re Whitaker*, 173 B.R. 359 (Bankr. S.D. Ohio 1994) with *United States v. Driggs*, 185 B.R. 214 (D. Md. 1995) (bankruptcy court's determination that IRS did not retain prepetition setoff rights after confirmation of a chapter 11 plan affirmed). A district court in the Fourth Circuit concluded that *United States v. Reynolds*, 764 F.2d 1004, 13 C.B.C.2d 239 (4th Cir. 1985) , controlled in chapter 11 cases as well as chapter 13 cases and rejected *In re DeLaurentiis Entertainment Group, Inc.*, 963 F.2d 1269, 26 C.B.C.2d 1435 (9th Cir. 1992) , and *Pettibone Corporation v. United States (In re Pettibone Corporation)*, 23 B.C.D. 1384 (Bankr. N.D. Ill. 1992) , *aff'd*, 161 B.R. 960 (N.D. Ill. 1993) , *aff'd*, 34 F.3d 536 (7th Cir. 1994) . The Third Circuit, in a non-tax case, declined to follow *De Laurentiis*. *United States v. Continental Airlines (In re Continental Airlines)*, 134 F.3d 536 (3d Cir. 1998) , *cert. denied*, 525 U.S. 929, 119 S. Ct. 336, 142 L. Ed. 2d 277 (1999) .



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Collier on Bankruptcy Taxation

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CHAPTER TX5 Litigation With the IRS in Bankruptcy Court

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P TX5.09 Preference Litigation Against the IRS

[1] Overview of Preferential Transfer Suits

Bankruptcy Code section 547 authorizes a debtor in possession or a trustee to pursue a cause of action to avoid certain prepetition transfers to a creditor of interests in property owned by the debtor. n1 When debtors or their trustees have sued the United States to recover prepetition payments to the IRS, courts have resolved many issues relating to preferential transfer suits against the United States, including the court's jurisdiction over the United States and the proof of each element of a section 547 action.

[2] The Sovereign Immunity Defense

Prior to the Amendments of 1994 that made substantial revisions to the sovereign immunity waiver provisions of the Bankruptcy Code, the United States asserted the defense of sovereign immunity in avoidance actions such as when a trustee attempted to recover money from the United States. n2 The Supreme Court had defined the waiver of sovereign immunity contained in *Bankruptcy Code section 106* when that section is applied to the United States. n3 Section 106 was since completely amended by the Bankruptcy Reform Act of 1994. n4

Many of the reported cases dealing with the defense of sovereign immunity raised by the United States are now a matter of historical inquiry in light of the revisions to *section 106 of the Bankruptcy Code* in the Bankruptcy Reform Act of 1994. Section 106(a)(1) specifically provides for the waiver of sovereign immunity for a preference action under *section 547 of the Bankruptcy Code*. To the extent the Internal Revenue Service or any other taxing authority files a proof of claim in the case, the sovereign immunity defense will be waived by section 106(b) if the proof of claim and the preference arise out of the same transaction or occurrence. Finally, if there is a right of setoff against a taxing authority, section 106(c) preserves that right of setoff against the claim without interference by a defense of sovereign immunity. n4a

Even under the law as it existed prior to the enactment of the revisions to section 106 in the Bankruptcy Reform Act of 1994, the United States and the IRS generally found little refuge in the sovereign immunity defense. This result was generally true based on the prior provisions of section 106(c) which referred to "governmental units" as the triggering phrase that brought the IRS within its scope n5 or because the IRS filed a proof of claim in the case. n6 n7-13

If the Internal Revenue Service has filed a proof of claim in the taxpayer's bankruptcy case, court decisions confirm that

section 106(b) will provide a waiver of sovereign immunity for a preference action without resort to section 106(c). The United States has defended itself against a preference suit under *section 547 of the Bankruptcy Code* by asserting that the compulsory counterclaim rule of *section 106(b) of the Bankruptcy Code* has not been met, and therefore that it has not waived its sovereign immunity. n14 A compulsory counterclaim for section 106(b) purposes is one described in *Rule 13(a) of the Federal Rules of Civil Procedure*, made applicable in bankruptcy cases by *Federal Rule of Bankruptcy Procedure 7013*, which arises out of the same transaction or occurrence that is the subject matter of the opposing party's claim, and does not require for its adjudication the presence of third parties over whom the court cannot acquire jurisdiction. n15 Applying a "logical relationship" test, it is not necessary that there be an "identity of issues" between the two claims before the Rule 13(a) counterclaim test is met. All that need be established is that the respective claims arise out of the same series or course of interrelated dealings. n16 Using this analysis, the court in *United States v. Pullman Construction Industries, Inc.* concluded that the Internal Revenue Service, by its proof of claim, sought the payment of prepayment taxes Pullman failed to pay. Pullman, on the other hand, sought to recover prepetition payments to the Internal Revenue Service in satisfaction of the same tax liabilities because the Internal Revenue Service would receive a windfall absent the recovery of the payment. Both the Internal Revenue Service and Pullman claims arose from the failure of Pullman to pay payroll taxes to the Internal Revenue Service, and the filing of a proof of claim by the Internal Revenue Service waived its sovereign immunity with respect to the debtor's preference action. n17

This analysis has support from several courts, and it is also consistent with the legislative history of section 547. In the case of *In re Ballard*, n18 the court held the United States waived its defense of sovereign immunity to a section 547 suit. The *Ballard* court quoted the legislative history of section 547 and concluded that the court had jurisdiction over the United States in a suit under section 547: n19

In addition, the legislative history of *11 U.S.C. section 547(b)(2)*, part of the preference provision at issue in this case, explicitly said that preference actions can be maintained against the government. That legislative history states "As provided, section 106(c) of the House amendment overrules contrary language in the House report so that the Government is subject to avoidance of preferential transfers."

Although bankruptcy courts may not have jurisdiction over the United States in some Bankruptcy Code avoidance actions, if a preferential transfer to the Internal Revenue Service has occurred, the United States should not be able to raise jurisdictional defenses to avoid prosecution under section 547.

[3] IRS Levy on Assets and Wages as Preferential Transfer

Section 547 contains several predicates that must be met before a court may find a preferential transfer occurred. There must have been a transfer of an interest in the debtor's property to or for the benefit of a creditor in satisfaction of an antecedent debt at a time when the debtor was insolvent. That transfer must have occurred on or within ninety days before the filing of the petition, n20 and because of the transfer, the creditor must receive more than he or she would have received in a chapter 7 case if the transfer had not been made. These prerequisites to a recovery under section 547 are also applicable to the Internal Revenue Service. n21

[a] Payment Against an Antecedent Debt

A transfer of the debtor's property must have been with respect to an antecedent debt owed by the debtor before the transfer was made. n22 For purposes of section 547(b)(2), a debt for a tax is incurred on the day when that tax liability is last payable without penalty, including any extension. n23 Thus, the payment of estimated tax payments and the withholding of income tax payments from wages is not a payment of an antecedent debt due before the transfer because those payments are made in anticipation of a future tax liability and not with respect to assessed, delinquent liabilities. n24 A payment of an assessed tax penalty in order to litigate the validity of that assessment in district court is in fact a "payment" and not a "deposit." n25

[b] The 90-Day Time Period

Payments can be made to the Internal Revenue Service in two different ways. The taxpayer may voluntarily pay monies to the Internal Revenue Service in satisfaction of an assessed tax liability. The Internal Revenue Service, on the other hand, may receive involuntary payments from the debtor or third parties who possess assets owned by the debtor by the implementation of the administrative collection procedures in the Internal Revenue Code. n26 If administrative collection procedures are used by the Internal Revenue Service, an issue is raised regarding the existence of a transfer of the debtor's property within the ninety day prepetition period.

If a levy pursuant to *I.R.C. section 6331* is served outside the ninety day period preceding the petition date, the Internal Revenue Service may contend that the assets subject to the levy were transferred to the Internal Revenue Service on the date of the levy. n27 This argument places the transfer mentioned in section 547 outside the 90-day prepetition period and allows the Internal Revenue Service to avoid liability for a preferential transfer. Courts have held a transfer of property under a garnishment lien does not occur until the wages are earned and the debtor owns something subject to the levy. n28 Under this view, an Internal Revenue Service levy issued more than 90 days before the petition date does not automatically result in a transfer of ownership in wages for section 547 purposes, and the payment or transfer occurs only as the wages are earned during the 90-day period. n29 Other courts have, on the contrary, held that a continuous wage levy divests the debtor of any interest he or she may have in future wages. n30 The court in the case of *In re Tabita* held that wages are not owned until earned, that section 547(a)(3) prevented the transfer of any interest in those wages until they had been earned, and that, therefore, the wage levy occurred during the ninety day prepetition period. n31

There is a split of authority concerning the effect of an Internal Revenue Service levy on the ownership of assets held by a debtor. n32 The Supreme Court has confirmed that the ownership interests of the debtor in tangible assets are not extinguished by levy until the Internal Revenue Service has sold the assets and the debtor has lost the right of redemption. n33 If the Internal Revenue Service levied upon tangible assets of the debtor before the ninety day prepetition period and sold those assets within that period, it can be argued that the transfer required by section 547 occurred within the 90 day period because the debtor's ownership in the assets was not extinguished by the *I.R.C. section 6331* levy. In the case of intangible assets, cash or cash equivalents, the existence of a transfer of ownership by levy within the 90 day prepetition period will be more difficult to achieve because of the split of authority concerning the extent of a debtor's ownership in intangible assets after issuance of a levy. n34 If an Internal Revenue Service levy is issued against cash or cash equivalents before the 90 day period, and that levy is satisfied within that period, an argument can be made that this is a transfer made within the 90 day prepetition period. n35

[c] The Requirement of Transfer of Property Owned by the Debtor; Payments of Employment Tax Liabilities

A trustee or the debtor in possession "may avoid any transfer of an interest of the debtor in property" if the other requirements of section 547 are satisfied. Section 547 requires that a transfer occur, and that transfer must be of property owned by the debtor.

The necessary transfer of property to the Internal Revenue Service will not usually be difficult to identify. n36 The issue related to the transfer requirement is that noted in the preceding discussion regarding the existence of a transfer upon the issuance of an Internal Revenue Service levy. Generally, however, the exercise by the Internal Revenue Service of its collection procedures will result in a transfer for section 547 purposes. n37

The more difficult problem encountered by courts has been to decide whether the assets transferred, either voluntarily or by levy, to the Internal Revenue Service by a debtor were owned by the debtor. This issue resulted in litigation over the preferential status of payments of withheld income taxes and Federal Insurance Contribution Act (FICA) premiums to the Internal Revenue Service, n38 until it was resolved by the Supreme Court in *Begier v. Internal Revenue Service*. n39

Section 547 does not specifically define the property of the debtor's estate, so reference must be made to section 541 to determine whether property owned by the debtor was transferred to the Internal Revenue Service. Under section 541, property of the estate includes all property and interests in property owned by the debtor as of the commencement of the title 11 case. If a debtor holds property in trust for another person or entity, section 541 generally will not include that property in the debtor's estate and that property cannot be recovered in a preferential transfer action. n40

Under the Internal Revenue Code, a trust is imposed on a taxpayer who is required to collect, account for and pay over any tax, and that trust accrues for the benefit of the United States. n41 In *Begier*, the trustee for the debtor asserted that no trust relationship was created with the Internal Revenue Service because the withheld taxes were not segregated, and the monies were not paid to the Internal Revenue Service before the start of the 90-day prepetition preference period. The Court rejected this argument because the trust obligation was imposed when the event generating the tax liability occurred. The fact the tax monies were not segregated by the debtor had no effect on the validity of the trust under *I.R.C. section 7501*. n42

Although the Court concluded the debtor owed a trust obligation to the IRS under *I.R.C. section 7501*, the Court was also required to decide whether tracing was necessary to ascertain that the particular dollars paid to the Internal Revenue Service were ones held in trust for it. n43 37 In a common law trust, tracing rules might apply, but under *I.R.C. section 7501*, the trust created is for a dollar amount unrelated to a particular asset or fund of money. n44 Congress expected the IRS would be required to prove some connection between the statutory trust and the assets the Internal Revenue Service alleged to be subject to that trust. n44a The Court concluded that monies must have been held for payment for the *I.R.C. section 7501* trust to apply, and that a section 7501 trust will be imposed if the debtor has the financial ability to make the payments required to satisfy the trust. n45

After *Begier*, a voluntary prepetition trust fund payment will not be recoverable under section 547. n46 The Court's opinion does not, however, prevent the recovery of involuntary payments collected by the Internal Revenue Service by a levy. The Internal Revenue Service may still bear a tracing burden in a turnover action brought by a trustee or debtor in possession. n47

When a debtor can prove that it has an interest in the monies paid to the Internal Revenue Service, the Court's holding in *Begier* should not control even if the transfer represented the payment of taxes that were required to be collected, accounted for, and paid to a taxing authority. Thus, if the debtor borrows funds necessary to satisfy sales tax and payroll tax withholding obligations, those payments may be transfers of the debtor's property and be recoverable under section 547. n48

[d] Comparison to Chapter 7 Distribution Amount

In a transfer of property of the debtor, the recipient must, because of the transfer, have received more than he or she would have received had the debtor been liquidated in a chapter 7 case. n49 If the Internal Revenue Service holds a properly recorded Notice of Federal Tax Lien, payments made to the Internal Revenue Service within the 90 days before the petition date may not be a preferential transfer if the Internal Revenue Service's tax lien is fully secured and has priority over all other secured and unsecured claims. n50 If the Internal Revenue Service's tax lien is not fully secured or is subject to other liens of other creditors, then it is possible that prepetition payments on antecedent tax liabilities can result in a larger dividend to the Internal Revenue Service than it would receive in a chapter 7 case. n51 This mechanical test must be made to determine if section 547(b)(5) is applicable to the Internal Revenue Service under the facts of a particular case.

[e] Standing to File Preference Action

As a general rule, standing to pursue a preference action against a taxing authority will depend on the chapter under which the bankruptcy case was brought. In a chapter 11, 12 or 13 case, the debtor has standing to pursue preference

actions and there is no limitation on the amount that can be recovered. On the other hand, a taxpayer debtor in a chapter 7 case will have limited standing to pursue a preference action against a taxing authority. In a chapter 7 case, the chapter 7 trustee will be the only party having standing to file preference actions. A taxpayer/debtor will, however, have standing to file a preference action to the extent the recovery is of assets that are exempt under applicable Bankruptcy Code provisions. n52

[4] Recording of Notice of Federal Tax Lien as Preferential Transfer

The recording of a non-tax lien within the ninety days before the filing of a title 11 petition can result in a preferential transfer avoidable under section 547. With respect to the Internal Revenue Service's Notice of Federal Tax Lien, however, this general observation is not true. Section 547(c)(6) provides that a trustee or debtor in possession may not avoid a transfer that is the fixing of a statutory lien that is not avoidable under section 545. n53

Notwithstanding this rule, a court may partially invalidate a prepetition tax lien filed within 90 days of the petition date to the extent the tax lien relates to claims that are subject to avoidance or subordination under the Bankruptcy Code. Thus, a court can invalidate a tax lien under section 547 to the extent the tax lien is for penalties subject to avoidance or subordination under sections 724(a) and 726(a)(4). n54 In a thoughtful opinion, one bankruptcy court has held that section 547(c)(6) prevented debtors from avoiding two voluntary payments as well as a levy by the Internal Revenue Service on their bank account, all of which occurred within 90 days of the filing of their title 11 petition. The court concluded that because all three transactions involved cash, the Internal Revenue Service had fully perfected its lien rights by its levy and its receipt of the payments from the debtors. Since section 547(c)(6) provided that the "fixing" of a statutory lien right was a specific exception to avoidance of such transactions as preferential, the court ruled against debtors. n55

[5] The Ordinary Course of Business Defense to section 547 Actions

Section 547(c)(2) prevents the debtor in possession or the trustee from avoiding a transfer if that transfer was made in payment of a debt incurred in the ordinary course of the debtor's and the creditor's businesses, the transfer itself was made in the ordinary course of the debtor's and the creditor's businesses, or the transfer was made according to ordinary business terms. n55a The purpose behind this exception to the remedial authority in section 547 is to leave undisturbed the normal financial relationships between the debtor and its creditors, because those transactions do not detract from the general policy of section 547 to discourage unusual action by either the debtor or its creditors during the debtor's slide into bankruptcy. n56

Some courts have applied the ordinary course of business defense to prepetition collection of monies from a debtor by the Internal Revenue Service. n57 Because of the imperative public interest in favor of the prompt collection of tax delinquencies, and because the levy authority of the Internal Revenue Service enhances the voluntary compliance of taxpayers with the taxing system, the court in the case of *In re Garland* held the Notice of Levy was issued in the ordinary course of the businesses of both the debtor and the Internal Revenue Service. n58 On the other hand, other courts have concluded the payment of monies to the Internal Revenue Service via a levy under *I.R.C. section 6331* is not a transaction entered into in the ordinary course of the debtor's business. n59 Administrative collection activities such as a tax levy to seize assets of a debtor are not part of the normal tax payment procedures adopted by businesses. Therefore, the *Garland* opinion should not be viewed as valid authority that the involuntary, prepetition collection procedures of the Internal Revenue Service against a debtor are part of the debtor's ordinary course of business.

The timely payment of a tax liability in connection with the filing of a tax return with the Internal Revenue Service will be a payment made within the ordinary course of the debtor's business. n60

FOOTNOTES:

(n1)Footnote 1. The elements of a preference under the Bankruptcy Code are listed in section 547(b): ... [T]he trustee may avoid any transfer of an interest of the debtor in property--(1) to or for the benefit of a creditor; (2) for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) made while the debtor was insolvent; (4) made--(A) on or within 90 days before the date of the filing of the petition; or (B) 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; and (5) that enables such creditor to receive more than such creditor would receive if--(A) the case were a case under chapter 7 of this title; (B) the transfer had not been made; and (C) such creditor received payment of such debt to the extent provided by the provisions of this title. A detailed discussion of all the issues that are relevant with respect to preference litigation is beyond the scope of this chapter, however. For a complete discussion of preference litigation, see 5 Collier on Bankruptcy, chapter 547 (Matthew Bender 15th Ed. Revised).

(n2)Footnote 2. See, e.g., *In re Ballard*, 25 C.B.C.2d 823, 131 B.R. 97 (Bankr. D. Wis. 1991) (United States contended 11 U.S.C. § 106(c) did not waive sovereign immunity in a preference action against state governments and could not therefore result in a waiver against the United States).

(n3)Footnote 3. *United States v. Nordic Village, Inc.*, 503 U.S. 30, 112 S. Ct. 1011, 117 L. Ed. 2d 181, 26 C.B.C.2d 9 (1992) .

(n4)Footnote 4. Pub. L. No. 103-394.

(n5)Footnote 4a. With respect to a state, sovereign immunity is a valid defense. See *Seminole Tribe of Florida v. Florida*, 517 U.S. 44, 116 S. Ct. 1114, 134 L. Ed. 2d 252, 34 C.B.C.2d 1199 (1996) .

(n6)Footnote 5. See, e.g., *In re Ballard*, 25 C.B.C.2d 823, 131 B.R. 97 (Bankr. D. Wisc. 1991) (the Supreme Court's decision in *Hoffman v. Connecticut Department of Income Maintenance*, 492 U.S. 96, 109 S. Ct. 2818, 106 L. Ed. 2d 76, 20 C.B.C.2d 1204 [1989] did not prevent the assertion of a section 547 preference action against the IRS); *In re Bryant* 23 C.B.C.2d 337, 116 B.R. 272 (Bankr. D. Kan. 1990) ; *In re Simmons*, 110 B.R. 72 (Bankr. M.D. Fla. 1990) ; *In re Price*, 103 B.R. 989 (Bankr. N.D. Ill. 1989) , *aff'd*, 130 B.R. 259 (N.D. Ill. 1991) .

(n7)Footnote 6. See, e.g., *In re Malmart Mortgage Co. Inc.*, 109 B.R. 1 (Bankr. Mass. 1989) (IRS's filing of a proof of claim resulted in the waiver of the defense of sovereign immunity).

(n8)Footnote 7-13. [Reserved]

(n9)Footnote 14. *United States v. Pullman Construction Industries, Inc.*, 153 B.R. 539 (N.D. Ill. 1993) , *appeal dismissed*, 26 F.3d 1166 (7th Cir. 1994) ; *White v. Shalala (In re Pace Enterprises)*, 171 B.R. 444 (Bankr. D. Colo. 1994) .

(n10)Footnote 15. *United States v. Pullman Construction Industries, Inc.*, 153 B.R. 539, 541 (N.D. Ill. 1993) . See also *In re Pinkstaff*, 974 F.2d 113 (9th Cir. 1992) , *995 Fifth Avenue Assoc., L.P. v. New York State Dept. of Taxation and Finance*, 963 F.2d 503, 26 C.B.C.2d 1162 (2d Cir. 1992) , and *WJM, Inc. v. Mass. Dep't of Public Welfare*, 840 F.2d 996 (1st Cir. 1988) , each of which held that the determination of the existence of a compulsory counterclaim for section 106(a) purposes was made by reference to Rule 13(a) of the Federal Rules of Civil Procedure.

(n11)Footnote 16. The claims of governmental units were found to be logically related to trustees' suits for the return of preferences in: *In re Parker North American Corp.*, 24 F.3d 1145 (9th Cir. 1994) ; *WJM, Inc., v. Mass. Dep't of Public Welfare*, 840 F.2d 996, 1003-1004 (1st Cir. 1988) ; *U.S. v. Pullman Construction Industries, Inc.*, 153 B.R. 539 (N.D. Ill.1993) ; *In re McLean Industries, Inc.*, 162 B.R. 410 (S.D.N.Y. 1993) ; *In re Motivation Resources, Inc.*, 158 B.R. 184 (Bankr. C.D. Cal. 1993) ; *In re Malmart Mortgage Co., Inc.*, 109 B.R. 1 (Bankr. D. Mass. 1989) ; *In re*

Maytag Sales and Service, Inc., 23 B.R. 384 (Bankr. N.D. Ga. 1982) ; *In re Davis*, 20 B.R. 519 (Bankr. M.D. Ga. 1982) ; *contra*, *In re Rebel Coal Company, Inc.*, 944 F.2d 320 (6th Cir. 1991) .

(n12)Footnote 17. *United States v. Pullman Construction Industries, Inc.*, 153 B.R. 539, 543 (N.D. Ill. 1993) .

(n13)Footnote 18. *See In re Ballard*, 25 C.B.C.2d 823, 131 B.R. 97 (Bankr. D. Wis. 1991) .

(n14)Footnote 19. *In re Ballard*, 25 C.B.C.2d 823, 131 B.R. 97, 99 (Bankr. D. Wis. 1991) .

(n15)Footnote 20. There is a one year look-back period for transfers to insiders, but that provision will generally not be applicable to the United States.

(n16)Footnote 21. *See, e.g., In re Scherbenske Excavating, Inc.*, 38 B.R. 84, 87 (Bankr. D.N.D. 1984) (even though the IRS had a properly recorded tax lien, it was still subject to the limitations of 11 U.S.C. § 547; the court refused to allow the payment of monies to the IRS on its lien because that payment could result in a preference to the IRS to the detriment of creditors entitled to priority over the tax lien under 11 U.S.C. § 724(b)); *In re K&L Interiors, Inc.*, 34 B.R. 118 (Bankr. D. Or. 1982) (a levy under I.R.C. § 6331 does not rise to the level of a tax lien under I.R.C. § 6321; IRS levy therefore collected monies on an otherwise unsecured claim which could be recovered in a preference action).

(n17)Footnote 22. 11 U.S.C. § 547(b)(2).

(n18)Footnote 23. 11 U.S.C. § 547(a)(4). *See, e.g., In re Greasy Creek Coal Company*, 84-2 U.S. Tax Cas. (C.C.H.) P 9651 (Bankr. S.D. W. Va. 1984).

(n19)Footnote 24. *See, e.g., In re Wieser*, 86 B.R. 157 (Bankr. W.D. Ark. 1988) (payment of estimated tax payments to the IRS not a preferential payment). If, however, a taxpayer sends an estimated tax payment to the IRS with no corresponding designation to the IRS directing how that payment must be applied, the IRS will be able to apply that payment in the manner most beneficial to itself. An estimated tax payment might therefore be applied to a delinquent tax liability and thereby qualify as a transfer applied to an antecedent debt for 11 U.S.C. § 547 purposes.

(n20)Footnote 25. *In re Nielsen*, 143 B.R. 93 (Bankr. N.D. Tex. 1992) .

(n21)Footnote 26. *See, e.g., I.R.C. § 6331*, regarding the IRS's ability to levy and seize assets.

(n22)Footnote 27. *See, e.g., In re Ballard*, 25 C.B.C.2d 823, 131 B.R. 97 (Bankr. Wis. 1991) ; *In re Tabita*, 10 C.B.C.2d 736, 38 B.R. 511 (Bankr. E.D. Pa. 1984) .

(n23)Footnote 28. *See cases cited in the cases of In re Deardorff*, 195 B.R. 904 (Bankr. W.D. Wis. 1996) ; *In re Tabita*, 10 C.B.C.2d 736, 739-40, 38 B.R. 511 (Bankr. E.D. Pa. 1984) . *See also* 11 U.S.C. § 547(e)(3) which provides that a "transfer is not made until the debtor has acquired rights in the property transferred." *Compare, Grain Merchants of Indiana, Inc. v. Union Bank and Savings Co.*, 408 F.2d 209 (7th Cir. 1969) , *cert. denied*, 396 U.S. 827, 90 S. Ct. 75, 24 L. Ed. 2d 78 (1969) . In *Grain Merchants* the creditor contended, and the court agreed, that the transfer under the Bankruptcy Act occurred when the security agreement was executed and not when the assets were transferred. 11 U.S.C. § 547(e)(3) was added to the Bankruptcy Code to expressly overrule precedent such as *Grain Merchants*. *In re Tabita*, 10 C.B.C.2d 736, 38 B.R. 511, 513-14 (Bankr. E.D. Pa. 1984) .

(n24)Footnote 29. This was the conclusion made by the court in the case of *In re Tabita*, 10 C.B.C.2d 736, 38 B.R. 511 (Bankr. E.D. Pa. 1984) . The wages were not owned until they were earned, the wages were earned within the 90 day period, and the transfer therefore took place within the 90 day period for 11 U.S.C. § 547 purposes.

(n25)Footnote 30. *See the cases cited in the case of In re Tabita*, 10 C.B.C.2d 736, 739-40, 38 B.R. 511 (Bankr. E.D. Pa. 1984) . This is the argument the IRS will probably also adopt. The IRS's authority for its position in the case of *In re Tabita* was *In re Riddervold*, 647 F.2d 342, 4 C.B.C.2d 517 (2d Cir. 1981) , in which the court concluded that

under state law the debtor had no property or interest in property subject to the levy.

(n26)Footnote 31. *In re Tabita*, 10 C.B.C.2d 736, 38 B.R. 511 (Bankr. E.D. Pa. 1984) . The court concluded "the wages paid over to the IRS by the debtor's employer within the 90-day period preceding the debtor's filing are avoidable pursuant to Section 547(b) of the Code."

(n27)Footnote 32. See the discussion of the effect of an IRS levy on general and intangible assets in P TX5.07[3] *supra* .

(n28)Footnote 33. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 103 S. Ct. 2309, 76 L. Ed. 2d 515, 8 C.B.C.2d 710 (1983) .

(n29)Footnote 34. See the discussion of the effect of an IRS levy on cash and cash equivalents in turnover actions in P TX5.07[3] *supra* . The IRS will argue the levy is effective when issued and complied with because the levy extinguishes all of the debtor's ownership interest in cash or cash equivalents as no further steps are required to transfer ownership of those assets after possession has been perfected. The debtor will have to extend the authorities noted in P 5.07[3] to claim that the levy was not effective until a later date falling within the 90 day prepetition period. Note that the 90-day period is not extended when the ninetieth day falls on a weekend or holiday. *In re Greene*, 223 F.3d 1064 (9th Cir. 2000) .

(n30)Footnote 35. See, e.g., *In re Dunne Trucking Co.*, 9 C.B.C.2d 464, 32 B.R. 182 (Bankr. N.D. Iowa 1983) , in which the court held that the levy on cash was not effective until actually paid to the IRS; until the date of payment, the debtor still retained an ownership interest in the cash.

(n31)Footnote 36. See, e.g., *In re Garland, Inc.*, 39 B.R. 412 (Bankr. E.D. Mo. 1984) (debt payable to the IRS arose on the date the Notice of Levy was served, and the transfers required for 11 U.S.C. § 547 made on the date checks in satisfaction of the levy were paid to the IRS).

(n32)Footnote 37. See *In re Ballard*, 25 C.B.C.2d 823, 131 B.R. 97, 102-3 (Bankr. Wis. 1991) , and the cases cited therein which hold the issuance of an IRS levy on the wages of a taxpayer is a transfer of an interest in property of the debtor.

(n33)Footnote 38. See, e.g., *In re R&T Roofing Structures & Commercial Framing, Inc.*, 887 F.2d 981 (9th Cir. 1989) (the IRS failed to establish that monies were held in trust and that therefore the transfer of funds to the IRS was of funds held in trust and not owned by the debtor); *Drabkin v. District of Columbia*, 824 F.2d 1102, 17 C.B.C.2d 945 (D.C. Cir. 1987) (the IRS can assert that the funds used or seized to pay the taxes were held in trust if the prepetition payments or seizures pursuant to levy occurred more than 45 days after the due date of the tax payment); *In re Malmart Mortgage Co., Inc.*, 109 B.R. 1 (Bankr. D. Mass. 1989) (inability of the IRS to trace funds paid to the IRS to withheld trust fund monies allowed the debtor to recover payments); *In re Rodriguez*, 13 C.B.C.2d 395, 50 B.R. 576 (Bankr. E.D.N.Y. 1985) ; *In re Razorback Ready-Mix Concrete Co.*, 12 C.B.C.2d 221, 45 B.R. 917 (Bankr. E.D. Ark. 1984) (prepetition payments to the IRS of withheld income taxes and FICA premiums were not transfers of property of the debtor as these monies were held in trust for the IRS by the debtor); *In re Wellington Foods, Inc.*, 165 B.R. 719 (Bankr. S.D. Ga. 1994) (a debtor's voluntary prepetition payment of trust fund taxes from its general operating account within 90 days of the filing of its title 11 petition provided a sufficient nexus and the funds were actually remitted to the IRS).

(n34)Footnote 39. *Beigie v. Internal Revenue Service*, 496 U.S. 53, 110 S. Ct. 2258, 110 L. Ed. 2d 46, 22 C.B.C.2d 1080 (1990) .

(n35)Footnote 40. *Beigie v. Internal Revenue Service*, 496 U.S. 53, 110 S. Ct. 2258, 2263, 110 L. Ed. 2d 46, 59, 22 C.B.C.2d 1080, 1085 (1990) .

(n36)Footnote 41. I.R.C. § 7501.

(n37)Footnote 42. *Begier v. Internal Revenue Service*, 496 U.S. 53, 110 S. Ct. 2258, 2264, 110 L. Ed. 2d 46, 22 C.B.C.2d 1080 (1990) . *In re Megafoods Stores, Inc.*, 210 B.R. 351 (B.A.P. 9th Cir. 1997) (sales taxes were held in trust for the state so their remittance to the state was not a preferential transfer based on the *Begier* decision); *In re Al Copeland Enterprises, Inc.*, 133 B.R. 837, 839-840 (Bankr. W.D.Tex. 1991) , *aff'd*, 991 F.2d 233 (5th Cir. 1993) (same result); *U.S. v. Pullman Constr. Industries, Inc.* 210 B.R. 302 (N.D. Ill. 1997) (the Government established that \$460,946.19 of the "disputed payments" represented income and social security taxes *Pullman* withheld from gross wages. The court concluded that under *Begier*, those payments were held "in trust" for the Government and *Pullman* did not have an identifiable interest in those funds); *In re Nash Concrete Form Co., Inc.*, 159 B.R. 611 (D. Mass. 1993) (Massachusetts withholding taxes were trust funds and not preference payments per *Begier*); *Hoffman v. United States IRS (In re Jones & Lamson Waterbury Farrell Corp.)*, 208 B.R. 788 (Bankr. D. Conn. 1997) (employees' withheld taxes that an employer holds in trust for the government are not property of an employer-debtor's bankruptcy estate, and, consequently, any voluntary prepetition payment of trust-fund taxes out of the debtor's assets is not a transfer of the debtor's property); *In re Vacuum Corp.*, 215 B.R. 277 (Bankr. N.D. Ga. 1997) (monies advanced by lender to debtor to make payroll tax deposits were not impressed with trust fund character so any corresponding refund was not subject to trust of any kind); *In re Wellington Foods, Inc.*, 165 B.R. 719 (Bankr. S.D. Ga. 1994) ; *In re Lakeside Community Hospital*, 191 B.R. 122 (Bankr. N.D. Ill. 1996) ; *In re Pullman Constr. Industries, Inc.*, 190 B.R. 618 (Bankr. N.D. Ill. 1996) ; *compare, however, Department of Revenue v. Steege (In re Markos Gurnee Partnership)*, 163 B.R. 124 (Bankr. N.D. Ill. 1993) (funds collected by chapter 11 trustee pursuant to Illinois Hotel Operators' Occupation Tax Act and Illinois Use Tax Act were not funds held in trust for state, but rather were funds held by trustee as debt to state).

(n38)Footnote 43. The basis for the tracing requirement was found in a prior Supreme Court opinion, since superseded by statute, *United States v. Randall*, 401 U.S. 513, 91 S. Ct. 991, 28 L. Ed. 2d 273 (1971) , an opinion issued while the Bankruptcy Act was in effect. In that case, the Court refused to impose a trust for the benefit of the IRS when the result of that trust would be to "eat up an estate" leaving little for the subordinate creditors.

(n39)Footnote 44. The holding in *United States v. Randall*, 401 U.S. 513, 91 S. Ct. 991, 28 L. Ed. 2d 273 (1971) , was reversed by the Bankruptcy Code in 11 U.S.C. § 541 by the statement that trust fund taxes withheld prepetition were not property of the estate. *Begier v. Internal Revenue Service*, 496 U.S. 53, 110 S. Ct. 2258, 2265-6, 110 L. Ed. 2d 46, 22 C.B.C.2d 1080 (1990) .

(n40)Footnote 44a. *See, e.g., In re Sunrise Paving, Inc.*, 204 B.R. 691 (Bankr. D. Md. 1996) (although a trust was created in favor of IRS for withholding taxes when debtor paid its employees, there was inadequate evidence that debtor's issuing check to IRS for withholding taxes established res for trust).

(n41)Footnote 45. *Compare, however, Taylor v. Massachusetts Dep't of Revenue*, 151 B.R. 632 (Bankr. D. Mass. 1993) . In *Nash*, the court held that under Massachusetts law, state payroll taxes were not trust fund taxes, and that the amounts levied by the state must be returned to the debtor. The court reviewed the language of the applicable state statute and concluded that no trust fund tax amounts existed absent an actual withholding thereof by the debtor. Because no withholding took place, there was no trust fund, and the levied monies were assets owned by the debtor. The court distinguished the Supreme Court's opinion in *Begier v. Internal Revenue Service*, 496 U.S. 53, 110 S. Ct. 2258, 2264, 110 L. Ed. 2d 46, 22 C.B.C.2d 1080 (1990) , because the federal statute, *Internal Revenue Code Section 6672*, imposed a trust on the amount of the withheld tax and did not require the segregation of the actual funds.

(n42)Footnote 46. Falk, *Voluntary Prepetition Payments of Trust Fund Taxes Are Not Preferences*, 2 F&G Bank. L. Rev. 13, 19 (1991). When, prior to a title 11 petition being filed, the IRS received a check for \$368,938.31 along with a return for that amount in employment taxes, the "simultaneity" of the transfer satisfied the *Begier* requirements, and the transfer could not be set aside as a preferential one. *Stevenson v. Internal Revenue Service (In re Diamond Dismantling, Inc.)*, 305 B.R. 453 (Bankr. E.D. Mich. 2003) .

(n43)Footnote 47. Falk, *Voluntary Prepetition Payments of Trust Fund Taxes Are Not Preferences*, 2 F&G Bank. L. Rev. 13, 19 (1991).

(n44)Footnote 48. See, e.g., *In re Miller's Auto Supplies, Inc.*, 93 B.R. 344 (Bankr. E.D. Pa., 1988) (debtor obtained loan and used those monies to pay its delinquent tax liabilities; the fact the debtor had an obligation to remit trust fund tax liabilities to the IRS did not mean the funds used to pay those liabilities would per se be trust fund monies in which the debtor had no ownership interest).

(n45)Footnote 49. 11 U.S.C. § 547(b)(5). In determining whether the IRS received more than it would have in a hypothetical chapter 7 liquidation, the bankruptcy court must include the fees and expenses incurred by the trustee and give them priority as administrative claims. *Dakmak v. United States (In re Lutz)*, 241 B.R. 172 (E.D. Mich. 1998), *reh. den.*, 241 B.R. 179 (E.D. Mich. 1999).

(n46)Footnote 50. See, e.g., *In re Kohout*, 236 B.R. 365 (Bankr. N.D. Oh. 1999) (when the IRS has a validly recorded notice of federal tax lien, there is no preferential transfer as a result of collection of a tax claim through a levy on IRA accounts and wages; this is true even if the IRS collects more than it might in a chapter 7 liquidation as it is collecting on assets subject to its Notice of Federal Tax Lien); *In re PDQ Copy Center, Inc.*, 7 C.B.C.2d 1090, 26 B.R. 77 (Bankr. S.D.N.Y. 1982) (if the IRS holds a fully secured claim pursuant to a valid tax lien, no voidable preference results upon payment to the IRS because the IRS did not receive any more than it would receive in liquidation in a chapter 7 case); *In re Community Hospital of Rockland County*, 5 C.B.C.2d 895, 15 B.R. 785 (Bankr. S.D.N.Y. 1981); *In re Hale*, 5 C.B.C.2d 759, 15 B.R. 565 (Bankr. S.D. Ohio 1981); *In re Castillo*, 3 C.B.C.2d 351, 7 B.R. 135 (Bankr. S.D.N.Y. 1980).

(n47)Footnote 51. For instance, a prepetition wage levy to collect a dischargeable, nonpriority tax liability may enable the IRS to recover more on its tax claim than it would in a chapter 7 case. This is true because the nonpriority tax claim would share *pro rata* with other general unsecured claims in distributions from the bankruptcy estate. The prepetition wage levy in such circumstances could therefore be considered a preference. See *In re Williams*, 153 B.R. 74 (Bankr. S.D. Ala. 1992), *aff'd*, 156 B.R. 77 (S.D. Ala. 1993). On the other hand, if the tax liability in question is a priority, nondischargeable tax liability, the IRS may not receive a preference payment because of its priority claimholder status.

(n48)Footnote 52. See *In re Williams*, 153 B.R. 74 (Bankr. S.D. Ala. 1992), *aff'd*, 156 B.R. 77 (S.D. Ala. 1993) (the debtor had standing to recover only the amount of wages claimed as exempt).

(n49)Footnote 53. The Notice of Federal Tax Lien authorized by I.R.C. § 6321 is not avoidable under 11 U.S.C. § 545, so the recording of a Notice of Federal Tax Lien is not a preferential transfer. See *In re Braxton*, 224 B.R. 564, 569 (Bankr. W.D. Pa. 1998) (a lien filed by the Pennsylvania Bureau of Unemployment Compensation Benefits and Allowances is a statutory lien that was not avoidable as a preferential transfer); *In re Totten*, 82 B.R. 402 (Bankr. W.D. Pa. 1988); *In re Carolina Resort Motels, Inc.*, 51 B.R. 447 (Bankr. D.S.C. 1985); *In re Garland, Inc.*, 39 B.R. 412, 415 (Bankr. E.D. Mo. 1984); *In re Barry*, 31 B.R. 683 (Bankr. S.D. Ohio 1983). The filing of amended notices of federal tax liens after a case under title 11 was filed was not avoidable since the amended notices did not change the debtor's position with respect to creditors or improve the IRS's position. In the Matter of Hansen, 72 A.F.T.R.2d 93-5001 (W.D. Tex. 1993). A chapter 7 trustee was unsuccessful in his attempt to use section 545(2) to avoid a federal tax lien because 26 U.S.C. § 6323(b) imposed a requirement that the trustee qualify not merely as a purchaser for value, but rather for "full and adequate consideration." *United States v. Hunter (In re Walter)*, 45 F.3d 1023 (6th Cir. 1995). See also *Battley v. United States (In re Berg)*, 121 F.3d 535 (9th Cir. 1997); *In re Linn*, 212 B.R. 171 (Bankr. S.D. Fla. 1997) (following *Walter*); *In re Mulligan*, 234 B.R. 229 (Bankr. D.N.H. 1999). One court of appeals has held that a debtor may not use section 545 to avoid a tax lien because only a trustee may bring actions under that section. *Stangel v. United States (In re Stangel)*, 219 F.3d 498 (5th Cir. 2000).

(n50)Footnote 54. 11 U.S.C. § 724(a) allows the trustee or the debtor in possession to avoid a lien which is based upon a noncompensatory, prepetition penalty. 11 U.S.C. § 726(a)(4) subordinates the payment of noncompensatory, prepetition penalties to other claims. See, e.g., *In re Barry*, 31 B.R. 683 (Bankr. S.D. Ohio 1983); see, however, *In re Rogers Refrigeration, Inc.*, 9 C.B.C.2d 505, 33 B.R. 59 (Bankr. D. Or. 1983) (IRS's sale of seized assets terminated all

of the debtor's interest in those assets; sale proceeds were applied to the tax lien; prepetition turning over of the collateral of a loan to the lender not a preferential transfer; trustee could not recover the proceeds of the sale for redistribution under sections 724 and 726 because the tax lien had been satisfied before the petition date); *In re Debmar Corp.*, 6 C.B.C.2d 1290, 21 B.R. 858 (Bankr. S.D. Fla. 1982) (court concluded that the invalidation of a fixed tax lien in order to follow the priorities of 11 U.S.C. § 724(b) was not what Congress intended even though a literal reading of the Bankruptcy Code confirmed the result suggested in *Barry*).

(n51)Footnote 55. *Fandre v. Internal Revenue Service Fandre v. District Director, IRS (In re Fandre)*, 167 B.R. 837 (Bankr. E.D. Tex. 1994) . After considering a Chapter 11 trustee's "beguiling" arguments that the term "fixing" was ambiguous and should be construed against the government, a bankruptcy court held section 547(c) (6) prevented the avoidance of an IRS claim secured by a prepetition lien. *Spicer v. United States (In re Motion Marketing Solutions, Inc.)*, 403 B.R. 403 (Bankr. N.D. Tex. 2009) .

(n52)Footnote 55a. In 2005, Section 547(c)(2) was amended by substituting the disjunctive "or" for the conjunctive "and," thereby making it possible to establish an ordinary course of business defense by proving that the payment was made *either* in the ordinary course of both the debtor's and the creditor's businesses *or* according to ordinary business terms.

(n53)Footnote 56. H.R. Rep. No. 595, 95th Cong., 1st Sess. 373 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 989, 95th Cong., 2d Sess. 88 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised).

When a debtor has established a pattern of habitually making late payments, it can be argued that payments made within the range of these late payments are ones within the ordinary course of business. *In re Air South Airlines, Inc.* 247 B.R. 153 (Bankr. D.S.C. 2000) .

(n54)Footnote 57. *See, e.g., In re Garland, Inc.*, 39 B.R. 412, 416-17 (Bankr. E.D. Mo. 1984) . In this case, the debtor leased space to another taxpayer who remitted all of its sale proceeds to the debtor for accounting. At month's end, the debtor would distribute to the tenant the net profits of the tenant's operation after the debtor retained rent and other allowed expenses. The IRS served the debtor with a Notice of Levy to collect unpaid tax liabilities of the tenant.

(n55)Footnote 58. *In re Garland, Inc.*, 39 B.R. 412, 416-17 (Bankr. E.D. Mo. 1984) . The nexus of the ordinary course of the debtor's business to the levy served on the tenant was the landlord-tenant relationship. From this business relationship, the court concluded the debt arising from the service of the levy [the obligation to respond to the levy] on the income of the tenant was a part of the ordinary course of the landlord's business.

(n56)Footnote 59. *See, e.g., In re Cleveland Graphic Reproduction, Inc.*, 78 B.R. 819 (Bankr. N.D. Ohio 1987) . To the extent the court looks to the prior course of conduct of the debtor's business affairs to determine if the nature of any particular transaction was in the normal course of that business, the fact the debtor had never (or alternatively had frequently) paid its taxes via an administrative levy would be relevant to determine if the defense in 11 U.S.C. § 547(c)(2) was applicable.

(n57)Footnote 60. *See, e.g., In re Fulghum Construction Corp.*, 872 F.2d 739 (6th Cir. 1989) ; *In re Wieser*, 86 B.R. 157 (Bankr. W.D. Ark. 1988) ; *In re Morris*, 53 B.R. 190 (Bankr. D. Or. 1985) (payment of payroll taxes within 45 days of accrual of liability). A trustee's assertion that a prepetition estimated tax payment constituted an avoidable preference was rejected. *In re Middendorf*, 381 B.R. 774 (Bankr. D. Kan. 2008) .

One court has held that payments of back taxes, interest, and accrued interest made pursuant to a modified installment agreement with the IRS in settlement of its claims were not made in the ordinary course of business and were not a contemporaneous exchange for new value. *Official Plan Committee v. United States (In re Valley Steel Products Company, Inc.)*, 214 B.R. 202 (E.D. Mo. 1997) . Whether decisions like this one make it less likely that the IRS would

be willing to enter into settlements via installment agreements remains to be seen.



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Collier on Bankruptcy Taxation

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CHAPTER TX5 Litigation With the IRS in Bankruptcy Court

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P TX5.10 Abstention

Most disputes regarding the federal tax liability of the debtor or the bankruptcy estate will be core proceedings. n1 In spite of the status of a tax dispute as a core proceeding, there will be occasions when a bankruptcy court will defer its adjudication to another court. Since resolving objections to creditors' claims is inherently a function of the bankruptcy courts, the instances in which they have declined to exercise jurisdiction over tax disputes have occurred more frequently in the context of requests to determine tax liability made pursuant to section 505. n2 This distinction appears to be artificial because the issue to be decided is usually the same regardless of whether it arises in a claims objection or a section 505 proceeding. Notwithstanding the identity of the issue, most of the reported decisions which address the deferral of adjudication of tax liability to another court involve section 505. n3

In one of these cases, taxpayers in cases under title 11 were related to certain nondebtor taxpayers. Prior to the filing of the petitions under title 11, all of the taxpayers had instituted redetermination proceedings in the Tax Court that raised the same issues for the same taxable years. Concern that the various parties would assert different positions in the two courts led the bankruptcy court to modify the automatic stay over the opposition of the debtor taxpayers and permit a single trial before the Tax Court. n4 Another bankruptcy court concluded that it would refer adjudication of a debtor's tax dispute to the Tax Court because such action would promote judicial economy and would not prejudice the course of the bankruptcy case. n5

Frequently, concern for the impact of the resolution of a disputed tax liability upon the administration of the case under title 11 will be crucial to a bankruptcy court's decision to retain jurisdiction. n6 A variety of factors may be considered when a bankruptcy court is asked to determine a tax liability. These factors include the complexity of the tax issues to be decided, the need to administer the case under title 11 in an efficient manner, the burden on the bankruptcy court's docket, the length of time required for trial and decision, the asset and liability structure of the debtor, and the prejudice to the debtor and to the taxing authority. n7 For example, when a dispute between a debtor and the Service arose in a "no asset" case, *i.e.*, one in which there would be no assets in the bankruptcy estate to pay any tax claim which the debtor was held to owe, a bankruptcy court decided that the adjudication of a motion to determine tax liability would be pointless since other courts were available to resolve the dispute. n8

In another situation, a taxpayer filed a petition seeking a redetermination of its tax liability by the Tax Court. After four continuances, the taxpayer filed a petition under title 11 less than two weeks before the trial date in the Tax Court. Shortly thereafter, the taxpayer asked the bankruptcy court to determine its tax liability. The government responded

with a motion to modify the automatic stay and continue the Tax Court litigation. The taxpayer argued that the Tax Court had ruled against its attempt to raise new issues it intended to assert in the bankruptcy court. The bankruptcy court's rejection of this contention and order granting the government's motion were affirmed by the district court. n9

A similar situation may occur when a party to a suit by the government seeking the collection of unpaid taxes, perhaps including foreclosure of a federal tax lien, waits until the eve of trial in district court or even just before foreclosure to file a bankruptcy petition. When such a filing is used in this manner, the government may respond with a motion to withdraw the reference instead of a motion to modify the automatic stay. In abusive cases, district courts have been willing to withdraw the reference so that collection activities may proceed. n9a

In many cases the decision on whether to litigate a tax dispute in the bankruptcy court or transfer it to another court involves sending the case to the Tax Court because the proceeding would constitute a redetermination proceeding. If the tax had been assessed but not paid, then Tax Court jurisdiction would not be available, and because of the full payment rule imposed on refund suits, n10 the only court which could hear the case would be the bankruptcy court. Refund suits could, of course, be transferred to a district court or the Court of Federal Claims.

When considering whether to retain jurisdiction of a tax dispute, a bankruptcy court is frequently urged to do so because of the asserted need for a prompt decision which supposedly could not be obtained in another court. Without debating the merits of such a contention, this position ignores the fact that any decision by the bankruptcy court will be appealable to the district court or a bankruptcy appellate panel. n11 Accordingly, consideration should be given to whether reaching the first decision at an earlier point in the bankruptcy court or reaching a final decision at an earlier point by beginning in another court is of paramount importance. If it is a final decision on the tax dispute which is needed, the extra time required for an appeal through the district court should be compared to the direct appeal to the court of appeals available in any other forum in which federal tax disputes may be litigated.

The issue of whose tax liability may be determined by a bankruptcy court has been considered elsewhere in this chapter. n12 With respect to the question of abstention, however, it should be noted that one court of appeals has held that determination of a tax liability of a nondebtor party who owned the debtor accounting firm was not sufficiently "related to" the case under title 11 and that the bankruptcy court lacked jurisdiction to entertain the proceeding. n13 Accordingly, to the extent that a bankruptcy court concludes that the tax liability it is asked to resolve is not sufficiently related to the case under title 11, another possible basis for its declining to exercise jurisdiction over a tax dispute may be encountered.

FOOTNOTES:

(n1)Footnote 1. 28 U.S.C. § 157(b). For a discussion of whether refund suits fall within the definition of "core proceedings," see *In re Cook*, 230 B.R. 475, 476-477 (Bankr. D. Conn. 1999) (the court refused to abstain from determining the liability and dischargeability of a tax claim); *In re Murray Industries, Inc.*, 106 B.R. 284 (Bankr. M.D. Fla. 1989).

(n2)Footnote 2. The language of 11 U.S.C. § 505 itself provides that a bankruptcy court "may" determine tax liabilities. This jurisdiction has been held to be discretionary, not mandatory. *Queen v. United States*, 148 B.R. 256 (D. W. Va. 1992). See *Zack v. United States*, 224 B.R. 601, 606 (E.D. Mich. 1998) (the debtor originally filed a Tax Court petition and thereafter filed a title 11 petition; the debtor asked the bankruptcy court to determine the correct amount of his tax liability; the court properly abstained from determining the amount of the debtor's tax liability under the permissive abstention doctrine of 28 U.S.C. § 1334(c); *In re Mounier*, 232 B.R. 186, 194 (Bankr. S.D. Ca. 1998) (it was proper for the court to abstain from the determination of the tax liability of the debtor where such determination would have no impact on the debtor's no asset chapter 7 case; 11 U.S.C. § 505 states that the court "may" determine a tax claim and the use of the word may makes the determination subject to the discretion of the court; this case was closed and the

debtors received their discharge so there was no necessity to administration of the estate for the court to determine the amount of the tax claim); see P TX5.04[1] *supra*. But see *United States v. Sterling Consulting Corp. (In re Indian Motorcycle Co., Inc.)* 46 C.B.C.2d 588, 261 B.R. 800 (B.A.P. 1st Cir. 2001) (a bankruptcy court erred when it abstained from adjudication of a tax liability in favor of a district court in another district where a related receivership was pending; the bankruptcy court had exclusive jurisdiction to determine the debtor's tax liability).

(n3)Footnote 3. Note, however, that the provisions of 28 U.S.C. § 157(d) authorizing a district court to withdraw the reference to a bankruptcy court, in whole or in part, of any case or proceeding referred to it would appear to apply to any tax dispute regardless of the jurisdictional vehicle used to raise it. *Federal Rule of Bankruptcy Procedure 5011* addresses the effect of the filing of a motion for withdrawal or abstention. After first deciding that the IRS had properly moved to withdraw the reference, a district court held that the issue of whether interest payments with respect to life insurance policies could be deducted by a corporation was not a routine question of well-settled tax law. A split between courts of appeals was noted. The court held that withdrawal of the reference was mandatory when (1) consideration of federal law outside of title 11 was necessary and (2) the consideration of such law was substantial and material. *Internal Revenue Service v. CM Holdings, Inc. (In re CM Holdings, Inc.)*, 221 B.R. 715 (D. Del. 1998). Both *CM Holdings* and an earlier case involving withdrawal of the reference in a tax dispute, *In re Oil Co. Inc.*, 140 B.R. 30 (E.D.N.Y. 1992), were analyzed by another district court that withdrew the reference. *In re G-I Holdings, Inc.*, 295 B.R. 222 (D.N.J. 2003). After a district court determined a complex tax shelter issue that led it to withdraw the reference was not reviewable since no partner had made a timely challenge to the adjustments by the IRS, it sent the remaining "well-settled" issues back to the bankruptcy court for disposition. *In re Central Valley AG Enterprises v. United States*, 326 B.R. 807 (E.D. Cal. 2005). A motion to withdraw the reference was denied as untimely since the IRS could have filed it at the beginning of the adversary proceeding. *Scharffenberger v. United States (In re Allegheny Health Education and Research Foundation)*, 98 A.F.T.R.2d 8304 (W.D. Pa. 2006).

(n4)Footnote 4. *In re Hunt*, 20 C.B.C.2d 870, 95 B.R. 442 (Bankr. N.D. Tex. 1989). Actually, a variety of factors concerning whether to transfer adjudication of the debtors' tax liabilities to the Tax Court were discussed, but the bankruptcy court predicated its decision primarily upon the potential for a "whipsaw" of the government from inconsistent positions by the closely related taxpayers. The legislative history of section 505 contains the following remark: As under current Bankruptcy Act § 2a(2A), *Arkansas Corporation Commission v. Thompson*, 313 U.S. 132 (1941) [61 S. Ct. 888, 85 L. Ed. 1244], remains good law to permit abstention where uniformity of assessment is of significant importance. Notes of Committee on the Judiciary, S. Rep. No. 989, 95th Cong., 2d Sess. 67 (1978), reprinted in Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised). Although the Supreme Court's decision was based upon a number of grounds, the Congressional concern about uniformity of assessment when section 505 was enacted is noteworthy. See also *In re Smith*, 122 B.R. 130 (Bankr. M.D. Fla. 1990), distinguishing *Hunt* on the possibility of a "whipsaw" effect.

(n5)Footnote 5. *In re Huddleston*, 107 B.R. 102 (Bankr. E.D. La. 1989). See also, *Williams v. United States*, 209 B.R. 584 (Bankr. D.R.I. 1997), appeal denied, 156 F.3d 86 (1st Cir. 1998), cert. denied, 525 U.S. 1123 (1999).

(n6)Footnote 6. *In re Witte*, 19 C.B.C.2d 1339, 92 B.R. 218 (Bankr. W.D. Mich. 1988). Another bankruptcy court decided that it would rule upon the tax liability of funds deposited pursuant to a plan of reorganization because the funds were part of the bankruptcy estate and jurisdiction to determine tax liability was vested in it. *In re Goldblatt Bros.*, 21 C.B.C.2d 1294, 106 B.R. 522 (Bankr. N.D. Ill. 1989). A bankruptcy court refused to determine the tax liability of a bankrupt corporation upon the motion of a nonbankrupt corporate officer who was potentially liable for the same taxes in his individual capacity because such a determination did not serve the interests of either debtor or the creditors. *In re American Motor Club, Inc.*, 139 B.R. 578 (Bankr. E.D.N.Y. 1991). A bankruptcy court abstained where the tax liability arose after the title 11 case was filed and after its conversion to chapter 7, since it could not be asserted against the bankruptcy estate. *In re McGuirl*, 2002-1 U.S. Tax. Cases (CCH) P 50276 (Bankr. D.D.C. 2001).

(n7)Footnote 7. *In re Stevens*, 210 B.R. 200 (Bankr. M.D. Fla. 1997) (section 505 was created to allow bankruptcy courts to rapidly determine tax issues necessary to estate administration; thus in a no-asset case, there is no purpose

served by the provisions of section 505 and the court must weigh the interests of the parties to determine if it is appropriate to hear the dispute); *In re Beisel*, 195 B.R. 378 (Bankr. S.D. Ohio 1996) (the issue of employee versus independent contractor status is fact intensive and would require the court to apply detailed treasury regulations and interpret revenue rulings that could produce inconsistent results detrimental to other taxpayers and the IRS; those considerations combined with the fact this was a no-asset chapter 7 case justified abstention); *In re Williams*, 190 B.R. 225 (Bankr. W.D. Pa. 1995) (even though the debtor's only other legal venue to contest the tax claims was with the district court via a refund suit which required full payment of the claim first, the court abstained because this was a no asset case, the intended beneficiaries of a tax determination under section 505 [the creditors] would receive no benefit from the determination, and there was nominal prejudice to the debtor); compare, however, *In re Super Van, Inc.* 161 B.R. 184 (Bankr. W.D. Tex. 1993) (in a dispute regarding the employee versus independent contractor status, the court declined to abstain from the section 505 action; the factors of centralized management over the determination of the issue, the avoidance of inconsistent results between state and federal courts, Congress' intent that tax issues be resolved before the court, the avoidance of duplication of effort, and the application of the state law in the resolution of the dispute all contributed to the court's decision); *In re D'Alessio*, 181 B.R. 756 (Bankr. S.D.N.Y. 1995) (the court rejected the "no-asset case" bright line test for abstention as being a denial of the rights of the debtor to employ a statutory remedy granted by Congress; the no-asset case bright line rule fails to properly weight the significance of a bankruptcy discharge to the honest and deserving debtor). *In re Galvano*, 116 B.R. 367 (Bankr. E.D.N.Y. 1990) (citing *In re Hunt*, 20 C.B.C.2d 870, 95 B.R. 442 (Bankr. N.D. Tex. 1989)). After observing that a court should abstain from making a Section 505 determination only when there was a compelling reason, a bankruptcy court applied each of the six factors listed in the text above and granted a motion to abstain. *In re ANC Rental Corporation*, 316 B.R. 153 (Bankr. D. Del. 2004).

(n8)Footnote 8. *In re Diez*, 45 B.R. 137 (Bankr. S.D. Fla. 1984). The court held that the purpose of section 505(a) was to provide a forum for determining tax claims when litigation in other fora would cause undue delay. See also *In re Hemaya*, 153 B.R. 71 (Bankr. D. Kan. 1993) (abstention in postdischarge claim objection was proper; no bankruptcy purpose could be achieved because the estate was a no-asset estate); *In re Swan*, 152 B.R. 28 (Bankr. W.D.N.Y. 1992) (a court's review of tax liabilities under section 505 is discretionary and the beneficiaries of such a determination are the unsecured creditors of each case; when the intended beneficiaries will receive no benefit from the § 505 motion it is appropriate for the court to abstain); *Millsaps v. United States*, 133 B.R. 547 (Bankr. M.D. Fla. 1991), approved, 138 B.R. 87 (M.D. Fla. 1991); *Cain v. United States (In re Cain)*, 142 B.R. 785 (Bankr. W.D. Tex. 1992); *In re Byerly*, 154 B.R. 718 (Bankr. S.D. Ind. 1992); *In re Starnes*, 159 B.R. 748 (Bankr. W.D.N.C. 1993); *In re Stone*, 329 B.R. 882 (Bankr. M.D. Fla. 2005); *In re Drake*, 336 B.R. 155 (Bankr. D. Mass. 2006); *In re Shapiro*, 188 B.R. 140 (Bankr. E.D. Pa. 1995) (there may be circumstances when it is appropriate for a bankruptcy court to decline to determine a nondischargeable tax liability). *Shapiro* was followed by *In re Edwards*, 97-1 U.S. Tax Cas. (CCH) P 50,154 (Bankr. E.D. Mo. 1996). One bankruptcy court held that abstention is generally appropriate in no asset chapter 7 cases. *Gossman v. United States*, 37 C.B.C.2d 1113, 206 B.R. 264 (Bankr. N.D. Ga. 1997). Citing many of these opinions, a bankruptcy court abstained from a determination of tax liability when no bankruptcy purpose would be served. *Kopp v. United States (In re Kopp)*, 355 B.R. 296 (Bankr. N.D. Okla. 2006). Accord: *Kohl v. Internal Revenue Service (In re Kohl)*, 397 B.R. 840 (Bankr. N.D. Ohio 2008).

In a similar situation, a bankruptcy court held that it would determine whether the disputed tax debt was dischargeable, but if it held the tax nondischargeable that it would then abstain from determining the amount due. *Donoff v. United States (In re Donoff)*, 99-1 U.S. Tax Cas. (CCH) P 50,328 (Bankr. S.D. Ohio 1999). See also *Mounier v. United States (In re Mounier)*, 232 B.R. 186 (Bankr. S.D. Cal. 1998). One court of appeals criticized the bankruptcy courts that abstained when only the debtor's individual tax liability was at issue. Emphasizing the importance of a debtor's right to a fresh start, the court held that if a nondischargeable tax liability is challenged by a debtor, a bankruptcy court should not abstain from hearing the case. *Luongo v. Internal Revenue Service (In re Luongo)*, 259 F.3d 323 (5th Cir. 2001). However, a bankruptcy court in another circuit refused to reopen a chapter 7 proceeding that had been closed for two years in order to permit the debtors to challenge the dischargeability of a tax debt. The debtors acknowledged that they had an alternative forum in the Tax Court, but contended that the bankruptcy court was more

convenient, efficient, and economical. The bankruptcy court considered a number of factors in rejecting the request, including the length of time the case had been closed and the availability of another forum. *In re Otto*, 311 B.R. 43 (Bankr. E.D. Pa. 2004) . The lack of another forum led a bankruptcy court to deny a motion to abstain in a case involving ad valorem taxes. *In re Hospitality Ventures/LaVista*, 314 B.R. 843 (Bankr. N.D. Ga. 2004) .

(n9)Footnote 9. *In re Universal Life Church, Inc.*, 127 B.R. 453 (E.D. Cal. 1991) (district court referred to the factors originally identified in the case of *In re Hunt*, 20 C.B.C.2d 870, 95 B.R. 442 (Bankr. N.D. Tex. 1989)) . See also *Noli v. Commissioner*, 860 F.2d 1521 (9th Cir. 1988) . The decision on whether to abstain from determining a tax liability is subject to the abuse of discretion standard of review. *New England Power & Marine Inc. v. Tyngsborough, Mass. (In re Middlesex Power Equipment & Marine Inc.)*, 292 F.3d 61 (1st Cir. 2002) .

(n10)Footnote 9a. Fogg, Hartt, & Wallace, *When, Why, and How Should a District Court be Asked to Withdraw the Reference of a Tax Controversy to a Bankruptcy Court?*, 20 The Practical Tax Lawyer 41, 49 (2006). After a third successful appeal by the United States of a bankruptcy court order dismissing its claim, a district court withdrew the reference to resolve the remaining creditors' claims. *In re Statistical Tabulating Company*, 2007 WL 98371 (N.D. Ill. 2007). A district court affirmed a bankruptcy court's decision to abstain on a debtor's motion to determine tax liability and to modify the stay in a case filed on the eve of a trial in the Tax Court so that trial could proceed. *Beane v. United States (In re Beane)*, 404 B.R. 942 (M.D. Fla. 2008) .

(n11)Footnote 10. See *Flora v. United States*, 357 U.S. 63, 78 S. Ct. 1079, 2 L. Ed. 2d 1165 (1959) , *aff'd on reh'g*, 362 U.S. 145, 80 S. Ct. 630, 4 L. Ed. 2d 623 (1960) .

(n12)Footnote 11. 28 U.S.C. § 158. While most appeals from bankruptcy courts go to district courts, the statute makes a provision for the substitution of an appeal to a bankruptcy appellate panel ("BAP"). Appeals from decisions of a BAP, like those from district courts, are taken to the appropriate court of appeals. See, e.g., *In re Mark Anthony Construction, Inc.*, 886 F.2d 1101 (9th Cir. 1989) . In 2005, this provision was amended to add a new Section 158(d)(2) that permits direct appeals from bankruptcy courts to the court of appeals in certain situations. This new provision has the potential to ameliorate the problem posed by an extra appellate step.

(n13)Footnote 12. See P TX5.04[5] *supra*.

(n14)Footnote 13. *In re Quattrone Accountants, Inc.*, 895 F.2d 921, 22 C.B.C.2d 427 (3d Cir. 1990) . The court of appeals analyzed the issue of whether jurisdiction was available by resort to 28 U.S.C. § 1334 and "abstaining from hearing a particular proceeding." See also *In re McGuirl*, 2002-1 U.S. Tax. Cases (CCH) P 50276 (Bankr. D.D.C. 2001).



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CHAPTER TX5 Litigation With the IRS in Bankruptcy Court

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P TX5.11 Subordination

The subordination of a claim to other claims of the same priority was not provided for in the former Bankruptcy Act. n1 The concept, however, was well known prior to the enactment of the Bankruptcy Code, which expressly authorized bankruptcy courts to subordinate certain claims in appropriate circumstances. n2 Section 510(a) recognizes the enforceability of subordination agreements. Section 510(b) provides for the subordination of security purchase rescission claims. Section 510(c) authorizes a bankruptcy court to subordinate claims, after notice and hearing, under principles of equitable subordination.

The first two provisions of section 510 do not have any particular relevance to tax claims, but the issue of equitable subordination under section 510(c) has arisen with some frequency since the enactment of the Bankruptcy Code. n3 Subordination of a claim should be distinguished from disallowance of the claim. n4 The subordination of a claim affects the order of its payment *vis a vis* other claims of the same class or priority and results in the postponement of its payment until other claims of the same priority have been paid. Of course, it should be obvious that, as a practical matter, subordination of a claim may equate to outright disallowance if the title 11 estate is not large enough to pay all of the allowed claims.

It should be equally obvious that it is in precisely those cases in which the subordination of a claim results in its receiving a lesser payment than other claims of equal priority that disputes will occur. A dispute over whether a claim should be subordinated will usually be an adversary proceeding. n5 Accordingly, the full panoply of discovery devices provided by the amended Federal Rules of Civil Procedure should be available. n6

In enacting section 510(c), Congress recognized that the cases that had ordered equitable subordination generally had done so only if the claimant had been guilty of some type of misconduct. n7 Following the passage of section 510(c), some courts have continued to require some form of inequitable conduct by the claimant as a prerequisite for subordination. n8 As the issue of subordination of a federal tax claim has emerged under the Bankruptcy Code, it has focused on the penalty portion of the claim and whether the very nature of the penalty obviated the need to establish inequitable conduct. n9

Some courts have concluded that a noncompensatory tax penalty (as distinguished from a compensatory penalty such as 26 U.S.C. section 6672) n10 intended to sanction conduct by the debtor should not be allowed to punish other creditors by diluting the estate available to pay their claims. Accordingly, these courts have subordinated the penalty portion of

the tax claim without a showing of inequitable conduct by the government. n11 These courts have based their decisions, in part, upon their analysis of the relevant legislative history of section 510(c). n12 Although the courts willing to invoke equitable subordination in the absence of misconduct by the claimant include the Seventh and Eighth Circuits, other courts such as the Fifth Circuit continue to require misconduct. n13

The Court of Appeals for the Third Circuit has adopted a position between automatic subordination of tax penalties and requiring government misconduct as a prerequisite. n14 Reversing a district court which had embraced the Seventh Circuit's automatic subordination approach, the Third Circuit held that the issue must be determined on an ad hoc basis in each case based upon its unique equities. n15 It would appear to follow that such a decision could only be made after the notice and hearing requirement of section 510(c) had been satisfied.

This highly uncertain area became even more confused after the Court of Appeals for the Sixth Circuit considered the issue. The Sixth Circuit reversed both of the courts below and held that an excise tax incurred as the result of underfunding a pension plan was a "tax," not a "penalty," because the plain language of the statute denominated it a tax. n16 Having determined that the tax was not a penalty, the court then considered whether subordination of the tax was appropriate. The Sixth Circuit found that the decisions of the Seventh and Third Circuits were inapposite since they involved penalties, not a tax itself. n17

Ultimately, the court held that equitable subordination might be appropriate when a claim holder is guilty of misconduct or the claim itself is of a status susceptible to subordination but refused to extend this general concept to federal tax claims. n18

At least some of the confusion in this area was dispelled by the Supreme Court's decision in *United States v. Noland (In re First Truck Lines, Inc.)*. n19 After a chapter 11 proceeding was converted to a chapter 7 proceeding, the trustee and the Internal Revenue Service stipulated that the taxes and interest that accrued while the case was in chapter 11 were entitled to priority as administrative expenses. The trustee contended, however, and the courts below agreed, that the noncompensatory penalties on these administrative taxes could be subordinated even in the absence of creditor misconduct. The Supreme Court noted the conflicting approaches taken by the various courts of appeals that had considered the question of subordination without creditor misconduct and rejected the "categorical" approach as contrary to the policy judgment by Congress that tax penalties receive priority as administrative expenses. Accordingly, the decisions by the courts below permitting such categorical subordination were reversed, but the Court left open the question of whether creditor misconduct must always be established as predicate for equitable subordination. n20

FOOTNOTES:

(n1)Footnote 1. 4 *Collier on Bankruptcy* P 510.02 (Matthew Bender 15th Ed. Revised).

(n2)Footnote 2. See, e.g., *Pepper v. Litton*, 308 U.S. 295, 60 S. Ct. 238, 84 L. Ed. 281 (1939) . Although equality of distribution was said to be an "underlying theme of the Bankruptcy Act," the rule was not "inexorable" if equitable considerations intervened. *Benjamin v. Diamond (In the Matter of Mobile Steel Co.)*, 563 F.2d 692 (5th Cir. 1977) .

(n3)Footnote 3. Under the former Bankruptcy Act the issue did not arise since noncompensatory tax claims were expressly disallowed. *Simonsen v. Granquist*, 369 U.S. 38, 40, 82 S. Ct. 537, 538, 7 L. Ed. 2d 557 (1962) . Note that section 726(a)(4) of the Bankruptcy Code effectively "subordinates" noncompensatory tax penalties to general unsecured claims in liquidations under chapter 7 by virtue of the order of distribution established. See 6 *Collier on Bankruptcy*, P 726.02[4] (Matthew Bender 15th Ed. Revised).

(n4)Footnote 4. See generally 4 *Collier on Bankruptcy*, P 510.02 (Matthew Bender 15th Ed. Revised). A discussion of the distinction between the claims objection process and the procedure for subordinating claims can be

found in *Gordon Sel-Way, Inc. v. United States* (Matter of Gordon Sel-Way, Inc.), 97-1 U.S. Tax Cases (CCH) P 50,146 (E.D. Mich. 1996), *on remand*, 1997 LEXIS 91 (Bankr. E.D. Mich. 1997).

(n5)Footnote 5. *Fed. R. Bankr. P. 7001(8)*, as amended by the 1999 Amendments to the Federal Rules of Bankruptcy Procedure, effective December 1, 1999. Note that the rule provides an exception if the subordination is provided for in a chapter 9, 11, 12 or 13 plan. Presumably the plan confirmation process would afford sufficient opportunity for notice and hearing to satisfy section 510(c).

(n6)Footnote 6. *See Fed. R. Bankr. P. 7026-7037* which closely parallel amended *Federal Rules of Civil Procedure* 26-37.

(n7)Footnote 7. S. Rep. No. 989, 95th Cong., 2d Sess. 74 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised). According to the Court of Appeals for the Fifth Circuit in *Benjamin v. Diamond* (*In the Matter of Mobile Steel Co.*), 563 F.2d 692 (5th Cir. 1977), three conditions had to be satisfied before equitable subordination was appropriate: (1) The claimant must have engaged in some type of inequitable conduct; (2) The misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant; and (3) Equitable subordination of the claim must not be inconsistent with the provisions of the *Bankruptcy Act*. *Benjamin v. Diamond* (*In the Matter of Mobile Steel Co.*), 563 F.2d 692, 700 (5th Cir. 1977).

Mobile Steel was followed and applied to a tax case in which the bankruptcy court held that a proof of claim filed three and one-half years late by the IRS would not be equitably subordinated in the absence of any proof of inequitable conduct by the IRS. The unsecured creditors who would have benefitted from the equitable subordination had not taken any action or expended any effort other than the filing of their own claims. *In re Johnson Rehabilitation Nursing Home, Inc.*, 239 B.R. 168 (Bankr. N.D. Ill. 1999).

A District Court in the Ninth Circuit cited the same three factors identified in *Mobile Steel* in affirming denial subordination of a tax claim, but cited opinions by its own Court of Appeals as authority. *Laxa v. United States* (*In re Laxa*), (D. Ariz. 2004).

(n8)Footnote 8. *See, e.g., Fabricators, Inc. v. Technical Fabricators, Inc.* (*In the Matter of Fabricators, Inc.*), 926 F.2d 1458, 24 C.B.C.2d 1489 (5th Cir. 1991); *In re Wilnor Drilling, Inc.*, 8 C.B.C.2d 1045, 29 B.R. 727 (Bankr. S.D. Ill. 1983).

(n9)Footnote 9. A bankruptcy court has suggested that subordination of a tax claim itself might be appropriate when a priority tax claim is filed after the bar date in a chapter 7 proceeding. This court suggested subordinating the late-filed priority tax claim to timely filed priority claims as an appropriate balance between the competing interests of prompt administration and adherence to the regime of priorities established by the Bankruptcy Code. *In re Rago*, 149 B.R. 882 (Bankr. N.D. Ill. 1992).

(n10)Footnote 10. *See P TX15.02 infra* for a discussion of I.R.C. § 6672.

(n11)Footnote 11. *Schultz Broadway Inn v. United States*, 912 F.2d 230 (8th Cir. 1990); *In the Matter of Virtual Network Services Corporation*, 902 F.2d 1246, 22 C.B.C.2d 1667 (7th Cir. 1990); *In re Mantz*, 151 B.R. 928, 931 (B.A.P. 9th Cir. 1993); *In re Airlift International, Inc.*, 97 B.R. 664, 670 (Bankr. S.D. Fla. 1989); *In re Standard Johnson Co., Inc.*, 90 B.R. 41 (Bankr. E.D.N.Y. 1988); *In re Merwede*, 18 C.B.C.2d 815, 84 B.R. 11 (Bankr. D. Conn. 1988).

(n12)Footnote 12. *See, e.g., In the Matter of Virtual Network Services Corporation*, 902 F.2d 1246, 1247, 22 C.B.C.2d 1667 (7th Cir. 1990). The continuing validity of *Virtual Network Services* has been questioned in light of the Supreme Court's ruling in *United States v. Noland* (*In re First Truck Lines, Inc.*), 517 U.S. 535, 116 S. Ct. 1524, 134 L. Ed. 2d 748, 35 C.B.C.2d 1 (1996), and subsequent decisions by the *Seventh Circuit*. *Freeland v. Internal Revenue*

Service (In re White Trailer Corp.), 264 B.R. 916 (N.D. Ind. 2001) .

(n13)Footnote 13. Both, *In the Matter of Virtual Network Services Corporation*, 902 F.2d 1246, 22 C.B.C.2d 1667 (7th Cir. 1990) , and *Schultz Broadway Inn v. United States*, 912 F.2d 230 (8th Cir. 1990) , were decided in 1990. In the following year, the Fifth Circuit reaffirmed its adherence to the misconduct requirement in a nontax case. See *Fabricators, Inc. v. Technical Fabricators, Inc. (In the Matter of Fabricators, Inc.)*, 926 F.2d 1458, 24 C.B.C.2d 1489 (5th Cir. 1991) . Bankruptcy courts in the Fifth Circuit have applied the *Fabricators* rule to prohibit subordination of nonpecuniary tax penalties in the absence of misconduct by the IRS *In re Kirk*, Case No. 91-21995-C-13 (Bankr. S.D. Tex. Aug. 4, 1992) (unreported). This view also prevailed in the case of *In re Sheldon Transfer & Storage Company, Inc.*, 1992 Bankr. LEXIS 2409 (Bankr. D. Mass. Sept. 15, 1992) . After the Supreme Court's decision in *Noland*, a bankruptcy court in the Seventh Circuit relied heavily upon the Fifth Circuit's approach to equitable subordination requiring creditor misconduct. In a case filed before the 1994 amendment of the Bankruptcy Code regarding the treatment of late claims, this court held that the filing of a late claim for unpaid trust fund taxes did not justify subordination under section 510(c) where the adversely affected creditors had taken no action in reliance upon the IRS's failure to file a timely claim. *Solow v. United States (In re Johnson Rehabilitation Nursing Home, Inc.)*, 99-1 U.S. Tax Cas. (CCH) P 50,460 (Bankr. N.D. Ill. 1999).

(n14)Footnote 14. *Burden v. United States*, 917 F.2d 115, 24 C.B.C.2d 187 (3d Cir. 1990) .

(n15)Footnote 15. Curiously, in *Burden*, on appeal the government appears to have abandoned its prior position that misconduct must be demonstrated before subordination was permitted. *Burden v. United States*, 917 F.2d 115, 24 C.B.C.2d 187 (3d Cir. 1990) .

(n16)Footnote 16. *In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055, 25 C.B.C.2d 591 (6th Cir. 1991) , cert. denied, 502 U.S. 1092, 112 S. Ct. 1165, 117 L. Ed. 2d 412 (1992) . The Tenth Circuit has reached a contrary conclusion. *In re Cassidy*, 983 F.2d 161 (10th Cir. 1992) ; *In re CF&I Fabricators of Utah, Inc.*, 53 F.3d 1155 (10th Cir. 1995), rev'd, 518 U.S. 213, 116 S. Ct. 2106, 135 L. Ed. 2d 506, 35 C.B.C.2d 463 (1996) . A district court reached a result similar to the Sixth Circuit by explaining that even though the tax may have had deterrence as its purpose, it was imposed by self-assessment and compensated the government for lost use of income taxes. *United States v. Plan Committee of Juvenile Shoe Corp. of Am. (In re Juvenile Shoe Corp. of America)*, 180 B.R. 206 (E.D. Mo. 1995) , rev'g, 166 B.R. 404 (Bankr. E.D. Mo. 1994) . The district court was affirmed in the first decision by a court of appeals following the Supreme Court's decision in *United States v. Juvenile Shoe Corporation (In re Juvenile Shoe Corp. of America)*, 99 F.3d 898 (8th Cir. 1996) .

(n17)Footnote 17. *In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055, 1061, 25 C.B.C.2d 591 (6th Cir. 1991) , cert. denied, 502 U.S. 1092, 112 S. Ct. 1165, 117 L. Ed. 2d 412 (1992) .

(n18)Footnote 18. *In re Mansfield Tire & Rubber Co.*, 942 F.2d 1055, 1062, 25 C.B.C.2d 591 (6th Cir. 1991) , cert. denied, 502 U.S. 1092, 112 S. Ct. 1165, 117 L. Ed. 2d 412 (1992) . The Sixth Circuit later adopted the Fifth Circuit requirement of creditor misconduct as a condition for equitable subordination in a non-tax case. *In re Baker & Getty Financial Services, Inc.*, 974 F.2d 712, 27 C.B.C.2d 1112 (6th Cir. 1992) .

(n19)Footnote 19. *United States v. Noland (In re First Truck Lines, Inc.)*, 517 U.S. 535, 116 S. Ct. 1524, 134 L. Ed. 2d 748, 35 C.B.C.2d 1 (1996) .

(n20)Footnote 20. After the Supreme Court's decisions in *CF & I Fabricators* and *Noland*, a tax penalty would not be subordinated without alleging and substantiating inequitable conduct by the IRS. *Holloway v. Internal Revenue Service (In re Odom Antennas, Inc.)*, 340 F.3d 705 (8th Cir. 2003) . Accord: *In re J. A. Jones, Inc.*, 95 A.F.T.R.2d 911 (Bankr. W.D. N.C. 2005) . Indeed, in the years following these two decisions, it does not appear that any tax claims have been subordinated without a showing of inequitable conduct by the IRS. A bankruptcy court ruled that even though there had been no inequitable conduct by the IRS, its claim would be subordinated because of the "interplay"

between sections 726(a)(4) and 1129(a)(7), but the district court reversed on the basis of *CF & I Fabricators* and *Noland*. Internal Revenue Service v. Morande Enterprises, Inc. (*In re* Morande Enterprises, Inc.), 2008 U.S. Dist. LEXIS 104475 (M.D. Fla. Sept. 30, 2008).



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CHAPTER TX5 Litigation With the IRS in Bankruptcy Court

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P TX5.12 Appeals

An appeal from an order of a bankruptcy court regarding a tax controversy will proceed according to the same rules that govern appeals from other orders of a bankruptcy court. Although the subject of bankruptcy appeals is treated thoroughly elsewhere, n1 a few general remarks about them as they relate to tax litigation in the bankruptcy court are in order.

Appeals from orders of a bankruptcy court will be to the appropriate district court. n2 There is an optional alternative to an appeal to the district court if the judicial council of the circuit has established a bankruptcy appellate panel ("BAP") which would be comprised of bankruptcy judges within the circuit. n3 Subject to the time limitations imposed by *Federal Rule of Bankruptcy Procedure 8002*, an appeal from a bankruptcy court will generally proceed in the same manner as an appeal from a district court to a court of appeals. n4 Appeals from decisions of district courts or bankruptcy appellate panels reviewing orders entered by a bankruptcy court will be taken to the appropriate court of appeals. n5

As noted elsewhere in this chapter, the necessity of appealing first to the district court or BAP before reaching the court of appeals may significantly delay obtaining a final decision. This extra level of appellate review should be compared to the direct appeal to the court of appeals available from decisions of the Tax Court, the Court of Federal Claims, and the district courts. n5a In 2005, *28 U.S.C. section 158(d)* was amended to allow direct appeals from the bankruptcy court to the court of appeals in certain circumstances, thereby creating the opportunity to avoid the extra appellate step usually encountered when a bankruptcy court decides a tax liability. n5b Note also that section 158(d) provides that courts of appeals have jurisdiction over appeals in title 11 cases when district courts, in exercising appellate jurisdiction over bankruptcy court decisions, have entered "final decisions, judgments, orders, and decrees." n5c Accordingly, a decision by a district court remanding a case back to a bankruptcy court is generally not appealable to the court of appeals. n5d An exception to this general requirement that a district court's order of remand is not subject to further appeal arises when the remand would require the bankruptcy court to perform only "ministerial" tasks that do not detract from an otherwise final order. Even if more than ministerial acts remain, an order of a district court may be sufficiently final for appeal to the court of appeals if it conclusively determines the question presented by the appeal. n5e In *Internal Revenue Service v. Pransky*, n5f the Third Circuit listed four factors to be considered when deciding whether to accept a further appeal following a remand by the district court that involved the possibility of more than ministerial functions: (1) the effect of the disputed issue on the assets of the bankruptcy estate; (2) the necessity for additional fact-finding on remand; (3) the preclusive effect of the court of appeals' decision on the merits of subsequent litigation; and (4) judicial

economy. n5g

To initiate an appeal from an order of a bankruptcy court, a party must file a notice of appeal within 10 days following entry of the order. n6 Note that the appeal is to be taken from a "final" order, and that the filing of a motion, pursuant to *Federal Rule of Bankruptcy Procedure* 9023, to reconsider or to alter or amend will prevent an order from becoming final and appealable until the court has ruled on it. n7 It should also be understood that an order may become final even though it does not provide a sum certain for a claim filed by the IRS, so long as the remaining actions are purely "ministerial." n7a The filing of a notice of appeal will trigger another 10-day period within which the appellant must file with the bankruptcy clerk a designation of the items to be included in the record on appeal and a statement of the issues to be presented. n8 Once the record has been completed and the appeal has been docketed in the district court, the appellant has 15 days within which to file and serve its brief. The appellee will then have 15 days to file and serve its brief, following which the appellant has 10 days to file and serve a reply brief. n9 The standards of appellate review should be understood before an appeal is taken, indeed before litigation even begins in the bankruptcy court. As is generally the case, findings of fact are subject to the clearly erroneous rule while conclusions of law are subject to plenary, or *de novo*, review. n10 The usual proscription against raising new issues on appeal which were not raised in the bankruptcy court applies to tax cases. n11

A particularly vexing issue encountered in bankruptcy appeals is the problem of what orders are subject to appeal. There are two aspects to the problem. Many orders on issues which come before bankruptcy courts are interlocutory in nature and not subject to immediate appeal. n12 Conversely, because of the rapid pace at which cases under title 11 usually proceed, many appeals become moot since it will not be possible for an appellate court to return the parties to the status quo. This may occur when distributions are made pursuant to a confirmed plan of reorganization. n13 Although the lack of a final order is not often a problem in litigating tax controversies in bankruptcy court, n14 the mootness problem occurs with some regularity. An appeal by the government from an adverse decision may become moot if distributions to other creditors deplete the estate to the point that the full amount of the taxes found to be due on appeal can no longer be paid. An appeal can also become moot if the underlying title 11 proceeding is dismissed. n14a Of course, the government might pursue individually those creditors who received the distributions. Another possibility, at least in the case of individual debtors, is an increase in the amount of the government's nondischargeable claim. In the case of corporate debtors with confirmed plans, the inability to pay in full the amount of any additional taxes entitled to priority under section 1129(a)(9) following a successful appeal could well be fatal to the reorganization. Because of the potentially devastating consequences of such appeals, it is wise to evaluate the possible outcomes of the appeal at the beginning of the process.

FOOTNOTES:

(n1)Footnote 1. 1 *Collier on Bankruptcy*, P 3.03 (Matthew Bender 15th Ed. Revised); 10 *Collier on Bankruptcy*, PP 8001.01-8019.03 (Matthew Bender 15th Ed. Revised).

(n2)Footnote 2. 28 *U.S.C. § 158(a)*. Jurisdiction over bankruptcy matters is initially vested in the district courts and then delegated to the bankruptcy courts. 28 *U.S.C. § 1334(a)*.

(n3)Footnote 3. 28 *U.S.C. § 158(b)*. The Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, *reprinted in* Vol. E *Collier on Bankruptcy*, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised), encourages the various federal judicial circuits to establish bankruptcy appellate panels. Prior to 1994, the First Circuit had experimented with a BAP but abandoned it. Only the Ninth Circuit was using a BAP prior to the 1994 amendments. Since then the First, Second, Sixth, Eighth, and Tenth Circuits have adopted (or readopted in the case of the First Circuit) BAPs.

(n4)Footnote 4. 28 *U.S.C. § 158(c)*. *Fed. R. Bankr. P. 8002* was amended by the 1994 Amendments to the Federal Rules of Bankruptcy Procedure, effective August 1, 1994.

(n5)Footnote 5. 28 U.S.C. § 158(d). *Federal Rule of Appellate Procedure* 6 governs appeals in bankruptcy cases from final orders of a district court or BAP to the court of appeals. Rule 6(b)(2)(ii) requires the appellant to file a designation of record and statement of issues within 10 days of the filing of the notice of appeal.

(n6)Footnote 5a. *I.R.C. § 7482(a)(1)*; 28 U.S.C. §§ 1291, 1295(a)(3).

(n7)Footnote 5b. The circumstances in which a court of appeals might agree to a direct appeal from a bankruptcy court order were discussed in *Weber v. United States Trustee*, 484 F.3d 154 (2d Cir. 2007) .

(n8)Footnote 5c. *In re Blue Coal Corporation*, 986 F.2d 687 (3d Cir. 1993) .

(n9)Footnote 5d. *Internal Revenue Service v. Hildebrand (In re Brown)*, 248 F.3d 484 (6th Cir. 2001) .

(n10)Footnote 5e. A Court of Appeals reviewed a District Court's decision to remand for further proceedings, because its "resolution of the central issue will materially aid the bankruptcy court in reaching its decision on remand." *Neilson v. United States (In re Olshan)*, 356 F.3d 1078 (9th Cir. 2004) .

(n11)Footnote 5f. *Internal Revenue Service v. Pransky (In re Pransky)*, 318 F.3d 536 (3d Cir. 2003) .

(n12)Footnote 5g. Other circuits have developed similar sets of criteria for determining when a district court order in a tax dispute is sufficiently final to allow a further appeal. See *United States v. Fowler (In re Fowler)*, 394 F.3d 1208 (9th Cir. 2005) .

(n13)Footnote 6. *Fed. R. Bankr. P. 8001(a)* describes the method for taking an appeal "as of right." *Fed. R. Bankr. P. 8001(b)* provides for an appeal "by leave" of the district court but is not generally relevant to appeals involving tax controversies. *Fed. R. Bankr. P. 8002(a)* requires that the notice of appeal must be filed with the bankruptcy clerk, not merely served, within 10 days of entry of the order. *In re Robinson*, 640 F.2d 737 (5th Cir. 1981) . A late notice of appeal creates a jurisdictional defect which is usually lethal to the appeal. *Stangel v. United States (In re Stangel)*, 219 F.3d 498 (5th Cir. 2000) ; *Moore v. Hogan*, 851 F.2d 1125 (8th Cir. 1988) ; *In re Universal Minerals, Inc.* 755 F.2d 309 (3d Cir. 1985) ; *In re White*, 183 B.R. 356 (D. Conn. 1995) .The failure to file a timely notice of appeal deprives the district court of jurisdiction to consider the appeal. *Don Vicente Macias, Inc. v. Texas Gulf Trawling Co. (In re Don Vincente Macias, Inc.)*, 168 F.3d 209 (5th Cir. 1999) . Note also that *Fed. R. Bankr. P. 9006(a)*, unlike *Fed. R. Civ. P. 6(a)*, includes Saturdays, Sundays, and legal holidays when the prescribed period of time is 10 days. The circumstances in which a bankruptcy court may extend the time for the filing of the notice of appeal are provided in *Fed. R. of Bankr. P. 8002(c)*.

(n14)Footnote 7. Reversing a bankruptcy court, the district court held that a hypertechnical interpretation of the motion should be rejected in favor of looking to the timing and the substance of the motion. The district court also specifically rejected the bankruptcy court's determination that the motion to alter or amend its decision should have been brought pursuant to 11 U.S.C. § 502(j) and *Fed. R. Bankr. P. 3008*. *United States v. Colvin*, 203 B.R. 930 (N.D. Tex. 1996) .

(n15)Footnote 7a. *Basher v. United States*, 301 B.R. 175 (Bankr. E.D. Pa. 2003) . In commenting upon this potential trap for the unwary, the bankruptcy court remarked that when the IRS unilaterally determined an order to be final, it did so at its own peril. According to the court, the "prudent litigator" files a timely appeal from an order that is not clearly interlocutory. If he is wrong, the court observes that the worst he faces is dismissal for lack of appellate jurisdiction, leaving him free to appeal again when the order is final. The court did not provide any advice for what is or is not clearly interlocutory, leaving the prudent litigator to confront the possibility of numerous precautionary appeals.

(n16)Footnote 8. *Fed. R. Bankr. P. 8006*. Failure to file a Statement of Issues within the prescribed time period is not a jurisdictional defect, but it may result in the imposition of sanctions, including dismissal of the appeal. *In re Turner*, 186 B.R. 108 (B.A.P. 9th Cir. 1995) . *Fed. R. Bankr. P. 8001(a)*. Note that although the bankruptcy court loses

jurisdiction over the subject matter of the appeal once the notice of appeal has been filed, it retains jurisdiction over motions to grant extensions of time to designate the record on appeal. *In re Schwinn Bicycle Co.*, 204 B.R. 13 (Bankr. N.D. Ill. 1997) .

(n17)Footnote 9. The time limits for filing briefs are found in *Fed. R. Bankr. P. 8009* and the contents of the briefs are described in *Fed. R. Bankr. P. 8010*. Note that these rules are subject to being changed by any applicable local rules in the district in which the appeal is taken. Accordingly, both the local rules of the bankruptcy court and the district court should be consulted. In a case where the IRS filed its appellee's brief one day late, the district court denied the appellant's request for entry of a default judgment as "grossly disproportionate." *In re Madison*, 168 B.R. 990 (D. Haw. 1994) . The deadlines found in *Rule 8009* governing the filing of briefs are not jurisdictional. *Southern Pacific Transportation Co. v. Voluntary Purchase Groups, Inc.*, 229 B.R. 122 (E.D. Tex. 1999) . However, an inordinate delay by an appellant in filing a brief led a district court to grant a motion by the IRS to dismiss the appeal for failure to prosecute. *In re Salter*, 251 B.R. 689 (S.D. Miss. 2000) .

(n18)Footnote 10. See, e.g., *Fed. R. Bankr. P. 8013*; *In re O'Connor*, 808 F.2d 1393 (10th Cir. 1987) ; *Richmond Leasing Co. v. Capital Bank, N.A.*, 762 F.2d 1303, 12 C.B.C.2d 1202 (5th Cir. 1985) ; *Owens-Corning Fiberglas Corp. v. Ctr. Wholesale, Inc. (In re Center Wholesale, Inc.)*, 759 F.2d 1440 (9th Cir. 1985) . Note that the harmless error rule of *Federal Rule of Civil Procedure 61* is expressly made applicable to cases under title 11 by *Fed. R. Bankr. P. 9005*.

The clearly erroneous scope of appellate review is predicated upon the greater deference accorded to a trial court as the finder of fact since the trial judge heard the testimony of the witnesses and assessed their credibility. This concern was reflected by a district court's refusal to consider an IRS contention on appeal that improper venue provided an alternative ground for affirming a bankruptcy court because venue was an inherently factual issue that had to be determined after a hearing on remand. *In re Taflan*, 94 A.F.T.R. 2d 5211 (N.D. W. Va. 2004) .

(n19)Footnote 11. *In re Greene*, 145 B.R. 714 (Bankr. S.D. Ga. 1992) . Although a detailed discussion of practice under *Fed. R. Bankr. P. 9023-24* is beyond the scope of this topic, the practitioner should be aware that the prohibition against raising new issues on appeal may include attempting to raise them for the first time in a motion for reconsideration filed in the bankruptcy court. See e.g., *Laxa v. United States (In re Laxa)*, 312 B.R. 394, 399 (D. Ariz. 2004) ("[I]t is a cardinal tenet of federal-civil practice that a court--trial or appellate--will not consider matters raised for the first time in a motion for reconsideration. [citation omitted] The court may refuse to consider an issue raised for the first time in a motion for reconsideration. [citation omitted]").

(n20)Footnote 12. See, e.g., Towber, *A Uniform Approach to Determining Finality in Bankruptcy Appeals Under 28 U.S.C. § 158(d)*, 29 S. Tex. L. Rev. 587 (1988). Another dimension of the final order problem was considered in *Pullman Construction Industries, Inc. v. United States*, 23 F.3d 1166 (7th Cir. 1994) . After both the bankruptcy court and the district court had rejected a sovereign immunity defense to a preference action in a tax case, the government appealed again. The court of appeals held that the order appealed from was not final since the amount of the preferential transfer had not been determined and dismissed the appeal for want of jurisdiction. See also *United States v. Fleet Bank of Massachusetts (In re Calore Express Company Inc.)*, 288 F.3d 22 (1st Cir.) , dismissed on remand, 288 B.R. 167 (D. Mass. 2002) .

A district court stated that leave for an interlocutory appeal should be granted sparingly and only in exceptional cases. It applied the standard found in 28 U.S.C. § 1292(b) which requires: (1) the question involved be one of law; (2) the question be controlling; (3) there exists a substantial ground for difference of opinion respecting the correctness of the [bankruptcy] court's decision; and (4) a finding that an immediate appeal would materially advance the ultimate termination of the litigation. *Hanson v. United States (In re Hanson)*, 94 A.F.T.R.2d 5089 (D. Minn. 2004) . A comprehensive discussion of the issues relating to interlocutory appeals of bankruptcy court orders may be found in 1 *Collier on Bankruptcy P 5.07* (Matthew Bender 15th Ed. Revised).

(n21)Footnote 13. See, e.g., *In the Matter of Sullivan Central Plaza I, Ltd.*, 914 F.2d 731 (5th Cir. 1990) ; *Central*

States, Southeast & Southwest Areas Pension Fund v. Central Transport, Inc., 841 F.2d 92 (4th Cir. 1988) . Note that it is possible to seek a stay of the bankruptcy court's order pending the outcome of the appeal. *Fed. R. Bankr. P.* 7062 and 8005. Compare *Hoban v. Washington Area Metro. Transit Auth.*, 841 F.2d 1157 (D.C. Cir. 1988) with *In re Westwood Plaza Apartments, Ltd.*, 150 B.R. 163 (Bankr. E.D. Tex. 1993) . The requirements for a stay under Rule 8005 as they related to an appeal by the IRS were considered by a bankruptcy court that ultimately denied the stay. *In re F. G. Metals, Inc.*, 390 B.R. 467 (Bankr. M.D. Fla. 2008) .

For an interesting discussion of the collateral order doctrine and under what circumstances it might be appropriate for a court to dispense with the requirement of posting a bond as a prerequisite to an appeal, see *In the Matter of Carlson*, 224 F.3d 716 (7th Cir. 2000) . In situations where the IRS seeks to setoff an overpayment of one tax liability against an unpaid liability for another tax period, courts have reached different answers to the question of whether refunding the overpayment during the course of the litigation renders an appeal moot. Compare *Internal Revenue Service v. Ealy (In re Ealy)*, 396 B.R. 20 (B.A.P. 8th Cir. 2008) (moot) with *United States v. Gould (In re Gould)*, 401 B.R. 415 (B.A.P. 9th Cir. 2009) (not moot).

(n22)Footnote 14. *In re White*, 183 B.R. 356 (D. Conn. 1995) . The order overruling of the debtor's motion for reconsideration of his objection to an IRS claim was a final order which initiated the period of time in which he could appeal.

(n23)Footnote 14a. *United States v. Pattullo (In re Pattullo)*, 271 F.3d 898 (9th Cir. 2001) (vacating earlier decision as moot because underlying chapter 13 case had been dismissed, despite filing of new chapter 13 case in which same issue might arise). *United States v. Davis*, 2007 U.S. Dist. LEXIS 38268 (M.D. Fla. May 25, 2007) (same result).



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Collier on Bankruptcy Taxation

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CHAPTER TX5 Litigation With the IRS in Bankruptcy Court

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P TX5.13 Settlements

The dynamics of the bankruptcy process often make a settled resolution of disputed claims preferable to litigating them to a final conclusion. When the disputed claim is one for federal taxes, certain unique procedures and issues arise which are not encountered in the resolution of non-tax claims. n1 Because these procedures and issues may result in a more lengthy process of negotiation and approval of a proposed settlement, especially in larger cases, they frequently have a profound impact upon the ultimate disposition of a case under title 11. Accordingly, it is prudent to become familiar with them at the beginning of the case.

[1] General Procedures for Settling Tax Disputes

[a] Authority to Settle Tax Disputes

The Internal Revenue Code provides the Secretary of the Treasury or his or her delegate with authority to compromise any civil or criminal case arising under the internal revenue laws prior to referral to the Department of Justice for prosecution or defense, and the Attorney General or his or her delegate with authority to compromise any such case after a referral. n2 In civil tax cases, the Internal Revenue Service and the Department of Justice have traditionally limited the basis for settling cases to either hazards of litigation or doubt as to collectability. It follows that both agencies are strongly opposed to "nuisance" settlements in which the government is requested to make a nominal concession merely to avoid the burden of a trial.

The term "hazards of litigation" is self-evident and requires no elaboration here. "Doubt as to collectability," however, raises some subtler questions in a case under title 11. For instance, doubt as to the collectability of a tax claim is not always present in such a case. Although doubt as to the collectability of some creditor's claim should be implicit in all legitimately filed cases under the Bankruptcy Code, tax claims may be secured and are frequently entitled to a higher priority than those of general unsecured creditors. n3 For this reason, to ascertain whether there is doubt as to the payment of a tax claim, it is necessary to determine the amount and priority not only of the tax claim but also of all claims which will be paid before the tax claim. In some cases, estimating the ultimate magnitude of the administrative claims may make this analysis exceedingly difficult. It should also be remembered that, at least in the case of individuals, the Service may have another avenue for collection if its claim is nondischargeable.

For some time, the Service has operated what it calls an "Offer in Compromise" Program for taxpayers who are unable to pay the full amount of an undisputed tax liability. The authority to accept such "OICs" is founded upon the broad

authority to accept less than full payment provided by the Internal Revenue Code. n3a In recent years, a controversy has arisen over whether the IRS can be compelled by a bankruptcy court to consider an OIC submitted by a taxpayer who is a debtor in a title 11 proceeding. The first reported decision to address this issue held that the refusal to do so by the IRS violated *11 U.S.C. section 525* by discriminating against debtors who seek relief under the Bankruptcy Code. n3b Subsequently, several other courts have disagreed about the applicability of section 525, but they have nevertheless agreed that the IRS can be compelled to consider OICs submitted by debtors by virtue of the bankruptcy court's equitable authority under section 105(a). n3c It should be noted that in each instance, the court was careful to state that it could not compel the IRS to accept an OIC once it had considered the offer. In response the IRS has published guidance explaining its policy for the treatment of OICs submitted by taxpayers in bankruptcy proceedings. n3d

Typically, tax disputes which are primarily factual in nature or which present non-recurring legal issues are easier for the government to settle. If the issue is one which is likely to be encountered with some regularity, then the government will have to factor into any proposed settlement the desirability of litigating the issue in order to have it resolved. Settlements of such recurring issues are not impossible, but they may be more difficult, particularly if the government decides that the case provides an opportune "litigating vehicle." Whether a case qualifies as a litigating vehicle would depend upon whether it is one with favorable facts, one arising in a circuit with favorable precedent, etc. With respect to factual cases, or factual issues in larger cases, the nature of the dispute should be carefully considered. Are there multiple issues in contention? Will the available evidence be conclusive to either side? Will presentation of the evidence consume a significant amount of time on the crowded docket of the bankruptcy court, necessarily resulting in a piecemeal trial?

[b] Representation of the Government in Settlement Negotiations

A tax dispute in a case under title 11 may involve any stage of the assessment and collection process. In some cases, multiple tax years may present questions ranging from periods which have not yet been examined to ones with outstanding liens. If a tax liability is still under examination when a petition under title 11 is filed, then initially the revenue agents conducting the examination and their supervisors will represent the government in any discussions about possible compromises. It is also possible to conduct settlement discussions with the Appeals Division or the Collection Division if they had authority over a tax dispute prior to the filing of the petition.

Attorneys for the government may enter the case at any stage. Generally, an objection to the Service's claim will trigger a referral to the Department of Justice, although in some cases a referral may be made without an objection because of unique circumstances such as ongoing litigation with the debtor, the size of the anticipated claim, etc. When a referral to the Department of Justice has been made, responsibility for the case will then be assigned to the Tax Division. n4

[c] Authority to Agree to a Settlement on Behalf of the Government

Prior to referral to the Department of Justice, the Service will usually maintain authority to settle tax disputes under the same procedures which would have been applicable had the petition not been filed. n5 Once a referral has been made, a different set of procedures will be implemented. With certain exceptions, monetary guidelines determine the official who has final authority to bind the government with respect to settlements. As a general rule, as the amount the government would concede under the terms of the proposed settlement increases, the levels of internal review within the Tax Division increase as well. n6 It should be understood that any increased level of internal review will be in addition to, not in substitution for, all lower levels which would otherwise be involved.

The internal review process begins with preparation of a detailed memorandum by the individual attorney to whom the case is assigned which concludes with a recommendation regarding the proposed settlement. If applicable, the views of the Service will be obtained at this point. The next step is the review of these recommendations by the attorney's Section Chief. If the amount of the proposed government concession is less than \$300,000 (or \$500,000 if trust fund taxes are at issue), the Section Chief has final authority to bind the government. If the amount exceeds the \$300,000/\$500,000 limit

on the Section Chief's authority, then the Section Chief's views, along with those of the individual attorney and the Service, will be referred to the Office of Review in the Tax Division. This component of the Tax Division has responsibility for evaluating all large settlements, and its Chief has final authority over all concessions of less than \$1,500,000. If the amount to be conceded is beyond the authority of the Chief of the Office of Review but is less than \$1,500,000, the Deputy Assistant Attorneys General in the Tax Division have final authority. In certain instances in which the settlement involves a refund or a credit, the views of the Joint Committee on Taxation of the Congress must also be obtained. n7

[d] Settlement Procedures After Referral

The Tax Division's policy is not to make offers to settle cases. This policy is intended to avoid disputes which might arise over whether an offer was actually accepted. Accordingly, the Tax Division will only respond to offers made by representatives of taxpayers. Although the Tax Division does not formally make settlement offers, its attorneys actively participate with taxpayer representatives n8 in negotiating proposals which they can recommend for approval by the government. Once such a proposal has been negotiated, the proponent should submit it in writing in an "offer letter." n9 The attorney representing the government will then prepare a memorandum analyzing the proposal, which includes a recommended response, and the review and approval process will begin.

A comprehensive list of the factors which may influence the negotiation of a proposal to settle a tax dispute is not possible because of the unique circumstances of each case. Nevertheless, some tax and non-tax considerations do recur with some regularity. Tax considerations include the immediate "tax costs" and limiting exposure. They may also include past and future tax implications such as the impact on tax attributes like net operating loss deductions. The desire to obtain a final resolution of a tax liability without litigation and subsequent appeals may be another factor, especially when the taxpayer faces a multiplicity of other problems as frequently happens in cases under title 11. Nontax considerations may include limiting publicity, although if a taxpayer is already a debtor in a case under title 11, limiting the possible adverse publicity of a tax dispute may be of negligible value. A variety of concerns related to the ongoing operation of a business in a chapter 11 case may be significant. How large a reserve for the tax liability must be maintained? What would the impact of an adverse decision on the tax liability be on the viability of the company and upon the perception of its viability? How much internal disruption will result from tax litigation? Other nontax factors would include the possible emotional impact in the case of individual taxpayers and limiting the costs of discovery. n10

From the government's perspective, the economic factor will also be significant; however, because the duty to protect the public fisc may present issues in addition to the immediate monetary result of a particular case, the economic impact of such a case may not be controlling. Policy goals, including the need to clarify the law applicable to recurring issues, must be considered by the government's representatives. Occasionally, pursuit of these goals may outweigh the expense and the risk of litigating what might appear to be a relatively small case.

When all of these factors have been evaluated and the government's review and approval process has been concluded, the proponent will receive a letter accepting or rejecting the settlement offer on behalf of the Attorney General. Overall, the extensive review process has been instituted to ensure that settlements agreed to by the government are in its best interests and that a consistent and uniform policy for settlements is adhered to in all cases.

Alternative Dispute Resolution ("ADR") is now being used in the settlement of tax disputes in title 11 cases. Although there was some initial uncertainty about the use of ADR (sometimes referred to as "mediation") in such cases, the Department of Justice has agreed to participate in ADR in what it considers to be appropriate situations. n11 It will undoubtedly be necessary for both the Government and other parties to acquire some experience with ADR before definitive procedures appear. Nevertheless, ADR does offer the practitioner another possibility for pursuing settlement.

[2] Unique Issues Encountered in Settling Tax Disputes in Cases Under Title 11

[a] Time Constraints

Because cases under title 11 often move faster than litigation in other courts where tax disputes may be brought, there is frequently a need to accelerate the negotiation and conclusion of any settlement of a tax claim which may be possible. The timing of a settlement offer may involve important strategic considerations. It may be necessary to weigh the possibility that an early offer may be perceived as a sign of weakness against the need to allow enough time for negotiation and acceptance of a settlement of the tax dispute which conforms to other scheduling imperatives in the case. Resolution of the amount of disputed tax liability may be necessary before any plan of reorganization can be confirmed. In other cases, the rationale supporting the settlement of the tax claim may be based upon the early confirmation of a plan so that the crushing administrative expenses often associated with large cases may be curtailed. This approach involves the preservation of a larger estate to pay the claims of all creditors, including the government. To facilitate such expedited negotiation and review, creativity and cooperation by the proponent's representatives are essential. New and imaginative approaches to settlement will be considered by the government, but the extensive review and approval process previously described is designed, in part, to identify and reject offers which are unsound. Accordingly, creativity must be balanced with objective reasonableness. In addition, consideration should be given to the time required to complete this process, especially if a new approach is involved.

[b] Participation by Additional Parties in Settlement Negotiations

Traditionally, settlement of tax disputes involved a bilateral process between the taxpayer and the government. In cases under title 11, additional parties, such as a trustee and other creditors or creditors' committees may participate in the negotiation of a settlement. n12 Even in those cases in which additional parties are not direct participants, the debtor or the trustee may find it necessary to obtain their agreement to the proposed settlement of the tax dispute since it will directly affect their own recovery. n13 Obviously, as more participants become involved in settlement negotiations, the more complicated they will become. For these reasons, cooperation among the additional parties will be important in those cases where an expedited review and approval of a proposal which emerges from the negotiations is desired. Consideration should also be given to the possibility that other parties in the case may oppose a disposition of the tax dispute which the debtor or the trustee may advocate. Both the government and these other parties have the right to conduct negotiations on their own. n14

[3] Unique Problems Confronting the Government in Resolving Tax Disputes in Cases Under Title 11**[a] Incomplete Examinations**

It will be a rare case in which the Service has completed examinations for all of a taxpayer's prepetition years at the time a case under title 11 is filed. n15 Typically, there may be multiple years which are still under examination or subject to examination when a petition under the Bankruptcy Code is filed. Completion of these examinations is essential for the government to be able to make a considered decision on a proposed settlement. It is also significant that in many cases under title 11, the years immediately preceding the filing of the petition may involve losses which produce net operating loss deductions which are available to reduce the tax liabilities of earlier years. Consequently, debtors may often have an interest in the completion of these examinations as well. Years for which returns have not been filed, or years for which the Service was compelled to file estimated returns on behalf of the taxpayer n16 present similar problems. Accordingly, all returns should be filed as soon as possible after the beginning of a case under title 11.

[b] The Government's Status as an Involuntary Creditor

Unlike most other creditors in cases under title 11, the Service may not be able to state with precision the exact amount of taxes, interest and possibly penalties it is owed by the debtor immediately after the filing of a petition. Part of the explanation for this problem is the likelihood of incomplete examinations. More fundamentally, the very nature of the Service's role as a tax collector means that it does not make a voluntary, considered decision to become a creditor of the taxpayer. This status as an involuntary creditor and the difficulties that it creates were recognized by the Supreme Court

in *Kimbell Foods, Inc. v. United States*. n17 In those cases in which expedited review and approval of a proposed settlement will be sought, this situation must be addressed early in the process.

[4] Issues Related to the Absolute Priority Rule

[a] Settlements Predicated Upon Waiver of the Absolute Priority Rule by the Government

The Bankruptcy Code requires that, in a chapter 11 case, all claims of a particular class must be paid in full before claims of any junior class may receive payment. n18 Since most of the disputed tax claims will be entitled to priority over general unsecured claims by virtue of section 507(a)(8), a common issue is whether the government should consent to receiving less than full payment on its claim, or at least receiving all of the available assets in partial satisfaction of its claim, in order to create some possibility of payment for junior creditors. The junior creditors frequently will be important in order to gain the consent necessary for approval of a plan of reorganization or, in the case of trade creditors, to enable the reorganized debtor to survive after confirmation of the plan.

Under these circumstances, some justification for the government receiving less than all of the money it would be entitled to under the absolute priority rule must be found if a settlement is to be reached. Implicit in any such proposal is an agreement that the confirmation of a plan offers the best opportunity for the government to maximize its recovery. If the tax claim would be paid in full under a liquidation, there would be no reason for the government to consider a lesser payment in a reorganization.

Assuming that this initial hurdle is successfully crossed, one possibility for resolving the absolute priority problem would be to establish that a settlement permitting the quick confirmation of a plan that leaves more money for all creditors is a more desirable outcome for the Service. For example, seventy-five percent of \$100 is more favorable than a later litigated resolution which leaves the government with one hundred percent of \$50. Developing empirical evidence to support such a theory, *e.g.*, quantifying and assuring the savings in administrative expenses, will be essential to a settlement based upon this approach. Nebulous hopes to preserve a larger estate for the benefit of all creditors will not be particularly persuasive. n18a

[b] Discharge Problems Resulting From a Partial Waiver of the Absolute Priority Rule by the Government

In the case of individual debtors, if the government relinquishes its right to absolute priority in order to facilitate a settlement with the junior creditors, an issue may arise with regard to whether such a waiver of priority should reduce the size of any nondischargeable claim the government will have against the debtor after distributions from the estate or the plan. It has been held that the "fair and equitable" requirement of the absolute priority rule is intended to protect the interests of creditors, not debtors and, therefore, the waiver of the right to full priority does not diminish the size of any nondischargeable claim which results from such a waiver. n19

[5] Use of the IRS' Appeals Function to Resolve Factual Issues

Many tax disputes will be factual in nature, such as substantiation issues. This problem may be acute in large cases in which the Service's normal audit period has been curtailed by the filing of a case under title 11 and the need to file a proof of claim before a bar date. To the extent the Service receives additional information establishing the correctness of a debtor's position with respect to an item in dispute, it may agree to amend its claim without invoking the Tax Division's review and approval procedures. Such cases may be referred to the Appeals function, which can administer this process more quickly and less expensively than would be possible through formal discovery procedures. The role to be played by Appeals after a taxpayer files a petition under title 11 depends, in part, upon the views of the Tax Division; however, in an appropriate case, it may be worthwhile to make a request for its involvement. n20

[6] Issues Related to the Confirmation of Plans of Reorganization

[a] Issues Other Than the Amount and Character of Prepetition Tax Liabilities

In the typical case under title 11, most of the attention of the debtor and the government focuses on the amount and character of the prepetition tax liability. However, the government, like any other creditor, will have an interest in issues besides the amount of its own claim such as the feasibility of a proposed plan of reorganization. This interest will be especially keen when the payment of the tax claim is to be extended over a period of years and is dependent upon the successful completion of the plan of reorganization. Administrative tax claims can be settled in the same manner as prepetition claims and logically should be included in any overall settlement. n21 Issues arising by virtue of the confirmation of the plan itself add yet another level of complexity to achieving a global resolution of all issues between the debtor and the government. These issues may include income from the discharge of indebtedness and the entitlement to prepetition tax attributes such as net operating loss deductions, and they may vitally affect the postconfirmation viability of the debtor.

[b] Closing Agreements

One possible way of resolving such postconfirmation issues ahead of time is through the use of a "closing agreement." The Internal Revenue Code authorizes the Secretary to enter into an agreement with any person relating to a liability of that person (or the person or estate for whom the person acts) in respect to any internal revenue tax for any taxable period. n22 Such closing agreements can include particular tax periods or specific matters and how they will be treated for all taxable periods. The Regulations permit the government to enter into a closing agreement in any case in which there appears to be an advantage in having the case permanently and conclusively closed, or if good and sufficient reasons are shown by the taxpayer for desiring a closing agreement and it is determined by the Commissioner that the government will sustain no disadvantage through consummation of the agreement. n23

Although a closing agreement is a possible vehicle for resolving these types of issues, it should be understood that pursuit of such an agreement may require the willingness of the parties concerned to commit substantial time and resources to the resolution of the many questions which may be involved. For this reason, closing agreements are frequently not a practical solution in cases in which a prompt decision on a proposed settlement will be necessary. In those cases where they will be required, the proponent should take the initiative at the earliest possible time.

[7] Settlement of Tax Issues Presented by Prepackaged Plans of Reorganization

The advent of "prepackaged plans of reorganization" as a means of limiting the administrative expenses associated with many chapter 11 cases and the exposure of the debtor to a loss of control while in chapter 11 often presents significant tax issues. Because of the need to obtain confirmation quickly, the "typical" prepackaged plan may simply provide for any prepetition tax liability to "flow through" the plan and to be determined later, *i.e.*, by agreement or by litigation in the Tax Court. Estimation procedures may also be available, n24 but even they may be too time consuming and expose the debtor to the danger of a decision which may derail its hopes for a quick confirmation. Nevertheless, even a "flow through" provision may present problems for the government if it is concerned about whether the debtor will survive long enough to pay any tax liability ultimately owed. The government may also disagree with the postconfirmation tax consequences of the plan. n25

These concerns could provoke feasibility objections by the government. In order to avoid the risk that objections by the government might imperil a speedy confirmation, a party considering a prepackaged plan may want to include the Service among the creditors with whom it negotiates agreements prior to filing.ss

FOOTNOTES:

(n1)Footnote 1. One respect in which settlements of tax disputes in cases under title 11 are not unique is the

requirement that they must be approved by the bankruptcy court after a determination that the proposed settlement is beneficial to the bankruptcy estate and is "fair and equitable." *In the Matter of AWECO, Inc.*, 725 F.2d 293 (5th Cir. 1984) ; *In re Apex Oil Company*, 92 B.R. 847 (Bankr. E.D. Mo. 1988) . Without court approval, the settlement may not be enforceable against the debtor. *In re Sparks*, 190 B.R. 842 (Bankr. N.D. Ill. 1996) . The requirement that the bankruptcy court approve the settlement does eliminate the possibility of a dispute over whether there has been a final settlement, which is an issue that occasionally arises in other contexts. See e.g., *Varnum v. United States*, 2000-2 U.S. Tax Cas. (CCH) P 50,617 (S.D. Tex. 2000); *Gregory v. United States*, 111 F. Supp. 2d 851 (S.D. Tex. 2000) . If a settlement occurs while a dispute is on appeal, and the approval by the court will require notice to parties who are not part of the appeal, the appellate court should stay the appeal and remand the case to the bankruptcy court for consideration of the proposed settlement. Without such a remand, the bankruptcy court does not have jurisdiction over the matter. *In re FBI Distribution Corp.*, 267 B.R. 655 (B.A.P. 1st Cir. 2001) .

(n2)Footnote 2. I.R.C. § 7122(a). Authority for delegates of the Commissioner to enter into "Closing Agreements" with taxpayers to resolve disputed tax liabilities is provided by 26 U.S.C. § 7121. If several delegation orders have been issued, then the more specific one will control. *Crowell v. United States*, 305 F.3d 474 (6th Cir. 2002) . *Crowell* affirmed the decisions of both courts below and distinguished a decision by a bankruptcy court in another circuit that had held the same IRS employee lacked authority to enter into a closing agreement involving a virtually identical tax shelter. See *In re Klee*, 216 B.R. 42 (Bankr. D. Or. 1997) .

(n3)Footnote 3. See 11 U.S.C. § 507(a)(8), amended in 1994 by the Bankruptcy Reform Act, Pub. L. No. 103-394.

(n4)Footnote 3a. I.R.C. § 7122(a); Treas. Reg. § 301.7122- 1(d).

(n5)Footnote 3b. *Mills v. United States (In re Mills)*, 42 C.B.C.2d 1807, 240 B.R. 689 (Bankr. S.D. W. Va. 1999) .

(n6)Footnote 3c. *United States v. Macher (In re Macher)*, 51 C.B.C.2d 895, 303 B.R. 798 (W. Va. 2003) ; *Internal Revenue Service v. Holmes*, 309 B.R. 824 (M.D. Ga. 2004) . Both district courts affirmed decisions by the respective bankruptcy courts. *Holmes* was followed by the bankruptcy court in *In re Peterson*, 317 B.R. 532 (Bankr. D. Neb. 2004) , motion to reconsider denied, 321 B.R. 259 . However, *Macher* and *Holmes* were considered and rejected by another bankruptcy court which refused to order the IRS to process a debtor's OIC. *1900 M Restaurant Associates, Inc. v. United States (1900 M Rest. Assocs. v. United States (In re 1900 M Restaurant Associates, Inc.)*, 319 B.R. 302 (Bankr. D.D.C. 2005) . After the decision in *1900 M Restaurant Associates*, two other bankruptcy courts applied its conclusions and held neither 11 U.S.C. § 105 nor § 525 provided authority to compel the IRS to consider OICs submitted by taxpayers in bankruptcy proceedings. *In re Uzialko*, 339 B.R. 579 (Bankr. E.D. Pa. 2006) ; *In re Shope*, 347 B.R. 270, 2006 Bankr. LEXIS 1688 (Bankr. S.D. Ohio 2006) . *1900 M Restaurant* was subsequently affirmed. *1900 M Restaurant Associates, Inc.v. United States*, 352 B.R. 1 (D. D.C. 2006) .

(n7)Footnote 3d. IRS Office of Chief Counsel Notice (CC-2004-025) (July 12, 2004). Among the factors listed in the notice which might lead the IRS to accept less than full payment for a tax owed by a bankrupt taxpayer are: (1) whether the taxpayer is in compliance with tax return filing requirements; (2) the extent of the taxpayer's previous noncompliance with filing and payment requirements; (3) whether creditors with the same priority, such as state taxing authorities, are accepting less than full payment of their claims; (4) whether the Service would receive more if the bankruptcy case is dismissed or converted to a Chapter 7 liquidation; (5) the amount of time remaining on the statute of limitations for collection; (6) whether there is anything precluding the debtor from dismissing the bankruptcy case and submitting an administrative offer in compromise (e.g., is the Service the only creditor in the case); and (7) whether the tax liabilities are nondischargeable.

(n8)Footnote 4. Whether Tax Division attorneys, Assistant United States Attorneys, or Internal Revenue Service attorneys acting as Special Assistant United States Attorneys will have responsibility for the case is discussed in P TX5.02 *supra*.

(n9)Footnote 5. It is not uncommon for a referral to be made before an examination is complete, especially in large cases under chapter 11. This problem is considered in *P TX5.13[3][a] infra*. Note, however, that the IRS is reluctant to consider Offers in Compromise submitted by taxpayers who are debtors in title 11 proceedings, as explained in *P TX5.13[1][a] supra*.

(n10)Footnote 6. The details of the delegations of authority are found in 28 C.F.R. Part O [Tax Division Directive No. 105], 60 Fed. Reg. 31244. Note that these delegations are amended periodically.

(n11)Footnote 7. *I.R.C. § 6405*.

(n12)Footnote 8. In a case under title 11, representatives of a trustee or other parties in interest may participate in these negotiations.

(n13)Footnote 9. Although it is not required, the proponent may wish to submit computations reflecting the impact of the settlement. These computations may expedite the review and approval process in larger cases and may be significant with respect to the use and preservation of tax attributes. The proponent may also want to consider submission of any other material which would expedite the review and approval process. Briefs or memoranda in support of contested legal positions are only rarely submitted and are not expected.

(n14)Footnote 10. Discovery available to the parties in a tax dispute litigated in the bankruptcy court will be similar to that in a civil case litigated in a district court and may be much more expensive than in a Tax Court proceeding. *See PP TX5.03[1], TX5.04[2] supra*.

(n15)Footnote 11. An Order "Promoting the Broader Appropriate Use of Alternative Dispute Resolution Techniques" was signed by the Attorney General on April 6, 1995. OBD 1160.

(n16)Footnote 12. The right of other parties to participate in tax controversies in the bankruptcy court is discussed in *PP TX5.03[1], TX5.04[5] supra*. It should also be understood that any settlement reached must ultimately be approved by the bankruptcy court subject to the "fair and equitable" standard. *Protective Committee for Independent Stockholders of TMT Trailer Ferry, Inc. v. Anderson*, 390 U.S. 414, 88 S. Ct. 1157, 20 L. Ed. 2d 1 (1968). Such determinations will be subject to the abuse of discretion standard of review on appeal. *United States v. AWECO, Inc.* (In re AWECO, Inc.), 725 F.2d 293 (5th Cir. 1984), cert. denied, 469 U.S. 880, 105 S. Ct. 244, 83 L. Ed. 2d 182 (1984).

(n17)Footnote 13. As a general proposition, courts have held that although the desires of other creditors are not conclusive, they should be considered carefully when a bankruptcy court is asked to approve a settlement. *Connecticut General Life Insurance Co. v. United States Financial Corporation* (In re Foster Mortgage Corporation), 68 F.3d 914 (5th Cir. 1995); *Reiss v. Hagmann*, 881 F.2d 890 (10th Cir. 1989); *In re Transcontinental Energy Corp.*, 764 F.2d 1296 (9th Cir. 1985).

(n18)Footnote 14. *See, e.g., United States v. Wilson*, 974 F.2d 514 (4th Cir. 1992).

(n19)Footnote 15. The usual period of limitations on the examination of returns is three years after the date the return was due. *I.R.C. § 6501(a)*.

(n20)Footnote 16. *See I.R.C. § 6020(b)*.

(n21)Footnote 17. *Kimbell Foods, Inc. v. United States*, 440 U.S. 715, 734, 99 S. Ct. 1448, 59 L. Ed. 2d 711 (1979). The Supreme Court noted this point again in *United States v. McDermott*, 507 U.S. 447, 113 S. Ct. 1526, 123 L. Ed. 2d 128 (1993).

(n22)Footnote 18. *See 11 U.S.C. § 1129* (the "fair and equitable" requirement). In *Bank of America NT & SA v.*

203 North LaSalle Street Partnership, 526 U.S. 434, 119 S. Ct. 1411, 143 L. Ed. 2d 607, 41 C.B.C.2d 526 (1999) the Supreme Court interpreted the statutory requirements of section 1129(b)(2)(B)(ii) without passing on the validity of the new value principle.

(n23)Footnote 18a. The conditions under which the IRS will consider an Offer in Compromise providing for less than full payment of a priority tax claim are enumerated in IRS Office of Chief Counsel Notice (CC-2004-025). See n.3d, *supra*.

(n24)Footnote 19. *In re Koelbl*, 751 F.2d 137, 11 C.B.C.2d 1208 (2d Cir. 1984) . A somewhat similar result was reached by a district court that held an agreement by the IRS to waive its rights to collect postpetition interest from a Chapter 7 estate on a nondischargeable claim did not waive its rights to collect that interest from the debtor individually. *Tashjian v. Internal Revenue Service (In re Tashjian)*, 325 B.R. 56 (D. Mass. 2005) .

(n25)Footnote 20. The role of the IRS Appeals is described in the Internal Revenue Manual--Administration, § 8(15)(10). See 5 Internal Revenue Manual (C.C.H.), p. 26,251. IRS Appeals may retain jurisdiction to settle a disputed tax claim for six months after the filing of a case under title 11, or longer, if the Tax Division concurs. However, the filing of an objection to the IRS claim will terminate the authority of IRS Appeals over the matter, unless the Chief of the Tax Division's civil trial section with responsibility for the case makes a written request to IRS Appeals. The IRS Appeals function is described at P 5.02[2] *supra* .

(n26)Footnote 21. The Service may be expected to object vigorously to a debtor's incurring additional unpaid tax liabilities while in chapter 11, i.e., "pyramiding." However, legitimate disputes over the amount of taxes actually owed for postpetition periods may also occur.

(n27)Footnote 22. *I.R.C. § 7121(a)*. The Secretary's authority to enter into a closing agreement may be delegated. However, after reviewing a delegation order, a bankruptcy court held that the Associate Chief of Appeals for an IRS District lacked authority to execute a closing agreement while litigation of the disputed tax liability was pending in the Tax Court. Accordingly, the assessment based upon the closing agreement was invalid, and a subsequent claim in a title 11 case was disallowed. *In re Klee*, 216 B.R. 42 (Bankr. D. Or. 1997) .

(n28)Footnote 23. *Treas. Reg. § 301.7121-1(a)*.

(n29)Footnote 24. *11 U.S.C. § 502(c)*. Issues related to the propriety of estimating tax claims are discussed at P TX5.05 *supra*.

(n30)Footnote 25. Confirmation of a prepackage chapter 11 plan was denied where the bankruptcy court found that the capital gains taxes which resulted from the proposed plan were an administrative expense as opposed to a postconfirmation liability; that the plan's attempt to shield parties from tax liability violated the Anti-Injunction Act (26 U.S.C. § 7421); and, that the primary purpose of the plan was tax avoidance. *In re Scott Cable Communications, Inc.*, 227 B.R. 596 (Bankr. D. Conn. 1998) .



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CHAPTER TX6 Discharge of Indebtedness and I.R.C. Section 108 Relief

15-TX6 Collier on Bankruptcy Taxation TX6.syn

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CHAPTER TX6 Discharge of Indebtedness and I.R.C. Section 108 Relief

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P TX6.01 Introduction

Gross income is broadly defined to include income from the discharge of indebtedness. A discharge of indebtedness occurs when a debt is forgiven or cancelled, or when a creditor accepts payment of less than the unpaid balance in complete satisfaction thereof. The amount of taxable gross income created by a discharge of indebtedness between unrelated parties generally equals the excess of (1) the adjusted issue price of the obligation being cancelled, and (2) the amount of any consideration paid in complete settlement thereof. Special rules apply to related party transactions and contributions of indebtedness by a shareholder to the capital of the debtor corporation.

A transaction resulting in a reduction or discharge of indebtedness may not constitute a "true" discharge of indebtedness. Instead, for example, the transaction may be characterized as a gift, an equity contribution to capital, the settlement of a contested liability, a reduction or adjustment in the purchase price of property or a medium for a different form of actual payment by the debtor, such as salary, rent or settlement of a dispute between the parties. These transactions will be treated for federal income tax purposes in accordance with their underlying substance.

To preserve a financially troubled debtor's "fresh start" after a discharge of indebtedness, Congress enacted *I.R.C. section 108* in the Bankruptcy Tax Act of 1980. Among other things, *I.R.C. section 108* provides that discharge of indebtedness income realized by certain financially troubled debtors or with respect to certain types of qualifying indebtedness is excluded from gross income. The exclusion means that the qualifying debtor will not be burdened with an immediate federal income tax liability.

A debtor will qualify for the exclusion if the following requirements are met: (1) the debtor realizes discharge of indebtedness income (as opposed to, for example, gain realized on the disposition of property in satisfaction of indebtedness includable in income under *I.R.C. section 61(a)(3)*); (2) the income realized is with respect to indebtedness of the debtor; and (3) either (i) the discharge occurs when the debtor is in a title 11 case, (ii) the discharge occurs when (but only to the extent) the debtor is insolvent, (iii) the indebtedness discharged is qualified farm indebtedness, (iv) for a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness, (v) the indebtedness discharged in 2009 or 2010 is an applicable debt instrument, or (v) the indebtedness discharged in 2007 through 2012 is qualified principal residence indebtedness. If more than one of the four categories apply, the title 11 exclusion takes precedence over the insolvency exclusion and the insolvency exclusion takes precedence over the qualified farm indebtedness and qualified real property business indebtedness exclusion. Thus, a marginally solvent debtor in a title 11 case is entitled to exclude all discharge income realized in its title 11 case without limitation to the

amount by which the debtor is insolvent. This rule provides an important tax benefit for a debtor in a title 11 case.

The "price" of the *I.R.C. section 108* exclusion is that the debtor's tax attributes must be reduced by the amount of excluded discharge income. Accordingly, under most circumstances, *I.R.C. section 108* does not permanently exclude income. Rather, it permits a debtor to defer the current recognition of ordinary discharge income by reducing the debtor's tax attributes, such as net operating loss carryovers and the basis of depreciable and nondepreciable assets. The attribute reduction rules effectuate the congressional intent to permit deferral but eventually collect federal income tax on ordinary discharge income in subsequent tax years. A debtor's reduction of tax attributes is reported on Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and section 1082 Basis Adjustment). Any gain realized on a subsequent disposition of reduced basis property is "recaptured" as ordinary income to the extent of the basis reduction. n1

FOOTNOTES:

(n1)Footnote 1. See the flow chart illustrating the provisions of *I.R.C. Section 108* at P TX6.50 *infra* .



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CHAPTER TX6 Discharge of Indebtedness and I.R.C. Section 108 Relief

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P TX6.02 Definition of Discharge of Indebtedness Income

[1] General Rule

I.R.C. section 61(a) provides that gross income includes "all income from whatever source derived." Among the statutorily delineated items of gross income is "[i]ncome from [the] discharge of indebtedness." n1 Congress added this language to the Internal Revenue Code in 1954, codifying the concept established in 1931 by the Supreme Court in *United States v. Kirby Lumber Co.* n2 Given the brevity of the statute, the determination of the circumstances under which a taxpayer realizes income from discharge of indebtedness has been left to the courts. n3

A discharge of indebtedness occurs when a debt is forgiven or cancelled or when a creditor accepts payment of less than the unpaid balance in complete satisfaction thereof. The amount of gross income created by a discharge of indebtedness between unrelated parties generally equals the difference between (1) the amount of the obligation being cancelled (using the issue price, adjusted for any unamortized premium or discount, reduced by any principal amounts previously paid), and (2) the amount of any consideration paid in complete settlement thereof. n4 Thus, when a corporation issues bonds at a premium, the corporation will realize income upon the repurchase of those bonds to the extent the adjusted issue price (minus any amount of premium previously included in income) exceeds the repurchase price. n5

The "issue price" of an obligation is generally the amount of loan proceeds the debtor originally received at the time the obligation was created, subject to certain adjustments. For this purpose, the "issue price" is determined under *I.R.C. sections 1273 and 1274*. n6 The amount of consideration paid is generally the amount of cash and the fair market value of any property transferred to the creditor, subject to the following: (1) if a debtor is properly treated for federal income tax purposes as having issued a debt instrument in satisfaction of indebtedness, the debtor will be treated as having satisfied the "old" indebtedness with an amount of money equal to the issue price of the "new" debt instrument, as provided under *I.R.C. section 108(e)(10)*; n7 (2) if *I.R.C. section 108(e)(4)* applies, the debtor will be treated as having satisfied the "old" indebtedness with an amount of money equal to (a) the related holder's cost on the acquisition date if the holder acquired the debt by purchase within the prior 6 months or, if not, (b) the fair market value of the "old" debt instrument, as provided under the *I.R.C. section 108(e)(4)* final regulations; n8 and (3) with respect to the transfer of property in satisfaction of debt, the fair market value of property securing a nonrecourse debt will not be less than the issue price, subject to certain adjustments, of the nonrecourse debt. n9

[2] What is "Indebtedness" for Purposes of I.R.C. section 61(a)(12)?

[a] Theoretical Framework

To analyze the taxation of discharge of indebtedness income, the theoretical framework for treating discharge of indebtedness as gross income must be examined. That examination begins with the fundamental question of what is "gross income" within the meaning of *I.R.C. section 61(a)*. After initially attempting to provide a rigid definition of "income" in *Eisner v. Macomber*,ⁿ¹⁰ the Supreme Court has consistently defined "gross income" in terms of "accessions to wealth."ⁿ¹¹ Stated differently, Congress intended to "tax all gains except those specifically exempted."ⁿ¹² Thus, for a discharge of indebtedness to generate gross income, the discharge must result in an accession to wealth for the taxpayer. Given the inconsistent development of the law by the courts over the past sixty years, it is difficult to identify a standard that should be used to determine whether a particular discharge of indebtedness causes an accession to wealth. Any attempt to identify such a standard must begin with the Supreme Court's decision in *United States v. Kirby Lumber*.

In *United States v. Kirby Lumber*,ⁿ¹³ the Court held that if a corporation repurchases its own bonds for an amount less than the issue price, the difference between the issue price and the repurchase price constitutes taxable income to the corporation. The Court based its decision on the theory that the reduction in outstanding liabilities results in a "freeing" of assets.ⁿ¹⁴ That is, a reduction in liabilities makes available a corresponding amount of assets, and this positive adjustment in the balance sheet constitutes gross income.

Kirby Lumber and subsequent cases have been the subject of extensive commentary.ⁿ¹⁵ While an exhaustive review is beyond the scope of this chapter, that case law and commentary yield two distinct theoriesⁿ¹⁶ that support the result in *Kirby Lumber*: (1) the "loan proceeds" theory;ⁿ¹⁷ and (2) the "net worth" or "freeing of assets" theory.ⁿ¹⁸ Under the loan proceeds theory, if a debtor receives funds tax-free because of the obligation to repay, the debtor realizes, and must report, income in the taxable year in which the obligation to repay is cancelled.ⁿ¹⁹ Under the net worth theory, a debtor realizes income when a debt is discharged in whole or in part, because the discharge decreases the debtor's liabilities without decreasing the debtor's assets, thereby increasing the debtor's net worth.

Of the two theories, the loan proceeds theory best explains the concept of discharge of indebtedness income. The net worth theory complicates the analysis by requiring either examination of the debtor's use of the loan proceeds or of the debtor's balance sheet.ⁿ²⁰ In contrast, the loan proceeds theory is easier to apply and allows principles of tax symmetry to operate. When a taxpayer borrows money, it is well settled that the taxpayer does not realize income because of the offsetting obligation to repay the borrowed funds.ⁿ²¹ It follows that the borrowing transaction should remain "open" until the taxpayer either repays or is released from the obligation.ⁿ²² If that obligation is ultimately cancelled, the debtor realizes an accession to wealth and should be taxed accordingly. Thus, the two step analysis can be summarized as follows: (1) at the inception of the transaction, were the borrowed funds excluded from the taxpayer's income upon receipt because of an offsetting obligation to repay; and (2) if so, has the taxpayer's obligation to repay been cancelled or forgiven.ⁿ²³ While not applicable to each and every transaction, the application of the two step analysis serves as a useful starting point to properly determine the federal income tax consequences of a debt discharge transaction.

The loan proceeds theory does not rely on a "freeing" of identified assets. Instead, to the extent that an obligation to repay borrowed funds (excluded from income in the year borrowed) is extinguished, the taxpayer should be treated as having earned an amount of taxable income equal to the cancelled amount and thereafter having used that amount to repay the cancelled indebtedness.ⁿ²⁴ Courts have often adopted this view to explain the economic consequences of a transfer of property "subject to" a debt. For example, the Supreme Court in *Commissioner v. Tufts*ⁿ²⁵ stated that when property is transferred with or subject to debt, "it is as if the mortgagor first had been paid with cash borrowed by the third party from the mortgagee ... and then had used the cash to satisfy his obligation to the mortgagee."ⁿ²⁶

The two step loan proceeds analysis explains the result in such cases as *Commissioner v. Rail Joint Co.*,ⁿ²⁷ in which the Rail Joint Company had raised its book value, declared and paid a nondeductible dividend with bonds, and later purchased the bonds at a discount. The Second Circuit held that a corporation realized no discharge income when it

purchased its unmatured bonds at a discount. n28 The Second Circuit's decision was supported by the fact that the corporation had not received any property or cash upon the issuance of the bonds. n29 Therefore, the Rail Joint Company realized no accession to wealth when it repurchased its obligations at a discount. n30

[b] Examples of Indebtedness

A taxpayer will realize discharge of indebtedness income under *I.R.C. section 61(a)(12)* only if a lender cancels a true debt. This requirement is important because exclusion of discharge income from a taxpayer's gross income under *I.R.C. section 108* n31 is available only if the taxpayer realizes discharge of indebtedness income. n32

There is no discharge of indebtedness income if the taxpayer had no obligation to repay funds initially advanced. Suppose, for example, Mother transfers \$100 to Son and subsequently informs Son that he need not repay the \$100. If the initial \$100 transfer was a gift from Mother to Son, then there was no debt and Mother's subsequent statement did not constitute a discharge of indebtedness within the meaning of *I.R.C. section 61(a)(12)*. n33 If the initial transfer was a loan, then Son would have discharge of indebtedness income under *I.R.C. section 61(a)(12)* but, because of their relationship, may be able to exclude that income as a gift under *I.R.C. section 102(a)*. n34 However, when a transfer of funds originates in a non-personal environment, such as a business or investment setting, a taxpayer is unlikely to succeed in "recharacterizing" the transfer (or subsequent cancellation of a loan) as a gift. n35

A true debt is commonly defined as "an unconditional and legally enforceable obligation for the payment of money." n36 For purposes of the corollary provision to the debtor's realization of discharge income, the allowance of a bad debt deduction to the creditor under *I.R.C. section 166*, Treasury Regulations define a *bona fide* debt as "a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money." n37 With respect to the characterization of withdrawals and advances between shareholders and their closely-held corporation, the definition is expanded somewhat. In this context, a true debt will be found to exist only if, at the time of the transfer of funds, there is "an unconditional obligation on the part of the transferee to repay the money, and an unconditional intention on the part of the transferor to secure repayment." n38 The existence of a debtor-creditor relationship is a question of fact to be resolved based on the economic substance of the transaction. n39

In considering whether a true debt exists for purposes of *I.R.C. section 61(a)(12)*, courts have often turned to the general body of law and commentary on the characterization of an instrument as debt or equity. n40 The courts often frame the central inquiry as one aimed at the determination of the intent of the parties based on the objective facts. n41 While labels attached to an instrument are of some importance, it is well settled that courts will consider a list of factors in determining the instrument's true character for federal income tax purposes. n42 There is no "one characteristic which can be said to be decisive in the determination of whether obligations are risk investments in a corporation or debt." n43 In addition, it appears that, in debt/equity cases, the initial form of the transaction may not bind a taxpayer. n44

The characterization issue arises in a variety of circumstances. For example, advances by creditors to a financially troubled corporation may be deemed equity. n45 Promissory notes with too many equity characteristics may represent a true equity interest, and the transfer of funds may be treated as a contribution to capital. n46 A loan may be treated as an equity contribution to a joint venture (between the lender and the borrower) when the lender has a substantial participation in future profits. n47 Finally, a so-called loan may be treated as a "disguised" advance payment for services if, among other things, repayment is contingent on future events within the control of the service-provider. n48

A true debt does not exist if the debtor disputes the existence of the debt. Under the so-called "contested liability" doctrine, the reduction of a disputed debt will not result in the recognition of discharge income by the debtor. Thus, the courts have held that the reduction of bank loans alleged invalid under state law n49 and the reduction of gambling debts alleged to be unenforceable n50 do not create discharge income. Once a settlement or court order fixes the amount of the debt, any subsequent reduction would create discharge income. n51 For example, the settlement of a disputed \$1,000 debt for \$600 would be a "nonevent" for the debtor for federal income tax purposes. However, if the debtor

subsequently paid \$500 cash in complete satisfaction of the subsequently agreed upon \$600 debt, the debtor would realize \$100 of discharge income.

A taxpayer will not realize discharge income if the discharged liability is contingent or indefinite to such a degree that it does not constitute a debt of the taxpayer. n52 If the debt is too contingent to be included in basis for federal income tax purposes upon its creation, the taxpayer-debtor cannot realize income upon the release of the obligation because the debt never represented an unconditional obligation to repay. n53 In a similar context, the Tax Court has held that a debt void under state usury laws is not a debt for purposes of the bad debt deduction under *I.R.C. section 166*. n54

Shareholders of closely-held corporations sometimes execute notes payable to the corporation that represent binding obligations to contribute additional cash. More commonly, limited partners formalize their obligation to contribute additional funds by delivering promissory notes payable to the limited partnership. If the partnership reduces or cancels these notes, does the reduction constitute discharge income? As a general matter, the shareholder or limited partner should not realize discharge income under these circumstances because the taxpayer-obligor did not receive any cash or other economic benefit in exchange for the execution of the note. n55 Thus, applying the two-step analysis set forth above, n56 the taxpayer-obligor did not borrow money that was excluded from income at the time the note was executed and, therefore, no income should be realized upon cancellation of the note. However, the answer might change, for example, when the notes represent the limited partner's obligation to restore a negative capital account and such partner had received allocations of recourse losses in prior taxable years. n57

A related issue arises when, instead of a direct obligation, a partner's negative capital account is cancelled or discharged. As a general rule, absent an agreement to the contrary, a partner will be liable to a partnership to the extent of such partner's negative capital account balance upon liquidation and dissolution of the partnership. n58 If that obligation is ultimately cancelled, then the partner will be treated as having received a distribution of money under *I.R.C. section 752(b)* and will recognize gain under *I.R.C. section 731*. n59 This issue is complicated by the requirement that a capital account balance of one partner must carry over to his or her successor partner upon a transfer of the partnership interest. n60 Thus, if a new partner succeeds to a large negative capital account that is not offset by subsequent income or gain during the life of the partnership, the new partner will recognize gain on the ultimate cancellation of the negative capital account.

Another discharge of indebtedness issue involves use of "straw" or nominee corporations. To avoid the usury laws in many states, investors who desire to use a partnership as the investment vehicle commonly form a "straw" corporation to act as the nominal borrower and record owner of the mortgaged property. All parties, including the lender, will regard the partnership as the true owner and borrower and will treat the corporation as the partnership's agent. For federal income tax purposes, will the partnership be treated as the obligor with respect to the mortgage? In a number of cases, the IRS argued that the corporation, not the partnership, was the owner of the mortgaged properties for federal income tax purposes. n61 However, the Supreme Court has held that the partnership will be treated as the owner for tax purposes if the evidence clearly establishes that the corporation is the genuine agent of the partnership. n62

Yet another issue involves the reduction of debt incurred in connection with the purchase of property. Courts have long recognized that, under appropriate circumstances, a reduction in purchase money debt can be a non-taxable adjustment in purchase price (rather than discharge income) with a concomitant reduction in basis. n63 It is relatively clear that this judicially developed doctrine has survived the enactment of *I.R.C. section 108(e)(5)* in the Bankruptcy Tax Act of 1980. n64 The IRS has applied this doctrine in support of its conclusion that rebates given by car manufacturers to purchasers of new cars n65 and "buy downs" of mortgage payments by home builders n66 are purchase price reductions that are not includable in income. n67 Trade discounts are similarly treated as a nontaxable adjustment to basis provided they arise at or after the time of purchase. n67a

Finally, even if there is a valid debt, discharge of the debt may not generate income under *I.R.C. section 61(a)(12)* in certain limited circumstances. The IRS has ruled that the waiver of payments for selected types of debts, when

repayment would cause an undue economic hardship, does not result in income. For example, the IRS has ruled that the discharge of an obligation to repay interim benefits paid to surviving dependents of deceased law enforcement officers was not includable in income because the waiver of repayment was in the nature of a relief payment and for the general welfare. n68 The IRS recently reiterated this position in private letter rulings. n69

[c] Exchange of Partnership Debt For Equity

The cancellation of an existing loan to a partnership by a taxpayer in exchange for an interest in the partnership should not result in the realization by the partnership of discharge of indebtedness income. Surprisingly, there is little direct authority on the existence of a partnership "equity for debt" exception. n70

There are no partnership provisions corresponding to the "stock for debt" exception which permits a creditor to exchange stock for debt of a corporation in a title 11 case (or to the extent of its insolvency) without recognition to the debtor corporation. n71 Although the legislative history of the House Ways and Means Committee version of what became the Bankruptcy Tax Act provided that rules similar to the corporate stock for debt exception would apply to an exchange of partnership equity for debt, n72 the Senate Report omitted any such provision. n73 That omission should not resolve the issue, particularly because the underlying theory for providing nonrecognition treatment to corporate transactions applies equally to partnerships. n74

An examination of related statutory provisions suggests that nonrecognition under a partnership equity for debt exception is the correct treatment. For example, *I.R.C. section 721* provides for nonrecognition treatment on the contribution of "property" to a partnership in exchange for a partnership interest. n75 Debt owed by a partnership should be treated as "property" for purposes of *I.R.C. section 721*. If a creditor contributed cash to the partnership to pay off the debt, the cash would clearly constitute "property." Collapsing the two transactions (the contribution of cash by the creditor followed by the partnership's use of that cash to pay the debt) into one, *i.e.*, contribution of the debt for a partnership interest in capital and profits, should not lead to a different result. n76

Further, strong inferences can be drawn from the statutory language of *I.R.C. section 108* in favor of partnership nonrecognition treatment. *I.R.C. section 108(e)(7)*, which provides a recapture rule upon a subsequent sale or exchange of stock exchanged for debt, n77 specifically provides that the Treasury is authorized to issue regulations applying similar recapture rules "with respect to indebtedness of a partnership." n78 Such a recapture rule would be necessary only if Congress understood a partnership equity for debt exception to exist.

In the past, the IRS indicated that it had not formulated an opinion on the partnership equity for debt issue. n79 However, the preamble to the proposed regulations promulgated in 1991 under *I.R.C. section 108(e)(4)* included a statement that the Treasury intended to issue regulations providing for recognition treatment for debt exchange transactions otherwise qualifying under certain nonrecognition provisions, including *I.R.C. section 721*. n80 However, the IRS promptly repudiated this statement. n81 Until either the Treasury or the IRS issues further guidance, an exchange of partnership debt for equity will be treated "in accordance with current law," and the exchange of partnership debt for a partnership interest "is not within the scope of the preamble." n82 Because the term "property" should include partnership indebtedness and, alternatively, the underlying theory for providing nonrecognition on the exchange of corporate stock for debt applies equally to partnerships, the exchange of partnership debt for a partnership interest should qualify for nonrecognition treatment. n83 With respect to the repeal of the corporate stock for debt exception in the Omnibus Budget Reconciliation Act of 1993, generally effective for stock transferred after 1994, n84 the legislative history clarified that "no inference is intended with the enactment of this provision as to the treatment of any cancellation of the indebtedness of any entity that is not a corporation in exchange for an ownership or equity interest in such entity." n85

In the American Jobs Creation Act of 2004, n85a Congress repealed the partnership equity for debt exception. The Act provides that when a partnership transfers a capital or profits interest in the partnership to a creditor in satisfaction of

partnership debt, the partnership recognizes discharge income to the extent the fair market value of the partnership interest is less than the adjusted issue price of the debt. n85b This provision applies whether the partnership debt is recourse or nonrecourse and the amount of discharge income is allocated solely among the partners holding an interest in the partnership immediately before the debt was satisfied. This provision is effective for cancellations of partnership debt on or after October 22, 2004. n85c

The IRS issued proposed regulations in 2008 on the rules applicable to indebtedness satisfied by a partnership interest, effective prospectively when the regulations are final. n85d Generally, the proposed regulations provide that, in a partnership debt-for-equity exchange, *I.R.C. section 721* will apply. n85e The partnership is treated as having satisfied the debt (whether recourse or nonrecourse) for an amount of money equal to the fair market value of the partnership interest. The fair market value will be presumed equal to the liquidation value of the interest if (1) capital accounts are properly maintained under the rules of *I.R.C. section 704(b)*, (2) the parties all treat the fair market value as the liquidation value, (3) the exchange is an arm's-length transaction, and (4) there is no plan at the time of the exchange to redeem or repurchase the interest which has a principal purpose of avoiding discharge income. n85f

[3] What Constitutes a "Discharge" of Indebtedness for Purposes of I.R.C. section 61(a)(12)?

[a] True Discharge

A "true" discharge occurs when a debt is forgiven or cancelled or when a creditor accepts a payment of less than the unpaid balance of the debt in complete satisfaction of the liability. A creditor will accept less when convinced that the debtor is financially unable to pay the full amount due or when the creditor determines there is a benefit to the receipt of early payment. n86 Premature payment is particularly beneficial for a lender, for example, when the interest rates have risen significantly, thereby reducing the current value of the debt instrument. n87 A cancellation may also occur if the creditor fails to act within the period of the applicable statute of limitations to enforce the debt, thus extinguishing the obligation by operation of law, n88 or if the debtor is otherwise released from his or her obligations to repay. n89 Generally, a cancellation of the debt will not occur if there is a reasonable expectation the debt will be repaid. n90

The Supreme Court has stated that a "discharge" qualifying for *I.R.C. section 108* treatment will occur only if there is a negotiated "forgiveness of, or release from, an obligation to repay." n91 The Court drew a distinction between the satisfaction of a legal duty between two parties and the discharge of a true debt. The Court concluded that a discharge relates not merely to the satisfaction of a legal duty, but instead refers to the cancellation or forgiveness of the debtor's legal obligation to repay a debt owed a creditor created at the outset of the relationship between the debtor and creditor. n92

[b] Discharge as a "Medium" of Payment

There is no cancellation when a creditor offsets a debt against a liability the creditor owes to the debtor or when the debtor and the creditor agree to a setoff or settlement of amounts they owe each other. n93 The legislative history of the Bankruptcy Tax Act of 1980 provides that "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." n94 For example, assume that a seller of goods sues the buyer to recover the selling price of \$1,000, and the buyer counterclaims for damages based on the seller's breach of contract. In release of their respective claims, the parties settle for a payment of \$800 by the buyer and a "discharge" of the remaining \$200 by the seller. Under these facts, the buyer will not have discharge income eligible for treatment under *I.R.C. section 108* because there has been no "discharge" of a debt. Instead, the buyer will realize income in an amount equal to the difference, \$200, on the grounds that the buyer received a constructive payment for his or her counterclaim. n95 The distinguishing feature in this example is that there is no dispute over the amount or nature of the debt, merely in the method by which the full \$1,000 debt is satisfied.

Commentators have labeled debt discharge that serves as a "medium" for a different form of payment (with the net

result that the debt has actually been paid in full by the delivery of equivalent goods or services) a "spurious" cancellation of indebtedness. n96 For example, assume that an employer "lends" an employee \$50 and the parties agree that the amount due will be offset against the employee's next paycheck.

When this occurs, the debt is paid in full even though no cash changes hands. The employee must report the \$50 as income, not because the debt has been cancelled for less than its face amount within the meaning of the *Kirby Lumber* case but because he has been paid for his services. n97

The test for determining whether a transaction involves a cancellation of debt or a disguised payment can be stated as follows: Has the creditor accepted less than the issue price of the debt in full satisfaction thereof (a cancellation) or, when other forms of consideration transferred are taken into account, has the debt been repaid in whole or in part (a disguised payment)? As explained above, other forms of consideration the debtor can transfer include services performed by the debtor, property or rights to property held by the debtor, separate claims the debtor has against the creditor or separate obligations owed by the creditor to the debtor. n98

The question of how to distinguish between a "true" cancellation of debt and a discharge that is merely a "medium" for a different form of payment presents some interesting conceptual problems. For example, if a certificate of deposit ("CD") holder makes an early withdrawal and, under the pre-set terms of the CD contract, must forfeit some of the interest on the deposit, does the bank realize discharge of indebtedness income in the amount of forfeited interest? Put another way, when a depositor incurs an early withdrawal penalty, is the depositor a "lender" cancelling a portion of the bank's debt (the obligation to repay the principal and to pay interest at the agreed rate for the term of the CD) or is the depositor paying a separate obligation by allowing the bank a setoff against the depositor's account? Resolving a split in the circuit courts, the Supreme Court in *Centennial Savings Bank v. United States*, n99 held that because the penalties were pre-set and the release of the deposits (which triggers the early withdrawal penalty) was solely at the discretion of the depositor, the bank realized income but such income could not be characterized as income from the discharge of indebtedness eligible for exclusion from gross income under *I.R.C. section 108*. The Court concluded that "the depositor does not 'discharge' the bank from an obligation when it accepts an amount equal to the principal and accrued interest minus the penalty, for this is exactly what the bank is obligated to pay under the terms of the CD Agreement." n100

[c] Substitution of Debt

Another exception to the *Kirby Lumber* rule is that a taxpayer generally will not realize discharge income when the debtor modifies an existing debt or substitutes a new obligation for the original debt, n101 unless the issue price of the new debt is less than the old debt. n102 Also, the taxpayer must make an appropriate adjustment to the issue price for unamortized premium or discount with respect to the debt. n103

In *Zappo v. Commissioner*, n104 the taxpayer argued that he did not realize income when he substituted a guarantee agreement for an existing debt, essentially making him secondarily liable for a debt for which he was previously the primary debtor. The Tax Court held that the taxpayer realized debt discharge income because a guarantee agreement is merely a contingent obligation which may or may not result in an obligation to pay in the future. As such, it was not a substitute for, or refinancing of, the first loan agreement, which imposed absolute liability. n105

It is not uncommon to find that a lender is willing to convert a recourse loan into a nonrecourse loan. Because the effect of this transaction is that the debtor is personally relieved of the entire amount of the loan, the IRS could argue that the debtor realizes discharge of indebtedness income equal to the amount of the debt. However, there is case authority for the proposition that a conversion from recourse to nonrecourse is not a taxable event. n106 At best, the IRS could contend that the debtor has realized a financial benefit or "accession to wealth" upon conversion to the extent that the amount of the debt exceeds the fair market value of the property securing the debt. n107 In effect, the debt has been satisfied to the extent of the fair market value of property received in exchange therefor. This result is consistent with the treatment of nonrecourse indebtedness as true debt to the extent of the fair market value of the collateral. n108

[d] Corporation-Shareholder Loans

Generally, if a creditor-corporation cancels a debtor-shareholder's loan, the cancellation will not be treated as discharge of indebtedness income but rather as a distribution of property under *I.R.C. section 301*. n109 If a creditor-subsiary corporation cancels a debt owed by its debtor-parent corporation in connection with a complete liquidation of the subsidiary, and the parent is entitled to nonrecognition under *I.R.C. section 332*, the debtor-parent will not realize (or recognize) income on the receipt of its own note. n110 However, the Treasury has indicated it will issue regulations providing for the realization of discharge of indebtedness income in certain nonrecognition transactions, including *I.R.C. section 332* liquidations, occurring on or after March 22, 1991. n111

[4] Indirect Creation of Discharge Income

[a] Determination of Issue Price and Application of the OID Rules

[i] Issue Price

As discussed above, n112 the amount of taxable income created by a discharge of indebtedness equals the difference between the "issue price" of the obligation, subject to certain adjustments, and the amount paid in complete settlement thereof. n113 The determination of the "issue price" is essentially a question of how much the debtor received at the time the indebtedness was incurred. If a debtor borrows money from an institution in the business of lending money, it is relatively easy to identify the amount of cash received. However, if a debtor borrows from investors in the market place through the issuance of debt instruments, particularly in the sophisticated financial markets which now exist, it is difficult to identify the amount of cash and/or property received in exchange for the issuance of a debt instrument.

In 1984, n114 Congress enacted *I.R.C. sections 1271-1274*, creating an extremely complex regime known as the "original issue discount" ("OID") rules. These rules require a holder of a debt instrument issued at a discount to include in income, as interest, original issue discount attributable to the debt, on a constant interest rate basis. n115 The term "original issue discount" means the excess of the stated redemption price at maturity over the issue price of a debt instrument. n116 Thus, as with the debt discharge rules, the determination of the "issue price" is one of the cornerstones of the OID rules. In general, the OID rules apply to debt instruments issued after December 31, 1984. n117 The issue price of debt instruments issued after December 31, 1984 that are neither (1) part of a publicly traded debt issue, nor (2) issued for stock or securities that are publicly traded, generally will be their stated redemption price at maturity (*i.e.*, stated principal). n118 The following discussion assumes the OID rules apply.

As discussed below, the issue price of a debt instrument is generally its stated principal. However, in certain instances the stated principal amount of a debt instrument does not accurately reflect the "actual" issue price. For example, if a \$1,000 bond is publicly traded and the initial offering price in the marketplace is \$900, the issue price can be accurately set at \$900. Similarly, if a \$1,000 bond is issued in exchange for publicly traded property, the issue price can be determined based on the value of the property received. Finally, if a "new" \$1,000 debt instrument with "inadequate" interest payable (as determined by a measuring or testing rate that varies with market conditions) is issued for an "old" \$1,000 debt, the issue price of the new debt may be determined by discounting all payments due based on the "test" or market rate that should have been charged. In general, the OID rules prohibit taxpayers from treating the stated principal amount of the debt as its issue price and instead require taxpayers to use a more accurate economic method of determining issue price when certain factors, such as public trading of the debt instrument, are available to identify the "true" issue price. The following material provides a more detailed discussion of the issue price rules.

Under the OID rules, the determination of the issue price of a debt instrument depends on whether the instrument (or property received in exchange therefor) trades publicly and whether the instrument is issued for "property." n119 *I.R.C. section 1273(b)(5)* defines the term "property" broadly to include all property other than money. n120 If a debt instrument is *not* issued for property (*i.e.*, is issued for cash) the issue price will be (1) if the debt instrument is publicly

offered, the initial offering price to the public, n121 or (2) if a debt instrument is not publicly offered, the price paid by the first buyer. n122 If a debt instrument is issued for property and the debt instrument is either (1) traded (or is part of an issue that is traded) on an established securities market, (2) issued for stock or securities that are so traded, or (3) to the extent provided in regulations, issued for other property that is regularly traded on an established securities market, the issue price will be the fair market value of the item that is publicly traded. n123 If a debt instrument is issued for property, and the public trading rules described above do not apply, the issue price will be generally the instrument's stated redemption price at maturity (*i.e.*, its stated principal), *unless* the instrument does not bear adequate stated interest, as discussed below.

Generally, *I.R.C. section 1274* applies to any debt instrument issued in exchange for property. *I.R.C. section 1274* will not apply, however, if the debt instrument provides for adequate qualified stated interest, which interest is to be paid currently at a constant rate at least annually at a single fixed rate over its entire term and the debt instrument is not issued in a "potentially abusive situation" as defined in Proposed *Treasury Regulation section 1.1274-3*. n124 In general, a debt instrument provides for "adequate stated interest" interest if it provides for interest at a stated rate over the entire term fixed rate, that is paid or compounded at least annually, which rate is at least equal to the testing rate--the applicable federal rate published by the IRS based on semiannual compounding for instruments of comparable maturities that is paid or compounded at least annually. n125 The issue price of a debt instrument subject to *I.R.C. section 1274* will be (1) the stated principal amount if the instrument provides for adequate stated interest, or (2) in all other cases, the imputed principal amount--the sum of the present value of all payments due discounted at a rate equal to the applicable federal rate if the instrument does not provide for adequate stated interest, or (3) the fair market value of the property received in the exchange (less the value of any consideration given in the exchange other than the debt instrument), in a "potentially abusive situation" (as defined). n126

[iii] Creation of Discharge Income Under OID Rules

For debt instruments (the "new" debt) issued in satisfaction of outstanding debt (the "old" debt) after October 9, 1990, Congress enacted a new provision that subjects the debt exchange to the OID rules. n127 Specifically, *I.R.C. section 108(e)(10)* provides that a debtor who issues new debt for old debt is treated as satisfying the old debt for an amount of money equal to the issue price of the new debt, n128 which issue price will be determined under the OID rules of *I.R.C. sections 1273 and 1274*. n129 Thus, under current law, discharge income and OID can be created in debt for debt exchanges based on the fair market value or inadequacy of stated interest of the new debt, even if the stated principal amounts of the old and new debt instruments are the same. n130

As discussed above, n131 if either the old or new debt is publicly traded, the issue price will be the fair market value of the publicly traded debt. n132 Thus, for example, if a debtor exchanges publicly traded old debt with a stated principal amount of \$1,000 and a fair market value of \$800 for new debt with a stated principal amount of \$1,000, the debtor will realize \$200 of discharge income. In effect, the debtor is treated under *I.R.C. section 108(e)(10)* as having satisfied the \$1,000 old debt for an amount equal to fair market value, in this case, \$800. The \$200 difference will also be "original issue discount" subject to ratable inclusion by the debt holder (and deductible by the issuer) over the term of the debt instrument. n133 On the other hand, if neither the old debt nor the new debt is publicly traded (and *I.R.C. section 1274* does not apply because the instrument provides for constant interest paid or compounded annually at a rate at least equal to the testing rate) n134 the debtor will not realize any discharge income on the exchange because the issue price of the new debt, in the above example, would equal its stated redemption price at maturity, the \$1,000 stated principal amount. n135

With respect to exchanges of corporate debt on or before October 9, 1990, n136 if a new debt was issued pursuant to a plan of reorganization under *I.R.C. section 368(a)(1)* and the issue price (as determined under the OID rules) of the new debt was less than the adjusted issue price of the old debt, the issue price of the new debt was deemed equal to the adjusted issue price n137 of the old debt. Thus, under prior law, corporate debt exchanges pursuant to a plan of reorganization did not create OID or discharge income if the stated principal of the new debt equaled the stated principal

of the old debt. n138

[b] Discharge Through Acquisitions of Debt by Related Parties

[i] The Statutory Language

A debtor realizes discharge of indebtedness income to the extent its indebtedness is satisfied for an amount less than the issue price, subject to certain adjustments. Prior to the Bankruptcy Tax Act of 1980, a debtor could structure a transaction so that, instead of directly reacquiring (and thereby cancelling) its debt, a related party would acquire the debt from the unrelated holder. Because of the close relationship between the parties, the debtor could "control" the enforcement actions of the creditor or engage in a series of subsequent transactions resulting in the functional equivalent of cancellation. For example, in *Peter Pan Seafoods, Inc. v. United States*, n139 the taxpayer successfully avoided discharge income by arranging for the acquisition of its mortgage notes by a newly organized sister corporation. The Court of Appeals for the Ninth Circuit rejected the government's argument that the debtor had, in effect, acquired its debt at a discount. Although it accepted the trial court's factual finding that the sister corporation was formed primarily for the purpose of permitting the taxpayer to avoid discharge income, the court of appeals held that the government had not established that the sister corporation was a "conduit, agent, alter ego, tool or instrumentality" used by the taxpayer to reacquire its mortgage notes at a discount. n140

In the legislative history of the Bankruptcy Tax Act of 1980, Congress acknowledged that "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." n141 To remedy this perceived abuse, Congress enacted *I.R.C. section 108(e)(4)* which provides that an acquisition of debt by a party related to the debtor from an unrelated holder will be treated as an acquisition by the debtor for purposes of the debt discharge rules. n142

Specifically, *I.R.C. section 108(e)(4)* provides that, for purposes of determining income from the discharge of indebtedness, to the extent provided in regulations issued by the Treasury (which, as discussed below, were issued in 1991), the acquisition of outstanding debt by a person bearing a special relationship to the debtor from an unrelated holder will be treated as the acquisition of the debt by the debtor. n143 For example, if a party related to the debtor acquires a debt instrument originally issued by the debtor for \$1,000 from a holder unrelated to the debtor for \$800, *I.R.C. section 108(e)(4)* should treat the acquisition as if the debtor had reacquired its \$1,000 debt for \$800. Accordingly, the debtor should be treated as realizing \$200 of discharge income under *I.R.C. section 61(a)(12)* by reason of the related party acquisition, even if the debt remains outstanding. n143a As discussed below, the final regulations under *I.R.C. section 108(e)(4)* provide that the cost is generally used to measure the amount of discharge income (the fair market value will be used if the related holder did not acquire the debt by purchase within 6 months before the acquisition date) and the post-acquisition treatment of the parties is conformed to the original issue discount rules through certain "correlative adjustments." n144

The definition of a "related party" for purposes of *I.R.C. section 108(e)(4)* is quite broad. For individuals, related parties include members of the individual's "family," which term is specially defined to include the individual's spouse, children, grandchildren, parents and any spouse of the individual's children or grandchildren. n145 Under this definition, an individual's brothers and sisters are not treated as related family members. n146 For business organizations, the general attribution rules of *I.R.C. section 267(b)* are expanded to include multiple entities which are treated as a single employer under *I.R.C. section 414(b)* or (c). n147

If the debtor is a partnership, a "related" party includes any partner who owns more than 50% of the capital profits of the debtor partnership (including attribution from related parties). n147a It also includes someone who is not a partner directly, but who is related (via the attribution rules of *I.R.C. section 267(b)-(c)*) to one or more persons who, in combination, own more than 50% of the capital or profits of the debtor partnership. In addition, a corporation would be

"related" to the debtor partnership, if the same person or persons own more than 50% (by value) of the outstanding stock of the corporation, and more than 50% of the capital or profits of the debtor partnership. n147b Similarly, another partnership will be "related" to the debtor partnership, if the same person or persons own more than 50% of the capital or profits in each partnership. n147c

If the debtor is a corporation, a "related" party includes any individual who owns (with attribution) more than 50% in value of the outstanding stock of the debtor corporation. n147d In this context, each partner in a partnership is deemed to own all of the stock owned by the other partners. n147e So, for example, if individual A acquires the debt of X Corp. while owning a small amount of X Corp. stock, and if A is a partner in the P partnership, then this will be treated as the acquisition of debt by a related party if the P partners in the aggregate own more than 50% of the value of the outstanding stock of X Corp. However, there is no attribution from the other partners in P to A, if A has no direct ownership of stock in X Corp. and no indirect ownership from anyone else other than family members. n147f Thus, if A owns no stock of X Corp., A's spouse owns 40% of the outstanding stock of X Corp., and more than 10% of the outstanding stock of X Corp. stock is owned by partners of the P partnership, A still can acquire the debt of X Corp. without that acquisition being treated as an acquisition by a related party within the meaning of *I.R.C. section 108(e)(4)*.

For purposes of determining who is included as a "related party" under *I.R.C. section 108(e)(4)*, the holder of an option to acquire stock may, under certain circumstances, be treated as having exercised that option, with the result that the list of "related parties" may be substantially expanded. As a starting point, *I.R.C. section 267(c)*, which provides rules for the constructive ownership of stock, does not mention options. n148 However, a careful reading of the Internal Revenue Code indicates that certain options will be treated as exercised for purposes of *I.R.C. section 108(e)(4)*. If two entities are treated as a single employer under *I.R.C. section 414(b)* or *414(c)*, those entities will be related within the meaning of *I.R.C. section 267(b)*. n149 *I.R.C. section 414(b)* treats as a single employer all corporations that are members of a "controlled group of corporations" under *I.R.C. section 1563(a)*. For purposes of determining the existence of a controlled group under *I.R.C. section 1563(a)*, "[i]f any person has an option to acquire stock, such stock shall be considered as owned by such person." n150 Thus, it is possible that an unrelated corporation holding options to purchase stock of the debtor will be treated as having exercised those options and may therefore be added to the list of "related parties" for purposes of *I.R.C. section 108(e)(4)*.

[Ii] The 1992 Final Regulations

The final regulations apply to transactions with an acquisition date on or after March 21, 1991, while providing that the statute is effective for pre-March 21 transactions. n151 The regulations address the following matters: (1) the circumstances under which an acquisition of debt will trigger application of the related party rules; (2) the amount for which the debtor is deemed to have reacquired its debt (generally, costs); (3) the post-acquisition treatment of the related party debt (called "correlative adjustments"); and (4) the exceptions to the rules.

Generally, the regulations provide that a debtor will realize discharge income (to the extent required under *I.R.C. sections 61(a)(12)* and *108*) if a person bearing a certain relationship to the debtor acquires a debtor's outstanding debt from a person who is not so related. n152 The regulations apply to both direct and indirect acquisitions of debt (as discussed below) and the "acquisition date" is the date on which the direct or indirect acquisition occurs. n153 The regulations generally measure the amount of discharge income by the related party's cost basis of the debt on the acquisition date n154 if the holder acquired the debt by purchase on or less than 6 months before the acquisition date. On the other hand, if the holder does not acquire the debt by purchase on or less than six months before the acquisition date, the discharge income will be measured by reference to the fair market value. Thus, if a related party buys a bond with a stated principal amount of \$1,000 for \$1,000 cash and becomes related to the debtor 7 months later, the debtor will realize discharge income under these rules if it can be established that the fair market value is actually less than the \$1,000 acquisition cost. n155

The related party rules apply to both direct and indirect acquisitions. A direct acquisition occurs if a related party (or an

unrelated party who becomes related on the date of the debt acquisition) acquires the debt from an unrelated debtholder. n156 An indirect acquisition occurs if a holder of outstanding debt subsequently becomes related *and* the holder acquired the debt "in anticipation of becoming related to the debtor." n157

The regulations provide that the "in anticipation" determination will generally be based on the facts and circumstances, including for example, the intent of the parties at the time of the acquisition, the nature of the contacts between the parties before the acquisition and the significance of the debt in proportion to the total assets of the holder group (as defined in section 1.108-2(c)(5)). n158 However, the debt will be deemed acquired in anticipation of becoming related if the holder acquired the debt less than 6 months before the date the holder becomes related to the debtor. n159

If the holder becomes related under the following circumstances, the regulations require the debtor to disclose by attaching a statement to its tax return for the year in which the debtor becomes related to the holder. n160 These circumstances are:

1. The holder acquired the debt within 6 to 24 months prior to the date the holder becomes related; or
2. On the date the holder becomes related, more than 25 percent of the fair market value of the holder's gross assets (or the total gross assets of the "holder group," which includes all persons who are related to the debtor both before and after the date the holder becomes related to the debtor) consist of debt of the debtor. For this purpose, "total gross assets" exclude cash, so-called cash items, marketable stock or securities, short term debt, options, future contracts, notional principal contracts, and similar items. n161

If the debtor fails to file the statement, in addition to applicable penalties that may apply, the regulations provide that the holder will be *presumed* to have acquired the debt "in anticipation" of becoming related unless the facts and circumstances are clearly to the contrary. n162

In an indirect acquisition, the debtholder first acquires the debt and then is deemed related to the debtor because of a subsequent transaction in which the requisite relationship with the debtor is created (for example, an acquisition of a substantial equity interest in the debtor, or a related party's acquisition of stock of the holder). With respect to the treatment of the debtholder in an indirect acquisition subject to *I.R.C. section 108(e)(4)*, the regulations provide that the debtholder will not recognize gain or loss under *I.R.C. section 1001*. n163

As discussed above, if the related party rules of *I.R.C. section 108(e)(4)* apply, the debtor is conceptually treated "as if" it reacquired (and cancelled) the debt from the unrelated holder. In fact, the debt remains outstanding after the fictional cancellation. The legislative history provides that if the debt is ultimately repaid by the debtor, the "entire transaction is to be treated generally the same as if the debtor had originally acquired the debt." n164 Thus, for example, if a subsidiary corporation repaid a debt purchased by its parent at a discount, the excess would be treated as a dividend. n165 In the regulations, however, the Treasury rejected the "as if acquired by the debtor" approach and instead conformed the post-acquisition treatment of the parties to the time value of money (or "original issue discount") rules enacted by Congress subsequent to the Bankruptcy Tax Act of 1980. n166 Accordingly, if a debtor realizes discharge income under *I.R.C. section 108(e)(4)*, it will be treated as having issued a new debt instrument to the related holder on the acquisition date with an issue price equal to either the holder's cost basis or the fair market value of the debt instrument, under the rules discussed above. n167 The excess of the stated redemption price at maturity over the issue price is treated as original issue discount, deductible by the debtor and includable in income by the related holder over the term of the instrument. n168 The following example from the regulations illustrates the post-acquisition treatment of the debtor and the related holder: n169

P, a domestic corporation, owns 70 percent of the single class of stock of S, a domestic corporation. S has outstanding indebtedness that has an issue price of \$10,000,000 and provides for monthly interest payments of \$80,000 payable at the end of each month and a payment at maturity of \$10,000,000. The

indebtedness has a stated maturity date of December 31, 1994. On January 1, 1992, P purchases S's indebtedness from I, an individual not related to S within the meaning of Regulations section 1.108-2(c)(2), for \$9,000,000. The fair market value of the indebtedness on that date is \$9,000,000. S repays the indebtedness in full at maturity.

(i) Under I.R.C. *section 61(a)(12)*, I.R.C. *section 108(e)(4)*, and Regulations section 1.108-2(a) and (f), S realizes \$1,000,000 of income from discharge of indebtedness on January 1, 1992.

(ii) Under Regulations section 1.108-2(e)(1), the indebtedness is treated as issued to P on January 1, 1992, with an issue price of \$9,000,000. Under section 1273(a), the \$1,000,000 excess of the stated redemption price at maturity of the indebtedness (\$10,000,000) over its issue price (\$9,000,000) is original issue discount, which is includable in gross income by P and deductible by S over the remaining term of the indebtedness under I.R.C. *sections 163(e)* and *1272(a)*.

(iii) Accordingly, S deducts and P includes in income original issue discount, in addition to stated interest, as follows: in 1992, \$289,144.88; in 1993, \$331,286.06; and in 1994, \$379,569.06.

Finally, the regulations provide two instances in which the related party rules do not apply: (1) if the debt has a stated maturity date that is one year or less after the acquisition date, provided the debt is actually retired on or before the maturity date; and (2) if the debt is acquired by a dealer in the ordinary course of its business of dealing in securities, provided the dealer (i) accounts for the debt as one held for sale to customers in the ordinary course of business; (ii) disposes of the debt within a period consistent with a debt held for sale to customers; and (iii) the dealer does not sell the debt to a party related to the debtor (unless such party can also satisfy the foregoing dealer rules). n170

Interestingly, the final regulations under I.R.C. *section 6050P* provide that information reporting (on Form 1099-C) is not required in the case of a deemed discharge under I.R.C. *section 108(e)(4)*, unless the creditor made the disposition to the related party "with a view to avoiding the reporting requirements of this section." n171

[5] Does Relief From a Guarantee Create Discharge of Indebtedness Income?

[a] General Rule

The taxpayer-guarantor should not realize discharge of indebtedness income upon the release of the taxpayer's obligation as a guarantor. n172 In *Bradford v. Commissioner*, n173 the taxpayer executed a note as payment for a prior debt of her husband and subsequently purchased the note at a discount. Applying a rationale similar to that in *Commissioner v. Rail Joint Co.*, n174 the Sixth Circuit held that the taxpayer did not realize income from the discharge of her indebtedness because the taxpayer had promised to pay the prior debt of her husband "without receiving any consideration in return." n175 It should be noted that, in *Bradford*, the taxpayer did not execute the guarantee contemporaneously with the underlying debt nor did the taxpayer receive compensation for the guarantee. n176

If a taxpayer is released from an obligation under the guarantee agreement before the guarantee is "triggered," the taxpayer can argue that he or she realized no discharge income because the obligation of a guarantor is too contingent or indefinite to constitute a debt of the taxpayer. n177 However, even if a guarantor becomes liable under the terms of the guarantee agreement, absent unusual circumstances (such as those discussed below), a guarantor should not realize discharge income upon release. Such a conclusion is supported by the two-step analysis of a debt discharge transaction: n178 because the guarantor did not borrow money that it received and excluded from its income upon execution of the

guarantee, the guarantor should not realize any income upon the cancellation of its guarantee. This conclusion is also supported by the common sense rationale that the cancellation of a \$100 debt to A, guaranteed by Z, can at most only produce a maximum of \$100 of discharge income. To conclude otherwise would "double" the maximum of \$100, requiring complicated and unnecessary correlative adjustments through an offsetting bad debt deduction for the guarantor, Z in this example. n179

Suppose a taxpayer personally guarantees a debt, the debtor defaults and the creditor calls on the taxpayer to pay the debt. What are the federal income tax consequences to the taxpayer if someone *other* than the taxpayer satisfies the obligation? In *Tennessee Securities, Inc. v. Commissioner*, n180 the Tax Court upheld the IRS's position that the guarantors realized income in the amount of the guarantee satisfied by their closely-held corporation. The Tax Court based its decision not on a "discharge of indebtedness income" theory but instead on the general principle that a taxpayer realizes income whenever a third party satisfies the taxpayers' legal obligation. n181

On appeal, the Court of Appeals for the Sixth Circuit affirmed the Tax Court on two different grounds. n182 First, the court cited *Wortham Machinery Co. v. United States* n183 for the proposition that satisfaction of a personal loan guarantee by the guarantors' closely-held corporation results in an imputed dividend distribution to the shareholder-guarantor. n184 Second, the court concluded that the Tax Court had properly imputed income to the guarantors in the amount of the debt because the satisfaction of the guarantee by the closely-held corporation had benefitted them. n185 The court distinguished *Bradford* on the grounds that the guarantors, unlike the taxpayer in *Bradford*, had received consideration because they had guaranteed the debt in exchange for the expectation of profit from their closely-held corporation. n186

Although the proper answer is that a taxpayer should not realize discharge income upon the cancellation of its obligation as a guarantor, the above-cited authorities indicate that, under certain unusual circumstances, the IRS may impute income to a taxpayer upon such an event. If the taxpayer's obligation as a guarantor is satisfied by a third party, the IRS may impute dividend or other income to the taxpayer. As discussed below, even if income is imputed to the taxpayer as the result of the discharge or satisfaction of the taxpayer's obligation as a guarantor, the taxpayer should be entitled to a bad debt or loss deduction to the extent the taxpayer is deemed to have paid the debt as a guarantor. n187

[b] Treatment of Payments by Guarantors

A payment made by a taxpayer in discharge of all or part of the taxpayer's obligation as a guarantor where the taxpayer entered into the guarantee agreement in the course of his or her trade or business is treated as a business bad debt under *I.R.C. section 166*, and neither *I.R.C. section 163* (interest deduction) nor *I.R.C. section 165* (loss deduction) will apply with respect to payments made by the taxpayer if the taxpayer entered into the guarantee agreement in the course of his or her trade or business. n188 If the taxpayer guarantees a debt pursuant to a transaction entered into for profit but not in the course of a trade or business, a payment by the taxpayer in discharge of part or all of the obligation as a guarantor is treated as a worthless non-business debt when payment is made. n189 As with a business bad debt, the guarantor may claim a deduction only under *I.R.C. section 166*. n190 However, the guarantor is not entitled to a bad debt deduction if the guarantor did not receive reasonable consideration in exchange for entering into the non-trade or business guarantee. n191

A payment made by a taxpayer to be released from an obligation under the terms of a guarantee before the taxpayer becomes liable as a guarantor should be deductible as a loss incurred in a transaction entered into for profit under *I.R.C. section 165(c)(2)*. n192

[6] Dispositions of Property in Satisfaction of Debt

[a] Gain or Loss From a Sale or Exchange or Part Discharge of Indebtedness Income

A debtor's transfer of property to a creditor in satisfaction of a debt (whether voluntary or involuntary, *i.e.*, foreclosure) has the same economic result as a discharge of indebtedness. However, as the following discussion illustrates, a transfer of property to satisfy or discharge a debt may be treated in part as a "discharge" of indebtedness (with the income eligible for exclusion under *I.R.C. section 108*) and in part as a "sale or exchange" of property governed by *I.R.C. section 1001*. Alternatively, such a transfer may be treated entirely as a sale or exchange upon which the transferor realizes gain or loss under *I.R.C. section 1001*. The Treasury Regulations provide that the former result (depending on the fair market value of property, transaction may be part discharge and part sale or exchange) applies if the debt is recourse debt, and the latter result (all sale or exchange without regard to fair market value) applies if the debt is nonrecourse debt.

By way of background, a transfer of property in exchange for consideration received is treated as a "sale or exchange," n193 with the difference between the "amount realized" and the transferor's adjusted tax basis in the property recognized as gain or loss under *I.R.C. section 1001(c)*. n194 A taxpayer's "amount realized" with respect to a sale or exchange of property includes the amount of liabilities relieved or taken subject to. n195 To the extent the "amount realized" exceeds adjusted tax basis, the resulting gain is "derived from dealings in property" and includable in gross income under *I.R.C. section 61(a)(3)*. n196 The most significant consequence of the recognition of gain "derived from dealings in property" is that the taxpayer will not be eligible to use *I.R.C. section 108* to exclude the gain from gross income. n197 As a result, the taxpayer will include gain in gross income whether or not the taxpayer is insolvent or in a title 11 case. n198

As discussed above, the consideration received by a transferor of property, or "amount realized," includes the amount of liabilities relieved or taken subject to by the transferee. The amount of liabilities relieved or taken subject to will equal the amount of liabilities extinguished by the transfer of property in the sale or exchange transaction. n199 To the extent a liability is extinguished, the transferor has received value or consideration for the property transferred. n200 Thus, for example, the transaction will be treated as a sale or exchange of property for an "amount realized" of \$100 whether the taxpayer first sells an asset for a sales price of \$100 cash and uses the cash proceeds to satisfy a \$100 debt or alternatively transfers the asset (with a value of \$100) to the creditor in satisfaction of a \$100 debt. n201

The amount of liabilities extinguished by a transfer of property that secures a liability will generally depend upon whether the debt is recourse or nonrecourse. If the debt is recourse, the debt will be satisfied only to the extent of the fair market value of the property transferred. For this reason, the Treasury Regulations n202 provide that a transfer of property in full satisfaction of a recourse debt is bifurcated into two separate transactions: (1) a sale or exchange transaction (producing gain or loss under *I.R.C. section 1001*) for an amount realized equal to the fair market value of the property transferred and (2) a discharge of indebtedness for the amount of debt discharged in excess of fair market value. n203 On the other hand, if the debt is nonrecourse, the transfer is treated as one transaction: a sale or exchange for an amount equal to the adjusted issue price of the nonrecourse debt. n204

The distinction between recourse and nonrecourse debt is based on the position adopted by the IRS and subsequently accepted by the Supreme Court in *Commissioner v. Tufts* n205 that nonrecourse debt is true debt. Under this position, a transfer of collateral to the lender in satisfaction of a nonrecourse debt will not give rise to discharge of indebtedness income, because the debt has been satisfied according to its terms and the lending transaction has come to an end. That is, the lender's only recourse in the event of a default on the debt instrument is repossession of the collateral. n206 The transaction is therefore treated a "sale or exchange" under *I.R.C. section 1001* with an "amount realized" equal to the adjusted issue price of the nonrecourse debt. n207 Thus, the "amount realized" will not be limited to the fair market value of the property transferred in satisfaction of a nonrecourse obligation. n208 The Supreme Court reached this conclusion in *Tufts* in part on the theory that the taxpayer is treated as if he received cash in exchange for the property transferred and thereafter used the cash to pay the nonrecourse debt in full. n209

The following example illustrates the tax treatment of a transfer of property to a creditor in satisfaction of a debt. Owner owns property subject to a debt of \$25,000 with an adjusted basis of \$20,000 and a fair market value of \$10,000. Owner

transfers the property to Lender in full satisfaction of Owner's debt to Lender. n210 Owner's total liabilities exceed the fair market value of Owner's assets by \$50,000 immediately before the transfer. Therefore, Owner is insolvent to the extent of \$50,000 within the meaning of *I.R.C. section 108(a)(1)(B)* and *(d)(3)*.

Owner's federal income tax consequences as a result of the transfer depend on whether the debt is recourse or nonrecourse. n211 If the debt is recourse, the regulations provide that Owner must bifurcate the transfer into two separate transactions: (1) a sale or exchange transaction (producing gain or loss), and (2) a discharge of debt transaction. n212 Owner first determines the amount of gain or loss realized under *I.R.C. section 1001(a)* on the disposition of the property. n213 Owner's "amount realized" on the transfer is limited to \$10,000, the fair market value of the property. Because Owner's adjusted basis is \$20,000, Owner has a \$10,000 loss as a result of the transfer to Lender. Owner also has \$15,000 of discharge of indebtedness income (\$25,000 (discharged debt)--\$10,000 (fair market value of the property)). n214 This result occurs regardless whether the transfer is voluntary or made under the threat of foreclosure. n215

On the other hand, if the debt is nonrecourse, the regulations require Owner to treat the amount of the debt (\$25,000) as the amount realized. n216 Thus, Owner will have \$5,000 of gain (\$25,000 (amount realized)--\$20,000 (adjusted basis)) and no discharge income. The debtor will be treated as having sold the property securing the nonrecourse debt, whether the creditor forecloses on the collateral or the debtor voluntarily transfers the collateral back to the creditor, abandons the property, or merely executes a release to the mortgagee. n217

[b] Treatment of Partially Recourse Debt

When a secured debt is partially recourse, n218 the IRS takes the position that a settlement or transfer in complete satisfaction of the debt, whether by cash payment or the transfer of property, will be allocated to the nonrecourse portion of the debt first absent an agreement to the contrary. n219 Thus, if the value of the property transferred to the creditor is less than the outstanding balance of the nonrecourse portion, the "amount realized" will equal the outstanding balance of the nonrecourse portion of the debt. n220 The difference between the outstanding balance of the nonrecourse debt and the total debt, the recourse portion, will be treated as discharge of indebtedness income. n221 On the other hand, if the fair market value of the property exceeds the outstanding balance of the nonrecourse debt, the "amount realized" will equal the fair market value of the property, and discharge of indebtedness income will be realized only to the extent the balance of the recourse portion of the debt exceeds the value of the transferred property.

Although the IRS' position may be arbitrary in assuming that the nonrecourse portion will be paid first, the position benefits the debtor in that, if the debt is completely discharged as a result of the transfer, the assumption that the nonrecourse portion of the debt is paid first maximizes the amount of discharge income and, therefore, the availability of the *I.R.C. section 108* exclusion. In any event, if the value of the collateral is less than the nonrecourse portion of the debt, absent an agreement specifically allocating the collateral in settlement of a partial recourse debt, the financially troubled debtor will maximize the nonrecognition benefit of *I.R.C. section 108* by selling the collateral and using the proceeds to discharge the debt or, if possibly, by converting the entire debt to a recourse debt before making a transfer in satisfaction of the debt.

[c] Definition of Nonrecourse Debt

The definition of nonrecourse debt and methods used to determine the character of debt as recourse or nonrecourse are unclear. The term "nonrecourse debt" is not defined in *I.R.C. section 1001* or in the regulations promulgated thereunder. n222 The examples set forth in the regulations indicate that a nonrecourse debt is one for which the debtor has no personal liability and the creditor's remedies upon default are limited to the property securing the debt. n223 This definition is consistent with *I.R.C. section 108(d)(1)(B)* which includes as indebtedness of the taxpayer, a debt "subject to which the taxpayer holds property" and with prior case law. n224 Thus, a nonrecourse debt should be defined as a debt for which the debtor is not personally liable and the creditor's remedies upon default are limited to the property

securing the debt. n225

The definition of nonrecourse debt for purposes of *I.R.C. section 1001* should not fully incorporate the partnership rules (particularly the debt sharing rules of *I.R.C. section 752*), because those rules are based on whether any partner (or related person) bears the economic risk of loss for a partnership liability. n226 Thus, for example, a partnership nonrecourse debt generally is recharacterized as recourse if a lender becomes a partner in the partnership. n227

As a general rule, the character of a debt as nonrecourse should be based on a state law examination of the "four corners" of the debt instrument, taking into account separate but related contractual obligations such as guarantees executed by parties that have a direct relationship with the debtor such as partners or shareholders. If the debtor is not personally liable under the terms of the instrument, the debt is not guaranteed and the creditor's remedies are limited to the collateral securing the debt, the debt should be nonrecourse. n228

[d] Reduction in Basis

The discussion in *P TX6.02[6][a]* above addresses the consequences of a disposition of property in satisfaction of a debt. A related question is what are the tax consequences when a debtor obtains a discharge of indebtedness secured by property and the debtor retains the property. If the indebtedness is recourse to the debtor, the debtor retains the collateral, n229 the reduction is not a purchase price adjustment n230 and the taxpayer is not eligible to make an election to reduce basis under *I.R.C. section 108(a)(1)(D)* with respect to qualified real property business indebtedness, n231 the debtor will realize discharge income under *I.R.C. section 61(a)(12)* to the extent of the discharge. n232

Discharge income results from the reduction of a third-party purchase money nonrecourse debt when the taxpayer retains the collateral. n233 The IRS ruled that a taxpayer realizes ordinary discharge income upon the reduction of a nonrecourse debt by a holder who was not the seller of the property securing the debt. n234 As an aside, *Revenue Ruling 91-31* is important because it recognizes nonrecourse debt as "indebtedness of the taxpayer" that can produce discharge income eligible for exclusion from gross income under *I.R.C. section 108*. n235

[e] Miscellaneous Issues Arising When Debt Is Satisfied With Property

[i] Application of Foreclosure Proceeds Between Principal and Interest

Absent an agreement to the contrary, if a debtor is insolvent at the time of foreclosure or transfer in lieu of foreclosure, the proceeds from foreclosure or the value of the property transferred first will be applied to principal and then to interest. n236 On the other hand, if the debtor is solvent, then the proceeds from foreclosure or the value of the property transferred are first applied to payment of accrued interest on the debt. n237

[ii] Treatment of Accrued but Unpaid Interest

The tax treatment of interest that has accrued under the terms of the debt instrument but is unpaid depends, in part, on the value of the collateral. If, in a foreclosure proceeding, a cash basis lender bids in an amount of debt equal to the principal plus accrued interest and acquires the collateral, the lender will realize interest income to the extent of the accrued interest. n238 A cash basis debtor will be entitled to a corresponding deduction for the interest paid. n239 If, in lieu of foreclosure, the debtor voluntarily surrenders the collateral to the mortgagee and the value of the collateral exceeds the principal amount of the debt, then the cash basis creditor realizes interest income to the extent of such excess, and the cash basis debtor is entitled to a corresponding deduction for a deemed payment of interest. n240 An accrual basis lender who has not previously accrued interest income because of uncertainty as to the collectibility of the debt n241 is treated the same as a cash basis lender and will realize interest income upon a surrender of the collateral by the debtor. n242 On the other hand, if the value of the collateral is less than the principal amount of the debt, the cash basis lender (or accrual basis lender that did not include the interest in income) will generally not realize interest income, n243 and the cash basis debtor will neither add the interest to the amount realized nor claim an interest

deduction. n244 To the extent the accrual basis lender included interest in taxable income in a prior taxable year and the interest becomes uncollectible, the lender is entitled to a bad debt deduction. n245

[iii] Application of Tax Benefit Rule

The application of the tax benefit rule must be considered when a taxpayer disposes of property in satisfaction of a debt. In *Allan v. Commissioner*, n246 the Court of Appeals for the Eighth Circuit held that the interest and taxes advanced by the mortgagee constituted a true loan that was added to principal under the terms of the original debt instrument. n247 As an addition to principal, the court concluded that such amounts were properly included as part of the amount realized on the transfer. n248 As a result, although the debtor had previously claimed deductions for taxes and interest, none of the gain on the sale was recharacterized under the tax benefit rule as ordinary income. n249 Also, the court concluded that the lender did not realize interest income as a result of the transfer because the value of the collateral was less than the outstanding principal on the debt. n250

[7] Other Issues

Discharge of indebtedness can create a number of specific problems for the debtor, the lender and third parties. This section contains examples of these problems.

[a] Nonrecourse Seller Financing

For property placed in service after December 31, 1986, *I.R.C. section 465(b)* provides that investors in real estate will be considered "at risk" to the extent of indebtedness for which they are personally liable as well as any share of "qualified nonrecourse financing" that they have undertaken. Generally, "qualified nonrecourse financing" does not include nonrecourse seller financing. n251 As a result, if a lender acquires title to real estate by foreclosure or deed in lieu of foreclosure and thereafter transfers the property to a new owner subject to the lender's debt, seller financing is in place and the indebtedness is not at risk. As an alternative, the lender may request or, if possible, direct the borrower to transfer the foreclosed property to the new third party owner. This alternative may, however, be in conflict with older case law regarding the time at which a creditor becomes the effective owner of property. n252

[b] Effect of Sale of Property Subject to Indebtedness With Direction to Pay Sales Proceeds to Lender

In *Danenberg v. Commissioner*, n253 an insolvent taxpayer sold property securing a bank loan to a third party and directed that the proceeds of the sale be paid directly to the bank and applied to the outstanding indebtedness. After crediting the proceeds of the sale of the collateral against the taxpayer's debt, the bank forgave the remaining balance of the loan. In rejecting the taxpayer's argument that these transactions amounted to a discharge of indebtedness rather than a sale or exchange, the Tax Court held that a debtor's transfer of property to a creditor or to a third party is treated as a sale or exchange to the extent of the value received from the third party. n254 The result was not changed because the third party paid the sale proceeds directly to the bank. In such a case, the taxpayer is treated as if he or she had sold the asset for a cash equivalent and used that amount to pay down the debt. n255 The court then held that the taxpayer's insolvency at the time of the sale did not affect the recognition of gain realized upon the sale. There is no insolvency exception to gain recognition under *I.R.C. section 1001* and *I.R.C. section 61(a)(3)*. n256

[c] Timing of Realization of Income From Discharge of Indebtedness

An important question is when the taxpayer must realize discharge income for federal income tax purposes. The answer depends upon the time at which a debt is discharged. The determination of timing, in turn, depends upon whether the debtor is in a title 11 case.

[i] Debtor in a Title 11 Case

If the debtor is in a title 11 case, the timing of discharge depends upon whether the debtor is in a reorganization or liquidation case. In a chapter 11 reorganization, unless otherwise provided in the debtor's plan or the court's order confirming the plan, all debts that arose before the date of confirmation are generally discharged upon confirmation of the plan of reorganization. n257 For an individual debtor in a chapter 7 liquidation, all debts that arose before the date of the court's order for relief are generally discharged upon entry of an order granting the debtor a discharge. n258 Non-individual debtors, such as corporations and partnerships, cannot obtain a discharge in a chapter 7 liquidation. n259

Overall, for debtors in a title 11 case, a debt should be discharged upon the earlier of (1) the transfer or distribution of property in satisfaction of the debt or claim, or (2) the date the debt or claim is discharged under the Bankruptcy Code, as described above. n260

[iii] Debtor Not in a Title 11 Case

Outside a title 11 case, the time at which a debt is discharged is not as clear. Confusion with respect to timing is due, in part, to the variety of circumstances under which a debt can be discharged for less than the amount due: (1) debtor's payment of cash to the creditor; (2) debtor's transfer of property other than cash to the creditor; (3) a binding agreement of the debtor and creditor without the transfer of consideration; (4) debtor's (or a party related to the debtor as provided under *I.R.C. section 108(e)(4)*) purchase of its debt from a debtholder for an amount less than the issue price (typically, a corporation's repurchase of its outstanding bonds); (5) conclusive unilateral acts of the creditor which can be formal (written notice of forgiveness or cancellation) or informal (debt is "written off" on creditor's books with no intent to seek collection); (6) collection procedures established under applicable law, such as foreclosure; and (7) running of applicable statute of limitations for enforceability of debt.

As a general rule, a debt is discharged when one of the following identifiable events occurs: (1) the debt is forgiven by a binding agreement of the parties, n261 (2) the debt is cancelled by a conclusive unilateral act of the creditor or by operation of applicable law n262 or (3) a creditor accepts payment of an amount less than the issue price of the debt in complete satisfaction thereof n263 (as discussed below, the transfer of property other than cash may be treated in part as a "sale or exchange" producing gain or loss and in part as a discharge of debt), n264 or (4) the moment it becomes clear the debt will not be repaid, based on the facts and circumstances relating to the likelihood of repayment. n265 Courts have held that a discharge occurs when the evidence (an "identifiable event") indicates that the debt will not be repaid. n266 For example, a debt may be discharged when the creditor writes the debt off on its books with no expectation of repayment. n267 Although the courts have held a debt to be discharged earlier, a debt will be discharged when cancelled or extinguished by operation of applicable law, such as in certain cases the running of the applicable statute of limitations. n268 If the debt is partially recourse, such as a partial guarantee, the debt should be divided into two separate liabilities. However, absent the events discussed above, a debt should not be discharged merely because the lender has not actively pursued its remedies, claims a deduction for financial or regulatory purposes or claims a bad debt deduction for tax purposes. n269

As discussed above, although economically discharging the debt, a debtor's transfer of property other than cash in satisfaction of a debt will be treated as a taxable "sale or exchange." n270 The amount of gain or loss realized by a debtor will be measured by the difference between the "amount realized" and the debtor's adjusted tax basis in the property transferred. n271 The "amount realized" by a debtor generally depends on whether the debt is recourse or nonrecourse. n272 In any event, a taxable disposition will take place when a foreclosure terminates the debtor's interest in the collateral. n273 Therefore, a taxable disposition and cancellation of debt will not occur until the debtor's right to redeem under applicable law, if any, expires or is released by the debtor. n274 If a debtor acts to dispose of property prior to foreclosure, a taxable disposition of property will occur upon the earlier of a debtor's conveyance of property to a creditor in a consensual deed in lieu of foreclosure n275 or an abandonment of the collateral securing the debt. n276 Cancellation will not occur if the debtor remains personally liable for the debt. n277

Absent an identifiable event fixing the discharge, there is some question whether an agreement between the debtor and creditor will determine the date of discharge. For example, it has been held that a debtor will realize all of the discharge income in the year of settlement rather than proportionately over a 10-year installment period when the so-called installment payments were merely offsets that were not created for valid business reasons. n278 However, absent facts indicating a tax avoidance purpose without independent substance, discharge income should be realized at the time the parties provide in writing that the debtor is legally relieved from the repayment of the indebtedness, taking into account conditions precedent to discharge. n279 For transactions after September 23, 1996, a contingent reduction in principal (or other changes to the debt instrument) will most likely be a "significant modification"; resulting in the immediate recognition of COD income. n279a

[d] Fair Market Value of Collateral Established in Foreclosure Proceedings and Tax Treatment of Creditor

Generally, a third-party creditor who acquires collateral in satisfaction of a debt will recognize gain or loss to the extent of the difference between the fair market value of the collateral received (less collection expenses) and its adjusted basis in the debt. n280 If a creditor acquires the collateral pursuant to a foreclosure proceeding, the fair market value of the collateral received is presumed to be the bid price at the foreclosure proceeding, absent clear and convincing proof to the contrary. n281 Either the IRS or the taxpayer may subsequently attempt to establish that the bid price did not reflect the fair market value of the property. n282 The presumption that the bid price establishes fair market value is rebuttable even if state law indicates that the bid price is conclusive evidence of fair market value. n283 If a strict foreclosure occurs or if the creditor accepts a conveyance in lieu of foreclosure (so that there is no bid price), the courts treat the creditor as having collected the debt to the extent of the fair market value of property. n284

If the value of the collateral is less than the adjusted basis of the debt and costs of collection, the creditor may deduct the loss as a bad debt in the taxable year of the foreclosure, assuming the creditor is not entitled to a deficiency judgment that may be collectable. n285 If the value is in excess of adjusted basis and costs of collection, the gain realized by the creditor will be ordinary income because a conveyance of property to the creditor is not treated as a "sale or exchange." n286 However, if the creditor buys the mortgage or pledged property pursuant to a foreclosure sale, it will realize "sale or exchange" gain (or loss) under *I.R.C. section 1001*. n287 The creditor's basis in the property acquired is the fair market value of the property at the date of acquisition. n288

[e] Waiver or Cancellation of Interest Between Parties With Special Relationships

I.R.C. section 7872 applies to loans that do not require the payment of interest or require payment of interest at a rate below the statutory rate established in *I.R.C. section 7872* (so-called "below market loans") made after June 6, 1984 between lenders and borrowers with special relationships. n289 If applicable, *I.R.C. section 7872* provides that a below market loan is recharacterized as an "arm's length" loan transaction in which (1) the lender made a loan to the borrower with a statutory rate of interest (equal to the applicable federal rate published by the IRS) payable annually, (2) the lender then makes an imputed transfer of an amount of money equal to the foregone interest (the difference between the actual interest rate and the required statutory rate), which transfer is characterized for federal income tax purposes based on the relationships involved (gift, dividend, compensation, etc.), and (3) the borrower then makes an imputed retransfer of the amount back to the lender as a deemed payment of interest. n290 Thus, in the case of a below market term loan made by a corporation to a shareholder, the shareholder will receive dividend income equal to the imputed difference at the time the loan is made, while the corporation will realize additional interest income in the form of original issue discount includable under *I.R.C. section 1273*. n291

The proposed regulations provide that if a loan requires the payment of adequate statutory interest and, subsequently, the accrued but unpaid interest is waived, cancelled or forgiven by a related lender, the waiver, cancellation or forgiveness will be treated as (1) an imputed payment of interest by the borrower to the lender, and (2) an imputed payment retransfer of the amount back to the borrower by the lender. n292 Thus, in a loan from a corporation to a shareholder, the shareholder will be treated as having paid the interest and the corporation will be treated as having

retransferred the interest amount to the shareholder as a dividend distribution. However, this treatment will only apply if (a) the loan initially would have been subject to *I.R.C. section 7872* had it been made without interest, (b) a substantial part of the cancellation does not include a reduction of the loan principal, and (c) a principal purpose of the cancellation is to confer a benefit on the borrower (*i.e.*, a dividend distribution). The "principal purpose" requirement in (c) is presumed in the case of loans between the parties bearing the special relationship (family members, corporations and shareholders, employers and employees) unless the taxpayer can show by clear and convincing evidence that the interest obligations was waived, cancelled, or forgiven for a legitimate business purpose of the lender who is acting in the capacity as a creditor seeking to maximize satisfaction of a claim, such as in the case of a borrower's insolvency. n293

[f] Cancellation of an Installment Obligation

If a taxpayer sells property and the installment sale rules govern the reporting of the sale, the seller will have a recognition event upon disposition of the note. *I.R.C. section 453B(a)* provides that, in general, if the installment obligation "is satisfied at other than its face value or distributed, transmitted, sold, or otherwise disposed of," the seller will recognize gain or loss. Prior to 1980, case law suggested that a taxpayer could avoid this general rule by selling property to someone such as a close relative in exchange for an installment note and thereafter cancelling the note. n294 The relative was presumably entitled to a full cost basis. n295 To prevent this result, Congress added *I.R.C. section 453B(f)* in 1980 n296 to make it clear that a seller cannot avoid *I.R.C. section 453B(a)* by cancelling an installment obligation. n297 Specifically, *I.R.C. section 453B(f)* provides that a disposition of the installment obligation occurs if the obligation is "cancelled or otherwise becomes unenforceable." If the seller and buyer are unrelated, then the amount realized by the seller will equal the fair market value of the debt at the time of the cancellation. n298 However, if the parties are related, the fair market value will not be less than the face amount of the installment obligation. n299

The issue remains whether *I.R.C. section 453B(f)* applies to a reduction of an installment obligation between an unrelated seller and buyer reflecting an adjustment in the original purchase price. Prior to the enactment of *I.R.C. section 453B(f)*, the IRS took the position that an adjustment in sales price and concomitant reduction in payments due under an installment note was not a disposition of the installment note for purposes of former *I.R.C. section 453(d)*, which governed recognition of gain or loss on disposition of installment obligations. n300 Notwithstanding the apparent broad language of *I.R.C. section 453B(f)*, the legislative history makes it clear that Congress enacted the provision to prevent sellers from avoiding *I.R.C. section 453B(a)* by cancelling installment obligations. n301 Thus, the IRS's pre-1980 position still seems appropriate for *bona fide* purchase price reductions if the seller otherwise remains eligible for installment reporting because such a price reduction is not an attempt to circumvent *I.R.C. section 453B(a)*. n302 Of course, the buyer should be required to reduce the basis of the asset to reflect the reduction in the purchase price. n303

[g] Reporting Requirements

[i] General

There are generally no information reporting requirements imposed on creditors who are not financial institutions in connection with the cancellation of unsecured debt. n304 *I.R.C. section 6041* imposes information reporting with respect to a broad range of transactions on persons engaged in a trade or business. n305 However, *I.R.C. section 6041* only applies to those who make a "payment" to another person of certain enumerated items, including the catch-all phrase of "other fixed or determinable gains, profits and income ..." n306 The cancellation of debt does not involve an actual "payment" of "fixed or determinable" income but merely the extinguishment of a legal obligation. n307

[ii] Discharge By Financial Entity

In the Omnibus Budget Reconciliation Act of 1993, n308 Congress added *I.R.C. section 6050P* which imposes a reporting obligation on certain financial institutions with respect to debt discharges of \$600 or more. Specifically, an "applicable financial entity" must report discharges of indebtedness (within the meaning of *I.R.C. section 61(a)(12)*) on an informational return filed with the IRS. Lenders subject to the reporting requirement include (a) any financial

institution (or direct or indirect subsidiaries) described in *I.R.C. sections 581* (banks) or 591(a) (savings and loans and mutual savings banks) and credit unions, or (b) the FDIC, RTC, National Credit Union Administration and any other federal executive agency (as described in *I.R.C. section 6050M*). Effective April 26, 1996, the reporting requirement applies also to executive, judicial or legislative agencies. An executive, judicial or legislative agency is an agency, department, court, court administrative office or instrumentality in the executive, judicial or legislative branch of government, including government corporations. For discharges after December 31, 1999, information reporting also applies to any organization a significant trade or business of which is the lending of money (such as finance companies and credit card companies). n308a Finally, the discharge must be reported regardless whether the debtor is subject to tax under *I.R.C. sections 61* or *108*. n308b

In lieu of filing an information return, these agencies may submit the relevant information to the IRS to complete the return on the agency's behalf. n309 The information return Form 1099-C is the form prescribed and it includes the following: (1) the name, address and taxpayer identification number of the debtor whose debt was discharged during the calendar year, (2) the amount and date of the discharge, (3) a description of the origin of the loan transaction (student loan, mortgage, etc.), and (4) if known, an indication whether the debt was discharged in bankruptcy. n310 A copy must also be furnished to the taxpayer by January 31 of the following calendar year. n311

The information returns must be filed by governmental lenders for discharges after the date of enactment, August 10, 1993, and by non-governmental lenders for discharges after December 31, 1993. n312 The standard informational return penalties are imposed for the failure to file. n313

In 1996, the IRS issued final regulations under *I.R.C. section 6050P*. n314 These regulations are generally effective with respect to debt discharges occurring after December 21, 1996. n315 The regulations provide that a debt will be considered discharged, and reporting is required, upon the occurrence of any one of eight events. The list is exclusive: if none of the specified events occur, then a Form 1099-C is not required to be filed. In general terms, the eight "identifiable" discharge events are as follows: n316

1. A discharge in bankruptcy (although reporting is required only if the creditor knows from its books and records that the debt was incurred for business or investment purposes);
2. A cancellation or extinguishment of a debt that renders a debt unenforceable in a receivership, foreclosure or similar proceeding in a federal or state court (as described in *I.R.C. section 368(a)(3)(A)(ii)*);
3. A cancellation or extinguishment of a debt upon the expiration of the applicable statute of limitations for collection actions (this rule is subject to some exceptions);
4. A cancellation or extinguishment of a debt pursuant to an election of foreclosure remedies that statutorily extinguishes or bars the creditor's right to pursue collection;
5. A cancellation or extinguishment of a debt pursuant to a probate proceeding in which the debt is rendered unenforceable;
6. A discharge of debt pursuant to an agreement between the financial entity and a debtor for less than full consideration;
7. A discharge of debt resulting from a decision by the creditor to discontinue collection activity; or
8. The expiration of a "non-payment testing period"--generally no payments received by a creditor within a 3 year period (subject to exceptions and limitations).

[iii] Foreclosures and Abandonments of Security

I.R.C. section 6050J requires certain lenders who acquire an interest in property in connection with the full or partial satisfaction of debt to file an information return with the IRS. n317 Specifically, a lender who, in connection with a trade or business, loans money secured by property and who (1) in full or partial satisfaction of a debt, acquires an interest in any property securing the debt or (2) has "reason to know" that property in which the lender has a security interest has been abandoned, must file an information return with the IRS. n318 The prescribed form is Form 1099-A. n319 An information return must be filed with respect to each abandonment or foreclosure n320 and a copy of the Form 1099-A must be furnished to the borrower. n321 This reporting requirement is not generally satisfied by a notice filed with the IRS under the rules governing withholding on dispositions of U.S. real property interests by foreign persons. n322 The penalty for failure to file an information return is generally \$50 for each return. n323

The reporting requirement is not limited to lenders in the trade or business of loaning money. It applies to any person who loans money secured by property in connection with the lender's trade or business. n324 The Temporary Regulations provide detailed guidance regarding whether a lender has acquired an interest in property securing a debt, n325 and whether an abandonment has occurred. n326

The reporting requirements do not apply to individual loans secured by tangible personal property that is neither held for investment nor used in a trade or business. n327 A lender has knowledge regarding the nature of the borrower's use of the security if the information is included on the lender's books and records or if it maintains a system for classifying loans. n328 The reporting requirements are also not applicable if (1) the security is located outside the United States and (2) the borrower furnishes a signed statement (under penalties of perjury) that he or she is an exempt foreign person. n329

In any event, a secured party who forecloses on a real property interest located in the United States and owned by a foreign taxpayer may also be subject to a tax withholding (as well as reporting) obligation under *I.R.C. section 1445(a)*. n330

[h] Character of Discharge Income Under Passive Loss Rules

Generally, losses from passive activities can only be deducted to the extent of income from passive activities. n331 Excess passive activity losses which are disallowed are carried forward and treated as passive losses in the next taxable year. n332 The characterization of discharge income as passive, active or portfolio may be important to taxpayers subject to the passive loss rules. In particular, taxpayers with suspended passive losses will generally desire to offset those losses against discharge income realized and, as discussed above, can do so only if the discharge income is characterized as passive income. n333

In 1987, the Treasury promulgated temporary regulations providing guidelines for allocating interest expense under the passive loss rules. n334 Generally, interest expense is characterized in the same manner as the underlying debt to which the interest relates. n335 The temporary regulations provide that debt is characterized using tracing principles. Thus, debt (and therefore the attendant interest) is characterized by tracing the expenditure or use of the debt proceeds to specific expenditures. n336 The IRS has ruled that it is "generally appropriate" to follow these same rules to characterize income realized on the cancellation of a debt as passive, active or portfolio. n337 Similarly, under the interest allocation rules, discharge income will be characterized as investment income under *I.R.C. section 163(d)(4)(B)* if the debt was incurred to purchase property held for investment. n338

[i] Withholding if Borrower is a Foreign Person

Generally, tax must be withheld with respect to income earned by a foreign person. n339 It is now clear there is no duty to withhold with respect to discharge of indebtedness income attributable to a foreign borrower. n340 However, it

appears that this "no withholding" rule does not apply to debtor partnerships with foreign partners that realize discharge income that is effectively connected with a United States trade or business. n341

FOOTNOTES:

(n1)Footnote 1. *I.R.C. § 61(a)(12)*.

(n2)Footnote 2. *United States v. Kirby Lumber Co.*, 284 U.S. 1, 52 S. Ct. 4, 76 L. Ed. 131 (1931) .

(n3)Footnote 3. *See, e.g., Estate of Newman v. Commissioner*, 934 F.2d 426, 430 (2d Cir. 1991) ; *Vukasovich, Inc. v. Commissioner*, 790 F.2d 1409, 1417 (9th Cir. 1986) . For a detailed discussion of discharge of indebtedness, *see* Report of the Section 108 Real Estate and Partnership Task Force, 46 *Tax Law*. 209 (Fall 1992) ("Section 108 Task Force Report--Part I") and 46 *Tax Law*. 397 (Winter 1993) ("Section 108 Task Force Report--Part II"). For a discussion of the application of discharge income principles to noncorporate debtors, *see* Frankel, *Tax Planning for Troubled Real Estate and Partnership Transactions --Part 1*, 19 *J. Real Est. Tax'n* 285 (Summer 1992); Lipton, *Planning for Noncorporate Debt Workouts Outside of Bankruptcy*, 70 *Taxes* 275 (May 1992).

(n4)Footnote 4. Section 108(e)(3); *Treas. Reg. § 1.61-12(a)*; *Treas. Reg. § 1.61-12(c)(2)*; *Treas. Reg. § 1.1275-1(b)*; *Treas. Reg. 1.6050P-1(a), (c)* (January 3, 1996) (information reporting of discharge income by financial institutions). The general statement of the rule in *Treas. Reg. § 1.61-12(a)* confuses the issue somewhat by providing that "[a] taxpayer may realize income by the payment or purchase of his obligations at less than their face value." The reference to "face value" is imprecise because the "face value" of a debt instrument does not always reflect the amount the borrower received from the lender. As subsequent portions of the regulations make clear, the debtor must compute discharge income by comparing the amount repaid with the issue price, as adjusted for any premium or discount. *See, e.g., Treas. Reg. § 1.61-12(c)(3)*; *Rev. Rul. 2004-79, 2004-31 I.R.B. 106* ; *see also I.R.C. § 108(e)(10)*; *Commissioner v. Tufts*, 461 U.S. 300, 309 n.6, 103 S. Ct. 1826, 1832, 75 L. Ed. 2d 863, 871 (1983) (indicating the amount realized "might be" limited to the amount of funds actually received); *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 151-53, 94 S. Ct. 2129, 2138-39, 40 L. Ed. 2d 717, 728-30 (1974) (no bond discount created on corporation's exchange of \$50 par preferred stock (issued at par for cash) for \$50 face debentures); *United States Steel Corp. v. United States*, 848 F.2d 1232 (Fed. Cir. 1988) (original issue price and not intervening market value determinative of whether a corporation realizes discharge income); *Vukasovich, Inc. v. Commissioner*, 790 F.2d 1409, 1414 (9th Cir. 1986) (difference between amount borrowed and amount repaid recognized as discharge income despite fact that taxpayer lost money on the transaction); *Kramon Development Co., Inc. v. Commissioner*, 3 T.C. 342, 349 (1944) , *acq.*, 1944 C.B. 17 (issue price, not par value, used in determining amount of discharge income); *Hahn v. Commissioner*, 93 T.C.M. (CCH) 1055 (2007) (Cancellation of extra loan charges resulted in COD); *Rev. Rul. 77-437, 1977-2 C.B. 28* (issuing corporation recognized discharge income to extent face value (which was the issue price) of old bonds exceeded face of new bonds transferred in exchange; fact that exchange of bond qualified as a reorganization under *I.R.C. § 368(a)(1)(E)* does not exempt issuing corporation from taxation); *Priv. Ltr. Rul. 200606037* (Oct. 27, 2005) (mere exercise of conversion right in original debt instrument resulted in COD); *Priv. Ltr. Rul. 200222026* (May 31, 2002) (no cancellation of debt income realized on termination of partnership, where value of assets distributed exceeded amount of liabilities).

(n5)Footnote 5. *Treas. Reg. § 1.61-12(c)(3)*; *see also United States Steel Corp. v. United States*, 848 F.2d 1232 (Fed. Cir. 1988) ; *Priv. Ltr. Rul. 9710015* (March 7, 1997 (holding 9)); Wilcox, *Issuing Mixed Consideration in Troubled Debt Restructurings*, 10 *Va. Tax Rev.* 357 (1990). For a discussion of the treatment of unamortized bond issuance expenses under prior law, *see Rev. Rul. 68288, 1968-1 C.B. 53* .

(n6)Footnote 6. *See P TX6.02[4][a][i] infra*.

(n7)Footnote 7. *See P TX6.02[4][a][ii] infra*.

(n8)Footnote 8. See P TX6.02[4][b][ii] *infra*.

(n9)Footnote 9. See P TX6.02[6][a] *infra*.

(n10)Footnote 10. *Eisner v. Macomber*, 252 U.S. 189, 40 S. Ct. 189, 64 L. Ed. 521 (1920) . In *Eisner*, the Court defined "income" for purposes of the *Sixteenth Amendment* as "the gain derived from capital, from labor, or from both combined." 252 U.S. 189, 207, 40 S. Ct. 189, 193, 529 (1920) . Based on this definition, the Supreme Court had previously concluded that discharge income was not taxable because it was not derived from capital or labor. See *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170, 46 S. Ct. 449, 70 L. Ed. 886 (1926) . *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3, 52 S. Ct. 4, 4, 76 L. Ed. 131, 132 (1931) , and *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 75 S. Ct. 473, 99 L. Ed. 483 (1955) , have implicitly limited *Kerbaugh-Empire*. *Vukasovich, Inc. v. Commissioner*, 790 F.2d 1409, 1416-17 (9th Cir. 1986) ; *Fifth Avenue Fourteenth Street Corp. v. Commissioner*, 147 F.2d 453, 457 (2d Cir. 1944) (after *Kirby Lumber*, *Kerbaugh-Empire* "has been limited to its precise or almost precisely equivalent facts").

(n11)Footnote 11. See, e.g., *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 431, 75 S. Ct. 473, 476, 99 L. Ed. 483, 490 (1955) ("Here we have instances of undeniable accessions to wealth, clearly realized, and over which the taxpayers have complete dominion."); see also *James v. United States*, 366 U.S. 213, 81 S. Ct. 1052, 6 L. Ed. 2d 246 (1961) (Supreme Court has given liberal construction to the definition of gross income).

(n12)Footnote 12. *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 430, 75 S. Ct. 473, 476, 99 L. Ed. 483, 489 (1955) ; see also *Commissioner v. Lo Bue*, 351 U.S. 243, 76 S. Ct. 800, 100 L. Ed. 1142 (1956) (gross income defined broadly unless specifically exempted).

(n13)Footnote 13. *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3, 52 S. Ct. 4, 4, 76 L. Ed. 131, 132 (1931) . See also *Treas. Reg. § 1.61-12(c)(3)*; *Commissioner v. Jacobson*, 336 U.S. 28, 69 S. Ct. 358, 93 L. Ed. 477 (1949) ; *Helvering v. American Chicle Co.*, 291 U.S. 476, 54 S.Ct. 460 (1934) ; *Warner Co. v. Commissioner*, 11 T.C. 419 (1948) , *aff'd per curiam*, 181 F.2d 599 (3d Cir. 1950) ; *Commissioner v. Coastwise Transp. Corp.*, 71 F.2d 104 (1st Cir. 1934) .

(n14)Footnote 14. *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3, 52 S. Ct. 4, 4, 76 L. Ed. 131, 133 (1931) . "As a result of its dealings [the taxpayer] made available \$137,521.30 assets previously offset by the obligation of bonds now extinct. We see nothing to be gained by the discussion of judicial definitions. The [taxpayer] has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here." *Id.* (citation omitted).

(n15)Footnote 15. See, e.g., 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts*, P 6.4 (WGL 3d ed. 1999) ("Bittker & Lokken"); Cunningham, *Payment of Debt with Property--The Two-Step Analysis after Commissioner v. Tufts*, 38 *Tax Law*. 575 (1985); Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 *Tax L. Rev.* 225 (1959).

(n16)Footnote 16. One commentator has offered a third "theory" for taxation of discharge income. The "reverse loan theory" reflects Kotlarsky's conclusion that post-1986 rules governing treatment of discharge income may create a disincentive for prepayment of debt. Kotlarsky's explanation is as follows:

the prepayment of the loan [should] be treated as a "reverse loan" from the original debtor to the original creditor earning market interest. The debtor would be deemed for tax purposes to have received interest from the creditor, and to have paid interest to the creditor during the remaining life of the original loan. The difference between the interest deemed received and the interest deemed paid over the remaining term of the debt would result in income to the debtor.

Kotlarsky, *The Reverse Loan Theory of Debt Discharge*, 6 *Am. J. Tax Pol'y* 51, 60 (1987) ("Kotlarsky"). See Crane,

More Theory About Debt Discharge Income, 8 *Am. J. Tax Pol'y* 107, 113 (1989) for a thoughtful criticism of the "reverse loan theory." Whatever the merits of the "reverse loan theory," implementation of Kotlarsky's proposal would require congressional action.

(n17)Footnote 17. See, e.g., Bittker & L. Lokken, P 6.4.1.

(n18)Footnote 18. See *United States v. Kirby Lumber Co.*, 284 U.S. 1, 3, 52 S. Ct. 4, 4, 76 L. Ed. 131, 133 (1931) ; *Merkel v. Commissioner*, 109 T.C. 463 (1997) ; *Lakeland Grocery Co. v. Commissioner*, 36 B.T.A. 289, 292 (1937) . As one commentator has noted, "[t]his theory is based on the Haig-Simons definition of income: income for a period equals the value of what is consumed plus the change in net worth during that period." ("Kotlarsky") (citing H. Simons, *Personal Income Taxation* 50 (1938)).

(n19)Footnote 19. See, e.g., Bittker & L. Lokken, P 6.4.1.

(n20)Footnote 20. In *Estate of Newman*, the Court of Appeals for the Second Circuit made the following observation:

Because money is fungible, identifying the use of borrowed funds, as contemplated by *Kerbaugh-Empire*, is virtually impossible. If the tax consequences of borrowing were to depend on the use to which the borrowed funds were put, chaos would follow, and the obtuseness that now pervades the law of taxation would soon be regarded as a Golden Era of clarity and simplicity.

Estate of Newman v. Commissioner, 934 F.2d 426, 431-32 (2d Cir. 1991) . See also, Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 *Tax L. Rev.* 225, 246-247 (1959).

(n21)Footnote 21. See *United States v. Centennial Savings Bank FSB*, 499 U.S. 573, 111 S. Ct. 1512, 1518, 113 L. Ed. 2d 608, 620 (1991) ; *Commissioner v. Indianapolis Power & Light Co.*, 493 U.S. 203, 110 S. Ct. 589, 107 L. Ed. 2d 591 (1990) (customer deposits not income because of express obligation to repay); *Commissioner v. Tufts*, 461 U.S. 300, 307, 103 S. Ct. 1826, 1831, 75 L. Ed. 2d 863, 870 (1983) (loan proceeds not income because of repayment obligation); *Westpac Pacific Food v. Commissioner*, 451 F.3d 970 (9th Cir. 2006) (advance trade discounts were, like a security deposit, subject to repayment); *Toberman v. Commissioner*, 294 F.3d 985, 988 (8th Cir. 2002) ; *Collins v. Commissioner* 3 F.3d 625, 630 (2d Cir. 1993) ; *Zarin v. Commissioner*, 916 F.2d 110, 113 (3d Cir. 1990) ; *Vukasovich, Inc. v. Commissioner*, 790 F.2d 1409, 1413 (9th Cir. 1986) ; *United States v. Rochelle*, 384 F.2d 748, 751 (5th Cir. 1966) ; see also *United Gas Improvement Co. v. Commissioner*, 240 F.2d 312, 318 (3d Cir. 1956) (advances were treated as loans even though repayment was contingent); *Old Colony Trust Assoc. v. Hassett*, 150 F.2d 179, 183 (1st Cir. 1944) ("advances may be loans even when there is an absence of personal liability and the lender can look only to the pledged securities for repayment"); *Herbel v. Commissioner*, 106 T.C. 392 (1996) (settlement payment includable in gross income); *Falkoff v. Commissioner*, 62 T.C. 200, 206 (1974) , *nonacq.*, 1975-2 C.B. 1 (note payable only from net income treated as true loan and not taxable income); *Faris v. Commissioner*, 56 T.C.M. (CCH) 319, 326 (1988) (proceeds characterized as loan and not commission income due to obligation to repay); *Collins v. Commissioner*, 22 T.C.M. (CCH) 1467 (1963) ; *Rev. Rul. 84-138*, 1984-2 C.B. 123 (amounts received in reimbursement for prior advances are not income); *Rev. Rul. 75-57*, 1975-1 C.B. 141 (income not realized in year of loan despite lack of personal liability of debtor); *Priv. Ltr. Rul. 199926024* (March 31, 1999) (reimbursement of costs is a nontaxable repayment of a loan); *Tech. Adv. Mem. 9719005* (May 9, 1997) (advance payments includable in income: payments did not qualify as a nontaxable loan or trade discount).

(n22)Footnote 22. See, e.g., *Burnet v. Logan*, 283 U.S. 404, 51 S. Ct. 550, 75 L. Ed. 1143 (1930) ; *IRS CCA 200402004* (Jan. 9, 2004) (no cancellation of debt income on discharge of DOE restitution obligation because original receipt was included in taxable income).

(n23)Footnote 23. In *United States v. Centennial Savings Bank FSB*, 499 U.S. 573, 581-82, 111 S. Ct. 1512,

1518, 113 L. Ed. 2d 608, 620 (1991) , the Supreme Court explained the two step analysis as follows:

Borrowed funds are excluded from income in the first instance because the taxpayer's obligation to repay the funds offsets any increase in the taxpayer's assets; if the taxpayer is thereafter released from his obligation to repay, the taxpayer enjoys a net increase in assets equal to the forgiven portion of the debt, and the basis for the original exclusion thus evaporates.

See also *Estate of Newman v. Commissioner*, 934 F.2d 426, 430-1 (2d Cir. 1991) ; *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95, 96 (5th Cir. 1934) .

(n24)Footnote 24. This treatment reflects what ordinarily has happened for federal income tax purposes when a taxpayer repays a debt with cash. Although debts can be repaid with the proceeds of equity contributions or additional borrowings, or through the sale or transfer of assets, a debtor will generally repay its debt, if at all, by generating taxable earnings.

(n25)Footnote 25. *Commissioner v. Tufts*, 461 U.S. 300, 103 S. Ct. 1826, 75 L. Ed. 2d 863 (1983) .

(n26)Footnote 26. *Commissioner v. Tufts*, 461 U.S. 300, 312, 103 S. Ct. 1826, 1834, 75 L. Ed. 2d 863, 873 (1983) .

(n27)Footnote 27. *Commissioner v. Rail Joint Co.*, 61 F.2d 751 (2d Cir. 1932) .

(n28)Footnote 28. *Commissioner v. Rail Joint Co.*, 61 F.2d 751, 752 (2d Cir. 1932) .

(n29)Footnote 29. See, e.g., *United States Steel Corp. & Affil. Cos. v. United States*, 848 F.2d 1232, 1236 (Fed. Cir. 1988) (court discussed *Rail Joint* and stated that the "critical inquiry is whether the effect of the cancellation is to increase the corporation's assets"); *Vukasovich, Inc. v. Commissioner*, 790 F.2d 1409, 1415 (9th Cir. 1986) ("requiring some benefit to the taxpayer from the transaction creating the indebtedness explains such cases as *Rail Joint*"); *Sheraton Plaza Co. v. Commissioner*, 39 T.C. 697 (1963) , acq., 1963-2 C.B. 5 (on organization of subsidiary corporation by parent corporation, subsidiary assumed a stranger's obligation to pay past-due rent to its parent: held, no cancellation of indebtedness income realized when debt was cancelled); *Fashion Park, Inc. v. Commissioner*, 21 T.C. 600, 603-04, 607 (1954) , nonacq., 1955-1 C.B. 7 (taxpayer that exchanged its bonds for its preferred stock and dividend arrearages on that stock had no discharge income upon repurchase of the bonds for less than it had received on issuance of the preferred stock). But cf. 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts*, P 6.4.2 (WGL 3d ed. 1999) ("Bittker & Lokken") (suggesting that the Second Circuit wrongly decided *Rail Joint* because the distribution of bonds was analogous to a sale of bonds for cash, followed by a distribution of the proceeds as a dividend).

(n30)Footnote 30. In *United States Steel Corp. v. United States*, 848 F.2d 1232, 1236 (Fed. Cir. 1988) , the Federal Circuit held that United States Steel ("USS") did not recognize discharge of indebtedness income in the following situation. USS issued preferred stock in exchange for cash of \$100 a share. Later, USS recapitalized in 1966, exchanging debt with a face amount of \$175 for each share of preferred stock, which was then worth \$165 a share. In 1972, the tax year in issue, USS repurchased the debt for \$118 a bond. USS argued, and the Federal Circuit agreed, that it did not realize any discharge income because the \$118 purchase price exceeded the original issue price of \$100.

(n31)Footnote 31. See P TX6.03 *infra*.

(n32)Footnote 32. *United States v. Centennial Savings Bank FSB*, 499 U.S. 573, 111 S. Ct. 1512, 113 L. Ed. 2d 608 (1991) ; *Philip Morris Inc. v. Commissioner*, 104 T.C. 61 (1995) , *aff'd*, 71 F.3d 1040 (2d Cir. 1995) .

(n33)Footnote 33. See also *Treas. Reg. § 1.166-1(c)* ("a gift or contribution to capital shall not be considered a

debt" for purposes of a bad debt deduction under *I.R.C. § 166*; *Garrett v. Commissioner*, 67 T.C.M. (CCH) 2214 (1994) (no discharge occurred where taxpayer was not personally liable for payment of federal estate tax); *Priv. Ltr. Rul. 7804072* (Oct. 28, 1978) (no discharge income when it was determined another taxpayer was liable for the debt). There is an issue whether the discharge of a tax obligation under an Offer in Compromise, for example, may constitute discharge income. See 63 *Tax Notes* 455 (April 25, 1994). However, for the reasons discussed below, a discharge of a taxpayer's tax obligation should not create income because the taxpayer did not borrow or benefit from the amount due in the first instance--the taxpayer merely had to pay less than the full amount due. To conclude otherwise would clearly defeat the purpose of the IRS Offer program. In a 1992 Field Service Advice, the Internal Revenue Service concluded the taxpayer did not realize any income under either *I.R.C. § 61(a)(12)* or the tax benefit rule. See 1992 *FSA LEXIS* 324 (May 28, 1992).

(n34)Footnote 34. But see *Hunt v. Commissioner*, 59 T.C.M. (CCH) 635 (1990) (intrafamily transfers held *bona fide* loans and not gifts: subsequent cancellation held discharge of indebtedness income excludable under *I.R.C. § 108*).

(n35)Footnote 35. See, e.g., *Treas. Reg. § 1.83-4(c)* (if debt incurred to purchase property transferred in connection with services rendered is cancelled, the amount not paid is includable in service-provider's income in taxable year of cancellation); *Commissioner v. Lo Bue*, 351 U.S. 243, 246, 76 S. Ct. 800, 803, 100 L. Ed. 1142, 1147 (1956) (stock transferred to employee not a gift; no detached and disinterested generosity); *Commissioner v. Jacobson*, 336 U.S. 28, 47-49, 69 S. Ct. 358, 368-69, 93 L. Ed. 477, 488-89 (1949); *Capitol Coal Corp. v. Commissioner*, 250 F.2d 361 (2d Cir. 1957); *Cook v. United States*, 897 F. Supp. 1403 (M.D. Fla. 1995) (waiver of repayment of government overpayment treated as discharge income and not a gift); *Marshall Drug Co. v. United States*, 95 F. Supp. 820, 821-22 (Ct. Cl. 1951); *Randolph v. Commissioner*, 80 T.C.M. (CCH) 192 (2000) (advance from corporation was a loan not a gift); *Waterhouse v. Commissioner*, 68 T.C.M. (CCH) 744 (1994) (discharge of VA loan not a gift); *DiLaura v. Commissioner*, 53 T.C.M. (CCH) 1077 (1987) (discharge of home mortgage by a savings and loan was not a gift). See generally *Millar v. Commissioner*, 540 F.2d 184, 186-87 (3d Cir. 1976), on remand, 67 T.C. 656, 658 (1977) (court determined that funds were received in the form of a loan, not as a gift), *aff'd in part*, 577 F.2d 212, 213-14 (3d Cir.); *Canton v. United States*, 226 F.2d 313, 317-18 (8th Cir. 1955) (question of whether cancellation of a loan was taxable income or a gift was for the jury); *Sutphin v. United States*, 14 Cl. Ct. 545, 549 (1988) (no evidence of donative intent by savings and loan on forgiveness of part of home mortgage); *Rodgers v. Commissioner*, 49 T.C.M. (CCH) 1434, 1437-39 (1985) (IRS unsuccessfully argued against related taxpayer's bad debt deduction on grounds that original loan was in fact a gift); *Bosse v. Commissioner*, 29 T.C.M. (CCH) 1772, 1777 (1970) (under controlling state law, the delivery of a note to debtor with donative intent created a gift); S. Rep. No. 1035, 96th Cong., 2d Sess. 19 n.22, *reprinted in* Vol. E *Collier on Bankruptcy*, App. Pt. 5(b)(i) (Matthew Bender 15th Edition Revised) (Congress intended no "gift exception in a commercial context ... to the general rule that income is realized on discharge of indebtedness.").

(n36)Footnote 36. *Autenreith v. Commissioner*, 115 F.2d 856, 858 (3d Cir. 1940) (citation omitted); see also *Knetsch v. United States*, 364 U.S. 361, 365-67, 81 S. Ct. 132, 134-36, 5 L. Ed. 2d 128, 131-33 (1960) (so-called loans held to be a sham and not recognized as debt for tax purposes); *Agro Science Co. v. Commissioner*, 927 F.2d 213 (5th Cir. 1991) (same); *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254, 113 T.C. No. 21 (Oct. 19, 1999); *Horn v. Commissioner*, 90 T.C. 908, 938 (1988) (same); *Fisher v. Commissioner*, 54 T.C. 905, 909-910 (1970) (intent of debtor to pay and of creditor to seek repayment); *Arlen v. Commissioner*, 48 T.C. 640, 648, 155 U.S.P.Q. 665 (1967), *acq.*, 1968-1 C.B. 2 (loan was *bona fide* debt and not a sham); *Erickson Post Acquisition Inc. v. Commissioner*, 86 T.C.M. (CCH) 111 (2003); *Garrett v. Commissioner*, 67 T.C.M. (CCH) 2214, 2224 (1994) (because taxpayer was not personally liable for payment of estate tax, no discharge occurred).

(n37)Footnote 37. *Treas. Reg. § 1.166-1(c)*; see also *Ellinger v. United States*, 470 F.3d 1325, 1333 (11th Cir. 2006); *Andrew v. Commissioner*, 54 T.C. 239, 244-45 (1970); *Clark v. Commissioner*, 18 T.C. 780, 783-84 (1952), *aff'd*, 205 F.2d 353 (2d Cir. 1953) (true debt did not exist because obligation to repay subject to contingency that had not occurred); *Erickson Post Acquisition, Inc. v. Commissioner*, 86 T.C.M. (CCH) 111 (2003) (advance held a non-taxable *bona fide* debt); *Cleo Perfume, Inc. v. Commissioner*, 75 T.C.M. (CCH) 2200 (1998) (retailer only held merchandise on consignment and no debtor/creditor relationship existed: held, since no debt owed, no discharge income

realized); *Bradshaw v. Commissioner*, 71 T.C.M. (CCH) 2412 (1996) (check-kiting proceeds were not a loan because no consensual agreement to repay; held income could not be excluded under I.R.C. § 108(a)(1)(B)). For purposes of I.R.C. § 7872 (treatment of loans with below market interest rates), a "loan" is defined more broadly to include any extension of credit. See Prop. Treas. Reg. § 1.7872-2(a)(1), 50 Fed. Reg. 33,553 (1985); *Priv. Ltr. Rul.* 9024022 (March 14, 1990) (advance to utility with right to repayment within fixed term treated as a loan subject to I.R.C. § 7872).

(n38)Footnote 38. See *Indmar Products Inc. v. Commissioner*, 444 F.3d 771 (6th Cir. 2006) (advances were held to be debt, not equity); *Estate of Chism v. Commissioner*, 322 F.2d 956 (9th Cir. 1963); *Haag v. Commissioner*, 88 T.C. 604, 616 (1987) (and cases cited therein); *Pierce v. Commissioner*, 61 T.C. 424 (1974), acq., 1976-2 C.B. 2; *PK Ventures, Inc. v. Commissioner*, 91 T.C.M. (CCH) 806 (2006). See also *Welch v. Commissioner*, 204 F.3d 1228, 1230 (9th Cir. 2000).

(n39)Footnote 39. See *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968); *Fisher v. Commissioner*, 54 T.C. 905, 909-10 (1970).

(n40)Footnote 40. See, e.g., *Yale Ave. Corp. v. Commissioner*, 58 T.C. 1062 (1972); *J.A. Maurer, Inc. v. Commissioner*, 30 T.C. 1273, 1289-91 (1958), acq., 1959-1 C.B. 4.

(n41)Footnote 41. See, e.g., *Bauer v. Commissioner*, 748 F.2d 1365, 1367 (9th Cir. 1984); *Busch v. Commissioner*, 728 F.2d 945, 949 (7th Cir. 1984); *Haag v. Commissioner*, 88 T.C. 604, 615-16 (1987). Congress enacted I.R.C. § 385 in an attempt to establish rules for distinguishing between debt and equity. Although I.R.C. § 385 specifically authorizes the Treasury to issue regulations identifying the factors to be used, there are currently no regulations outstanding. In a failed attempt to promulgate such regulations, the Treasury issued regulation on December 31, 1980 and revised and repropounded the regulations on January 5, 1982. Treasury finally withdrew those regulations in 1983. T.D. 7920, 1983-2 C.B. 69.

(n42)Footnote 42. *Welch v. Commissioner*, 204 F.3d 1228, 1230 (9th Cir. 2000); *Roth Steel Tube Co. v. Commissioner*, 800 F.2d 625, 629-30 (6th Cir. 1986); *Slappey Drive Indus. Park v. United States*, 561 F.2d 572, 581-82 (5th Cir. 1977). See also I.R.C. § 385(b) (five factors listed). Although the courts often refer to numerous factors, the "essential" factors of a debt instrument appear to be (1) the existence of a written instrument and the names used thereon; (2) presence of interest, a fixed maturity date and security for repayment; (3) adequate (as opposed to "thin") capitalization; (4) participation of the debt holder in management; (5) status equal to "regular" corporate creditors; and (6) were payments actually made. See *Ellinger v. United States*, 470 F.3d 1325 (11th Cir. 2006) (transfers were not bona fide debts); *Hardman v. United States*, 827 F.2d 1409, 1412 (9th Cir. 1987); *In re Lane*, 742 F.2d 1311, 1314-15 (11th Cir. 1984); *Stinnett's Pontiac Service, Inc. v. Commissioner*, 730 F.2d 634, 638 (11th Cir. 1984); *In re Uneco, Inc.* 532 F.2d 1204, 1208 (8th Cir. 1976); *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712, 718-19 (5th Cir. 1972); *In re Indian Lake Estates*, 448 F.2d 574, 578-79 (5th Cir. 1971); *Erickson Post Acquisition, Inc. v. Commissioner*, 86 T.C.M. (CCH) 111 (2003); *Ray v. Commissioner*, 61 T.C.M. (CCH) 2122, 2130-31 (1991). For extended discussions of the distinction between debt and equity for federal income tax purposes, see B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders*, ch. 4 (WGL 6th ed. 1994); Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 Tax L. Rev. 369, 404-55 (1971).

(n43)Footnote 43. *John Kelly Co. v. Commissioner*, 326 U.S. 521, 530, 66 S. Ct. 299, 304, 90 L. Ed. 278, 284 (1946); see also *Rev. Rul.* 77-437, 1977-2 C.B. 28.

(n44)Footnote 44. See *Selfe v. United States*, 778 F.2d 769, 773-75 (11th Cir. 1985). But see I.R.C. § 385(e) (characterization by corporate issuer as stock or debt is binding on the issuer and all holders, but not the IRS, for instruments issued after October 24, 1992); *Harris v. United States*, 902 F.2d 439, 443 (5th Cir. 1990).

(n45)Footnote 45. See *In re Indian Lake Estates, Inc.*, 448 F.2d 574, 578-80 (5th Cir. 1971); *American Cigar Co. v. Commissioner*, 66 F.2d 425 (2d Cir. 1933); *J.A. Maurer, Inc. v. Commissioner*, 30 T.C. 1273 (1949). See also *In re Larson*, 862 F.2d 112, 116-17 (7th Cir. 1988) (transfer was capital contribution not loan); *Jewell Ridge Coal Corp. v. Commissioner*, 318 F.2d 695 (4th Cir. 1963) (unsecured advances to corporation with no immediate ability to repay held contribution to capital); *Kavich v. United States*, 507 F. Supp. 1339 (D. Neb. 1981) (amounts paid by shareholder-guarantor treated as equity advances and not *bona fide* debt due, in part, to thin capitalization). But see *I.R.C. § 385(c)* (applicable to corporate debt instruments issued after October 24, 1992); *Schneller v. Commissioner*, 71 T.C.M. (CCH) 2089 (1996) (stockholder repayments are evidence that corporate advances were true loans).

(n46)Footnote 46. See *Rev. Rul. 83-98*, 1983-2 C.B. 40, 41 (adjustable rate convertible notes held equity). But see *Rev. Rul. 85-119*, 1985-2 C.B. 60 (notes with floating interest and payable at maturity in stock of issuer held debt); *Tech. Adv. Mem. 200101001* (Jan. 8, 2001) (parent corporation did not gratuitously forgive subsidiary corporation's debt).

(n47)Footnote 47. See, e.g., *Nassau Lens Co., Inc. v. Commissioner*, 308 F.2d 39 (2d Cir. 1962); *Farley Realty Corp. v. Commissioner*, 279 F.2d 701, 704 (2d Cir. 1960); *Treas. Reg. § 1.856-5(b)* (definition of "interest" for purposes of the REIT rules); Gen. Couns. Mem. 36,702 (April 12, 1976) (applying the debt-equity analysis in *Farley Realty Corp.* in a partnership context). But cf. *O'Hare v. Commissioner*, 641 F.2d 83, 86 (2d Cir. 1981) (court rejected taxpayer's argument that he was converted from a guarantor into a joint venturer); *Republic Supply Co. v. Commissioner*, 66 T.C. 446, 462-63 (1976), *aff'd in unpublished opinion* (10th Cir. Dec. 29, 1978) (court rejected taxpayer's argument that loan was in fact an equity contribution; thus, taxpayer realized discharge of indebtedness income on cancellation of debt). See generally Feder, "Either a Partner or a Lender Be:" *Emerging Tax Issues in Real Estate Finance*, 36 *Tax Law.* 191 (1983); Madison, *The Deductibility of "Interest" on Hybrid Securities*, 39 *Tax Law.* 465 (1986).

(n48)Footnote 48. *Friedrich v. Commissioner*, 925 F.2d 180 (7th Cir. 1991); see also *Zimmerman v. United States*, 318 F.2d 611 (9th Cir. 1963) (no *bona fide* debt existed because repayment contingent on events that had not occurred); *Burnham Corp. v. Commissioner*, 90 T.C. 953, 955-56 (1988), *aff'd*, 878 F.2d 86 (2d Cir. 1989) (a liability subject to a condition subsequent is fixed).

(n49)Footnote 49. See *N. Sobel, Inc. v. Commissioner*, 40 B.T.A. 1263, 1265 (1939), *nonacq.*, 1940-1 C.B. 8; *Preslar v. Commissioner*, 72 T.C.M. (CCH) 1496 (1996), *rev'd*, 167 F.3d 1323 (10th Cir. 1999) (since original loan amount was determined and fixed, settlement discharge caused the taxpayer to realize COD income). See also *Algerine Allen Smith Estate v. Commissioner*, 198 F.3d 515 (5th Cir. 1999) (both amount and enforceability of claim contested: no COD income realized on settlement).

(n50)Footnote 50. See *Zarin v. Commissioner*, 916 F.2d 110 (3d Cir. 1990); *United States v. Hall*, 307 F.2d 238 (10th Cir. 1962); see also *Schlifke v. Commissioner*, 61 T.C.M. (CCH) 1697, 1698 (1991) (court declined to address sub-issue of unenforceability of underlying debt).

(n51)Footnote 51. *Zarin v. Commissioner*, 916 F.2d 110, 115 n.10 (3d Cir. 1990).

(n52)Footnote 52. See *United States v. Henderson*, 375 F.2d 36, 39 (5th Cir. 1967); *Central Paper Co. v. Commissioner*, 158 F.2d 131, 133 (6th Cir. 1946); *Corporacion de Ventas de Salitre y Yoda de Chile v. Commissioner*, 130 F.2d 141 (2d Cir. 1942); *Terminal Inv. Co. v. Commissioner*, 2 T.C. 1004, 1015 (1943), *acq.*, 1944 C.B. 27; *Preslar v. Commissioner*, 72 T.C.M. (CCH) 1496 (1996) (following *N. Sobel, Inc.*, taxpayer realized no discharge income because liability was too indefinite), *rev'd*, 167 F.3d 1323 (10th Cir. 1999) (contested liability doctrine applies only if debt is unliquidated, i.e., the original loan amount cannot be determined: held, since original loan amount was fixed, taxpayer realized COD income on settlement discharge).

(n53)Footnote 53. *Treas. Reg. § 1.1001-2(a)(3)*; *Temp. Reg. § 1.1060-1T(c)(2)* (1988); *CRC Corp. v.*

Commissioner, 693 F.2d 281, 283, 75 O.&G.R. 429 (3d Cir. 1982) ; *Hudson v. Commissioner*, 103 T.C. 90, 108 (1994) , *aff'd in unpublished opinion*, 71 F.3d 877 (5th Cir. 1995) (purported tax shelter notes disregarded, so that no discharge income could be realized on cancellation); *Hotel Astoria, Inc. v. Commissioner*, 42 B.T.A. 759 (1940) , *acq. in result*, 1940-2 C.B. 4 ; *see also Pleasant Summit Land Corp. v. Commissioner*, 863 F.2d 263 (3d Cir. 1988) (only amount of nonrecourse debt in excess of fair market value disregarded; amount up to FMV of property securing the debt treated as genuine debt); *Brannen v. Commissioner*, 722 F.2d 695 (11th Cir. 1984) (nonrecourse purchase money debt not includable in basis when purchase price substantially exceeded fair market value of property securing the debt); *Estate of Franklin v. Commissioner*, 544 F.2d 1045 (9th Cir. 1976) (nonrecourse purchase money debt was not a "genuine" debt because the taxpayer failed to establish that the purchase price approximated the fair market value of the property securing the debt); *Bergstrom v. United States*, 37 Fed. Cl. 164; 1996 U.S. Claims LEXIS 217, 79 A.F.T.R.2d (RIA) 305 (Cl. Ct. 1996) (nonrecourse purchase money debt that does not approximate FMV is totally disregarded); *Denver & Rio Grand Western R.R. v. United States*, 505 F.2d 1266 (Ct. Cl. 1974) (contingent liabilities dependent on rail freight traffic not includable in cost basis of assets); *La Rue v. Commissioner*, 90 T.C. 465, 477-79 (1988) (reserves for potential liabilities to customers that were not fixed were not treated as "liabilities" which could increase bases of partners' interests in partnership); *Waddell v. Commissioner*, 86 T.C. 848, 898-904 (1986) , *aff'd*, 841 F.2d 264 (9th Cir. 1988) (so-called recourse debt held too speculative to be recognized for tax purposes); *Dean v. Commissioner*, 83 T.C. 56, 78 n. 10 (1984) (note was not genuine debt and could not be included in basis; facts did not fit within context of *Tufts*); *Long v. Commissioner*, 71 T.C. 1, 7-8 (1978) (contingent liabilities not includable in basis until year of settlement), *aff'd in part and rev'd in part on other grounds*, 660 F.2d 416 (10th Cir. 1981) ; *Yoc Heating Corp. v. Commissioner*, 61 T.C. 168, 179 (1973) (contingent liabilities not includable in basis of assets); *Albany Car Wheel Co. v. Commissioner*, 40 T.C. 831, 841 (1963) , *adopted in part per curiam*, 333 F.2d 653 (2d Cir. 1964) (taxpayer may not increase cost basis of assets purchased by contingent liability); *Regents Park Partners v. Commissioner*, 63 T.C.M. (CCH) 3131 (1992) (amount of recourse debt equal to FMV creates tax basis--excess amount treated as a contingent liability); *Rev. Rul. 88-77*, 1988-2 C.B. 129 (accrued interest and accounts payable of cash basis partnership were not "liabilities" under I.R.C. § 752 that could increase bases of partners' interest in partnership); *Priv. Ltr. Rul. 9431023* (May 6, 1994) (nonrecourse note restructured into senior note equal to FMV and second "hope" note: held, discharge income realized to extent of second note and second note disregarded for tax purposes).

(n54)Footnote 54. *Tharp v. Commissioner*, 31 T.C.M. (CCH) 22, 25 (1972) ; *see also Harriman v. Commissioner*, 26 T.C.M. (CCH) 941 (1967) (usurious debt was void under state law and no bad debt deduction was therefore allowed). *But cf. Flamingo Resort, Inc. v. United States*, 664 F.2d 1387, 1390-91 (9th Cir. 1982) (legally unenforceable advances to gambling patrons must be included in income by accrual basis casino).

(n55)Footnote 55. *See generally Brantley v. Commissioner*, 70 T.C.M. (CCH) 1430 (1995) (IRS conceded I.R.C. § 108(e)(5) applied to reduction of stock purchase note); *Whiting v. Commissioner*, 47 T.C.M. (CCH) 1334, 1336 (1984) (reduction in amount due under stock subscription agreement attributable to reduction in par value did not create income to shareholders); *see also Wilkerson v. Commissioner*, 655 F.2d 980, 982 (9th Cir. 1981) (note given in payment by cash basis taxpayer is nothing more than a mere promise to pay in the future); *Oden v. Commissioner*, 41 T.C.M. (CCH) 1285 (1981) , *aff'd in unpublished opinion* (4th Cir. April 2, 1982) (partner had zero basis in personal note contributed to partnership); *Treas. Reg. § 1.752-2(h)(4)* (promissory note contributed by a partner not taken into account unless readily tradeable on an established securities market); *Rev. Rul. 80-235*, 1980-2 C.B. 229 ; *Tech. Adv. Mem. 87-02-006* (Sept. 26, 1986) (personal note contributed to limited partnership increased basis only to the extent of actual payments). The rationale for this rule is also expressed in cases dealing with a shareholder's basis in the stock of an S corporation. For example, in *Harris v. United States*, 902 F.2d 439 (5th Cir. 1990) , the court, following a well established line of cases, held that an S corporation shareholder can only obtain a basis increase if the shareholder makes an economic outlay. Put another way, if the shareholder makes no additional investment in the S corporation, the shareholder receives no increase in stock basis. *See also Tech. Adv. Mem. 9403003* (Sept. 29, 1993) . Similarly, a taxpayer who receives no economic benefit in exchange for executing a note should not have discharge of indebtedness income upon cancellation of the note. *See, e.g., Treas. Reg. § 1.1001-2(a)(3)*.

(n56)Footnote 56. In *United States v. Centennial Savings Bank FSB*, 499 U.S. 573, 581-82, 111 S. Ct. 1512, 1518, 113 L. Ed. 2d 608, 620 (1991), the Supreme Court explained the two step analysis as follows:

Borrowed funds are excluded from income in the first instance because the taxpayer's obligation to repay the funds offsets any increase in the taxpayer's assets; if the taxpayer is thereafter released from his obligation to repay, the taxpayer enjoys a net increase in assets equal to the forgiven portion of the debt, and the basis for the original exclusion thus evaporates.

(n57)Footnote 57. *Treas. Reg. § 1.704-1(b)(2)(ii)(c)*; see also *Peracchi v. Commissioner*, 143 F.3d 487 (9th Cir. 1998) (taxpayer has basis equal to face amount of his note transferred to wholly-owned corporation); *Zager v. Commissioner*, 53 T.C.M. (CCH) 230, 234 n.7 (1987).

(n58)Footnote 58. *Park Cities Corp. v. Byrd*, 534 S.W.2d 668, 672-73, 19 Tex. Sup. Ct. J. 188 (Tex. 1976).

(n59)Footnote 59. *Treas. Reg. § 1.731-1(c)(2)*; see also *Austin v. United States*, 461 F.2d 733, 736-37 (10th Cir. 1972) (additional gain recognized by reason of deemed distribution of cash under I.R.C. § 752(b) when a co-partner assumed the taxpayer's liabilities upon dissolution of partnership); *O'Brien v. Commissioner*, 77 T.C. 113, 116-17 (1981); *Fixel v. Commissioner*, 33 T.C.M. (CCH) 857, 858 (1974), *aff'd in unpublished opinion*, 511 F.2d 1400 (5th Cir. 1975); *Dakotah Hills Offices Limited Partnership v. Commissioner*, 75 T.C.M. (CCH) 2122 (1998) (partners received constructive I.R.C. § 752(b) distribution when relieved of their share of partnership debt); *Ehrensperger v. Commissioner*, 67 T.C.M. (CCH) 3106 (1994) (partner realized income when relieved of obligation to restore negative capital account on dissolution of partnership); *Monahan v. Commissioner*, 67 T.C.M. (CCH) 2900 (1994) (taxpayer failed to actually repay negative capital account). *But see Citron v. Commissioner*, 97 T.C. 200 (1991) (abandonment of partnership interest, when no partnership liabilities existed, treated as an ordinary loss); *Kelley v. Commissioner*, 19 T.C.M. (CCH) 263, 267-68 (1960) (cancellation of unpaid balance of a partner's note to partnership that evidenced partner's negative capital account balance generated by excess nontaxable draws from the partnership held ordinary income); *Rev. Rul. 93-80*, 1993-2 C.B. 239 (loss on abandonment of partnership interest is ordinary if sale or exchange treatment does not apply); *Rev. Rul. 73-301*, 1973-2 C.B. 215, *clarified by*, *Rev. Rul. 57-318*, 1957-2 C.B. 362 (withdrawals by a partner that produced a negative capital account were treated as a distribution and not a loan, because there was not unconditional and legally enforceable obligation to repay); *Tech. Adv. Mem. 9619002* (Jan. 31, 1996) (individual partner's discharge of partnership debt is treated as gain under I.R.C. §§ 752 and 731). For a detailed discussion of I.R.C. §§ 752 and 731, see chapter TX13 *infra*.

(n60)Footnote 60. *Treas. Reg. § 1.704-1(b)(2)(iv)(l)*.

(n61)Footnote 61. See, e.g., *George v. Commissioner*, 844 F.2d 225, 228-29 (5th Cir. 1988) (on remand from Supreme Court).

(n62)Footnote 62. *Commissioner v. Bollinger*, 485 U.S. 340, 349-50, 108 S. Ct. 1173, 99 L. Ed. 2d 357 (1988). An agency relationship will be established if (1) the relationship is set forth in a written agreement at the time the asset is acquired; (2) the corporation acts as the agent at all times; and (3) the corporation is held out to third parties as the agent with respect to the asset. *Commissioner v. Bollinger*, 485 U.S. 340, 349-50, 108 S. Ct. 1173, 1179, 99 L. Ed. 2d 357, 366-67 (1988).

(n63)Footnote 63. *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934). For a complete discussion of the purchase price adjustment rules, see P TX6.03[5][e] *infra*.

(n64)Footnote 64. See P TX6.03[5][e][ii] *infra*; *Rev. Rul. 92-99*, 1992-2 C.B. 35 (acknowledging survival, but interpreting scope of common law narrowly).

(n65)Footnote 65. *Rev. Rul. 84-41*, 1984-1 C.B. 130; see also *Rev. Rul. 76-96*, 1976-1 C.B. 23.

(n66)Footnote 66. *Tech. Adv. Mem. 8942001 (Apr. 28, 1989)* .

(n67)Footnote 67. Interestingly, the IRS recently advanced the purchase price reduction argument in an attempt to eliminate a loss claimed by a taxpayer. The Tax Court properly rejected the argument. *Lockwood v. Commissioner*, 94 T.C. 252, 261 (1990) .

(n68)Footnote 67a. *Treas. Reg. § 1.471-3(b)*. See *Tech. Adv. Mem. 9719005 (May 9, 1997)* (advance cash payments were taxable).

(n69)Footnote 68. *Rev. Rul. 78-46, 1978-1 C.B. 22* . This ruling is consistent with the IRS's historic position that disbursements from a general welfare fund in the interest of the general public are not includable in the gross income of the recipients. See, e.g., *Rev. Rul. 78-170, 1978-1 C.B. 24* (payments made by state to low income individuals to reduce cost of energy not includable in income); *Rev. Rul. 63-136, 1963-2 C.B. 19* ("Benefit payments made to individuals undergoing training or retraining under either the Area Redevelopment Act or the Manpower Development and Training Act of 1962 are not includable in the gross incomes of the recipients." (summary statement of *Rev. Rul. 63-136*)); Chief Counsel Advice Memorandum 2000-10619 (Feb. 17, 2000) (state flood payments are in nature of nontaxable general welfare).

(n70)Footnote 69. *Priv. Ltr. Rul. 8839026 (June 29, 1988)* (waiver of balance of VA mortgage upon VA's determination that collection would be "against equity and good conscience" did not give rise to discharge income). But see *Waterhouse v. Commissioner*, 68 T.C.M. 744 (1994) (cancellation of VA loan owed by disabled veteran fully included in gross income under *I.R.C. § 61(a)(12)*; no exception found); *Porten v. Commissioner*, 65 T.C.M. (CCH) 1994 (1993) (cancellation of student loan included in income despite condition subsequent). The ruling does not mention *I.R.C. § 108(e)(1)*, enacted as part of the Bankruptcy Tax Act of 1980, which states that except as provided in *I.R.C. § 108* there is no insolvency exception from the general rule that gross income includes income from the discharge of indebtedness. Apparently, the IRS concluded that *I.R.C. § 108(e)(1)* does not prevent continued application of the exception for waivers in the nature of relief payments for the general welfare. The legislative history of *I.R.C. § 108* supports this conclusion: "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." S. Rep. No. 1035, 96th Cong., 2d Sess. 8 n.6 (1980), reprinted in Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised). If, as the IRS maintains, general welfare payments are not "gross income" within the meaning of *I.R.C. § 61(a)*, the IRS correctly refused to use *I.R.C. § 61(a)(12)* to transform the equivalent of such payments into gross income. See also *Rev. Rul. 91-36, 1991-2 C.B. 17* (utility rate reduction to participants in energy conservation program treated as purchase price adjustment); *Priv. Ltr. Rul. 9143016 (July 19, 1991)* (utility bill arrearages owed by low-income individuals and forgiven by utility are not includable in income).

(n71)Footnote 70. For a detailed discussion of this issue, see P TX13.03[3][d] *infra*.

(n72)Footnote 71. *I.R.C. §§ 108(e)(6), 351(d)(2)*.

(n73)Footnote 72. H.R. Rep. No. 833, 96th Cong., 2d Sess. 15 (1980), reprinted in Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Edition Revised).

(n74)Footnote 73. S. Rep. No. 1035, 96th Cong., 2d Sess. 17-18 (1980), reprinted in Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised) (indicating that the Senate bill "generally does not change the present law rule developed by the courts governing" the corporate stock-for-debt exception, thus leaving the inference that "present law" theories were unchanged).

(n75)Footnote 74. The principal theory supporting the stock-for-debt exception in the corporate context is the "substitution of liability" theory. See, e.g., *Capento Securities Corp. v. Commissioner*, 47 B.T.A. 691 (1942), *aff'd*, 140 F.2d 382 (1st Cir. 1944), *nonacq.*, 1943 C.B. 28; *Motor Mart Trust v. Commissioner*, 4 T.C. 931 (1945), *aff'd*, 156 F.2d 122 (1st Cir. 1946). See P TX8.02 *infra*.

(n76)Footnote 75. For purposes of *I.R.C. § 351*, which provides for nonrecognition on exchanges of "property" for stock in the corporate context, the Tax Court has held that "property" includes a corporation's debt exchanged for its stock. *Duncan v. Commissioner*, 9 T.C. 468, 470 (1947), *acq.*, 1948-2 C.B. 2; *Rev. Rul. 77-81*, 1977-1 C.B. 97. Note that this rule for contributions of debt in exchange for stock of a corporate debtor has been changed by Congress. *I.R.C. §§ 351(a) and (d)(2)*.

(n77)Footnote 76. See 1 McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners*, P 4.02[3] (WGL 2d ed. 1990). See, e.g., *Twenty Mile Joint Venture, Ltd. v. Commissioner*, 200 F.3d 1268 (10th Cir. 1999) (substance of transaction reflected cancellation of debt income, not contribution to partnership capital).

(n78)Footnote 77. See P TX6.03[4][f] *infra*.

(n79)Footnote 78. *I.R.C. § 108(e)(7)(E)*.

(n80)Footnote 79. See, e.g., *Priv. Ltr. Rul. 8444069* (July 31, 1984), *Priv. Ltr. Rul. 8117210* (Jan. 30, 1981).

(n81)Footnote 80. 56 *Fed. Reg. 12,135* (March 22, 1991) (to be codified at 26 C.F.R. pt. I).

(n82)Footnote 81. *I.R.S. 1991-1 C.B. 319, Notice 91-15*.

(n83)Footnote 82. *I.R.S. 1991-1 C.B. 319, Notice 91-15*.

(n84)Footnote 83. See, e.g., *Stafford v. United States*, 727 F.2d 1043, 1049 (11th Cir 1984); *Duncan v. Commissioner*, 9 T.C. 468 (1947), *acq.*, 1948-2 C.B.2. For a complete discussion of this issue, see P TX13.03[3][d] *infra*.

(n85)Footnote 84. See P TX8.03 *infra*.

(n86)Footnote 85. Pub. L. No. 103-66, § 13226(a) (1993).

(n87)Footnote 85a. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 896, 118 Stat. 1648 (Oct. 22, 2004).

(n88)Footnote 85b. *I.R.C. § 108(e)(8)(B)* (as amended).

(n89)Footnote 85c. Pub. L. No. 108-357, § 896(b), 118 Stat. 1648 (Oct. 22, 2004).

(n90)Footnote 85d. *Prop. Treas. Reg. § 1.108-8*, 73 *Fed. Reg. 64,903* (October 31, 2008).

(n91)Footnote 85e. *Prop. Treas. Reg. § 1.108-8(a)*. This may mean that a creditor may not be able to immediately claim a bad debt deduction under *I.R.C. § 1.166-6*. See, e.g., *Rev. Rul. 80-56*, 1980-1 C.B. 154 (REIT/creditor entitled to bad debt deduction for difference between bid price and note basis).

(n92)Footnote 85f. *Prop. Treas. Reg. § 1.108-8(b)*.

(n93)Footnote 86. In *OKC Corp. and Subs. v. Commissioner*, 82 T.C. 638, 647 (1984), the Tax Court stated that "the rule of Kirby Lumber is clearly applicable where the only relationship between the parties is that of debtor and creditor and where the creditor is willing to accept less than full payment in discharge of the debt because of his concerns about the debtor's solvency, or because a rise in interest rates has devalued the loan." For a discussion of *Kirby Lumber*, see P TX6.02[2][a] *supra*. See also reliable *Incubator & Brooder Co. v. Commissioner*, 6 T.C. 919, 922-23, 926-27 (1946) (creditor urgently in need of cash offered to discharge \$2 of principal for each \$1 of advance payment).

(n94)Footnote 87. *Michaels v. Commissioner*, 87 T.C. 1412, 1417 (1986) (discount realized by prepayment is

income, not a sale or exchange); *City of Columbus, Ohio v. Commissioner*, 75 T.C.M. (CCH) 2127 (1998) (prepayment discounts are discharge income under I.R.C. § 61(a)(12)). See, e.g., *Rev. Rul. 82202*, 1982-2 C.B. 35, amplified by *Rev. Rul. 91-31*, 1991-1 C.B. 19. (financial institution offering prepayment discount for outstanding loans with below-market rate of interest); *Priv. Ltr. Rul. 9530014* (Apr. 25, 1995). See generally, *Columbia Gas System, Inc. v. United States*, 473 F.2d 1244, 1247-48 (2d Cir. 1973); *San Marcos Hotel Co. v. Commissioner*, 11 T.C.M. (CCH) 388, 391-92 (1952), *aff'd*, 205 F.2d 641 (9th Cir. 1953).

(n95)Footnote 88. See *Carl T. Miller Trust v. Commissioner*, 76 T.C. 191, 195-97 (1981) (lapse of statutory period in which claims could be filed against the estate). But see *Bear Mfg. Co. v. United States*, 430 F.2d 152 (7th Cir. 1970) (conduct of parties, rather than running of statute of limitations, determinative).

(n96)Footnote 89. See *Great Plains Gasification Assoc. v. Commissioner*, 92 T.C.M. (CCH) 534 (2006) (identifiable event was year in which foreclosure litigation was terminated); *Cozzi v. Commissioner*, 88 T.C. 435 (1987) (abandonment of debt security was identifiable event which showed debt would not be repaid); *Salva v. Commissioner*, 65 T.C.M. (CCH) 2080 (1993) (release of mortgage liens treated as discharge under state law); *Rev. Rul. 93-7*, 1993-1 C.B. 125 (partner may realize discharge income when partner's debt to partnership is distributed).

(n97)Footnote 90. See, e.g., *Alexander v. Commissioner*, 61 T.C. 278, 289-91 (1973), *acq.*, 1974-2 C.B. 1; *Kuehner v. Commissioner*, 20 T.C. 875, 885 (1953), *acq.*, 1953-2 C.B. 5, *aff'd*, 214 F.2d 437 (1st Cir. 1954); *Clay Drilling Co. of Texas v. Commissioner*, 6 T.C. 324, 331 (1946), *acq.*, 1946-2 C.B. 1 ("we know of no law which is to the effect that a debt is cancelled and forgiven merely because the manner of its payment is restricted ... " and the debtor is no longer personally liable); *Reliable Incubator & Brooder Co. v. Commissioner*, 6 T.C. 919, 926-27 (1946) (debtor apparently did not realize discharge income upon agreement to pay creditor \$30 a week for creditor's life in cancellation of \$27,000 debt); *Coburn v. Commissioner*, 91 T.C.M. (CCH) 1243 (2006) (test requires a practical assessment of facts relating to repayment); see also *Whitfield v. Commissioner*, 311 F.2d 640 (5th Cir. 1962) (no evidence to indicate that debt had been cancelled); *Maros v. Commissioner*, 54 T.C.M. (CCH) 1270, 1272 (1987) (no discharge income realized because cancellation of debt was contingent on transfer of property that did not occur). For a discussion of the time at which a debt is discharged, see P TX6.02[7][c] *infra*.

(n98)Footnote 91. *United States v. Centennial Savings Bank FSB*, 499 U.S. 573, 111 S. Ct. 1512, 1517, 113 L. Ed. 2d 608, 619 (1991) (savings and loan did not realize discharge of indebtedness income with respect to early withdrawal penalties collected from depositors); *Milenbach v. Commissioner*, 318 F.3d 924 (9th Cir. 2003) (debt is discharged when it becomes clear the debt will never be repaid); *Philip Morris Inc. v. Commissioner*, 104 T.C. 61 (1995), *aff'd*, 71 F.3d 1040 (2d Cir. 1995) (gain on conversion of dollars into foreign currency, which currency was used to repay foreign loans, was not income realized "by reason of the discharge ... of indebtedness of the taxpayer"). See ns. 99, 100 *infra* and accompanying text.

(n99)Footnote 92. *United States v. Centennial Savings Bank FSB*, 499 U.S. 573, 111 S. Ct. 1512, 1517, 113 L. Ed. 2d 608, 619 (1991) (savings and loan did not realize discharge of indebtedness income with respect to early withdrawal penalties collected from depositors); *Philip Morris Inc. v. Commissioner*, 104 T.C. 61 (1995), *aff'd*, 71 F.3d 1040 (2d Cir. 1995) (gain on conversion of dollars into foreign currency, which currency was used to repay foreign loans, was not income realized "by reason of the discharge ... of indebtedness of the taxpayer"). See also 1-9851 C.B. 36, *Rev. Rul. 8542* (corporation that transferred assets to a trust for bondholders was not legally released from being the primary obligor); *Tech. Adv. Mem. 98-02-002*, *PLR 9802002*; 1997 *PLR LEXIS 1730* (January 9, 1998) (upfront lease payment resulted in a legal defeasance and released taxpayer from all liability; taxpayer realized ordinary discharge income).

(n100)Footnote 93. See, e.g., *Treas. Reg. § 1.61-12(a)*; *Bailey v. Commissioner*, 103 F.2d 448, 449-50 (5th Cir. 1939); *OKC Corp. and Subs. v. Commissioner*, 82 T.C. 638, 646-50 (1984) and authorities cited therein; *Tucker v. Commissioner*, 69 T.C. 675, 678-79 (1978); *Chatom Co. v. Commissioner*, 36 T.C. 540, 546-7 (1961), *acq. in result*, 1962-1 C.B. 4; *Porten v. Commissioner*, 65 T.C.M. (CCH) 1994 (1993); *Seay v. Commissioner*, 33 T.C.M. (CCH)

1406 (1974) ; *Lieb v. Commissioner*, 33 T.C.M. (CCH) 1231, 1237-38 (1974) , *aff'd in unpublished opinion*, (3d Cir. 1976); *Estate of Buder v. Commissioner*, 22 T.C.M. (CCH) 300, 312 (1963) , *aff'd in part*, 330 F.2d 441 (8th Cir. 1964) ; *Davis v. Commissioner*, 15 T.C.M. (CCH) 879, 881 (1956) . However, the mere release of claims and counterclaims should not have any tax consequences. Such a release would fall in the category of a contested liability. See P TX6.02[2][b] *supra*.

(n101)Footnote 94. S. Rep. No. 1035, 96th Cong., 2d Sess. 8 n.6 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n102)Footnote 95. *Treas. Reg.* § 1.61-12(a); *Rev. Rul.* 84-176, 1984-2 C.B. 34 ; *Gen. Couns. Mem.* 39049 (April 26, 1983) ; *Priv. Ltr. Rul.* 9043027 (July 27, 1990) ; *see also Spartan Petroleum Co. v. United States*, 437 F. Supp. 733 (D.S.C. 1977) (gasoline distributor agreed to termination of distributorship agreement with gas company in exchange for \$1,415,825.27 cash and cancellation of \$233,174.33 debt owed by gas company to distributor; held, no discharge income realized because \$233,174.33 debt not discharged for less than face value but was fully paid with property of equivalent value); *Freeman v. Commissioner*, 33 T.C. 323, 326-28 (1959) (recovery of damages for lost profits taxable as ordinary income, but recovery for replacement of capital is a nontaxable return of capital). *But see Rev. Rul.* 81-277, 1981-2 C.B. 14 (payment by builder to buyer in release of claims for failure to fulfill contract represents a return of capital instead of income); *Rev. Rul.* 57-47, 1957-1 C.B. 23 (recovery nontaxable); *Priv. Ltr. Rul.* 9041072 (July 18, 1990) (recovery in suit against builder was a nontaxable return of capital to the extent recovery does not exceed owner's basis); *Priv. Ltr. Rul.* 9043027 (July 27, 1990) (claims for a return of capital are not taxable). If the buyer in the textual example does not prevail on the argument that the debt discharge rules do not apply to the \$200, the buyer should consider whether the \$200 is excludable under *I.R.C.* § 108(e)(2) or (e)(5). See P TX6.03 *infra*.

(n103)Footnote 96. See, e.g., 1 B. Bittker & L. Lokken, *Federal Taxation of Income, Estates and Gifts*, P 6.4.4 (WGL 3d ed. 1999) ("Bittker & Lokken"). When the debt discharge serves as the medium for a different form of payment, the amount paid for the debt will be presumed to be equal to the fair market value of the property transferred. See *United States v. Davis*, 370 U.S. 65, 72, 82 S. Ct. 1190, 1194, 8 L. Ed. 2d 335, 342 (1962) ; *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184, 188-89 (Ct. Cl. 1954) ; *Spartan Petroleum Co. v. United States*, 437 F. Supp. 733, 736 (D.S.C. 1977) ; *cf. Shaheen v. Commissioner*, 44 T.C.M. (CCH) 694, 697 (1982) (basis of partnership interest acquired in debt cancellation transaction limited to fair market value of interest).

(n104)Footnote 97. See, e.g., 1 B. Bittker & L. Lokken, *Id.*, *see also Velasco v. Commissioner*, 82 T.C.M. (CCH) 640 (2001) (when debt owed to employer was satisfied, taxpayer received immediate benefit); *Lehew v. Commissioner*, 54 T.C.M. (CCH) 81, 82 (1987) ; ILM 200130038 (May 31, 2001) (discharge for services rendered is compensation income reportable under *I.R.C.* § 6041, and not cancellation of debt reportable under *I.R.C.* § 6050P).

(n105)Footnote 98. See *OKC Corp. v. Commissioner*, 82 T.C. 638 (1984) (to settle lawsuit over price to be paid under refinery products output contract, seller of refinery cancelled \$2.6 million of purchase money debt owed by buyer; held, buyer did not realize discharge income eligible for *I.R.C.* § 108 exclusion but instead realized ordinary income because cancellation was a payment for lost profits suffered by buyer under output contract); *Sands v. Commissioner*, 73 T.C.M. (CCH) 2398 (1997) (dispute settlement treated as *I.R.C.* § 1001 sale or exchange); *Anagnoston v. Commissioner*, 68 T.C.M. (CCH) 146 (1994) (transaction was a sale of property with debt cancelled in satisfaction, not a discharge of debt); *Tech. Rev. Ruling* 2004-37, 2004-11 I.R.B. 583 (reduction of recourse note for *I.R.C.* § 83 exercise of stock option is a medium for payment of compensation, not cancellation of debt income); Adv. Mem. 94-44-003 (July 22, 1994) (employee realized compensation income in year bonuses were offset against note due corporation); I.L.M. 2001-30-038 (May 31, 2001) (discharge of tuition loan is compensation for services rendered reportable under *I.R.C.* § 6041 [and not under *I.R.C.* § 6050P]. Income is reported on Form W-2 for employees or Form 1099 MISC for non-employees); *see, e.g., Treas. Reg.* § 15A.453-1(b)(3)(i); *Rev. Rul.* 76-398, 1976-2 C.B. 130 .

(n106)Footnote 99. *Centennial Savings Bank FSB v. United States*, 499 U.S. 573, 111 S. Ct. 1512, 1517-18, 113 L. Ed. 2d 608, 620 (1991) . For a discussion of *I.R.C.* § 108, *see P TX6.03 infra*. This particular issue is not as important

for years after 1986 because the Tax Reform Act of 1986 eliminated the "qualified business indebtedness" exception formerly in I.R.C. § 108(a)(1)(C). Thus, as discussed at P TX6.03[3][a] *infra*, a taxpayer can exclude discharge income under current law only if the taxpayer is in a title 11 case, insolvent (but only to the extent of insolvency) or if the debt is either "qualified farm indebtedness" or "qualified real property business indebtedness." I.R.C. § 108(a)(1). The Court in *Centennial Savings* noted this change in its opinion. *Centennial Savings Bank FSB v. United States*, 499 U.S. 573, 578, 111 S. Ct. 1512, 1516 n.3, 113 L. Ed. 2d 608, 617 (1991) .

(n107)Footnote 100. *Centennial Savings Bank FSB v. United States*, 499 U.S. 573, 581, 111 S. Ct. 1512, 1518, 113 L. Ed. 2d 608, 620 (1991) .

(n108)Footnote 101. See *Fifteen Hundred Walnut St. Corp. v. Commissioner*, 237 F.2d 933 (3d Cir. 1956) ; *Motor Prod. Corp. v. Commissioner*, 47 B.T.A. 983 (1942) , *aff'd*, 142 F.2d 449 (6th Cir. 1944) ; *Rev. Rul. 73-160*, 1973-1 C.B. 365 ; see also *Jackson v. Commissioner*, 708 F.2d 1402 (9th Cir. 1983) (no relief of debt because debtor-transferor remained liable on partnership loans); *Colonial Savings Ass'n v. Commissioner*, 85 T.C. 855, 863 (1985) , *aff'd*, 854 F.2d 1001 (7th Cir. 1988) ; *Jelle v. Commissioner*, 116 T.C. 63 (2001) (if agreement only cancels debt prospectively, debt will be discharged at the subsequent date the conditions are satisfied); *Kniffen v. Commissioner*, 39 T.C. 553, 565-66 (1962) , *acq.*, 1965-2 C.B. 5 ; *The Ernst Kern Co. v. Commissioner*, 1 T.C. 249, 266 (1942) . However, a "significant" modification can result in a deemed taxable exchange of the "old" debt for the "new" modified debt. Prop. Treas. Reg. § 1.1001-3, 57 Fed. Reg. 57034 (Dec. 2, 1992) ; *Rev. Rul. 89-122*, 1989-2 C.B. 200 (change in interest rate and reduction in principal results in deemed exchange); *Rev. Rul. 87-19*, 1987-1 C.B. 249 (waiver of right to receive higher rate of interest is material and constitutes a taxable exchange under I.R.C. § 1001); *Rev. Rul. 81-169*, 1981-1 C.B. 429 (changes were so material that a taxable disposition resulted). For a discussion of the issue of whether a change in the terms of a debt instrument will constitute a taxable disposition, see NYSBA Tax Section, Report of Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-For-Debt Exchanges, 51 *Tax Notes* 79 (April 8, 1991); Kalteyer, *Real Estate Workouts--Original Issue Discount Implications of Troubled Debt Restructurings*, 43 *Tax Lawyer* 579 (1990); Winterer, "Reissuance" and Deemed Exchanges Generally, 37 *Tax Law* 509 (1984). The modification of a debt instrument can also create original issue discount to the debt holder and discharge income to the issuer. See *Rev. Rul. 2004-37*, 2004-11 I.R.B. 583 . For a complete discussion, see chapter TX9 *infra*.

(n109)Footnote 102. I.R.C. § 108(e)(10); see also *Commissioner v. Great Western Power Co. of California*, 79 F.2d 94, 96 (2d Cir. 1935) , *aff'd*, 297 U.S. 543, 56 S. Ct. 576, 80 L. Ed. 853 (1936) ; *Rev. Rul. 77-437*, 1977-2 C.B. 28 ; *Rev. Rul. 58-546*, 1958-2 C.B. 143 . But see *Treas. Reg. § 1.108-2(a)*, --Fed. Reg.--(Dec. 29, 1992) (acquisition of debt by person related to the debtor). For a discussion of the special related party debt acquisition rules, see P TX6.02[4] *infra*.

(n110)Footnote 103. I.R.C. § 108(e)(3).

(n111)Footnote 104. *Zappo v. Commissioner*, 81 T.C. 77 (1983) .

(n112)Footnote 105. *Zappo v. Commissioner*, 81 T.C. 77, 87-89 (1983) . See *Jelle v. Commissioner*, 116 T.C. 63 (2001) (*Zappo* followed when it was held that existing debt cancelled and payment of replacement obligation totally within debtor's control), cf. *Alexander v. Commissioner*, 61 T.C. 278 (1973) , *acq.*, 1974-2 C.B. 1 ; *Republic Supply Co. v. Commissioner*, 66 T.C. 446 (1976) ; *White v. Commissioner*, 34 B.T.A. 424 (1936) , *aff'd sub nom. Walker v. Commissioner*, 88 F.2d 170 (5th Cir. 1937) (discharge income realized in 1930 when conditions set forth in 1927 agreement were ultimately satisfied); Tech. Adv. Memo. 8120014 (January 29, 1981) (*Walker* followed).

(n113)Footnote 106. See, e.g., *Lutz & Schramm Co. v. Commissioner*, 1 T.C. 682, 689 (1943) (indicating that a release from liability on a debt in a prior taxable year was not a taxable transaction); *Zappo v. Commissioner*, 81 T.C. 77, 86 (1983) ; *Aizawa v. Commissioner*, 99 T.C. 197 (1992) , *aff'd*, 29 F.3d 630 (9th Cir. 1994) (following *Lutz & Schramm Co.*). But see *Treas. Reg. § 1.1001-3(e)(5)*, 61 Fed. Reg. 32926 (June 26, 1996),--Fed. Reg.--(Dec. 2, 1992)

(subject to two exceptions, change in terms of debt instrument from recourse to nonrecourse, or nonrecourse to recourse, is a "significant" modification resulting in a deemed taxable exchange).

(n114)Footnote 107. *Commissioner v. Rail Joint Co.*, 22 B.T.A. 1277, 1278-79 (1931) , *aff'd*, 61 F.2d 751, 752 (2d Cir. 1932) ; *Treas. Reg. § 1.1001-2(a)(2) and (4)*; *see also Alexander v. Commissioner*, 61 T.C. 278 (1973) (no discharge income realized upon conversion of open account recourse note to an obligation to repay only from sales commissions to be earned in the future); *Clay Drilling Co. of Texas v. Commissioner*, 6 T.C. 324 (1946) , *acq.*, 1946-2 C.B. 1 (debt not cancelled or forgiven where converted to nonrecourse and repayment limited to earnings from certain services).

(n115)Footnote 108. Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, at 119 (Comm. Print 1984); *Gen. Couns. Mem.* 39668 (Sept. 24, 1987) .

(n116)Footnote 109. *Treas. Reg. § 1.301-1(m)*; *Haber v. Commissioner*, 52 T.C. 255, 262 (1969) , *aff'd*, 422 F.2d 198 (5th Cir. 1970) ; *Toberman v. Commissioner*, 80 T.C.M. (CCH) 81 (2000) , *rev'd and remanded*, 294 F.3d 985 (8th Cir. 2002) ; *Kaplan v. Commissioner*, 21 T.C. 134, 145 (1953) ; *Burke v. Commissioner*, 73 T.C.M. (CCH) 2826 (1997) ; *see also Enoch v. Commissioner*, 57 T.C. 781, 793 (1972) (constructive dividend distribution if corporation pays debt of shareholder). *But see Rev. Rul.* 61-96, 1961-1 C.B. 68 (transaction treated both as I.R.C. § 301 distribution and discharge of debt).

(n117)Footnote 110. *Rev. Rul.* 74-54, 1974-1 C.B. 76 ; *Priv. Ltr. Rul.* 9102029 (Oct. 15, 1990) ; *see also Estate of Gilmore v. Commissioner*, 130 F.2d 791 (3d Cir. 1942) ; *Priv. Ltr. Rul.* 8825048 (Mar. 23, 1988) . However, if distribution is made to the parent corporation as a creditor and not in respect of its stock, the parent corporation will recognize gain or loss. *See Treas. Reg. § 1.332-7*.

(n118)Footnote 111. Notice of Proposed Rulemaking, 56 Fed. Reg. 12135 (March 22, 1991) (to be codified at 26 C.F.R. pt. I), *clarified by* 1991-1 C.B. 319, *Notice 91-15* (June 3, 1991) .

(n119)Footnote 112. *See P TX6.02[1] supra*.

(n120)Footnote 113. *Treas. Reg. § 1.61-12(c)(3)*.

(n121)Footnote 114. Tax Reform Act of 1984, Pub. L. No. 98-369, §§ 41-45, 98 Stat. 494, 532-62.

(n122)Footnote 115. *Treas. Reg. § 1.1272-1(b)*, 59 Fed. Reg. 4799 (Feb. 2, 1994) . *See* chapter TX9 *infra* for a discussion of the OID rules in the context of debt-for-debt exchanges. For a general discussion of the OID rules, *see* Garlock, A Practical Guide to the Original Issue Discount Regulations (P-H 1990); Lokken, *The Time Value of Money Rules*, 42 *Tax L. Rev.* 1 (Fall 1986).

(n123)Footnote 116. *I.R.C. § 1273(a)(1)*. A "debt instrument" is defined as a "bond, debenture, note, or certificate or other evidence of indebtedness." *I.R.C. § 1275(a)(1)*.

(n124)Footnote 117. *See, e.g., Prop. Treas. Reg. § 1.1273-2(c)(2)*, 51 Fed. Reg. 12,022 (1986) .

(n125)Footnote 118. *I.R.C. § 1273(b)(4)*; *Treas. Reg. § 1.1273-2(d)*, 59 Fed. Reg. 4799 (Feb. 2, 1994) .

(n126)Footnote 119. *I.R.C. § 1273(b)*; *Treas. Reg. § 1.1273-2*, 59 Fed. Reg. 4799 (Feb. 2, 1994) .

(n127)Footnote 120. *I.R.C. § 1273(b)(5)*.

(n128)Footnote 121. *I.R.C. § 1273(b)(1)*. The "initial offering price to the public" does not include the initial offering price to bond houses and brokers. *I.R.C. § 1273(b)(1)*.

(n129)Footnote 122. *I.R.C. § 1273(b)(2)*.

(n130)Footnote 123. *I.R.C. § 1273(b)(3); Treas. Reg. § 1.1273-2(d)*, 59 *Fed. Reg.* 4799 (Feb. 2, 1994) .

(n131)Footnote 124. *I.R.C. § 1274(a); Treas. Reg. § 1.1274-1(b)*, 59 *Fed. Reg.* 4799 (Feb. 2, 1994) .

(n132)Footnote 125. *I.R.C. § 1274(c)(2) and (b)(2); Treas. Reg. § 1.1274-2(b) and (c)*, 59 *Fed. Reg.* 4799 (Feb. 2, 1994) .

(n133)Footnote 126. *I.R.C. § 1274(a) and (b); Treas. Reg. § 1.1274-2, (b)*, 59 *Fed. Reg.* 4799 (Feb. 2, 1994) . *See Rev. Rul. 89-122, 1989-2 C.B. 200* (modification of debt instrument resulted in deemed exchange; issue price of "new" modified debt instrument determined under *I.R.C. § 1274*).

(n134)Footnote 127. Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, § 11325(a)(1) (Nov. 5, 1990).

(n135)Footnote 128. *I.R.C. § 108(e)(10)(A)*. *See also Treas. Reg. § 1.61-12(c)(2)* (Dec. 30, 1997).

(n136)Footnote 129. *I.R.C. § 108(e)(10)(B)*.

(n137)Footnote 130. Pub. L. No. 101-508, § 11325(a)(1) (1990). *But see In re Chateaugay Corp.*, 961 F.2d 378, 26 C.B.C.2d 1174 (2d Cir. 1992) (no OID created in a face value debt-for-debt exchange). For a complete discussion of the tax consequences of debt-for-debt exchanges, *see* chapter TX9 *infra*. *See also see 46 Tax Law*. 397 (Winter 1993) ("Section 108 Task Force Report--Part II," 440).

(n138)Footnote 131. *See P TX6.02[4][a][i] supra*.

(n139)Footnote 132. *I.R.S. § 1273(b)*.

(n140)Footnote 133. *I.R.C. §§ 1273(a), 1272 and 163(e)*. Note that the issuer's deduction of OID may be limited by the applicable high yield discount obligation ("AHYDO") rules of *I.R.C. § 163(e)(5)*. For a detailed discussion of the OID rules, *see* chapter TX9 *infra*. For a discussion of the AHYDO rules, *see* Levin & Gallagher, *New Code Section 163(e)(5) Limiting Deductibility of Interest on OID and PIK Debentures*, 46 *Tax Notes* 555 (Jan. 29, 1990).

(n141)Footnote 134. *I.R.C. § 1274(a); Treas. Reg. § 1.1274-2(b) and (c)*, 59 *Fed. Reg.* 4799 (Feb. 2, 1994) .

(n142)Footnote 135. *See I.R.C. § 1274(b)(4)*. *See, e.g., In re Chateaugay Corp.*, 961 F.2d 378, 26 C.B.C.2d 1174 (2d Cir. 1992) (no OID created in a face value debt-for-debt exchange in a consensual loan workout).

(n143)Footnote 136. *I.R.C. § 1275(a)(4)*, prior to repeal by Pub. L. No. 101-508, § 11325(a)(2) (Nov. 5, 1990).

(n144)Footnote 137. For purposes of this provision, the "adjusted issue price" was defined as the issue price of the debt increased by the OID previously includable in income by the debtholder. *I.R.C. § 1275(a)(4)(B)(ii)*.

(n145)Footnote 138. For a complete discussion, *see* NYSBA Tax Section, Report of Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-For-Debt Exchanges, 51 *Tax Notes* 79 (April 8, 1991).

(n146)Footnote 139. *Peter Pan Seafoods, Inc. v. United States*, 417 F.2d 670 (9th Cir. 1969) ; *see also Rev. Rul. 61-96, 1961-1 C.B. 68* .

(n147)Footnote 140. *Peter Pan Seafoods, Inc. v. United States*, 417 F.2d 670, 673 (9th Cir. 1969) . *See also Forrester v. Commissioner*, 4 T.C. 907, 920-21 (1945) , *acq.*, 1945 C.B. 3 .

(n148)Footnote 141. S. Rep. No. 1035, 96th Cong., 2d Sess. 10, *reprinted in* Vol. E Collier on Bankruptcy, App.

Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised). The IRS had taken the position that if a parent corporation purchased bonds issued by its subsidiary at a discount and contributed them to the capital of the subsidiary prior to January 1, 1981, the subsidiary did not realize debt discharge income. *Gen. Couns. Mem. 38798 (Sept. 24, 1981)*.

(n149)Footnote 142. For an analysis of *I.R.C. § 108(e)(4)*, see Peaslee, *Discharge of Debt Through Its Acquisition by a Person Related to the Debtor--An Analysis of Section 108(e)(4)*, 37 *Tax L. Rev.* 193 (1982).

(n150)Footnote 143. In *Rev. Rul. 91-47, 1991-2 C.B. 16*, a person unrelated to the debtor corporation ("DC") formed a new corporation that acquired DC's outstanding debt of \$100 for \$70 and thereafter sold the new corporation stock to D.C. for \$70. Based on the form of the transaction, the related party rules of *I.R.C. Section 108(e)(4)* (as they existed prior to the issuance of *Treas. Reg. § 1.108-2*, Fed. Reg. (1992)) may not have applied and D.C. may have avoided the realization of \$30 of discharge income. Based on the "substance over form" doctrine, the IRS ruled that D.C. realized \$30 of discharge income because to conclude otherwise would permit avoidance of the "spirit" of *I.R.C. Section 108(e)(4)* solely based on form. It is unclear whether this ruling effectively applies the underlying principles of *Treas. Reg. § 1.108-2* (Dec. 28, 1992) retroactively.

(n151)Footnote 143a. See *Rev. Rul 2004-79, 2004-31 I.R.B. 106*.

(n152)Footnote 144. See *P TX6.02[4][b][ii] infra*.

(n153)Footnote 145. *I.R.C. Section 108(e)(4)(B)*.

(n154)Footnote 146. Compare *I.R.C. § 108(e)(4)(B)* with *I.R.C. § 267(c)(4)*.

(n155)Footnote 147. *I.R.C. § 108(e)(4)(C)*. See *Tech. Adv. Mem. 9541006 (July 5, 1995)*.

(n156)Footnote 147a. *I.R.C. § 707(b)(1)(A)*.

(n157)Footnote 147b. *I.R.C. § 267 (b)(10)*.

(n158)Footnote 147c. *I.R.C. § 707(b)(1)(B)*.

(n159)Footnote 147d. *I.R.C. § 267(b)(2)*.

(n160)Footnote 147e. *I.R.C. § 267(c)(3)*.

(n161)Footnote 147f. *I.R.C. § 267(c)(3)*.

(n162)Footnote 148. Compare, for example, *I.R.C. § 267(c)* with *I.R.C. § 318(a)(4)* (which does not apply to transactions governed by *I.R.C. § 108(e)(4)*), which specifically provides that a person who holds an option to acquire stock is deemed to own the stock covered by the option.

(n163)Footnote 149. *I.R.C. § 108(e)(4)(c)*.

(n164)Footnote 150. *I.R.C. § 1563(e)(1)*.

(n165)Footnote 151. For acquisitions occurring on or after March 21, 1991 and before December 28, 1992, taxpayers may rely on the proposed *I.R.C. § 108(e)(4)* regulations issued on March 22, 1991. See *I.R.S. 1993-2 C.B. 331, Notice 93-40*. For a critique of the proposed regulations, see NYSBA Tax Section Committee on Bankruptcy, *Acquisitions of Discount Debt by Related Parties Under the New Section 108(e)(4) Regulation*, 52 *Tax Notes* 211 (July 8, 1991).

(n166)Footnote 152. *Treas. Reg. § 1.108-2(a)*, 57 *Fed. Reg.* 61805, 1993-1 *C.B.* 19 (Dec. 29, 1992). See *Rev.*

Rul. 2004-79, 2004-31 I.R.B. 1 .

(n167)Footnote 153. *Treas. Reg. § 1.108-2(d)(1).*

(n168)Footnote 154. *Treas. Reg. § 1.108-2(f)(1).*

(n169)Footnote 155. The taxpayer generally bears the burden of proof. *See, e.g., Welch v. Helvering, 290 U.S. 111, 54 S. Ct. 8, 78 L. Ed. 212 (1933) .*

(n170)Footnote 156. *Treas. Reg. § 1.108-2(b).* *See Rev. Proc. 2000-33, 2000-2 C.B. 257* (acquisition of corporate debt by a beneficiary of a decedent creditor's estate or by a beneficiary of a revocable trust that became irrevocable upon the creditor's death where the beneficiary is related to the corporate debtor, the decedent creditor was also related to the corporate debtor, but the estate or trust is not related to the corporate debtor, is not a direct acquisition within the meaning of *I.R.C. § 1.108-2(b)*).

(n171)Footnote 157. *Treas. Reg. § 1.108-2(c)(1).*

(n172)Footnote 158. *Treas. Reg. § 1.108-2(c)(2).*

(n173)Footnote 159. *Treas. Reg. § 1.108-2(c)(3).*

(n174)Footnote 160. *Treas. Reg. § 1.108-2(c)(4).*

(n175)Footnote 161. *Treas. Reg. § 1.108-2(c)(4)(ii).*

(n176)Footnote 162. *Treas. Reg. § 1.108-2(c)(4)(v).*

(n177)Footnote 163. *Treas. Reg. § 1.108-2(g)(2).*

(n178)Footnote 164. S. Rep. No. 1035, 96th Cong., 2d Sess. 19-20 n. 23, *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n179)Footnote 165. S. Rep. No. 1035, 96th Cong., 2d Sess. 19-20 n. 23, *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n180)Footnote 166. CO-90-90, 56 *Fed. Reg. 28,124 (1991) .*

(n181)Footnote 167. *Treas. Reg. § 1.108-2(g)(1).* *See Rev. Rul. 2004-79, 2004-31 I.R.B. 1 .*

(n182)Footnote 168. *Treas. Reg. § 1.108-2(g)(1).* Note that the debtor's deduction of OID may be limited by the AHYDO rules of *I.R.C. § 163(e)(5).*

(n183)Footnote 169. *Treas. Reg. § 1.108-2(g)(4), Ex. 1.*

(n184)Footnote 170. *Treas. Reg. § 1.108-2(e).*

(n185)Footnote 171. *Treas. Reg. § 1.6050P-1(d)(5)*, 61 *Fed. Reg. 262* (Jan. 4, 1996) , amended by *T.D. 8895 (August 17, 2000) .*

(n186)Footnote 172. The Tax Court explained the rationale for this result:

The situation of a guarantor is not like that of a debtor who as a result of the original loan obtains a nontaxable increase in assets. The guarantor obtains nothing except perhaps a taxable consideration for his promise. Where a debtor is relieved of his obligation to repay the loan, his net worth is increased over

what it would have been if the original transaction had never occurred. This real increase in wealth may be properly taxable. *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931) . However, where the guarantor is relieved of his contingent liability, either because of payment by the debtor to the creditor or because of a release given him by the creditor, no previously untaxed accretion in assets thereby results in an increase in net worth. *Commissioner v. Rail Joint Co.*, 61 F.2d 751 (C.A. 2, 1932) ; *Fashion Park, Inc.*, 21 T.C. 600 (1954) . Payment by the principal debtor does not increase the guarantor's net worth; it merely prevents it, pro tanto, from being decreased. The guarantor no more realizes income from the transaction that [sic] he would if a tornado, bearing down on his home and threatening a loss, changes course and leaves the house intact.

Hunt v. Commissioner, 59 T.C.M. (CCH) 635, 649-50 (1990) (citing *Landreth v. Commissioner*, 50 T.C. 803, 813, 30 O.&G.R. 259 (1968)) . See also Treas. Reg. § 1.6050P-1(d)(7) (for reporting purposes, guarantor is not a debtor); *Payne v. Commissioner*, 75 T.C.M. (CCH) 2548 (1998) , rev'd on other grounds, 224 F.3d 415 (5th Cir. 2000) ; *Whitmer v. Commissioner*, 71 T.C.M. (CCH) 2213 (1996) (*Landreth* followed); *Friedland v. Commissioner*, T.C. Memo 2001236 (Sept. 10, 2001) (no amount realized where property transferred in satisfaction of another's debt). *Rev. Rul.* 79-89, 1979-1 C.B. 152 (any benefit to shareholder who guaranteed corporation's debt upon release from such guarantee was deemed "incidental"); *Rev. Rul.* 74-592, 1974-2 C.B. 47 (guarantor who paid interest on guaranteed debt not entitled to interest deduction because it was not a payment incidental to an obligation of the guarantor); Chief Counsel Advice 200402004 (Jan. 9, 2004); *Priv. Ltr. Rul.* 9125013 (Mar. 21, 1991) (follows *Rev. Rul.* 79-89) ; *Tech. Adv. Mem.* 7953004 (Sept. 7, 1979) ; see Report of the Section 108 Real Estate and Partnership Task Force, 46 *Tax Law.* 209 (Fall 1992) ("Section 108 Task Force Report - Part I", 225), Q-4. But see *Treas. Reg.* § 1.1001-3(e)(4)(iv), 61 *Fed. Reg.* 32926 (June 26, 1996) (addition or material alteration of a guarantee of a nonrecourse debt is a "significant" modification resulting in a deemed taxable exchange).

(n187)Footnote 173. *Bradford v. Commissioner*, 233 F.2d 935 (6th Cir. 1956) , nonacq., 1958-2 C.B. 9 .

(n188)Footnote 174. *Commissioner v. Rail Joint Co.*, 22 B.T.A. 1277 (1931) , aff'd, 61 F.2d 751 (2d Cir. 1932) .

(n189)Footnote 175. *Bradford v. Commissioner*, 233 F.2d 935, 938 (6th Cir. 1956) ; see also *United States v. Gotcher*, 401 F.2d 118, 121 (5th Cir. 1968) (taxpayer does not realize income under I.R.C. § 61 unless the taxpayer personally benefits from an economic gain); *Eagle Asbestos & Packing Co. v. United States*, 348 F.2d 528, 532 (Ct. Cl. 1965) (difference between amount paid in settlement and total amount originally due not includable in income).

(n190)Footnote 176. *Bradford v. Commissioner*, 233 F.2d 935, 938 (6th Cir. 1956) . Is the *Bradford* rationale applicable to the release of a partner's obligation as a guarantor of all or a portion of the debt of partnership when the lender would not have made the loan without each partner's individual guarantee? Although not involving a guarantee by a partner, *Tennessee Securities v. Commissioner*, 37 T.C.M. (CCH) 1803 (1978) , aff'd, 674 F.2d 570 (6th Cir. 1982) , suggests that the *Bradford* rationale would not apply. For further discussion of *Tennessee Securities*, see text accompanying ns. 181-187 *infra*. See also *Tech. Adv. Mem.* 7953004 (Sept. 7, 1979) , in which limited partners guaranteed nonrecourse notes of limited partnership up to a specified dollar amount. Under terms of a compromise agreement, the lender released the limited partners from their guarantees. The IRS ruled that the limited partners did not have discharge income as a result of the release, emphasizing that the release occurred before the guarantors had become primary obligors. See also *Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712, 723-24 (5th Cir. 1972) (equity contribution attributed to individual co-guarantor who court determined was one that would be ultimately looked to for repayment).

(n191)Footnote 177. See, e.g., *Zappo v. Commissioner*, 81 T.C. 77, 87-88 (1983) ; *Terminal Investment Co. v. Commissioner*, 2 T.C. 1004 (1943) , acq., 1944 C.B. 27 ; *Tech. Adv. Mem.* 7953004 (Sept. 7, 1979) ; see also *Harris v. United States*, 902 F.2d 439, 445 (5th Cir. 1990) (stock basis not increased because unperformed guarantees do not constitute an economic outlay by the guarantors); *Estate of Leavitt v. Commissioner*, 90 T.C. 206 (1988) , aff'd, 875

F.2d 420, 424 (4th Cir. 1989) (guaranteed loans by shareholders of an S corporation do not increase basis in stock when the shareholders have not made an economic outlay); *Ray v. Commissioner*, 61 T.C.M. (CCH) 2122, 2131 (1991) (same); *Rev. Rul. 84-42, 1984-1 C.B. 194* (if decedent's estate is not called upon to pay, amount of guaranteed debt is not deductible as a claim against the estate under *I.R.C. § 2053(a)(3)*).

(n192)Footnote 178. In *United States v. Centennial Savings Bank FSB*, 499 U.S. 573, 581-82, 111 S. Ct. 1512, 1518, 113 L. Ed. 2d 608, 620 (1991), the Supreme Court explained the two step analysis as follows:

Borrowed funds are excluded from income in the first instance because the taxpayer's obligation to repay the funds offsets any increase in the taxpayer's assets; if the taxpayer is thereafter released from his obligation to repay, the taxpayer enjoys a net increase in assets equal to the forgiven portion of the debt, and the basis for the original exclusion thus evaporates.

See also *Estate of Newman v. Commissioner*, 934 F.2d 426, 430-1 (2d Cir. 1991).

(n193)Footnote 179. *Treas. Reg. § 1.166-9*; Chief Counsel Advice 200402004, n1 (Nov. 26, 2003); see n.188 *infra* and accompanying text. See, e.g., *Treas. Reg. § 1.752-4(c)* amount of partnership indebtedness is taken into account only once). Because of possible differences in timing (income in one year and deduction in a subsequent year) and character (ordinary discharge income under *I.R.C. § 61(a)(12)* and capital loss deduction limited under *I.R.C. § 1211*), it is likely that the double counting and adjustment method may not "wash" for federal income tax purposes, leaving the guarantor in a net loss position.

(n194)Footnote 180. *Securities, Inc. v. Commissioner*, 37 T.C.M. (CCH) 1803 (1978), *aff'd*, 674 F.2d 570 (6th Cir. 1982).

(n195)Footnote 181. *Tennessee Securities, Inc. v. Commissioner*, 37 T.C.M. (CCH) 1803, 1810 (1978), *aff'd*, 674 F.2d 570 (6th Cir. 1982); see, e.g., *United States v. Hendler*, 303 U.S. 564, 566-67, 58 S. Ct. 655, 656, 82 L. Ed. 1018, 1019-20 (1938); *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 729, 49 S. Ct. 499, 504, 73 L. Ed. 918, 927-28 (1929); see also *Hahn v. Commissioner*, 93 T.C.M. (CCH) 1055 (2007); *Miller v. Commissioner*, 91 T.C.M. (CCH) 1267 (2006); *Amey v. Commissioner*, 22 T.C. 756, 761-62 (1954) (payments made by lessee directly to nonrecourse lender constituted rental income to lessor).

(n196)Footnote 182. *Tennessee Securities, Inc. v. Commissioner*, 674 F.2d 570 (6th Cir. 1982), *aff'g*, 37 T.C.M. (CCH) 1803 (1978).

(n197)Footnote 183. *Wortham Machinery Co. v. United States*, 521 F.2d 160 (10th Cir. 1975).

(n198)Footnote 184. *Tennessee Securities, Inc. v. Commissioner*, 674 F.2d 570, 573-74 (6th Cir. 1982), *aff'g*, 37 T.C.M. (CCH) 1803 (1978).

(n199)Footnote 185. *Tennessee Securities, Inc. v. Commissioner*, 674 F.2d 570, 573 (6th Cir. 1982), *aff'g*, 37 T.C.M. (CCH) 1803 (1978).

(n200)Footnote 186. *Tennessee Securities, Inc. v. Commissioner*, 674 F.2d 570, 573 (6th Cir. 1982), *aff'g*, 37 T.C.M. (CCH) 1803 (1978); see also *Kean v. Commissioner*, 91 T.C. 575, 605 (1988).

(n201)Footnote 187. *Treas. Reg. § 1.166-9*; *Tennessee Securities, Inc. v. Commissioner*, 674 F.2d 570, 574 (6th Cir. 1982), *aff'g*, 37 T.C.M. (CCH) 1803 (1978). See, e.g., *Putnam v. Commissioner*, 352 U.S. 82, 85, 77 S. Ct. 175, 176, 1 L. Ed. 2d 144, 146 (1956) (guarantor, under principles of subrogation, steps into creditor's shoes with respect to original debtor). But see *Helvering v. Price*, 309 U.S. 409, 413, 60 S. Ct. 673, 675, 84 L. Ed. 836, 839 (1940) (cash basis taxpayer made no payment and incurred no deductible loss in year guarantee was satisfied with a personal

promissory note). Alternatively, the guarantor could contend that the discharge income is eliminated under I.R.C. § 108(e)(2). See P TX6.03[5][f] *infra*.

(n202)Footnote 188. *Treas. Reg. § 1.166-9(a)*. See, e.g., *United States v. Generes*, 405 U.S. 93, 92 S. Ct. 827, 31 L. Ed. 2d 62 (1972) (dominant motivation for guarantee must be related to guarantor's trade or business); *Whipple v. Commissioner*, 373 U.S. 193, 83 S. Ct. 1168, 10 L. Ed. 2d 288 (1963) (advances by shareholder to corporation were nonbusiness debts because shareholder was not in business of lending money or financing corporations).

(n203)Footnote 189. Under I.R.C. § 166(c), a nonbusiness bad debt is treated as a short term capital loss.

(n204)Footnote 190. *Treas. Reg. § 1.166-9(b)*.

(n205)Footnote 191. *Treas. Reg. § 1.166-9(e)*; see *Lair v. Commissioner*, 95 T.C. 484 (1990) (no deduction allowed to parents who guaranteed son's debt when "direct consideration in the form of cash or property" was not received in consideration for the guarantee). *Priv. Ltr. Rul. 9441017* (July 7, 1994) (payment of guarantee obligation deductible as a nonbusiness bad debt).

(n206)Footnote 192. *Shea v. Commissioner*, 36 T.C. 577, 581-83 (1961), *aff'd*, 327 F.2d 1002 (5th Cir. 1964).

(n207)Footnote 193. An "exchange" is commonly defined as an act of giving one thing in return for another thing that is regarded as being of equivalent value. *Yarbro v. Commissioner*, 737 F.2d 479, 483 (5th Cir. 1984); *Lockwood v. Commissioner*, 94 T.C. 252, 260 (1990). Thus, the abandonment of property securing a debt is an "exchange" that is treated as a taxable disposition. *Id.*

(n208)Footnote 194. *Treas. Reg. § 1.1001-1(a)*.

(n209)Footnote 195. *Treas. Reg. § 1.1001-2(a)(1)*; *Bialock v. Commissioner*, 35 T.C. 649, 660 (1961). See *Friedland v. Commissioner*, T.C. Memo 2001-236 (Sept. 10, 2001) (no amount realized where property transferred in satisfaction of another's debt).

(n210)Footnote 196. *Treas. Reg. § 1.61-6(a)*; *Treas. Reg. § 1.1001-2(c)* (ex. 2), (ex. 7); *Temp. Treas. Reg. § 15a.453-1(b)(3)(i)* (Jan. 30, 1981); see, e.g., *Gehl v. Commissioner*, 102 T.C. 784 (1994), *aff'd*, 50 F.3d 12 (8th Cir. 1995); *Estate of Delman v. Commissioner*, 73 T.C. 15 (1979); *Rev. Rul. 76-111*, 1976-1 C.B. 214; Action on Decision 1987-013, I.R.S. Positions (CCH) P 45,013 (June 15, 1987) (acting on *Main Properties, Inc. v. Commissioner*, 4 T.C. 364 (1944)); Action on Decision 1987-017, I.R.S. Positions (C.C.H.) P 45,017 (June 15, 1987) (acting on *Texas Gas Distrib. Co. v. Commissioner*, 3 T.C. 57 (1944)); see also *Estate of Levine v. Commissioner*, 634 F.2d 12 (2d Cir. 1980) (amount realized on gift transfer of encumbered property includes full amount of nonrecourse debt).

(n211)Footnote 197. See, e.g., *In re Brubeck*, 133 B.R. 139 (S.D. Ind. 1991); *In re Collum*, 131 B.R. 793 (N.D. Tex. 1991); *Estate of Delman v. Commissioner*, 73 T.C. 15, 38-40 (1979); *Rev. Rul. 90-16*, 1990-1 C.B. 12; *Tech. Adv. Mem. 9302001* (Aug. 31, 1992); *Priv. Ltr. Rul. 9120010* (Feb. 14, 1991); *Tech. Adv. Mem. 8348001* (Aug. 18, 1983).

(n212)Footnote 198. *Danenberg v. Commissioner*, 73 T.C. 370 (1979), *acq.*, 1980-2 C.B. 1; *Correra v. Commissioner*, 74 T.C.M. (CCH) 273 (1997); *Slavin v. Commissioner*, 57 T.C.M. (CCH) 343, 347-48 (1989); see also *Tech. Adv. Mem. 9302001* (Aug. 31, 1992); *Tech. Adv. Mem. 8005002* (Oct. 11, 1979).

(n213)Footnote 199. *Treas. Reg. § 1.1001-2(a)(1)*, (b); see also *Lowry v. Commissioner*, 86 T.C.M. (CCH) 198 (2003), *aff'd in unpublished opinion*, 2006-1 U.S. Tax Cos. (CCH) P50, 187 (9th Cir. 2006) (gain realized in 1994 when terms of escrow satisfied and deed recorded); *Aizawa v. Commissioner*, 99 T.C. 197 (1992), *aff'd*, 29 F.3d 630 (9th Cir. 1994); *Frazier v. Commissioner*, 111 T.C. 243 (1998); *Hutchison v. Commissioner*, 42 T.C.M. (CCH) 1089,

1094-95 (1981) . A disposition of property securing a recourse debt will discharge the transferor from liability if another person agrees to pay the liability, whether or not the transfer is actually released from liability. *Treas. Reg. § 1.1001-2(a)(4)(ii)*; *Estate of Juden v. Commissioner*, 865 F.2d 960 (8th Cir. 1989) (transfer of encumbered property in exchange for assumption of recourse debt by transferee treated as a taxable sale or exchange with an amount realized equal to debt assumed even though transferors were not released from recourse note to lender); *see also Weyher v. Commissioner*, 66 T.C. 825, 829 (1976) (assumption of liability equated with termination for purposes of computing the amount realized). With respect to the allocation of a single purchase money debt among multiple properties, the IRS has indicated that a taxpayer can allocate the debt based on the original cost of the respective properties. *See Priv. Ltr. Rul. 9251023 (Sept. 18, 1992)* .

(n214)Footnote 200. Concluding that an abandonment of property subject to a nonrecourse debt was an "exchange," the Tax Court stated: "what characterizes the abandonment as an 'exchange' is the extinguishing of the debt concomitantly with the taxpayer's giving up his rights to the property." *Lockwood v. Commissioner*, 94 T.C. 252, 260 (1990) . *See also Yarbrow v. Commissioner*, 737 F.2d 479, 485 (5th Cir. 1984) . Generally, the value received in an exchange will be presumed equal to the fair market value of the property given up. *United States v. Davis*, 370 U.S. 65, 72, 82 S. Ct. 1190, 1194, 8 L. Ed. 2d 335, 342 (1962) ; *Philadelphia Park Amusement Co. v. United States*, 126 F. Supp. 184, 188-89 (Ct. Cl. 1954) ; *Moore-McCormack Lines, Inc. v. Commissioner*, 44 T.C. 745 (1965) (stock issued in taxable exchange presumed to have value equal to value of property exchanged therefor).

(n215)Footnote 201. *Commissioner v. Tufts*, 461 U.S. 300, 312-13, 103 S. Ct. 1826, 1833-34, 75 L. Ed. 2d 863, 873-74 (1983) . *See P TX6.02[7][b] infra*.

(n216)Footnote 202. *Treas. Reg. § 1.1001-2(a)(2), (c) (ex. 8)*; *see also Electro-Chemical Engraving Co. v. Commissioner*, 311 U.S. 513, 61 S. Ct. 372, 85 L. Ed. 308 (1941) ; *Gehl v. Commissioner*, 102 T.C. 784 (1994) , *aff'd in unpublished opinion*, 50 F.3d 12 (8th Cir. 1995) ; *Michaels v. Commissioner*, 87 T.C. 1412, 1415 (1986) ; *Danenberg v. Commissioner*, 73 T.C. 370, 380-81 (1979) , *acq.*, 1980-2 C.B. 1 ; *Millar v. Commissioner*, 67 T.C. 656 (1977) , *aff'd in part*, 577 F.2d 212 (3d Cir. 1978) ; *Bressi v. Commissioner*, 62 T.C.M. (C.C.H.) 1668, 1675 (1991), *aff'd*, 989 F.2d 486 (3d Cir. 1993) ; *Rev. Rul. 90-16, 1990-1 C.B. 12* ; *Gen. Couns. Mem. 39814 (Mar. 30, 1990)* ; *Priv. Ltr. Ruls. 92-45-023 (Aug. 7, 1992), 89-28-012 (Apr. 7, 1989), 85-04-010 (Oct. 26, 1984)*.

(n217)Footnote 203. The discussion in the text assumes that the amount of debt in excess of the fair market value was discharged by the creditor at the time of the transfer. In many cases, a creditor will not agree to a simultaneous discharge, resulting in a delay in the timing of the discharge transaction. *See Aizawa v. Commissioner*, 99 T.C. 197 (1992) , *aff'd*, 29 F.3d 630 (9th Cir. 1994) ; *Marcaccio v. Commissioner*, 69 T.C.M. (CCH) 2420 (1995) (foreclosure in 1986; discharge under settlement of deficiency lawsuit in 1988). For a discussion of the timing of a discharge of debt, *see P TX6.02[7][c] infra*.

(n218)Footnote 204. *Treas. Reg. § 1.1001-2(a)(1), (a)(4)(i), (c) (ex. 7)*; *Commissioner v. Tufts*, 461 U.S. 300, 309-10, 103 S. Ct. 1826, 1832-33, 75 L. Ed. 2d 863, 871-72 (1983) ; *see also Treas. Reg. § 15A.453-1(b)(3)(i) (Jan. 30, 1981)*.

(n219)Footnote 205. *Commissioner v. Tufts*, 461 U.S. 300, 307, 103 S. Ct. 1826, 1831, 75 L. Ed. 2d 863, 870 (1983) .

(n220)Footnote 206. *See H.R. Rep. No. 861, 98th Cong., 2d Sess. 868 (1984)*; *Treas. Reg. § 1.704-1(b)(4)(iv)(a), (k)*; *Treas. Reg. § 1.752-1(a)(2) (1992)*; *see also Mayerson v. Commissioner*, 47 T.C. 340, 350 (1966) , *acq.*, 1969-1 C.B. 21 .

(n221)Footnote 207. *Treas. Reg. § 1.1001-2(c) (ex. 7)*; *Commissioner v. Tufts*, 461 U.S. at 309-10, 103 S. Ct. 1826, 1832-33, 75 L. Ed. 2d 863, 871-72 (1983) ; *Crane v. Commissioner*, 331 U.S. 1, 67 S. Ct. 1047, 91 L. Ed. 1301 (1947) ; *Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950) ; *Gershkowitz v. Commissioner*, 88 T.C. 984, 1016-17 (1987)

; *Estate of Delman v. Commissioner*, 73 T.C. 15, 29-30 (1979) ; *Tech. Adv. Mem. 9302001* (Aug. 31, 1992) ; *see also* *Millar v. Commissioner*, 67 T.C. 656 , *aff'd in part*, 577 F.2d 212 (3d Cir. 1978) ; *Lutz & Schramm Co. v. Commissioner*, 1 T.C. 682, 688-89 (1943) .

(n222)Footnote 208. *See Commissioner v. Tufts*, 461 U.S. 300, 307-08, 103 S. Ct. 1826, 1831-32, 75 L. Ed. 2d 863, 870-71 - (1983).

(n223)Footnote 209. *Commissioner v. Tufts*, 461 U.S. 300, 312-13, 103 S. Ct. 1826, 1833-34, 75 L. Ed. 2d 863, 873-74 (1983) .

(n224)Footnote 210. Assume that Owner purchased the property from someone other than Lender so that, even if Owner were solvent, the discharge could not be a purchase price adjustment within the meaning of *I.R.C. § 108(e)(5)*. *See P TX6.03[6][e] infra*.

(n225)Footnote 211. Interestingly, Internal Revenue Service Publication 908, "Bankruptcy and Other Debt Cancellation" (revised December 1988), does not mention this important distinction.

(n226)Footnote 212. *Treas. Reg. § 1.1001-2(a)(2), (c)* (ex. 8).

(n227)Footnote 213. *Treas. Reg. § 1.1001-2(a)(2)*.

(n228)Footnote 214. *Treas. Reg. § 1.1001-2(c)* (ex. 8); *Marcaccio v. Commissioner*, 69 T.C.M. (CCH) 2420 (1995) ; *Rev. Rul. 90-16, 1990-1 C.B. 12* ; *Gen. Couns. Mem. 39814* (Mar. 30, 1990) ; *see also* *Treas. Reg. § 1.1017-1(b)(5)* (1956) (when debt is discharged by a transfer of property, difference between the fair market value and amount of debt discharged is the amount of discharge income); *I.R.S. FSA 200028019* (July 14, 2000) (no COD when partners still liable for recourse debt after sale of property); *Priv. Ltr. Ruls. 92-45-023* (Aug. 7, 1992); *91-20-010* (Feb. 14, 1991); *89-28-012* (Apr. 7, 1989); *87-35-065* (June 4, 1987).

(n229)Footnote 215. *See Helvering v. Hammel*, 311 U.S. 504, 61 S. Ct. 368, 85 L. Ed. 303 (1941) ; *R. O'Dell & Sons Co. v. Commissioner*, 169 F.2d 247 (3d Cir. 1948) ; *Lewis v. Commissioner*, 56 T.C.M. (CCH) 1328 (1989) , *aff'd in unpublished opinion*, 928 F.2d 404 (6th Cir. 1991) ; *Rev. Rul. 90-16, 1990-1 C.B. 12* (citing *Hammel*); *Priv. Ltr. Rul. 8918016* (Jan. 31, 1989) (same).

(n230)Footnote 216. *Treas. Reg. § 1.1001-2(a)(1), (c)* (ex. 7); *Neighbors v. Commissioner*, T.C. Memo 1998-263 (July 20, 1998) ; *Tech. Adv. Mem. 9302001* (Aug. 31, 1992) ; *see also* *Priv. Ltr. Rul. 8918016* (Jan. 31, 1989) (although analysis and conclusion represents double counting, IRS held that, upon abandonment of real property subject to a recourse debt in excess of fair market value by the trustee to the debtor under § 554 of the *Bankruptcy Code*, the recourse mortgage survives discharge in bankruptcy as a nonrecourse debt; subsequent post-bankruptcy foreclosure by lender will produce *Tufts* gain).

(n231)Footnote 217. *See, e.g., Helvering v. Nebraska Bridge Supply & Lumber Co.*, 312 U.S. 666, 61 S. Ct. 827, 85 L. Ed. 1111 (1941) (foreclosure of nonrecourse tax lien); *Chilingirian v. Commissioner*, 918 F.2d 1251 (6th Cir. 1990) (nonjudicial foreclosure); *Laport v. Commissioner*, 671 F.2d 1028 (7th Cir. 1982) (deed in lieu of foreclosure); *Middleton v. Commissioner*, 77 T.C. 310 (1981) , *aff'd per curiam*, 693 F.2d 124 (11th Cir. 1982) (voluntary conveyance); *Freeland v. Commissioner*, 74 T.C. 970 (1980) (voluntary conveyance); *Yarbro v. Commissioner*, 737 F.2d 479 (5th Cir. 1984) (abandonment); *Lockwood v. Commissioner*, 94 T.C. 252 (1990) (abandonment); *2925 Briarpark, Ltd. v. Commissioner*, 163 F.3d 313 (5th Cir. 1999) (sale of property and assignment of sales proceeds to nonrecourse lender equivalent to Section 61(a)(3) foreclosure); *Cox v. Commissioner*, 67 T.C.M. (CCH) 2809 (1994) (foreclosure).

(n232)Footnote 218. *See, e.g., Treas. Reg. § 1.752-1(i)* (Dec. 20, 1991) (part recourse partnership liability will be treated as two separate liabilities for purposes of *I.R.C. § 752*).

(n233)Footnote 219. *Tech. Adv. Mem. 8348001 (Aug. 18, 1983)* .

(n234)Footnote 220. *Treas. Reg. § 1.1001-2(c)* (ex. 7).

(n235)Footnote 221. *Treas. Reg. § 1.1001-2(c)* (ex. 8).

(n236)Footnote 222. The term "nonrecourse indebtedness" is referred to in a variety of different places in the Internal Revenue Code and regulations. *See, e.g., I.R.C. §§ 49(a)(1)(D), 465(b)(6), 7701(g); Treas. Reg. § 1.752-1(a)(2); Treas. Reg. § 1.704-2(b)(3); Temp. Treas. Reg. § 1.861-10T(b)* (1988). For the partnership allocation rules applicable to taxable years beginning before December 28, 1991 *see Treas. Reg. § 1.704-1(b)(4)(iv)(g); Temp. Treas. Reg. § 1.704-1T(b)(4)(iv)(k)(3)* (1989).

(n237)Footnote 223. *Treas. Reg. § 1.1001-2(c)* Ex. 6 & 7. *See also Treas. Reg. § 1.465-27(b)* (July 16, 1998).

(n238)Footnote 224. *See P TX6.03[3][a][ii] infra*.

(n239)Footnote 225. *See also Raphan v. United States, 759 F.2d 879, 885 (Fed. Cir. 1985)* . *See generally Kalteyer, Real Estate Workout--Original Issue Discount Implications of Troubled Debt Restructurings, 43 Tax Law. 579, 635-40 (1990)*.

(n240)Footnote 226. *Treas. Reg. § 1.752-1(a)* (1991).

(n241)Footnote 227. *Treas. Reg. § 1.752-2(c)(1)* (1991). *See, e.g., Priv. Ltr. Rul. 9431023 (May 6, 1994)* (subordinated note disregarded so that it represented neither a debt instrument nor a partnership interest).

(n242)Footnote 228. However, there could be instances in which a debt instrument appears to be recourse to the debtor but is, in fact, nonrecourse. For example, a partnership liability for which no partner is liable but which is secured by all of the partnership's assets, may be nonrecourse debt for purpose of section 752. *See Great Plains Gasification Assoc. v. Commissioner, 92 T.C.M. (CCH) 534 (2006)* (relying on *Treas. Reg. § 1.752-1(e)*, court incorrectly held the recourse debt of the partnership to be nonrecourse for purposes of section 1001). *See, e.g., Treas. Reg. § 1.752-1(a)(2); Treas. Reg. § 1.465-27(b)* (July 16, 1998) (personal liability of a partnership holding real estate is disregarded in determining whether a financing is qualified nonrecourse financing under *I.R.C. § 465(b)(6)*).

(n243)Footnote 229. For a discussion of the consequences when the debtor transfers property in satisfaction of indebtedness, *see P TX6.02[6][a] supra*.

(n244)Footnote 230. *See P TX6.03[5][e] infra*.

(n245)Footnote 231. For a discussion of the qualified real property business indebtedness election, *see P TX6.03[3][c][iv] infra*.

(n246)Footnote 232. *Montgomery v. Commissioner, 65 T.C. 511, 520-22 (1975)* ; *Londagin v. Commissioner, 61 T.C. 117, 124-25 (1973)* ; *Reliable Incubator & Brooder Co. v. Commissioner, 6 T.C. 919, 926-27 (1946)* ; *L.D. Coddon & Bros., Inc. v. Commissioner, 37 B.T.A. 393 (1938)* .

(n247)Footnote 233. *Rev. Rul. 91-31, 1991-1 C.B. 19* , distinguished by, *Rev. Rul. 92-53, 1992-2 C.B. 48* ; *Rev. Rul. 92-99, 1992-2 C.B. 35* . *See also Gershkowitz v. Commissioner, 88 T.C. 984, 1006 (1987)* (discharge income realized from discharge of nonrecourse, nonpurchase money debt); *see also Rev. Rul. 82-202, 1982-2 C.B. 35* (taxpayer realized ordinary income upon prepayment of nonrecourse purchase money mortgage at less than face amount); *Priv. Ltr. Rul. 8314021 (Dec. 29, 1982)* (discharge income results from payment to third party of an amount less than face value to substitute collateral under nonrecourse debt).

(n248)Footnote 234. *See also Rev. Rul. 92-99, 1992-2 C.B. 35* . *But cf. Rev. Rul. 81-277, 1981-2 C.B. 14*

(payment by builder to buyer in release of claims for failure to fulfill contract is not income but represents a return of capital); *Priv. Ltr. Rul. 8525003* (Mar. 4, 1985) (recovery treated in part as replacement of capital and as ordinary income). For a discussion of the election to reduce basis upon the realization of discharge income from qualified real property business indebtedness, see P TX6.03[3][c][iv] *infra*.

(n249)Footnote 235. *I.R.C. Section 108(d)(1)(B)*. For a discussion of this issue, see P TX6.03[3] *infra*.

(n250)Footnote 236. See *Manufacturers Life Ins. Co. v. Commissioner*, 43 B.T.A. 867, 872-74 (1941) ; *Priv. Ltr. Rul. 8821018* (Feb. 23, 1988) (when final payment will not exceed principal of bonds, payment is treated as return of principal and not interest); see also *Petit v. Commissioner*, 8 T.C. 228 (1947) , acq., 1947-1 C.B. 3 ; *Tech. Adv. Mem. 8348001* (Aug. 18, 1983) . But see *Treas. Reg. § 1.446-2(e)*, 59 *Fed. Reg.* 4799 (Feb. 2, 1994) (generally, each loan payment is treated as an interest payment to the extent of accrued and unpaid interest).

(n251)Footnote 237. See *Lackey v. Commissioner*, 36 T.C.M. (CCH) 890, 895 (1977) . But cf. *Petit v. Commissioner*, 8 T.C. 228, 236 (1947) , acq., 1947-1 C.B. 3 (satisfaction of debt at less than face value held to be entirely allocable to the principal of the debt without reference to debtor's solvency); see also *Darby Inv. Corp. v. Commissioner*, 37 T.C. 839, 843-44 (1962) , *aff'd per curiam*, 315 F.2d 551 (6th Cir. 1963) .

(n252)Footnote 238. See *Treas. Reg. § 1.166-6(b)(2)* (fair market value presumed equal to bid price); see also *Treas. Reg. § 1.446-2(e)(1)* (each payment treated first as a payment of accrued unpaid interest).

(n253)Footnote 239. See *Helvering v. Midland Mut. Life Ins. Co.*, 300 U.S. 216, 57 S. Ct. 423, 81 L. Ed. 612 (1937) ; *Blossom v. Commissioner*, 38 B.T.A. 1136 (1938) , acq. C.B. (pt. 1) 4; *Malmstedt v. Commissioner*, 35 T.C.M. (CCH) 199 (1976) .

(n254)Footnote 240. See *Helvering v. Missouri State Life Ins. Co.*, 78 F.2d 778 (8th Cir. 1934) ; *Newhouse v. Commissioner*, 59 T.C. 783 (1973) ; *Manufacturers Life Ins. Co. v. Commissioner*, 43 B.T.A. 867 (1941) , acq., 1941-1 C.B. 7 ; *Manhattan Mut. Life Ins. Co. v. Commissioner*, 37 B.T.A. 1041 (1938) ; *Lackey v. Commissioner*, 36 T.C.M. (CCH) 890 (1977) . See also *I.R.C. § 108(e)(2)*.

(n255)Footnote 241. See *Jones Lumber Co. v. Commissioner*, 404 F.2d 764 (6th Cir. 1968) ; *Rev. Rul. 80-361*, 1980-2 C.B. 164 . However, the IRS recently held that the "doubtful collectibility exception" does not apply to the accrual of original issue discount. See *Tech. Adv. Mem. 9538007* (June 13, 1995) .

(n256)Footnote 242. See *Corn Exch. Bank v. United States*, 37 F.2d 34 (2d Cir. 1930) ; cf. *Cuba R.R. v. Commissioner*, 9 T.C. 211 (1947) , acq., 1947-2 C.B. 2 (taxpayer not required to accrue income when payment depended on government action that was not reasonably certain to occur).

(n257)Footnote 243. *Allan v. Commissioner*, 856 F.2d 1169, 1173-74 (8th Cir. 1988) ; see also *Focht v. Commissioner*, 68 T.C. 223, 234 (1977) ; *Tech. Adv. Mem. 8348001* (Aug. 18, 1983) .

(n258)Footnote 244. See *Priv. Ltr. Rul. 9251023* (Sept. 18, 1992) .

(n259)Footnote 245. *Treas. Reg. § 1.166-6(a)*.

(n260)Footnote 246. *Allan v. Commissioner*, 856 F.2d 1169 (8th Cir. 1988) .

(n261)Footnote 247. *Allan v. Commissioner*, 856 F.2d 1169, 1174 (8th Cir. 1988) . See also *Treas. Reg. § 1.6050P-1(c)* (Jan. 3, 1996) (indebtedness defined for purposes of *I.R.C. § 6050P* to include interest, penalties, administrative costs, and fines). For a critical discussion of *Allan*, see Cunningham, *Reprise; Characterization of Income Recovered under the Tax Benefit Doctrine*, 43 *Tax Law.* 121 (1989) ["Cunningham"].

(n262)Footnote 248. *Allan v. Commissioner*, 856 F.2d 1169, 1174 (8th Cir. 1988) .

(n263)Footnote 249. *Allan v. Commissioner*, 856 F.2d 1169, 1174 (8th Cir. 1988) . See also *Hartland Associates v. Commissioner*, 54 T.C. 1580 (1970) ; *Bressi v. Commissioner*, 62 T.C.M. (CCH) 1668, 1676 (1991) , *aff'd*, 989 F.2d 486 (3d Cir. 1993) .

(n264)Footnote 250. *Allan v. Commissioner*, 856 F.2d 1169, 1173-74 (8th Cir. 1988) . One commentator argues that this result is incorrect and that the tax benefit rule should apply to the items the taxpayer deducted in previous years. See *Cunningham, Reprise; Characterization of Income Recovered under the Tax Benefit Doctrine*, 43 *Tax Law*. 132-140 (1989) ["Cunningham"]; see also *Rev. Rul. 70-406*, 1970-2 C.B. 16 ; *Rev. Rul. 67-200*, 1967-1 C.B. 15 (accrued but unpaid interest treated as discharge income on forgiveness, but subject to exclusion under § 111 to extent no tax benefit).

(n265)Footnote 251. 263. I.R.C. §§ 465(b)(6), 46(c)(8)(D)(iv).

(n266)Footnote 252. See, e.g., *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 62 S. Ct. 540, 86 L. Ed. 775 (1942) (creditors of insolvent corporation acquired effective control of the corporation when it filed for bankruptcy even though legal title passed at a later judicial sale); *Scofield v. San Antonio Transit Co.*, 219 F.2d 149 (5th Cir. 1954) (insolvent corporation was placed in receivership--the court followed *Alabama Asphaltic Limestone* and reached the same result).

(n267)Footnote 253. *Danenberg v. Commissioner*, 73 T.C. 370 (1979) , *acq.*, 1980-2 C.B. 1 .

(n268)Footnote 254. *Danenberg v. Commissioner*, 73 T.C. 370, 380-86 (1979) , *acq.*, 1980-2 C.B. 1 ; see also *R. O'Dell & Sons Co. v. Commissioner*, 8 T.C. 1165, 1167 (1947) , *aff'd*, 169 F.2d 247, 248 (3d Cir. 1948) ; *Aizawa v. Commissioner*, 99 T.C. 197 (1992) , *aff'd*, 29 F.3d 630 (9th Cir. 1994) ; *Peninsula Properties Co. Ltd. v. Commissioner*, 47 B.T.A. 84, 91 (1942) , *acq.*, 1942-2 C.B. 14 ; *Treas. Reg. § 1.1017-1(b)(5)*; *In re Brubeck*, 133 B.R. 139 (S.D. Ind. 1991) (prebankruptcy sale of farm assets to pay debt owed to Farmers Home Administration held a taxable sale; I.R.C. § 108 not applicable because no discharge of indebtedness); *Rev. Rul. 70-271*, 1970-1 C.B. 166 .

(n269)Footnote 255. *Danenberg v. Commissioner*, 73 T.C. 370, 383 (1979) , *acq.*, 1980-2 C.B. 1 . See generally *United States v. Hendler*, 303 U.S. 564, 58 S. Ct. 655, 82 L. Ed. 1018 (1938) (assumption of debt by third party regarded as if amount of debt had been paid directly to the debtor and then proceeds used by it to pay its creditors); *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716, 729-30, 49 S. Ct. 499, 504, 73 L. Ed. 918, 927-28 (1929) (taxpayer realizes income when debt is satisfied by a third party); *Wall v. United States*, 164 F.2d 462, 464 (4th Cir. 1947) (payment of a taxpayer's debt by agreement of third party is income to the taxpayer); *Priv. Ltr. Rul. 8930006* (Apr. 21, 1989) (same).

(n270)Footnote 256. The Tax Court offered the following explanation of its decision:

The situations which are exempted from the recognition provision are those in which the recognition of gain or loss is merely *postponed* until a later taxable disposition of the property. In the present case, the petitioners are not seeking merely a postponement of the recognition of gain; they are seeking a complete exemption of such gain. There is no "later disposition" of the property by the taxpayer. The final disposition of the properties by the petitioner occurred when he transferred such properties to the various third parties, and it is such final disposition on which the petitioner is taxable.

Danenberg v. Commissioner, 73 T.C. 370, 385 (1979) , *acq.*, 1980-2 C.B. 1 (emphasis added). See also *Home Builders Lumber Co. v. Commissioner*, 165 F.2d 1009, 1011 (5th Cir. 1948) (no insolvency exception to recognition of gain); *Gehl v. Commissioner*, 102 T.C. 784 (1994) , *aff'd in unpublished opinion*, 95-1 U.S. Tax Cas. (CCH) P50,191 (8th Cir. 1995); *2925 Briarpark, Ltd. v. Commissioner*, 163 F.3d 313 (5th Cir. 1999) ; *Rev. Rul. 90-16*, 1990-1 C.B. 12 ; *Tech. Adv. Mem. 9302001* (Aug. 31, 1992) ; *Priv. Ltr. Rul. 9251023* (Sept. 18, 1992) . With respect to the discharge of the remaining debt, the Tax Court held that the taxpayer had no discharge of indebtedness income because the taxpayer was insolvent. See also *Woodsam Associates v. Commissioner*, 16 T.C. 649, 655 (1951) , *aff'd*, 198 F.2d

357, 359 (2d Cir. 1952) (realization of gain postponed until final disposition of property at foreclosure sale).

(n271)Footnote 257. 11 U.S.C. § 1141(d)(1)(A); see also *Alpert v. United States*, 481 F.3d 404 (6th Cir. 2007) (COD realized in 1996 when the bankruptcy were concluded); *Delk v. Commissioner*, 113 F.3d 984 (9th Cir. 1997) (old common stock became worthless for purposes of I.R.C. § 165(g) when cancelled under confirmed plan of reorganization); *Priv. Ltr. Rul. 8632046* (May 15, 1986) . Reorganization plans are often drafted to provide that debts are discharged on the effective date of the plan. There are certain types of debts that will not be discharged by the confirmation of a plan. See 11 U.S.C. § 1141(d)(2)-(4).

(n272)Footnote 258. 11 U.S.C. § 727(a). There are nine conditions under which an individual debtor can be denied a discharge. See 11 U.S.C. § 727(a)(2)-(10).

(n273)Footnote 259. 11 U.S.C. § 727(a)(1). See *Friedman v. Commissioner*, 75 T.C.M. (CCH) 2383 (1998) , *aff'd*, 216 F.3d 537 (6th Cir. 2000) .

(n274)Footnote 260. See Section 108 Task Force Report - Part I, at 228, Q-1.

(n275)Footnote 261. *Likins-Foster Honolulu Corp. v. Commissioner*, 417 F.2d 285, 295-96 (10th Cir. 1969) (cancellation of debt occurred on execution of agreements whereby government assumed mortgage and released debtors; case remanded to trial court to determine effective dates of agreements); *Republic Supply Co. v. Commissioner*, 66 T.C. 446 (1976) , *aff'd in unpublished opinion*, (10th Cir. Dec. 29, 1978) (discharge income realized in year contractual obligation to pay expired); *Chatom Co., Ltd. v. Commissioner*, 36 T.C. 540 (1961) , *acq. in result*, 1962-1 C.B. 4 (loan obtained in 1949 was discharged in 1955 when settlement agreement was reached); *Federation Bank & Trust Co. v. Commissioner*, 27 T.C. 960, 970-71 (1957) , *acq.*, 1969-2 C.B. xxiv (purchase of assignment and release determined final amount of debt discharged); *Marcaccio v. Commissioner*, 69 T.C.M. (CCH) 2420 (1995) (discharge in year of settlement and release agreement); *Kelley v. Commissioner*, 19 T.C.M. (CCH) 263, 268 (1960) (balance of note cancelled on date of release agreement executed by the parties). *But see Meyers v. Commissioner*, 27 T.C.M. (CCH) 1535, 1536 (1968) (no forgiveness occurred in 1962 because trial court accepted debtor's testimony that he had no oral or written communication with the creditor indicating a forgiveness).

(n276)Footnote 262. *Carl T. Miller Trust v. Commissioner*, 76 T.C. 191, 195 (1981) (failure to file claim against estate within statutory period); *Estate of Bankhead v. Commissioner*, 60 T.C. 535, 539 (1973) (claim period lapsed); *Randolph v. Commissioner*, 80 T.C.M. (CCH) 192 (2000) (discharge occurred in year statute of limitations expired); *L.R. Schmaus Co. v. Commissioner*, 26 T.C.M. (CCH) 959, 967 (1967) , *rev'd on other grounds*, 406 F.2d 1044 (7th Cir. 1969) (discharge income realized in 1960, year applicable 6-year statute of limitations ran); *Callan Court Co. v. Commissioner*, 24 T.C.M. (CCH) 1419 (1965)) (discharge income in earlier year debt written off as a loss rather than in year statute of limitations had run on enforcement of debt); *Rev. Rul. 75-300*, 1975-2 C.B. 24 (income in year of expiration of statute of limitations); see also *Sparks v. Commissioner*, 4 T.C.M. (CCH) 854 (1945) (discharge income realized in 1942 when note was cancelled, not in 1939 when collateral securing the note was returned to debtor).

(n277)Footnote 263. *Treas. Reg. § 1.61-12(a)*; *Rinehart v. Commissioner*, 83 T.C.M. (CCH) 1379 (2002) (discharge occurred in year creditor foreclosed on collateral and issued Form 1099-C); *Yamamoto v. Commissioner*, 60 T.C.M. (CCH) 1050, 1060 (1990) ; see also *Kniffen v. Commissioner*, 39 T.C. 553, 561 (1962) , *acq.*, 1965-2 C.B. 5 (when debtor transfers obligation to creditor for valid consideration, the two interests are merged and the debt is immediately extinguished); *Priv. Ltr. Rul. 8931006* (Apr. 27, 1989) ; Section 108 Task Force Report - Part I, at 228, Q-1.

(n278)Footnote 264. See P TX6.02[6][a] *supra*; *Michaels v. Commissioner*, 87 T.C. 1412, 1414 (1986) ; *Montgomery v. Commissioner*, 65 T.C. 511, 520 (1975) . See also *Lowry v. Commissioner*, 86 T.C.M. (CCH) 198 (2003) , *aff'd in unpublished opinion*, 2006-1 U.S. Tax Cos. (CCH) P50, 187 (9th Cir. 2006) (gain realized in 1994 when terms of escrow satisfied and deed recorded); *Aizawa v. Commissioner*, 99 T.C. 197 (1992) , *aff'd*, 29 F.3d 630

(9th Cir. 1994) .

(n279)Footnote 265. Temp. Treas. Reg. 1.6050P-1T(b), 58 Fed. Reg. 68301 (Dec. 27, 1993) (effective for discharges occurring before December 22, 1996); Treas. Reg. § 1.6050P-1(b) (Jan. 3, 1996); *Cozzi v. Commissioner*, 88 T.C. 435, 445 (1987) ; *Harp v. Commissioner*, 72 T.C.M. (CCH) 401 (1996) (no identifiable event occurred to make it clear debt would never be repaid). For a discussion of when a debtor will consider a debt to be extinguished for financial accounting purposes, see *Tech. Adv. Mem. 9402003* (Sept. 9, 1993) .

(n280)Footnote 266. *Alpert v. United States*, 481 F.3d 404 (6th Cir. 2007) (discharge in year bankruptcy proceeding completed); *Friedman v. Commissioner*, 216 F.3d 537 (6th Cir. 2000) (mere filing of a chapter 7 liquidation case, without an "identifiable event," does not mean a discharge occurred); *Exchange Sec. Bank v. United States*, 492 F.2d 1096, 1099 (5th Cir. 1974) ; *Cozzi v. Commissioner*, 88 T.C. 435, 445 (1987) (discharge occurs when it is clear debt will not be repaid); *Great Plains Gasification Assoc. v. Commissioner*, 92 T.C.M. (CCH) 534 (2006) ("identifiable event" in year in which foreclosure litigation terminated); *Owens v. Commissioner*, 84 T.C.M. (CCH) 419 (2002) (determination of whether a discharge has occurred is "extremely fact specific"); *Marcus Estate v. Commissioner*, 34 T.C.M. (CCH) 38, 41 (1975) (discharge occurred on death of taxpayer where creditors had no intent of enforcing claims after death); *Priv. Ltr. Rul. 8120014* (Jan. 29, 1981) (discharge occurs in year all events occurred which established the unconditional cancellation); see also *Weiss v. Commissioner*, 60 T.C.M. (CCH) 746 (1990) , *rev'd*, 956 F.2d 242 (11th Cir. 1992) (partner was not relieved from liability on guarantee: there was no course of dealing that indicated a release in year in issue); *Bear Mfg. Co. v. United States*, 430 F.2d 152 (7th Cir. 1970) (previously deducted expense is "recovered" by debtor upon practical termination of liability by acts of the parties; running of statute of limitations is not determinative).

(n281)Footnote 267. See, e.g., *Santulli v. United States*, 76-2 U.S.T.C. (CCH) P 9677 (D.C. Md. 1976) (entry of discharge of debt on corporate books coupled with no intent to collect debt fixed discharge in 1961); *Magill v. Commissioner*, 70 T.C. 465, 472-73 (1978) , *aff'd per curiam*, 651 F.2d 1233 (6th Cir. 1981) (discharge income realized in year debt eliminated from creditor's books/records); *Rinehart v. Commissioner*, 83 T.C.M. (CCH) 1379 (2002) (lender discharged debt and issued Form 1099-C in 1995); *Schneller v. Commissioner*, 71 T.C.M. (CCH) 2089 (1996) (discharge of corporate-shareholder loan occurred in year corporation charged off against retained earnings). However, the mere issuance of a Form 1099A does not have the legal effect of a release or discharge under Texas law. See *Long v. Turner*, 134 F.3d 312 (5th Cir. 1998) .

(n282)Footnote 268. See, e.g., *Woltman v. United States*, 85-2 U.S.T.C. P9581 (S.D. Cal. 1985) (discharge occurred in 1977, year state statute of limitations for suit to collect on taxpayers' notes expired); *The Securities Co. v. United States*, 85 F. Supp. 532 (S.D.N.Y. 1948) ; *Rev. Rul. 75-300*, 1975-2 C.B. 23 .

(n283)Footnote 269. But see Treas. Reg. 1.6050P-1(b)(2), 61 Fed. Reg. 262 (Jan. 3, 1996) (indicating to the contrary for reporting purposes).

(n284)Footnote 270. See P TX6.02[6][a] *supra*.

(n285)Footnote 271. I.R.C. § 1001(a).

(n286)Footnote 272. See P TX6.02[6][a] *supra*.

(n287)Footnote 273. *Helvering v. Hammel*, 311 U.S. 504, 61 S. Ct. 368, 85 L. Ed. 303 (1941) ; *Eisenberg v. Commissioner*, 78 T.C. 336, 344 (1982) (in ordinary foreclosure sale which has become final, gain or loss is recognized in year in which property is disposed of and debt is discharged).

(n288)Footnote 274. *R. O'Dell & Sons Co., Inc. v. Commissioner*, 169 F.2d 247 (3d Cir. 1948) (foreclosure complete after expiration of 3 month redemption period under state law); *Hill v. Commissioner*, 40 B.T.A. 376 (1939) , *rev'd*, 119 F.2d 421 (6th Cir. 1941) (release of right of redemption); *Derby Realty Corp. v. Commissioner*, 35 B.T.A.

335, 340-41 (1937), *acq.*, 1938-1 C.B. 9 (right to redeem extinguished under law); *Ryan v. Commissioner*, 54 T.C.M. (CCH) 1503, 1506 (1988), *aff'd*, 873 F.2d 194 (8th Cir. 1989) (accrual basis taxpayer recognized gain from 1977 foreclosure in 1978, the year in which state appellate court issued final opinion in dispute concerning whether the mortgage was void under state usury law); *Rev. Rul. 75-57*, 1975-1 C.B. 141 (amount of unpaid nonrecourse loan included in debtor's income in tax year in which liability was discharged by transfer of property securing the loan); *Rev. Rul. 70-63*, 1970-1 C.B. 36 (sale due to nonpayment of real estate taxes is not completed before expiration of two-year redemption period); *Priv. Ltr. Rul. 8649051* (Sept. 10, 1986) (actual foreclosure sale determines date of recognition under I.R.C. § 1001); *see also Helvering v. Hammel*, 311 U.S. 504, 61 S. Ct. 368, 85 L. Ed. 303 (1941) (actual foreclosure sale is definitive event); *Hadley Falls Trust v. United States*, 110 F.2d 887 (1st Cir. 1940).

(n289)Footnote 275. *Lowry v. Commissioner*, 86 T.C.M. (CCH) 198 (2003), *aff'd in unpublished opinion*, 2006-1 U.S. Tax Cos. (CCH) P50, 187 (9th Cir. 2006) (gain realized in 1994 when terms of escrow satisfied and deed recorded); *Rogers v. Commissioner*, 103 F.2d 790 (9th Cir. 1939); *Freeland v. Commissioner*, 74 T.C. 970, 980-83 (1980).

(n290)Footnote 276. *Echols v. Commissioner*, 93 T.C. 553 (1989) (abandonment not effective for tax purposes), *rev'd*, 935 F.2d 703 (5th Cir. 1991) (trial court in error; abandonment of partnership interest was effective for tax purposes); *Yarbro v. Commissioner*, 737 F.2d 479, 483-85 (5th Cir. 1984); *Middleton v. Commissioner*, 77 T.C. 310 (1981), *aff'd per curiam*, 693 F.2d 124 (11th Cir. 1982); *Citron v. Commissioner*, 97 T.C. 200 (1991) (ordinary loss on abandonment of partnership interest); *Lockwood v. Commissioner*, 94 T.C. 252, 259-60 (1990) (taxable exchange occurred at time of abandonment not at subsequent foreclosure sale); *Cozzi v. Commissioner*, 88 T.C. 435 (1987); *Carlins v. Commissioner*, 55 T.C.M. (CCH) 228 (1988); *Priv. Ltr. Rul. 8649051* (Sept. 10, 1986); *see also Rev. Rul. 93-80*, 1993-2 C.B. 239 (to abandon, taxpayer must show intent and must overtly act to abandon the asset); *Rev. Rul. 75-563*, 1975-2 C.B. 199; *Rev. Rul. 71-265*, 1971-1 C.B. 223; *Tech. Adv. Mem. 8718003* (Jan. 7, 1987); *Tech. Adv. Mem. 8509002* (Nov. 16, 1984) (rulings indicate that a sale or other disposition will occur on the earlier of (1) date deed is executed and delivered, or (2) the time possession and benefits and burdens of ownership are transferred). *See P TX6.02[6][a] supra*.

(n291)Footnote 277. *Weiss v. Commissioner*, 60 T.C.M. (CCH) 746 (1990), *rev'd*, 956 F.2d 242 (11th Cir. 1992) (partner was not released from personal guarantee in 1979); *Jackson v. Commissioner*, 708 F.2d 1402, 1404 (9th Cir. 1983) (no relief of debt because debtor-transferor remained liable on debt); *Commissioner v. Green*, 126 F.2d 70 (3d Cir. 1941); *Aizawa v. Commissioner*, 99 T.C. 197 (1992), *aff'd*, 29 F.3d 630 (9th Cir. 1994); *Barker v. Commissioner*, 47 T.C.M. (CCH) 131 (1983); *Priv. Ltr. Rul. 9245023* (Aug. 7, 1992), holding 2.

(n292)Footnote 278. *United States v. Ingalls*, 399 F.2d 143 (5th Cir. 1968). *See also Jelle v. Commissioner*, 116 T.C. 63 (2001) (if arrangement effects a present cancellation of one debt and a replacement obligation to pay in the future, with repayment totally in the debtor's control, income from discharge is realized immediately).

(n293)Footnote 279. *Republic Supply Co. v. Commissioner*, 66 T.C. 446, 465-66 (1976), *aff'd in unpublished opinion* (10th Cir. 1978) (debt not discharged on execution of 20-year payout agreement; *Ingalls* distinguished); *Walker v. Commissioner*, 88 F.2d 170 (5th Cir. 1937) (agreement in 1927 was an agreement for forgiveness in the future; debt discharged in 1930 when conditions were performed); *see also Likins-Foster Honolulu Corp. v. Commissioner*, 417 F.2d 285, 295-96 (10th Cir. 1969) (cancellation of debt occurred on execution of agreements whereby government assumed mortgage and released debtors; case remanded to trial court to determine effective dates of agreements); *Chatom Co., Ltd. v. Commissioner*, 36 T.C. 540 (1961), *acq. in result*, 1962-1 C.B. 4 (loan obtained in 1949 was discharged in 1955); *Shannon v. Commissioner*, 66 T.C.M. (CCH) 1418 (1993) (discharge occurred in subsequent year when condition precedent, actual payment, satisfied); *Kelley v. Commissioner*, 19 T.C.M. (CCH) 263, 268 (1960) (balance of note cancelled on date of release agreement executed by the parties); *Tech. Adv. Mem. 8120014* (Jan. 29, 1981) (*Walker* followed). *See, e.g., Commissioner v. Segall*, 114 F.2d 706 (6th Cir. 1940) (asset sale subject to conditions precedent not complete for tax purposes until year in which all conditions are satisfied); *West Missouri Power Co. v. Commissioner*, 18 T.C. 105 (1952), *acq.*, 1952-2 C.B. 3; *Priv. Ltr. Rul. 9037009* (June 12, 1990).

(n294)Footnote 279a. *See I.R.C. § 108(e)(10); Treas. Reg. § 1.1001-3(b), (g)* (June 25, 1996); *Treas. Reg. § 1274-2(g)* (Jan. 27, 1994).

(n295)Footnote 280. *Treas. Reg. § 1.166-6(b); West Missouri Power Co. v. Commissioner* 18 T.C. 105 (1952) , *acq.*, 1952-2 C.B. 3 ; *Priv. Ltr. Rul. 9037009* (June 12, 1990) . *Rev. Rul. 80-56*, 1980-1 C.B. 154 ; *Rev. Rul. 68-523*, 1968-2 C.B. 82 . Certain lenders who acquire secured or pledged property must also file a Form 1099-A informational return with the IRS. *See P TX6.02[7][g] infra*.

(n296)Footnote 281. *Treas. Reg. § 1.166-6(b)(2); Marcaccio v. Commissioner*, 69 T.C.M. (CCH) 2420 (1995) (no evidence presented to overcome presumption); *see also Bondholders Committee v. Commissioner*, 315 U.S. 189, 62 S. Ct. 537, 86 L. Ed. 784 (1942) ; *Hadley Falls Trust Co. v. United States*, 110 F.2d 887 (1st Cir. 1940) .

(n297)Footnote 282. *Frazier v. Commissioner*, 111 T.C. 243 (1998) (taxpayer established that fair market value was below amount bid in by the lender); *Community Bank v. Commissioner*, 62 T.C. 503, 507 (1974) , *acq.*, 1975-1 C.B. 1. If the debtor voluntarily transfers the property to the creditor, the fair market value may be difficult to establish. Therefore, to provide some evidence of fair market value, the debtor should consider entering into an agreement with the creditor specifying the agreed value of the property and establishing the amount of the resulting debt discharge. As an alternative, the bankruptcy court can authorize the estate to sell assets under 11 U.S.C. § 363.

(n298)Footnote 283. *Community Bank v. Commissioner*, 79 T.C. 789, 792 (1982) , *aff'd*, 819 F.2d 940 (9th Cir. 1987) .

(n299)Footnote 284. *Kohn v. Commissioner*, 197 F.2d 480 (2d Cir. 1952) ; *Commissioner v. Spreckels*, 120 F.2d 517, 520-21 (9th Cir. 1941) ; *Hadley Falls Trust Co. v. United States*, 110 F.2d 887 (1st Cir. 1940) ; *Shaheen v. Commissioner*, 44 T.C.M. (CCH) 694 (1982) ; *Sargent v. Commissioner*, 29 T.C.M. (CCH) 941, 943 (1970) . *See also Rev. Rul. 68-523*, 1968-2 C.B. 82 . There are special rules applicable to reacquisitions of real estate. *See Treas. Reg. § 1.166-6(e); I.R.C. § 1038*.

(n300)Footnote 285. *Treas. Reg. § 1.166-6(a)(1); Securities Mortgage Co. v. Commissioner*, 58 T.C. 667 (1972) ; *see also Trust Co. of Georgia v. Commissioner*, 180 F.2d 527 (5th Cir. 1950) ; *cf. W.L. Moody Cotton Co. v. Commissioner*, 143 F.2d 712 (5th Cir. 1944) .

(n301)Footnote 286. *See, e.g., Fairbanks v. United States*, 306 U.S. 436, 59 S. Ct. 607, 83 L. Ed. 855 (1939) ; *Ogilvie v. Commissioner*, 216 F.2d 748 (6th Cir. 1954) ; *Spreckels v. Commissioner*, 120 F.2d 517 (9th Cir. 1941) . Note, however, that certain types of debt instruments may qualify for "sale or exchange" treatment. *See I.R.C. §§ 1271, 1276*.

(n302)Footnote 287. *Treas. Reg. § 1.166-6(b)(1); see also Hadley Falls Trust Co. v. United States*, 110 F.2d 887 (1st Cir. 1940) ; *Freeland v. Commissioner*, 74 T.C. 970 (1980) ; *Rev. Rul. 80-56*, 1980-1 C.B. 154 ; *Rev. Rul. 72-238*, 1972-1 C.B. 65 .

(n303)Footnote 288. *Treas. Reg. § 1.166-6(c). See Taggart, Workouts--Lender's Basis and Lender's Income*, 45 *Tax Law*. 263 (1992).

(n304)Footnote 289. The special relationships are described in *I.R.C. § 7872(c)(1)* (generally, gifts, compensated-related loans and corporation-shareholder loans).

(n305)Footnote 290. *Prop. Treas. Reg. § 1.7872-1(a), 50 Fed. Reg. 33,553* (1985) .

(n306)Footnote 291. *Prop. Treas. Reg. § 1.7872-7(a)*.

(n307)Footnote 292. *Prop. Treas. Reg. § 1.7872-11(a)*.

(n308)Footnote 293. Prop. Treas. Reg. § 1.7872-11(a).

(n309)Footnote 294. *Miller v. Usry*, 160 F. Supp. 368, 371 (W.D. La. 1958) .

(n310)Footnote 295. *Miller v. Usry*, 160 F. Supp. 368, 371 (W.D. La. 1958) .

(n311)Footnote 296. Installment Sales Revision Act of 1980, Pub. L. No. 96-471, § 2(a) (Oct. 19, 1980).

(n312)Footnote 297. S. Rep. No. 1000, 96th Cong., 2d Sess. 26 (1980).

(n313)Footnote 298. *I.R.C. § 453B(a)(2), (f)(1)*. See, e.g., *Riss v. Commissioner*, 368 F.2d 965 (1966) ; *Rev. Rul. 76-398*, 1976-2 C.B. 130).

(n314)Footnote 299. *I.R.C. § 453B(f)(2)*. See *Estate of Frane v. Commissioner*, 98 T.C. 341 (1992) .

(n315)Footnote 300. *Jerpe v. Commissioner*, 45 B.T.A. 199 (1941) , *acq.*, 1942-1 C.B. 9 (cancellation of two payments in later year did not affect installment treatment--percentage of gain recomputed); *Rev. Rul. 77-56*, 1977-1 C.B. 135 ; *Rev. Rul. 72-570*, 1972-2 C.B. 241 ; *Rev. Rul. 55-429*, 1955-2 C.B. 252 ; *Priv. Ltr. Rul. 8739045* (June 30, 1987) ; see also *Cox v. Commissioner*, 62 T.C. 247, 255 (1974) ; *Soter v. Commissioner*, 27 T.C.M. (CCH) 194, 203-04 (1968) ; *Rev. Rul. 75-457*, 1975-2 C.B. 196 , *amplified by Rev. Rul. 82-122*, 1982-1 C.B. 80 ; *Rev. Rul. 74-157*, 1974-1 C.B. 115 ; *Rev. Rul. 68-419*, 1968-2 C.B. 196 19682 C.B. 196 *amplified by Rev. Rul. 72570*, 1972-2 C.B. 241 . But see *Burrell Groves, Inc. v. Commissioner*, 223 F.2d 526 (5th Cir. 1955) ; *Rev. Rul. 82-188*, 1982-2 C.B. 90 (substantial increase in face amount of note in exchange for waiver of conversion right held a disposition). Even if not treated as a disposition for purposes of *I.R.C. § 453*, a "material" modification can result in an exchange of the "old" debt for the "new" modified debt, requiring a testing of the modified debt under the original issue discount rules. See Prop. Treas. Reg. § 1.1001-3 (Dec. 2, 1992). For a discussion of the original issue discount rules, see P TX6.02[4][a] *supra* and chapter TX9 *infra* .

(n316)Footnote 301. S. Rep. No. 1000, 96th Cong., 2d Sess. 26 (1980). See discussion of legislative history *supra*.

(n317)Footnote 302. See Priv. Ltr. Ruls. 95-06-018 (Nov. 7, 1994), 94-12-013 (Dec. 31, 1993) (modification of terms of debentures did not result in a disposition under *I.R.C. § 453B(f)*).

(n318)Footnote 303. For a discussion of this issue, see P TX6.03[5][e] *infra*.

(n319)Footnote 304. Indebtedness owed to a federal government agency that is discharged is reported by the agency on Form 1099-G.

(n320)Footnote 305. *I.R.C. § 6041(a)*; *Treas. Reg. § 1.6041-1*.

(n321)Footnote 306. *I.R.C. § 6041(a)*; *Treas. Reg. § 1.6041-1*.

(n322)Footnote 307. See I.L.M. 2001-30-038 (May 31, 2001) (discharge of debt for services rendered is compensation income reportable under *I.R.C. § 6041*, and not COD income reportable under *I.R.C. § 6050P*. The income is reported on Form W-2 for employees or Form 1099-MISC for nonemployees); *Priv. Ltr. Rul. 8919023* (Feb. 10, 1989) (reporting of original issue discount not required under *I.R.C. § 6041* because zero coupon bonds do not involve actual payments of interest).

(n323)Footnote 308. Pub. L. No. 103-65, 107 Stat. 311 (1993), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(k)(i) (Matthew Bender 15th Ed. Revised).

(n324)Footnote 308a. *I.R.C. § 6050P(c)(2)(D)*, as added by Pub. L. No. 106-170, 113 Stat. 1031 (1999). *Treas. Reg. § 1.6050P-2*, 69 Fed. Reg. 62181 (October 25, 2004) .

(n325)Footnote 308b. *Treas. Reg. § 1.6050P-1(Q)*.

(n326)Footnote 309. *I.R.C. § 6050P(a)*.

(n327)Footnote 310. *I.R.C. § 6050P(a); Treas. Reg. § 1.6050P-1(a)(1)*. See *In re Crosby*, 261 B.R. 470 U.S.T.C. P 50,404 (Bankr. D. Kan. 2001) (sending of Form 1099-C treated as discharge of debt under Bankruptcy Code).

(n328)Footnote 311. *I.R.C. § 6050P(d); Treas. Reg. § 1.6050P-1(f)*.

(n329)Footnote 312. *I.R.C. § 6050P(d)*.

(n330)Footnote 313. *I.R.C. § 6724(d); Treas. Reg. § 1.6050P-1(g)*. However, penalties for failure to comply will be waived under certain circumstances. See 1994-2 C.B. 553, Notice 94-73 (July 18, 1994) . See, e.g., *Eifert v. Commissioner*, 73 T.C.M. (CCH) 2736 (1997) (award of attorneys fees in context of Form 1099-G).

(n331)Footnote 314. *Treas. Reg. § 1.6050P-1*, 113 Fed. Reg. 1031 (Jan. 4, 1996) , amended by *T.D. 8895* (August 17, 2000) .

(n332)Footnote 315. *Treas. Reg. § 1.6050P-1(h)*.

(n333)Footnote 316. *Treas. Reg. § 1.6050P-1(b)(2)*. See I.L.M. 2001-30-038 (May 31, 2001) (discharge for services is compensation income, not COD income reportable under *I.R.C. § 6050P*); *Priv. Ltr. Rul. 200131027* (Aug. 6, 2001) (debt cancellation under terms of contract is not an "identifiable" discharge requiring reporting); *Priv. Ltr. Rul. 9642041* (October 18, 1996) (under state law, vehicle retail installment contracts must provide that the buyer is not responsible for "gap amount" due in the event of a total loss: held, the "gap amount" is a debt to be reported under *I.R.C. § 6050P* upon cancellation).

(n334)Footnote 317. *I.R.C. § 6050J; Moreno v. Commissioner*, 56 T.C.M. (CCH) 1021 (1989) .

(n335)Footnote 318. *I.R.C. § 6050J(a)*.

(n336)Footnote 319. Temp. Treas. Reg. § 1.6050J-1T, Q-25-Q-26 (1984). The information required to be included in the form is set forth in the regulations. Temp. Treas. Reg. § 1.6050J-1T, Q-25-Q-26 (1984).

(n337)Footnote 320. Temp. Treas. Reg. § 1.6050J-1T, Q-31(1984).

(n338)Footnote 321. Temp. Treas. Reg. § 1.6050J-1T, Q-36-Q-41 (1984).

(n339)Footnote 322. *Treas. Reg. § 1.1445-2(d)(3)(iii)*.

(n340)Footnote 323. *I.R.C. § 6721(a); Treas. Reg. § 301.6721-1(g)(3)(v)*.

(n341)Footnote 324. Temp. Treas. Reg. § 1.6050J-1T, Q-2 (1984).

(n342)Footnote 325. Temp. Treas. Reg. § 1.6050J-1T, Q-10-Q-12 (1984).

(n343)Footnote 326. Temp. Treas. Reg. § 1.6050J-1T, Q-17-Q-21 (1984).

(n344)Footnote 327. *I.R.C. § 6050J(b)*.

(n345)Footnote 328. Temp. Treas. Reg. § 1.6050J-1T, Q-8-Q-9.

(n346)Footnote 329. Temp. Treas. Reg. § 1.6050J-1T, Q-16.

(n347)Footnote 330. *Treas. Reg. § 1.1445-2(d)(3)*.

(n348)Footnote 331. *I.R.C. § 469(a)(1)*. The term "passive activity" means any activity that involves the conduct of a trade or business in which the taxpayer does not "materially participate." *I.R.C. § 469(c)(1)*. For a discussion of the passive loss rules, see Lipton & Evaul, *Passive Activity Losses*, *CCH Tax Transactions Library* (1990).

(n349)Footnote 332. *I.R.C. § 469(b)*.

(n350)Footnote 333. See *Shannon v. Commissioner*, 66 T.C.M. (CCH) 1418, 1423 (1993) (taxpayer argued unsuccessfully that discharge income should be characterized as passive). See, e.g., *FSA 200043004* (July 11, 2000) (cancellation of debt income increases amount "at risk" under *I.R.C. § 465*).

(n351)Footnote 334. *Temp. Treas. Reg. § 1.163-8T, T.D. 8145* (1987) .

(n352)Footnote 335. *Temp. Treas. Reg. § 1.163-8T(a)(3)*. See also *Priv. Ltr. Rul. 9729011* (July 18, 1997) (discharge income is not subpart F income).

(n353)Footnote 336. *Temp. Treas. Reg. § 1.163-8T(a)(3) and (c)*.

(n354)Footnote 337. *Rev. Rul. 92-92, 1992-2 C.B. 103* .

(n355)Footnote 338. See *Temp. Treas. Reg. § 163-8T; Priv. Ltr. Rul. 9522008* (Feb. 22, 1995) .

(n356)Footnote 339. *I.R.C. § 1441*.

(n357)Footnote 340. *Treas. Reg. § 1.1441-2(d)(2)*, 62 *Fed. Reg. 53387* (Oct. 14, 1997) . See also *Priv. Ltr. Rul. 9729011* (July 18, 1997) (discharge income is not subpart F income under *I.R.C. § 952*).

(n358)Footnote 341. *I.R.C. § 1446; Rev. Proc. 89-31, 1989-1 C.B. 895* .



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Collier on Bankruptcy Taxation

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CHAPTER TX6 Discharge of Indebtedness and I.R.C. Section 108 Relief

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P TX6.03 Statutory Relief--The I.R.C. section 108 Exclusion

[1] Applicable Statutes

I.R.C. section 61(a)(12) provides that "[e]xcept as otherwise provided in [subtitle A--income taxes], gross income means all income from whatever source derived, including (but not limited to) ... [i]ncome from discharge of indebtedness." n1 Principally, *I.R.C. section 108* creates an exclusion from gross income for discharge of indebtedness income realized by certain financially troubled taxpayers. *I.R.C. section 1017* provides for the reduction in the basis of the debtor's property for discharge income excluded and applied to reduce basis under *I.R.C. section 108*. n2

[2] Historical Background

[a] Prior Law

Prior to its revision in the Bankruptcy Tax Act of 1980, *I.R.C. section 108* provided that taxpayers realizing discharge income with respect to certain types of debt could elect to reduce the tax basis of assets in lieu of current income recognition. n3 Specifically, the election was available if the discharged debt was incurred (1) by a corporation or (2) an individual in connection with property used in his or her trade or business. n4 The election was not dependent on a taxpayer's financial distress. An election under the former *I.R.C. section 108* resulted only in a reduction of the tax basis of assets. n5 A debtor's other tax attributes, primarily its net operating loss carryforwards ("NOLs"), were left intact. n6 Therefore, while an electing debtor's future depreciation deductions were reduced (because of the reduction in tax basis), the debtor's NOLs, if any, were available to offset future income from operations or gain realized on the sale of assets. In revising *I.R.C. section 108* in the Bankruptcy Tax Act of 1980, Congress "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 from debt discharge." n7

Prior to 1981, financially troubled taxpayers sought relief from the immediate taxation of discharge income under two separate rules. For taxpayers outside of bankruptcy, the courts developed an "insolvency exception" to the general rule of *Kirby Lumber* and *I.R.C. section 61(a)(12)* that gross income includes discharge of indebtedness income. n8 Under the "insolvency exception," a debtor would not realize income from the discharge of indebtedness if the debtor was insolvent both before and after the discharge. n9 The debtor would realize income to the extent the debtor was made solvent by the debt discharge, i.e., to the extent the debtor's assets exceeded its remaining liabilities. n10 One court applied the insolvency exception at the partnership, rather than partner, level. n11

For taxpayers in bankruptcy, the former Bankruptcy Act provided that a debtor corporation would not realize income from the cancellation of indebtedness in a Chapter X insolvency reorganization. n12 Similar rules applied to so-called "arrangements" under Chapters XI and XII and a wage earner's plan under Chapter XIII. n13

[b] Reasons for Change in 1980

In 1978, Congress undertook the first major revision of federal bankruptcy law since 1898. n14 The new Bankruptcy Code prompted Congress to consider a uniform set of federal income tax rules applicable to insolvency and bankruptcy. The result of this reconsideration was the Bankruptcy Tax Act of 1980, n15 which, among other things, significantly amended *I.R.C. sections 108* and *1017*. The Deficit Reduction Act of 1984, n16 the Tax Reform Act of 1986, n17 the Technical and Miscellaneous Revenue Act of 1988 n18 and the Revenue Reconciliation Act of 1990 n19 further amended *I.R.C. section 108*.

Congress amended and expanded *I.R.C. section 108* in 1980 with the intent of accommodating both bankruptcy and tax policies. n20 The legislation was a compromise between the bankruptcy policy of rehabilitating financially troubled debtors and providing them with a "fresh start" and the tax policy of raising revenue under a system that treats all persons in an even-handed manner. n21 Bankruptcy policy provides the justification for permitting a limited class of taxpayers to exclude income from the discharge of indebtedness. In effect, the *I.R.C. section 108* income exclusion preserves the debtor's "fresh start" by ensuring that the debtor is not burdened with an immediate federal income tax liability. n22 On the other hand, tax policy is evidenced by the treatment of the excluded income: first, a debtor's net operating losses and other identified tax attributes, including the basis of property, are reduced so that discharge income is generally deferred, but not completely avoided; and, second, any gain realized on a subsequent disposition of reduced basis property is "recaptured" as ordinary income to the extent of the basis reduction. n23

[3] Exclusion of Discharge Income Under I.R.C. section 108

[a] General Qualification for Exclusion

I.R.C. section 108(a) provides that gross income realized by certain financially troubled taxpayers does not include income from the discharge of indebtedness. In order to qualify for exclusion, a taxpayer must (1) realize discharge of indebtedness income, (2) with respect to indebtedness of the taxpayer, (3) at a time when the taxpayer has a particular status generally indicative of financial difficulty or with respect to certain types of qualifying indebtedness. n24 Each of these requirements is discussed below. Generally, these provisions apply to an individual debtor, an individual's bankruptcy estate formed by the individual's filing of a case under title 11 of the *Bankruptcy Code*, n25 a decedent's estate, n26 and to most entities, such as "regular" C corporations and electing S corporations. n27 However, in the case of partnerships, *I.R.C. sections 108(a), (b), (c)* and *(g)* are applied at the partner level. n28

With the addition of the "check-the-box"; regulations effective January 1, 1997, n28a single member limited liability companies ("LLCs") are now used to hold title to a variety of business assets. A single member LLC is organized under a State limited liability company statute in order to shield the sole owner from the debts of the entity. For Federal income tax purposes, a single member LLC is disregarded as a taxable entity separate from its owner, and its activities are treated in the same manner as a sole proprietorship, branch or division of the sole member. n28b If a disregarded single member LLC is in a Title 11 case, does *I.R.C. section 108* apply at the entity level or at the owner level? The answer is unclear. If the LLC is viewed as a corporate entity shielding all owners from liability, *I.R.C. section 108* should be applied at the entity level. If the concern is that the "taxpayer" is not in a Title 11 case, then the status of the sole member should control. n28c

[i] Realize Discharge Income

I.R.C. section 108(a) provides that gross income does not include any amount *otherwise* includable in the taxpayer's

gross income by reason of the discharge, in whole or in part, of indebtedness of the taxpayer. n29 Accordingly, a taxpayer must realize discharge of indebtedness income otherwise includable in income under *I.R.C. section 61(a)(12)* (as opposed to, for example, gain realized on the disposition of property includable in income under *I.R.C. section 61(a)(3)*) to qualify for exclusion under *I.R.C. section 108*. n30 For example, discharge income realized by reason of a related party debt acquisition will be eligible for exclusion under *I.R.C. section 108*. n31

[ii] With Respect to Indebtedness of the Taxpayer

The discharge must be with respect to indebtedness of the taxpayer. *I.R.C. section 108(d)(1)* provides that 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." The legislative history restates the statutory language without explanation. n32 There is no need for Congress to explain statutory language that is clear on its face. n33 The subsection (A) language has been interpreted to require a legally enforceable obligation to repay. n34 As such, a gambling obligation unenforceable under applicable state law has not met this standard. n35 The subsection (B) language, "subject to which the taxpayer holds property," has been interpreted over the years to mean nonrecourse debt. n36

Although the meaning of the statutory language in subsection (B) is clear, the income tax treatment of nonrecourse debt upon disposition of property securing the debt creates some confusion with respect to the definition of "indebtedness" under *I.R.C. section 108*. The Supreme Court has held that, for purposes of determining a taxpayer's tax basis on acquisition and "amount realized" on disposition of property, nonrecourse debt securing property will be treated as the equivalent of recourse (or personal liability) debt. n37 However, unlike recourse debt, the "amount realized" on the sale or exchange of property securing nonrecourse debt will not be less than the adjusted issue price (generally the face amount) of the nonrecourse debt (without regard to the underlying fair market value of the property). n38 This means that, generally, to the extent the adjusted issue price of the nonrecourse debt exceeds a taxpayer's adjusted tax basis in the property disposed of, the taxpayer will realize gain under *I.R.C. section 61(a)(3)* that is not eligible for exclusion under *I.R.C. section 108*. n39

Despite the treatment of nonrecourse debt on the sale or exchange of property securing the debt, can a taxpayer realize discharge income on the reduction of nonrecourse debt in a non-sale or exchange transaction (*i.e.*, when the debt is reduced and the taxpayer keeps the property securing the debt)? The answer must be yes, if the inclusion of nonrecourse debt within the definition of "indebtedness" under *I.R.C. section 108(d)(1)(B)* is to have any meaning. In fact, the IRS and the courts have concluded that a taxpayer will realize discharge income on the reduction of a nonrecourse debt when the collateral is not disposed of. n40

[iii] Status Indicating Financial Difficulty

[A] Current Law

Assuming a debt of a taxpayer has been discharged, income from the discharge of indebtedness will be excluded from gross income if (1) the discharge occurs in a title 11 case, n41 (2) the discharge occurs when (but only to the extent) the taxpayer is insolvent, n42 (3) the debt discharged is qualified farm indebtedness, n43 (4) for a taxpayer other than a C corporation, the debt discharged is qualified real property business indebtedness, n44 (5) the indebtedness discharged in 2009 or 2010 is an applicable debt instrument, or (6) the indebtedness discharged in 2007 through 2012 is qualified principal residence indebtedness. The title 11 exclusion takes precedence over the insolvency exclusion and the insolvency exclusion takes precedence over the qualified farm indebtedness exclusion. n45 Thus, a marginally insolvent taxpayer in a title 11 case is entitled to exclude all discharge income realized in its title 11 case without regard to the amount by which the taxpayer is insolvent. n46 This rule obviously provides an important tax benefit for a debtor in a title 11 case.

[b] Summary of Treatment of "Solvent" Debtors

Any discharge of indebtedness realized by a "solvent" debtor who has not realized discharge income from a qualifying indebtedness (*i.e.*, other than a discharge (1) in a title 11 case, (2) that occurs when the taxpayer is insolvent, (3) of qualified farm debt, (4) for a taxpayer other than a C corporation, of qualified real property business debt, (5) of qualified principal residence debt, or (6) of an applicable debt instrument) results in the current recognition of ordinary income in the amount of the discharge. n47 As discussed below, solvent debtors can obtain statutory relief from current recognition only under specific exceptions enumerated in *I.R.C. section 108(e)*: (1) *I.R.C. section 108(e)(2)* (no discharge income to the extent payment would have been deductible), n48 (2) *I.R.C. section 108(e)(3)* (amount of discharge income should be properly adjusted for unamortized premium and discount with respect to the debt discharged), (3) *I.R.C. section 108(e)(5)* (reduction of purchase money debt treated as purchase price reduction), n49 and (4) *I.R.C. section 108(e)(6)* (on contribution of debt to capital, debtor corporation recognizes discharge income only to the extent principal of debt exceeds shareholder's adjusted basis). n50

[c] Extent of I.R.C. section 108 Exclusion Depends on Status of Taxpayer

[i] Taxpayers in a Title 11 Case

I.R.C. section 108 exclusion applies to all discharge income realized by a taxpayer who is subject to the jurisdiction of a bankruptcy court in a title 11 case. n51 Thus, for example, if a taxpayer in a title 11 case is only insolvent to the extent of \$100, but realizes \$10,000 of discharge income as a result of debts cancelled by the court, the full \$10,000 will qualify for exclusion under *I.R.C. section 108*. n52

A "title 11 case" is defined as a bankruptcy case under title 11 of the United States Code "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." n53 As a result, the discharge should be documented either in an order from the court (such as the order confirming the plan of reorganization) or in the plan of reorganization approved by the court. n54

[iii] Insolvent Taxpayers

[A] General Rule

With respect to an insolvent taxpayer who has not filed a title 11 petition, the discharge of indebtedness must occur when the taxpayer is insolvent. However, as under the prior "insolvency exception" created by the courts, n55 the amount of discharge of indebtedness excluded under *I.R.C. section 108* is limited to the amount by which the taxpayer is insolvent. n56 Congress intended that the statutory insolvency rule serve as the exclusive insolvency exception. n57

The term "insolvent" is defined as the excess of liabilities over the fair market value of assets. n58 This is generally the same definition used in the Bankruptcy Code except that assets are valued at "fair valuation." n59 Insolvency is determined by comparing the taxpayer's assets and liabilities immediately before the discharge. n60

The following example illustrates the treatment of an insolvent taxpayer who has not filed a title 11 case:

Example 1:

Debtor has total fixed liabilities of \$10,000 and total non-exempt assets with a fair market value of \$7,000 immediately prior to a debt discharge. Debtor is not in a title 11 case. Creditor forgives \$4,000 of liabilities. Debtor can exclude \$3,000 of the \$4,000 from gross income under *I.R.C. section 108(a)(1)(B)* because Debtor was insolvent to that extent. As the price for excluding the \$3,000, *I.R.C. section 108(b)* requires Debtor to reduce its tax attributes by the amount of income excluded. If the \$3,000 exceeds Debtor's tax attributes, the excess will not be recognized by Debtor but will, instead, "disappear." However, because Debtor "became solvent" to the extent of \$1,000, Debtor will recognize the remaining \$1,000 as ordinary discharge of indebtedness income under *I.R.C. section 61(a)(12)* unless the discharge falls within one of the specific exceptions contained in *I.R.C. section 108(e)*. n61

Historically, the courts have used a balance sheet approach to determine a taxpayer's insolvency. n62 Thus, the fair market value of tangible assets has been compared with stated liabilities. n63 In valuing assets for purposes of the insolvency calculation, courts have considered the testimony of expert witnesses n64 and subsequent sales as an indicator of earlier value. n65 The value of an operating business is not merely the sum of the values of separate assets, but will be valued as a going concern with a financial history. n66

Apart from the insolvency cases, there is a substantial body of law regarding the determination of fair market value of property. For federal income tax purposes, "fair market value" is defined as "the price at which the property would change hands between a willing buyer and a willing seller, neither being under any compulsion to buy or sell and both having a reasonable knowledge of relevant facts." n67 The same definition is used for estate tax purposes. n68 The definition generally assumes a hypothetical sale between unrelated parties in an arms-length transaction. n69 The determination of fair market value is a question of fact and no rules, methods or formulas are controlling. n70

Once a general value is reached, discounts are allowed for a lack of marketability, n71 a minority ownership interest n72 and, in the case of the valuation of a partnership interest, for restrictions on the right of a partner to demand liquidation of the partnership. n73

[B] Treatment of Assets in Insolvency Calculation

Prior to the Bankruptcy Tax Act of 1980, the Tax Court held without explanation that assets exempt from creditors under state law were not counted as "assets" for purposes of determining whether a taxpayer's assets exceeded liabilities immediately after a discharge. n74 Older case law suggests that exempt assets should not be included in the insolvency calculation because the discharge of indebtedness will not free or release those assets from the claims of creditors (and, therefore, will not create post-discharge asset value subject to the claims of creditors). n75 There is no suggestion either in the statute or the legislative history of the Bankruptcy Tax Act of 1980 that Congress intended to change prior law when it codified the insolvency exception, and there are authorities concluding that exempt assets are not counted as "assets" under current law. n76 However, the Tax Court, relying on the dictionary and "freeing of assets" theory of cancellation of debt ("COD") exclusion, recently held that exempt assets should be included as "assets" for the purposes of the insolvency calculation. n76a

Applicable state law determines which assets are exempt from the claims of creditors. n77 Only those assets that state law exempts from creditors are excluded in the insolvency calculation: a taxpayer is not permitted the option to use or "stack" the federal exemptions granted debtors in a title 11 case under *Bankruptcy Code section 522*. n78 Liabilities securing exempt property, such as a home mortgage, should also be accorded the treatment provided under applicable state law. n79 To the extent treatment is not provided, the liability should be excluded from the insolvency calculation (or offset against the value of the exempt property), n80 unless the secured creditor has recourse against the debtor for any deficiency.

A taxpayer will only include in the insolvency calculation property or rights to property owned and liabilities for which the taxpayer is liable n81 under applicable state law. Thus, for example, a taxpayer resident in a community property state must include all of his or her separate property and one-half of the value of community property. n82 Similarly, a husband and wife will (to the extent there is a difference) make the insolvency calculation individually and the separate assets of one spouse (to the extent not subject to the creditors of the other under state law) should not be included as assets of the other. n83

[C] Treatment of Liabilities in Insolvency Calculation

There are a number of unresolved issues with respect to the treatment of liabilities for purposes of the insolvency calculation. First, it is unclear whether a taxpayer includes contingent liabilities as "liabilities" for purposes of the *I.R.C.*

section 108 insolvency determination. n84 Case law prior to the Bankruptcy Tax Act of 1980 held that a taxpayer will not realize discharge of indebtedness income if the discharged liability is so contingent or indefinite that it does not constitute a debt of the taxpayer. n85 Neither *I.R.C. section 108* nor its legislative history suggests that Congress intended to change this result. In a Technical Advice Memorandum issued in 1983, the IRS held that contested estate and income taxes were not counted as liabilities for purposes of the insolvency calculation. n86 The IRS relied on *United States v. Consolidated Edison Co.*, n87 in which the Supreme Court, for purposes of determining the deductibility of real estate taxes, held that the contested portion of taxes paid by the taxpayer did not accrue until a final court order determining liability was entered. n88 The IRS noted that *Consolidated Edison Co.* supports the view that contested liabilities, absent special legislation, are to be treated differently from admitted liabilities. n89

On the other hand, for purposes of determining whether a debtor is insolvent under the Bankruptcy Code, n90 it is settled that contingent liabilities are included in the insolvency calculation. n91 Generally, contingent liabilities (including, for example, liability as a surety or guarantor) are counted subject to an offset or allowance for rights of subrogation or reimbursement from the primary obligor or from other co-sureties or co-guarantors. n92 This is consistent with the federal income tax provision that a guarantor, endorser or indemnitor that has made payment under the guaranty, etc., is not entitled to claim a worthless debt deduction under *I.R.C. section 166* until the tax year in which the right of subrogation (or similar right) becomes totally worthless (or partially worthless if the agreement arose in the taxpayer's trade or business). n93 In any event, contingent liabilities should not be reflected at face value but should be reduced to present or expected value by discounting the liability "by the probability that the contingency will occur and the liability become[s] real." n94 The Tax Court recently rejected the "likelihood of occurrence" test and proposed an all or nothing test--a contingent liability will be counted in full if "it is more probable than not" that the taxpayer will be called upon to pay the liability. n94A

Second, the proper treatment of nonrecourse debt in an insolvency calculation is unclear. There appear to be three possibilities: (1) include the nonrecourse debt in full as an indebtedness of the taxpayer; (2) include the nonrecourse debt in full if (and to the extent that) the nonrecourse debt is the debt being discharged; otherwise, include the nonrecourse debt only to the extent of the fair market value of the property securing the debt; or (3) exclude nonrecourse debt from the insolvency calculation. n95

The first alternative, which gives full recognition to nonrecourse debt, is the most supportable under current law. It is consistent with the Supreme Court's recognition that nonrecourse debt is true debt for federal income tax purposes. n96 Further, full recognition of nonrecourse debt appears to be required by a plain reading of the statute which includes nonrecourse debt as "indebtedness of the taxpayer" for purposes of *I.R.C. section 108*. n97

Nonetheless, full recognition can mean that a taxpayer could be insolvent for purposes of *I.R.C. section 108* while solvent from an economic liability standpoint. For example, assume that a taxpayer has \$1,000 of nonrecourse debt secured by land with a fair market value of \$600, \$100 of recourse debt and \$300 of other assets. From an economic liability standpoint, the taxpayer is *solvent* to the extent of \$200 (\$300 of other assets--\$100 of recourse debt). However, if the nonrecourse debt is included in full for purposes of computing the taxpayer's insolvency, the taxpayer would be *insolvent* to the extent of \$200 (land of \$600 and other assets of \$300--\$1,000 of nonrecourse debt and \$100 of recourse debt). For this reason, the IRS has adopted the second alternative--giving recognition to nonrecourse debt in excess of the fair market value of property securing debt only if (and to the extent that) the nonrecourse debt is being discharged. n98

[iii] Special Rule for Discharge of Farm Indebtedness

Congress recognized that farmers can have a solvent balance sheet because of the value of their farm land, but yet face severe cash flow problems that necessitate a reduction or discharge of indebtedness. As a result, there are special rules applicable to solvent farmers realizing income from the discharge of certain farm-related indebtedness. Basically, a solvent farmer that obtains a discharge of "qualified farm indebtedness" held by a "qualified" creditor can exclude the

discharge income (subject to certain limitations on amount described below) under *I.R.C. section 108(a)(1)(C)*. n99

Indebtedness owed by a solvent debtor will be treated as "qualified farm indebtedness" if (1) the indebtedness was incurred directly in connection with the debtor's operation of the trade or business of farming, and (2) 50 percent or more of the debtor's aggregate gross receipts for the 3 taxable years preceding the taxable year in which the discharge of indebtedness occurs is attributable to the trade or business of farming. n100

Indebtedness will be regarded as directly incurred in the trade or business of farming if the farm business debt is secured by farm land or farm equipment used in such trade or business. n101 Although somewhat unclear from the statute, it appears that the gross receipts test is met if the taxpayer's aggregate gross receipts from farming for the 3 taxable years preceding the year of discharge are 50 percent or more of the taxpayer's aggregate gross receipts from all sources for that same 3 year period. n102

The indebtedness must also be held by a "qualified" creditor, essentially an unrelated person actively engaged in the business of lending money. n103 A "qualified" creditor includes any federal, state or local government or agency. n104

Similar to an insolvent debtor, a solvent farmer meeting the above requirements is not entitled to unlimited exclusion of income from the discharge of qualified farm indebtedness. The amount excluded under *I.R.C. section 108(a)(1)(C)* cannot exceed the sum of (1) the adjusted tax attributes of the taxpayer and (2) the aggregate adjusted bases of all property used (or held for use) in a trade or business or for the production of income (called "qualified property"), n105 determined as of the first day of the taxable year following the year of the discharge. n106 As a result, the exclusion limit will be reduced to the extent the aggregate bases of the taxpayer's "qualified property" is reduced during the remainder of the taxable year of discharge (through, for example, subsequent sale or disposition or depreciation deductions). Any discharge of qualified farm indebtedness realized by a solvent farmer in excess of the attribute limitation will be recognized as gross income under *I.R.C. section 61(a)(12)*. n107

[iv] Special Rule for Discharge of Qualified Real Property Business Indebtedness

In part due to the changes made in the Tax Reform Act of 1986, the value of business real estate substantially declined in the late 1980's. Without the pre-1986 qualified business indebtedness exception, n108 solvent owners of business real estate were often forced to "hand the keys" to the lender rather than pay additional taxes on the phantom ordinary discharge income triggered by a debt restructuring, particularly where the debt was reduced below the debtor's adjusted tax basis. n109 Thus, the adverse tax consequences to solvent debtors became a frequent impediment to "economic" real estate debt restructurings negotiated by the lender and debtor.

In order to correct this inequity, Congress recognized that the incidence of taxation on debt reductions resulting from a decline in the value of business real estate should be deferred until the debtor disposes of the property. This led to the addition of the qualified real property business indebtedness exception, *I.R.C. section 108(a)(1)(D)*, in the Omnibus Reconciliation Act of 1993. n110 Basically, this provision permits solvent taxpayers other than C corporations to elect to reduce the basis of depreciable real property if the taxpayer realizes discharge income from the reduction of "qualified real property business indebtedness."

Under *I.R.C. section 108(a)(1)(D)*, discharge income is excluded if, in the case of a taxpayer other than a C corporation, n110a the debt discharged is qualified real property business indebtedness. Indebtedness is treated as "qualified real property business indebtedness" if (1) the debt is incurred or assumed in connection with real property used in a trade or business, (2) the debt is secured by that real property, (3) the debt is either (a) "qualified acquisition indebtedness" or (b) was incurred or assumed by the taxpayer before January 1, 1993, and (4) the taxpayer makes a qualifying election. n111 For debt incurred or assumed after 1992, "qualified acquisition indebtedness" is debt incurred to acquire, construct, reconstruct or substantially improve real property secured by the debt. n112 The term also includes refinanced "qualified acquisition indebtedness" to the extent the amount refinanced does not exceed the qualifying debt. n113 Since

the statute limits qualification of post-1992 indebtedness to circumstances in which the loan proceeds were used to acquire or improve real estate, no such limit should exist for pre-1993 indebtedness. n113a Thus, there should not be any tracing of the loan proceeds requirement prior to 1993.

The statutory language leaves many issues to be resolved. First, by using the term "real property" in the definitional language of *I.R.C. section 108(c)(3)(A)* while the term "depreciable real property" is used in *I.R.C. section 108(c)(2)(B)*, which provides a limit on the amount of discharge income that can be excluded (as discussed below), it is clear that debt secured by land used in a trade or business will qualify. n114 This makes sense from a policy perspective because, while debt reductions attributable to all real estate should qualify for exclusion under *I.R.C. section 108*, the "cost" of exclusion should be the reduction of future depreciation deductions. Thus, both land and improvements should be included as "real property" for purposes of threshold qualification, but the amount actually excluded cannot exceed the taxpayer's aggregate adjusted basis of all depreciable real estate. Further, by using the term "real property," Congress has apparently included the provision's application to mineral interests. Since *I.R.C. section 108(a)(1)(D)* does not specifically include or exclude certain types of real property, mineral interests should be included in the definition of real property. There are several instances in the I.R.C. where Congress has sought to limit the definition of real property by excluding mineral interests. n114a *I.R.C. section 108* provides no such exclusion. Since mineral interests are generally considered real property under state law, mineral interests should be treated as real property to which *I.R.C. section 108(a)(1)(D)* applies. n114b

Second, the meaning of the phrase "used in a trade or business" is unclear under current law. Although not defined in the Internal Revenue Code, the phrase is used in other sections--most notably *I.R.C. sections 1221(2)* and *1231(b)(1)* and the phrase was used in *I.R.C. section 108* prior to 1986. With respect to real estate, the level of activity needed to constitute a "trade or business" has not been clearly identified, particularly with respect to a single parcel of rental real estate. The Tax Court has adopted a low threshold such that the holding and offering of one parcel of real estate for rent can constitute a trade or business. n115

Third, the requirement that the debt be secured by the real estate appears simple enough. Presumably, the lender must have an unperfected security interest in the subject real estate. In such event, the security interest must only be valid on its face (based on the existence of a security agreement or interest of record) so that no additional inquiry beyond the documents is required. Also, so long as the debt being reduced was secured, delays in the actual discharge of the debt should not affect qualification. For example, if a debtor transfers the real estate project to the lender in satisfaction of a recourse debt and the discharge of the amount in excess of fair market value occurs only after a statutory redemption period (commonly 90 days), the transaction should qualify.

Fourth, there is the issue whether accrued but unpaid interest that is added to principal of an accrual method taxpayer increases the amount of "qualified real property business indebtedness." Based on a plain reading of the statute and under the authority of *Allan v. Commissioner*, accrued but unpaid interest and all other additional amounts owed which are equivalent to principal (in that future interest accrues on that amount) should be added to and become principal of such indebtedness. n116

Finally, in order to qualify, the taxpayer must make an election on the taxpayer's return for the taxable year in which the discharge occurs. n117 The election is made on the taxpayer's return (using Form 982) for the taxable year of the discharge. n118 Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and section 1082 Basis Adjustment), as revised in March 2009, provides a box to check for qualifying discharges of real property indebtedness. n119 Generally, a valid election can only be made on an original timely filed return including extensions (but not on an amended return). Amended return elections are permitted if filed within six months of the original due date n119a and the taxpayer establishes "reasonable cause" for the failure. n120 The instructions to Form 982 permit an election on an amended return filed within 6 months of the due date. While unclear, an election to exclude only a portion of the discharge income should be permitted.

If the debt qualifies there are two limitations. First, the amount excluded under *I.R.C. section 108(a)(1)(D)* cannot exceed the excess of (1) the outstanding principal balance of the debt (immediately before the discharge), over (2) the fair market value (immediately before the discharge) of the real property securing the debt, reduced by the outstanding principal amount of any other qualified real property business debt securing the property immediately before and after the discharge. n121 This limitation is illustrated by the following example. n122

Example 1a:

On July 1, 1993, Individual J owns a building worth \$150,000, used in his trade or business, that is subject to a first mortgage securing a debt of J's of \$110,000 and second mortgage securing a second debt of J's of \$90,000. J is neither a bankrupt nor insolvent and neither debt is qualified farm indebtedness. J agrees with his second mortgagee to reduce the second mortgage debt to \$30,000, resulting in discharge of indebtedness income in the amount of \$60,000. Under the provision, assuming that J has sufficient basis in business real property to absorb the reduction, J can elect to exclude \$50,000 of that discharge from gross income. This is because the principal amount of the discharged debt immediately before the discharge (*i.e.*, \$90,000) exceeds the fair market value of the property securing it (*i.e.*, \$150,000 of free and clear value less \$110,000 of other qualified business real property debt or \$40,000) by \$50,000. The remaining \$10,000 of discharge is included in gross income.

The second limitation is that, overall, the amount excluded cannot exceed the aggregate adjusted bases of depreciable real property (determined after any reductions under *I.R.C. section 108(b)* and *(g)* on the first day of the next taxable year, or on disposition if earlier) held by the taxpayer immediately before the discharge. n123 Depreciable property acquired to "build up" basis in contemplation of the discharge is not counted. n124 The depreciable basis limitation means that the taxpayer can "borrow" the basis of unrelated depreciable real estate in order to defer the recognition of ordinary discharge income on the subject property. As discussed above, it also means that the debt secured by land used in a trade or business should qualify for exclusion under *I.R.C. section 108(a)(1)(D)*, provided the taxpayer has sufficient adjusted basis in other depreciable real property.

For partnerships, the determination whether the debt is "qualified real property business indebtedness" and whether the reduction has not exceeded the fair market value of the property is made at the partnership level. n125 However, the election is made at the partner level by each partner. n126 A partner's interest in a partnership is treated as depreciable real property to the extent of the partner's proportionate interest in depreciable real property held by the partnership. n127 If a partner makes the election, the depreciable basis of the partnership's real property is reduced, presumably using *I.R.C. sections 754/743* principles. It is unclear whether a partnership unrelated to the qualified debt reduction transaction must consent to the basis adjustment necessitated by a partner's election under *I.R.C. section 108(a)(1)(D)*. Practically, consent will be required because a partner can exclude the discharge income only to the extent the partnership reduces its "inside" basis in depreciable real estate. n128

With respect to the collateral consequences of a partnership debt reduction, the legislative history clarifies that the adjustments required under Subchapter K for allocations of discharge income (a basis increase under *I.R.C. section 705*) and reductions of a partner's share of partnership debt under *I.R.C. section 752(b)* (a basis decrease under *I.R.C. section 733*) are separate from any basis reduction required by reason of an election to reduce depreciable basis under *I.R.C. section 108(a)(1)(D)*. n129

Example 1b:

Partnership has two 50% partners, Oscar and Ralph, who share profits, losses and liabilities equally and have an "outside" basis of \$300 each. It owns a depreciable building used in its trade or business with an adjusted tax basis of \$600, a fair market value of \$600 and secured by recourse debt with an outstanding principal balance of \$1,000. On July 1, 1993, the partnership's debt is reduced to \$600 (a \$400 reduction). Ralph is in a Title 11 case and Oscar is hopelessly solvent. To defer the recognition of his 50% share of the discharge income, Oscar elects to reduce the basis of depreciable property under *I.R.C.*

section 108(a)(1)(D) (and presumably, the partnership consents to make the necessary adjustments to its "inside" basis). Oscar is subject to the following adjustments of his "outside" basis: beginning basis of \$300, increased by his \$200 share of discharge income and reduced by \$200 for the debt reduction under *I.R.C. section 752(b)* and 733, leaving an ending basis of \$300. However, to take account of the *I.R.C. section 108(a)(1)(D)* exclusion, Oscar's basis (and the partnership's "inside" basis) must also be reduced by \$200, leaving an ending balance of \$100.

A significant partnership tax issue that remains unresolved is whether a minimum gain chargeback will be triggered when a partnership reduces a partnership nonrecourse debt secured by real estate. n130 Absent a specific exception added to the *I.R.C. section 704(b)* regulations, the chargeback provision will apply. Such a chargeback of partnership income and gain to the partners on account of the debt reduction would essentially "reverse" the deferral benefit of qualification under *I.R.C. section 108(a)(1)(D)*. Hopefully, Treasury or the IRS will exercise its authority and either create an additional exception to the chargeback requirement or clarify that the discharge income is the first income item charged back under *Treasury Regulation sections 1.704-2(f)(6)* and -2(j)(2) in cases where *I.R.C. section 108(a)(1)(D)* applies. n131

For S corporations, the election and exclusion of discharge income and reduction in the adjusted basis of depreciable real estate are all made at the S corporation level. n132 The legislative history explains that in order to defer (but not exclude) the discharge income, the shareholders' "outside" stock basis is not increased by the amount of discharge income excluded at the corporate level under *I.R.C. section 108(a)(1)(D)*. n133 Also, the amount of any losses suspended under *I.R.C. section 1366(d)(1)* are not "triggered" and treated as a net operating loss for the year to the extent the discharge income is excluded under *I.R.C. section 108(a)(1)(D)*. n134

[v] Special Rule for Discharge of an Applicable Debt Instrument before 2011

With the economic crisis extending to business debtors, Congress believed that solvent business debtors should be able to "deleverage" by repurchasing their debt at a discount and not be subject to immediate taxes due on the discharge income triggered by the debt restructuring. In the American Recovery and Reinvestment Act of 2009 (the "2009 Act"), n135 Congress added a new election for business debtors to defer the recognition of discharge income attributable to the reacquisition of an applicable debt instrument. This election is available for business debtors realizing discharge income in 2009 and 2010. The election is irrevocable and takes priority over or "preempts" the exclusions for discharge income found in *I.R.C. section 108*. n136

For business debtors contemplating a debt reduction transaction in 2009 and 2010, the 2009 Act provides elective relief from the immediate recognition of discharge income realized with respect to a qualifying debt instrument. As a result, debtors should review their options and alternative tax consequences in any transaction involving possible discharge income. Specifically, business debtors should examine which will provide a more optimal result--the "regular" rules of *I.R.C. section 108*, providing for exclusion and attribute reduction, or the new election to defer and ratably report discharge income, without any attribute reduction.

Under *I.R.C. section 108(i)*, a taxpayer can elect to defer discharge income attributable to an applicable debt instrument reacquired in 2009 and 2010. n137 Under the election, the discharge income is deferred for five taxable years (including the year of discharge) for a reacquisition of debt in 2009 and four taxable years for a reacquisition in 2010 (the "zero years"). After the zero years, there is ratable inclusion--with twenty percent of the discharge income included in gross income in each of the next five years. n138 As a result, the taxpayer is deferring and then ratably recognizing the ordinary discharge income from a transaction involving an applicable debt instrument. There is no reduction of tax attributes and the taxpayer will have, for example, the full availability of net operating losses and basis in property.

Example.

Corporation, a calendar year taxpayer, realizes \$1 million of discharge income attributable to an

applicable debt instrument repurchased at a discount in 2009. Corporation makes a valid *I.R.C. section 108(i)* election on its 2009 federal income tax return. As a result, Corporation will not recognize any discharge income for the first five "zero years," 2009 through 2013. Beginning in 2014, and for the next four years thereafter, Corporation will recognize \$200,000 of ordinary discharge income each year under *I.R.C. section 61(a)(12)*. Corporation will not be subject to any tax attribute reduction.

The election is available only for the reacquisition of an applicable debt instrument ("ADI"). To qualify, the ADI must be (1) a debt instrument (broadly defined to include a bond, note, debenture, certificate or contractual arrangement constituting indebtedness within the meaning of *I.R.C. section 1275(a)*), (2) which was issued by (i) a C corporation, or (ii) any other person in connection with the conduct of a trade or business by such person. n139 This language is similar to the basis reduction election business debtors were provided in *I.R.C. section 108* prior to repeal in 1986 and there are a number of cases and rulings under prior law. n140 From a historical perspective, the term "in connection with the conduct of a trade or business" has been interpreted broadly and is regarded as a low/minimal threshold requiring only some relation or connection to the business. n141 Specifically, the courts have adopted a low threshold for what constitutes a "trade or business" for real estate. n142 This suggests, for example, that the debt of an investment partnership holding only investment assets may not qualify, but the debt of other real estate entities, such as the operating partnerships of real estate investment trusts, should clearly qualify. n143

A "reacquisition," for this purpose, is defined as any "acquisition" of an ADI by the debtor that issued (or is the obligor under) the debt instrument or by a person related to the obligor (applying the related party rules of *I.R.C. section 108(e)(4)*). n144 An "acquisition" of a debt instrument is broadly defined to include, without limitation, an acquisition for cash, an exchange of one debt instrument for another, including an exchange resulting from a significant modification of the debt instrument, n145 the exchange of equity for debt by either a corporation or a partnership, the contribution of the debt to capital and the complete forgiveness by the holder. n146 The legislative history makes clear that that this list of qualifying transactions is "without limitation." n147 Accordingly, other transactions creating discharge income, such as the transfer of property in satisfaction of a recourse ADI, whether that property is collateral for the indebtedness conveyed in a foreclosure or deed-in-lieu of foreclosure or other property conveyed by the debtor, should also qualify. n148

Example.

Taxpayer issues a debt instrument qualifying as an "ADI" for \$1,000 in 2007. Due to a downturn in the economy, the lender agrees to any one of the following transactions in 2009: a discounted payment for \$600 cash (either by the taxpayer or a related party), a significant modification of the "old" debt instrument for a "new" \$600 debt instrument with adequate stated interest, an exchange of the debt for \$600 of stock of the debtor corporation (or a \$600 capital or profits interest in the debtor partnership), a satisfaction of the debt in exchange for the transfer of property owned by the taxpayer worth \$600, or a \$400 reduction of the existing debt. Under any of these facts, the transaction should result in the taxpayer realizing \$400 of discharge income with respect to an ADI, eligible for deferral under *I.R.C. section 108(i)*.

If the reacquisition transaction involves a debt-for-debt exchange, there are special rules that apply. If a new debt instrument issued (or deemed issued) in satisfaction of an ADI has original issue discount ("OID"), the OID deductions are deferred and allowed as a deduction ratably over the same five-taxable-year period as the deferred discharge income is included in gross income. n149

The election to defer discharge income with respect to an ADI is made on the taxpayer's return for the taxable year in which the reacquisition occurs and, once made, is irrevocable. n150 The IRS recently issued detailed election procedures. n151 The election is made on a debt instrument by debt instrument basis, and must include a statement which identifies the debt instrument and the amount of discharge income being deferred. n152 The amount of discharge income is equal to the excess of the adjusted issue price of the cancelled debt over the repurchase price. n153 Partial

elections are permitted. For example, if a taxpayer realizes \$100 from the reacquisition of an ADI, the taxpayer may elect to defer only \$40. n154 In the case of a partnership, S corporation or other pass-thru entity, the election is made at the entity level. n155

If the election is made, the "regular" exclusions provided in *I.R.C. section 108(a)*, relating to taxpayer's status as being in a title 11 case, or insolvent, or the status of the debt as being qualified farm or real property business indebtedness, will not apply with respect to that debt instrument for the taxable year of the election or any subsequent year. n156 Thus, the *I.R.C. section 108(i)* election will "preempt" the other rules of *I.R.C. section 108* and, for example, prevent the individual partners of a partnership from making an individual partner-by-partner determination of which alternative might be most beneficial.

Example:

Partnership, with 4 partners, realizes \$300 of discharge income from an ADI in 2009 that would also qualify as qualified real property business indebtedness. Partner A is in a personal title 11 case, Partner B is insolvent and Partner C is a solvent individual. If Partnership makes the *I.R.C. section 108(i)* election to defer and ratably recognize the \$300 of discharge income, the partners will be bound by that election and will not be eligible for the "regular" rules of exclusion provided under *I.R.C. section 108*. Thus, Partner A's individual title 11 case, Partner B's insolvency and Partner C's ability to elect basis reduction under *I.R.C. section 108(c)*, will be irrelevant. All partners will be bound by the irrevocable election made by Partnership and their tax treatment of their \$100 allocable share of partnership discharge income will be deferred and ratably recognized under *I.R.C. section 108(i)*.

However, the IRS will permit the partnership to specially determine the portion of a partner's discharge amount that is a deferred amount and the portion, if any, that is an included amount. n157 Thus, for example, the partnership could make a partial election to defer \$200, and allocate the \$100 of "regular" discharge income to Partner A.

Given the substantial deferral period, it should come as no surprise that there are events which will trigger accelerated recognition. n158 Certain events that occur prior to the full recognition of the discharge income over the ten year deferral period (nine years for transactions in 2010), will cause the amount to be accelerated and reported immediately. Generally, in the case of a death of the taxpayer, liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 case), or cessation of business by the taxpayer (collectively, a "trigger event"), the amount of discharge income not yet recognized as income (or remaining deferred), will be accelerated and recognized in the taxable year in which a trigger event occurs. In the case of a pass-thru entity, such as a partnership or S corporation, a trigger event will also occur upon the sale, exchange or redemption of an interest in the entity. Thus, for example, a partnership with an ADI election in place must consider whether certain events, such as the cessation of business, will cause an acceleration of the deferred discharge income. n159 While the statute does not address this issue, presumably only the deferred income attributable to the selling partner or S corporation shareholder would be triggered, not the entire amount of the entity's deferred income.

There are special rules for electing partnerships. n160 Any discharge income from an ADI is allocated to the partners immediately before the discharge in the manner provided under *I.R.C. section 704* if such income were recognized at the time of the discharge. Accordingly, the partnership must allocate the deferred income to the partners based on their agreement for sharing income immediately before the discharge and not on whatever agreement they may have in subsequent years when the income is actually recognized. n161 Any decrease in a partner's share of liabilities for purposes of *I.R.C. section 752* is not taken into account at the time of discharge to the extent the deemed distribution would cause the partner to recognize gain under *I.R.C. section 731*. n162 Thus, the deemed distribution is deferred to the extent it exceeds the partner's basis. n163 Any amount so deferred is taken into account at the same time, and to the same extent, as the discharge income from the ADI is recognized by the partner.

A corporation that elects to defer discharge income under *I.R.C. section 108(i)* must determine whether earnings and profits ("E&P") should be increased in the year in which the discharge transaction occurs or in the later years when the discharge income is actually recognized as taxable income. n164 This calculation is especially important for a real estate investment trust ("REIT"), because, in order for a REIT's dividend to be eligible for the dividends paid deduction, it must be attributable to either current or accumulated E&P. n165 Accordingly, is E&P increased immediately in 2009 for the full amount of discharge income realized or is E&P unchanged during the "zero years" and only increased for an electing corporation when the discharge income is ratably recognized in taxable years six to ten? While the 2009 Act did not expressly resolve this question, the better answer which is consistent with the regulations under *I.R.C. section 316*, is that discharge income deferred under *I.R.C. section 108(i)* should only increase E&P in the later years when it is recognized and reported in income. n166 This result would further Congress' desire to encourage taxpayers to "workout" their debts without immediate adverse tax consequences.

In *Rev. Proc. 2009-37*, n167 the IRS announced that it intends to issue regulations providing that, generally, deferred discharge income increases E&P in the taxable year realized and not in the later years recognized as gross income. However, the Revenue Procedure provides that, in the case of REITs and regulated investment companies, E&P will be unchanged during the "zero years" and only increased in the later years when includible in gross income.

[vi] Special Rule for Discharge of Qualified Principal Residence Indebtedness Before 2013

With the crisis in the home mortgage market looming, Congress believed that where taxpayers restructure their debt on their principal residence or lose their home in a foreclosure, it was an inappropriate time to treat the discharge income as taxable. In the Mortgage Forgiveness Debt Relief Act of 2007, n168 Congress added an exception, *I.R.C. section 108(a)(1)(E)*, for the discharge of qualified principal residence indebtedness ("QPRI") before 2013. Basically, this provision permits solvent homeowners to reduce the basis of their principal residence if the taxpayer realizes discharge income from the reduction of QPRI in years 2007 through 2012.

Under *I.R.C. section 108(a)(1)(E)*, taxpayers may exclude income from the discharge of up to \$2 million (or \$1 million in the case of married individuals filing separate returns) of QPRI in years 2007 through 2012. For these purposes, indebtedness is treated as QPRI if (1) the debt is acquisition indebtedness with respect to the taxpayer's principal residence (within the meaning of *I.R.C. section 163(h)(3)(B)*), basically the mortgage must have been incurred in acquiring, constructing, or substantially improving the qualified residence of the taxpayer (or be a refinancing of such debt), and be secured by the residence, n169 (2) the discharge must be directly related to a decline in the value of a residence or the financial condition of the taxpayer, and (3) the discharge is not on account of services performed for the lender. n170 A taxpayer's "principal residence" has the same meaning as under *I.R.C. section 121*. n171 If only a portion of the discharged debt is QPRI, the exclusion applies only to so much of the amount discharged as exceeds the amount of the loan which is not QPRI. n172 For example, assume that a home is secured by debt of \$1 million, of which \$800,000 is QPRI. If the home is sold for \$700,000 and \$300,000 is discharged, only \$100,000 may be excluded. Note that the discharge of so-called "home equity" loans where the proceeds were used to pay non-home improvement expenses (car loans or credit cards, for example) and thus, not used to substantially improve the home, will not qualify.

A taxpayer excludes the amount on Form 982 and the amount excluded is applied to reduce the basis of the principal residence, but not below zero. n173 Generally, the QPRI exclusion takes precedence over the insolvency exception, unless the taxpayer elects otherwise. n174

[4] Price of Exclusion: Reduction of Tax Attributes

The "price" of *I.R.C. section 108* exclusion is that the taxpayer's tax attributes must be reduced by the amount of excluded discharge income. n175 Thus, under most circumstances, *I.R.C. section 108* does not permanently exclude income. n176 Rather, it permits a taxpayer to defer the current recognition of ordinary discharge income by reducing the taxpayer's tax attributes. The attribute reduction rules effectuate the congressional intent of permitting deferral but

eventually collecting federal income tax on ordinary discharge income in subsequent tax years. n177 As discussed below, separate attribute reduction rules apply to a discharge of qualified farm indebtedness. n178

[a] Specific Tax Attributes Reduced

Unless a special election is made under *I.R.C. section 108(b)(5)* to first reduce basis in depreciable assets, n179 the taxpayer must reduce its tax attributes in the following order: (1) the net operating loss for the taxable year of the discharge (if any) and any net operating loss carryover to that year; n180 (2) any carryover to or from the taxable year of discharge of the general business credit (reduced at the rate of 33 1/3 cents for each dollar of discharge income) n181 under *I.R.C. section 38*, n182 including the investment tax credit (other than the Employee Stock Ownership Plan ("ESOP") credit), the Work Incentive Program ("WIN") credit, the new jobs credit, and the credit for alcohol used as a fuel; n183 (3) for discharges in tax years beginning after December 31, 1993, the amount of minimum tax credit available under *I.R.C. section 53(b)* (reduced at the rate of 33 1/3 cents for each dollar of discharge income) as of the beginning of the next tax year after the discharge; n184 (4) any net capital loss generated in the taxable year of discharge and any capital loss carryover to that year; n185 (5) the basis of the taxpayer's property (both depreciable and nondepreciable); n186 (6) for discharges in tax years beginning after December 31, 1993, any passive activity loss or credit carryover of the taxpayer under *I.R.C. section 469(b)* from the tax year of the discharge; n187 and (7) carryovers of the foreign tax credit. n188 In lieu of these ordering rules, a taxpayer can elect to apply any portion of the reduction first to the taxpayer's basis in its depreciable property. n189

It is unclear whether tax attributes that are not listed in *I.R.C. section 108(b)(2)* must also be reduced. These carryover or deferred expense provisions include, for example, excess charitable contributions, n190 excess percentage depletion, n191 losses disallowed under the "at risk" rules, n192 certain research and experimental expenditures, n193 excess soil and water conservation expenditures, n194 amortization permitted with respect to reforestation expenditures, n195 start-up expenditures n196 and organization expenses for the formation of a corporation n197 and partnership, n198 and possibly the amortization permitted for certain intangible expenditures (to the extent not treated as "property" under *I.R.C. section 108(b)(2)(D)*). n199 Since the Bankruptcy Tax Act of 1980, Congress has also created "new" tax attributes that are not specifically listed in *I.R.C. section 108(b)(2)*. For example, passive activity losses in excess of passive activity income are not deductible and are carried forward to the next taxable year (such losses are commonly called "suspended passive losses"). n200 Investment interest paid by a non-corporate taxpayer in excess of net investment income is not deductible and will be carried forward to the next taxable year. n201 Finally, special rules may limit or defer the deductibility of original issue discount on certain high yield discount obligations. n202 Although many of the foregoing attributes were in existence prior to the Bankruptcy Tax Act of 1980, the fact is that, with the exception of the passive activity loss and credit carryovers applicable to discharges in tax years beginning after December 31, 1993, none are specified as attributes to be reduced under *I.R.C. section 108(b)(2)*. n203 As a result, absent a statutory amendment, n204 any attributes not specified in *I.R.C. section 108(b)(2)* should not be reduced. n205

[b] Mechanics of Attribute Reduction

[i] Determination of Tax for Year

Before making the attribute reductions described above, the taxpayer first determines its tax for the taxable year of the discharge by applying the general rules of the Internal Revenue Code. n206 The tax attributes subject to reduction that are carryovers to the taxable year of discharge, or that may be carried back to prior taxable years, are taken into account before such attributes are reduced under *I.R.C. section 108(b)*. n207 As a result, a taxpayer's net operating loss carryovers n208 will be available to offset gross income realized in the debtor's taxable year of discharge, including any *I.R.C. section 61(a)(12)* discharge income that is not excluded under *I.R.C. section 108(a)*. Interpreted in this manner, the losses of an S corporation generated in the taxable year of discharge should pass through to its shareholders, without reduction. If any loss carryovers remain, then they are the first tax attributes reduced by the discharge income realized, absent a taxpayer election to reduce basis in depreciable property first. n209

Example 2:

Olivia realizes \$7,000 of discharge of indebtedness income in tax year 1992 and was insolvent to the extent of \$3,000 immediately before the discharge. Olivia only tax attribute is a \$5,000 net operating loss carry forward. Olivia also realizes \$1,000 of other gross income in tax year 1992. Under *I.R.C. section 108(b)(4)*, Olivia first determines its taxable income for the year. Olivia has total gross income of \$5,000 and therefore uses \$1,000 of NOLs to offset \$1,000 of gross income and \$4,000 of NOLs to offset \$4,000 of discharge of indebtedness income. n210 Olivia is then eligible to exclude the remaining \$3,000 of discharge of indebtedness income based on its \$3,000 insolvency. n211 Although it appears Olivia has zero taxable income (and, therefore, no tax liability for the year), Olivia may have an alternative minimum tax liability, because the net operating loss deduction allowable in computing the alternative minimum tax is limited to 90 percent of alternative minimum taxable income. Under these facts, 10 percent of Olivia gross income, or \$500, would not be offset by the NOLs and would be subject to the alternative minimum tax imposed under *I.R.C. section 55*. n212

[ii] Methods Used to Reduce Attributes

The reductions in net operating loss carryovers and capital loss carryovers apply to the loss (if any) for the taxable year of the discharge and then apply to reduce the loss carryovers in the order in which they would have been used were the discharge income included in gross income. n213 Thus, after reducing any net operating losses and capital losses for the taxable year of the discharge, the taxpayer reduces loss carryovers to the taxable year of the discharge beginning with the first year generating such a loss carryover. n214 Tax credit carryovers are reduced in the order in which they are taken into account for the taxable year of the discharge. n215 For purposes of calculating the amount of reduction in particular tax attributes, tax credits are reduced at the rate of 33 1/3 cents for each dollar of discharge income excluded (or \$3 of excluded income will reduce \$1 of credit) n216 and other tax attributes are reduced dollar for dollar. n217

After reducing the net operating losses and carryovers, business tax credits, minimum tax credits and capital losses and carryovers, the debt discharge amount is then applied to reduce the basis of all of the taxpayer's property, whether depreciable or nondepreciable. n218 The basis reduction applies to any property held by the taxpayer on the first day of the taxable year following the taxable year in which the discharge occurs. n219

The order of reduction of the bases of particular depreciable properties will be determined pursuant to the Treasury regulations. n220 Before the Treasury issued final regulations on October 22, 1998, the authority for the order of basis of reductions for depreciable property was uncertain. The legislative history of the Bankruptcy Tax Act of 1980 provides that Congress anticipated that the order of basis reduction generally follow the regulations (*Treas. Reg. sections 1.1016-7 and -8*) formerly applicable to discharges under the repealed Bankruptcy Act. n221 Despite the Congressional direction to the contrary, the IRS apparently regarded the "old" *Treas. Reg. sections 1.1017-1 and 1.1017-2* as fully applicable. n222 However, an in-depth analysis of the prior ordering rules is unnecessary since the 1998 final regulations essentially follow the same order. n223 The amount applied to reduce basis cannot exceed the amount of the adjusted basis, that is, basis cannot be reduced below zero. n224

On October 22, 1998, the Service issued final regulations that provide guidance for, among other things, the order of property basis reduction required under *I.R.C. section 108(b)(2)(E)*. n225 The regulations are effective for debt discharges occurring on or after October 22, 1998. n226 The adjusted bases of property held on the first day of the taxable year following the year of discharge is reduced (in proportion to adjusted basis, but not below zero), by the amount of excluded discharge income, in the following order:

1. Real property used in a trade or business or held for investment, other than real property held as inventory under *I.R.C. section 1221(1)*, that secured the discharged debt immediately before the discharge;

2. Personal property used in a trade or business or held for investment, other than inventory, accounts receivable, and notes receivable, that secured the debt immediately before the discharge;
3. Remaining property used in a trade or business or held for investment, other than inventory, accounts receivable, notes receivable, and real property held as inventory;
4. Inventory, accounts receivable, notes receivable, and real property held as inventory; and
5. Property not used in a trade or business nor held for investment.

Example 2A:

Sherry owns real estate used in a trade or business (adjusted basis of \$400 allocated equally between land and building) secured by a debt of \$1,000. The debt also secures office equipment and furniture and fixtures with an adjusted bases of \$75. Sherry is substantially insolvent and the debt is reduced by \$500 in a workout without disposing of any property and the discharge income is excluded under *I.R.C. section 108(a)(1)(B)*. Her only other tax attributes are \$50 of NOLs and \$100 of inventory. Under the final regulations, the \$500 of excluded discharge income would be applied to reduce tax attributes in the following order: (1) \$50 of NOLs (to zero); (2) \$400 to reduce bases of secured land and building (to zero), applied *pro rata* since basis was \$200 each; and (3) \$50 to personal property that secured the debt (\$25 of basis remains). The inventory basis would not be reduced.

There is a basis reduction "floor." In the case of discharge income excluded by a taxpayer who is in a title 11 case or who is insolvent, the aggregate bases of property held by the taxpayer, determined *immediately after the discharge*, cannot be reduced below the aggregate amount of the taxpayer's remaining undischarged liabilities. n227 Accordingly, a taxpayer who obtains a discharge of only a portion of its debt may not suffer significant basis reduction.

Example 3:

Corporation (using the calendar tax year) is insolvent to the extent of \$5,000. On June 1, 1993, Corporation realizes \$1,000 of discharge income which is excluded under *I.R.C. section 108(a)(1)(B)*. Immediately after the discharge, Corporation has aggregate bases in property as of June 1, 1993 of \$2,600 and remaining liabilities of \$2,000. Under *I.R.C. section 1017(a)*, the general rule is that the amount of discharge income excluded (\$1,000) must be applied to reduce the basis of property held by Corporation as of the first day of the following year, January 1, 1994. However, because aggregate bases (\$2,600) exceeded aggregate liabilities (\$2,000) immediately after the discharge on June 1, 1993 by \$600, the basis can only be reduced by \$600 due to the limitation provided under *I.R.C. section 1017(b)(2)*.

The basis reduction limitation is designed to permit a taxpayer to sell all of its property immediately after a discharge for an amount equal to its outstanding liabilities and not realize any taxable gain (nor, obviously, be burdened by an additional tax liability) as a result of the sale. n228

[iii] Attribute Reduction for a Member of a Consolidated Group

There are special rules when the taxpayer realizing COD income is a C corporation that files a consolidated federal income tax return as a member of an affiliated group. These rules are provided in final Regulations applying to discharges that occur after March 21, 2005. n229

Generally, qualification for exclusion of COD income realized by a C corporation member is determined separately based on the status of the debtor corporation--whether the subject member is in a Title 11 case or insolvent. n230 Consistent with the separate entity rule, for purposes of computing insolvency under *I.R.C. section 108(a)(1)(B)*, only

the assets and liabilities of the debtor corporation are considered.

If a member realizes excluded COD income, the regulations provide a consolidated approach to attribute reduction. All tax attributes available to the consolidated member will be reduced. The tax attributes of the debtor member are reduced first. n231 These attributes include (1) consolidated tax attributes attributable to the debtor corporation (such as consolidated net operating loss carryovers and carrybacks and tax credits); (2) attributes that arose in separate return limitation years; and (3) the basis of assets of the debtor member (subject to the limitation under *I.R.C. section 1017(b)(2)*, that basis is not reduced below the amount of remaining liabilities). The basis of subsidiary stock is not reduced below zero. n232 To the extent the excluded COD income exceeds the debtor's tax attributes, the excluded COD income is applied to reduce the remaining consolidated tax attributes of the group. n233 The basis of assets of other members is not subject to reduction under this rule.

[iv] Discharge Income in Excess of Attributes

With respect to debt discharge income realized by taxpayers in a title 11 case or to the extent insolvent in excess of tax attributes, the Senate Report explains that "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." n234 More directly, the Treasury Regulations provide that "if the excluded COD income exceeds the sum of the taxpayer's tax attributes, the excess is permanently excluded from the taxpayer's gross income." n235 Thus, *I.R.C. section 108* generally relieves the financially troubled debtor of a current income tax obligation at a time when the debtor is least able to afford it. In this sense, the debtor is permitted a "fresh start." n236

[v] Examples

The following examples further illustrate the operation of the attribute reduction provisions:

Example 4:

A corporate taxpayer in a chapter 11 case n237 has \$500 of net operating loss carryovers, \$200 of tax credits and \$100 of capital losses. The taxpayer owns property with an adjusted basis of \$1,000 and has liabilities of \$2,000, \$1,500 of which will be discharged by the Bankruptcy Court on the last day of the corporation's taxable year. If the taxpayer does not elect to reduce the basis of its depreciable assets first under *I.R.C. section 108(b)(5)*, then *I.R.C. section 108(b)* produces the following results: the taxpayer will realize \$1,500 of discharge income, all excludable under *I.R.C. section 108(a)(1)(A)*. The amount excluded must be applied to reduce tax attributes. Of the \$1,500, \$500 will reduce the net operating losses to zero. Next, \$600 of the discharge income will reduce the \$200 of tax credits to zero (33 1/3 cents for each dollar of excluded income). At this point, \$400 of discharge income remains; \$100 will reduce the capital losses to zero, and the remaining \$300 will reduce the basis of the taxpayer's property from \$1,000 to \$700. n238

Example 5:

Same facts as Example 4, except that the corporate taxpayer has \$2,500 of debts of which \$1,500 will be discharged. The basis of the taxpayer's property of \$1,000 now equals its undischarged liabilities. Because the basis may not be reduced below the outstanding undischarged debt, the remaining \$300 of discharge income will "disappear." If the assets are immediately sold or conveyed to a creditor in satisfaction of the debt, the taxpayer will not realize any gain.

Example 6:

Same facts as Example 4, except that the corporate taxpayer elects to reduce basis first under *I.R.C. section 108(b)(5)* and all of the taxpayer's property is depreciable. The \$1,500 of excluded discharge income will reduce the tax basis of \$1,000 to zero (without regard to the \$500 of remaining debt) n239 and the balance of \$500 will reduce the net operating losses. n240 The taxpayer's credits and capital

losses will remain intact for use in subsequent years. In effect, the taxpayer has accelerated future depreciation deductions and has credit and loss carryovers available to offset income generated after the taxpayer emerges from bankruptcy. This example illustrates the importance of considering the *I.R.C. section 108(b)(5)* election.

Four additional points relating to *I.R.C. section 108(b)* attribute reduction deserve attention. First, in a chapter 7 n241 or chapter 11 case involving an individual debtor, n242 any attribute reduction required under *I.R.C. section 108(b)* applies to the attributes of the bankruptcy estate and not to the attributes of the individual taxpayer generated after the filing of the title 11 petition. n243 If basis reduction is required for discharge income realized in the final year of the title 11 estate, the reduction is made in the adjusted basis of property acquired by the debtor from the estate at the time acquired. n244 Second, property that a debtor in a title 11 case treats as exempt under *section 522(b) of the Bankruptcy Code* (such as a residence and furnishings) will not be subject to basis reduction for discharge income excluded under *I.R.C. section 108(a)(1)(A)*. n245 By its terms, the statutory limitation applies only to debtors in a title 11 case. However, if an insolvent debtor outside a title 11 case excludes property that is exempt from creditors under applicable state law from the debtor's insolvency calculation, n246 there is a strong policy argument that the basis of that property should not be reduced for the discharge income excluded under *I.R.C. section 108(a)(1)(B)*. Unfortunately, until there is an amendment to *I.R.C. section 1017(c)(1)* extending the exempt property rule to insolvent debtors, it appears that the exempt property of an insolvent debtor outside a title 11 case is subject to basis reduction. Third, a reduction in basis is not treated as a "disposition" for tax purposes and there is no recapture of investment tax credit. n247 Finally, in the case of a corporate *I.R.C. section 381* transaction (generally a tax free acquisitive reorganization), the tax attributes of the acquired corporation are reduced immediately prior to the transaction (after the determination of the tax for the year). n248

[c] Special Attribute Reduction Applicable to Qualified Farm Indebtedness and Qualified Real Property Business Indebtedness

Special attribute reduction rules are provided in *I.R.C. 1017* for farm discharge income excluded under *I.R.C. section 108(a)(1)(C)*. n249 To the extent the excluded income is applied to reduce the basis of the taxpayer's property under *I.R.C. section 108(b)(2)(E)*, only the basis of "qualified property" is reduced and the reduction must occur in a specified order, beginning with depreciable property. n250

Special attribute reduction rules apply to real estate discharge income excluded under *I.R.C. section 108(a)(1)(D)*. The amount of excluded discharge income is applied to reduce the basis of depreciable real property held by the taxpayer. n251 The reduction occurs with respect to property held at the beginning of the next taxable following the year of the discharge. n252 If the taxpayer disposes of real property before the first day of the next tax year (whether as part of the discharge transaction or otherwise), the reduction is made immediately before the time of disposition. n253 As a result, for example, unless the amount of the qualified debt discharge income exceeds the depreciable basis of the collateral transferred back to the lender, an election to exclude the discharge income and reduce basis under *I.R.C. section 108(a)(1)(D)* will not defer the recognition of the income nor change the character from ordinary to capital (because any basis reduction in the year of disposition will be recaptured as ordinary income). n254

A partnership interest can be treated as depreciable real property to the extent of the partner's proportionate interest in the depreciable real property held by the partnership. n255 This rule applies only if the partnership makes a corresponding reduction in the "inside" basis of its depreciable property. Until guidance is provided, it appears that this adjustment would be made in a manner similar to the *I.R.C. sections 754/743* adjustment.

With respect to the ordering of the basis reduction, the rules of *I.R.C. section 1017* apply. n256 Although the current *I.R.C. section 1017* regulations were promulgated in 1956 under prior law, it appears that these regulations must be used for discharges occurring before October 22, 1998, the effective date of the new regulations. n257 Under the "old" regulations, in the case of debt incurred to purchase specific real property and specific real property subject to a lien, the

basis of such property is reduced first by the amount of the subject debt discharged and excluded under *I.R.C. section 108(a)*. n258 Any excluded discharge income in excess of basis is applied to reduce the basis of all of the taxpayer's other depreciable real property *pro rata* (the ratio by which the adjusted basis of each unit of property bears to the sum of adjusted bases of all depreciable real property). n259 Thus, the basis reduction applies first to the property secured by the discharged debt and any excess is applied *pro rata* to the taxpayer's other property--the taxpayer does not have the luxury to "pick and choose" which other property should have its basis reduced.

On October 22, 1998, the Service issued final regulations which provide guidance for, among other things, the rules governing basis reductions under *I.R.C. section 108(b)(5)* or *(c)* for partnerships. n260 The regulations will be effective for debt discharges occurring on or after October 22, 1998. n261

The rules for *I.R.C. section 108(c)* elections for debt discharge income realized by a partnership with respect to qualified real property business indebtedness can be summarized as follows:

A. Partnership interests treated as depreciable property. If a taxpayer makes an election under *I.R.C. section 108(c)*, the taxpayer must treat a partnership interest as depreciable real property to the extent of the partner's proportionate share of the partnership's basis in depreciable real property, *provided* the partnership consents to a corresponding reduction in the partnership's basis (inside basis) in depreciable property with respect to such partner.

B. Procedures for request by partner and consent of partnership. Subject to two exceptions, a taxpayer may choose whether or not to request that a partnership reduce the inside basis of its depreciable real property with respect to the taxpayer, and the partnership may grant or withhold such consent, in its sole discretion. A request by the taxpayer must be made before the due date (including extensions) for filing the taxpayer's Federal income tax return for the taxable year in which the taxpayer has debt discharge income that is excluded from gross income under *I.R.C. section 108(a)*.

C. Partner required to request consent. A taxpayer must request a partnership's consent to reduce inside basis if, at the time of discharge, the taxpayer owns (directly or indirectly) a greater than 50 percent interest in the capital and profits of the partnership, or if reductions to the basis of the taxpayer's depreciable property (or depreciable real property) are being made with respect to the taxpayer's distributive share of debt discharge income of the partnership.

D. Partnership required to consent. A partnership must consent to reduce its partners' shares of inside basis if consent is requested (i) by partners owning (directly or indirectly) an aggregate of more than 80 percent of the capital and profits interests of the partnership, or (ii) by five or fewer partners owning (directly or indirectly) an aggregate of 50 percent of the capital and profits interests of the partnership. For example, if there is a cancellation of partnership indebtedness securing real property used in a partnership's trade or business, and if partners owning (in the aggregate) 90 percent of the capital and profits interests of the partnership elect to exclude the debt discharge income under *I.R.C. section 108(c)*, the partnership must make the appropriate reductions in those partners' shares of inside basis.

[d] General Attribute Reduction Reported on Form 982

An informational return, Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and section 1082 Basis Adjustment), must be filed with the taxpayer's tax return for the taxable year of the discharge. The IRS revised Form 982 in December 1993 for discharges in tax years beginning before 1994 and issued a new revised Form 982 for discharges in tax years beginning after 1993. n262 The current form was revised in March 2009. As discussed below, n263 an election must be filed with the taxpayer's return for the taxable year in which the discharge occurs if the taxpayer desires to apply the excluded income first to reduce the basis of depreciable property under *I.R.C. section*

108(b)(5). n264 However, the instructions to Form 982 specify the form must be filed with a timely filed tax return (including extensions) for any year discharge of indebtedness is excluded under *I.R.C. section 108(a)*. n265 No similar election (or filing requirement) for the "regular" application of *I.R.C. section 108* is mentioned in the statute n266 and none should be inferred. n267

Unfortunately, some confusion on this point remains because the Treasury regulations promulgated under the pre-Bankruptcy Tax Act version of *I.R.C. section 108* (which, under prior law as discussed above, required an election) n268 were only recently repealed. n269 Although it is unclear from the facts whether the taxpayer was insolvent, at least one court apparently failed to distinguish between the "regular" basis reduction rules applicable to insolvent taxpayers (for which no election is required by statute) and the special election under *I.R.C. section 108(b)(5)* and/or application of the former "qualified business indebtedness" exception n270 (for which elections must be filed). n271

[e] Special Election to First Reduce Basis of Depreciable Property

In lieu of the ordering of reduction of tax attributes discussed above, a taxpayer realizing discharge income that is excluded under *I.R.C. section 108(a)(1)* may elect to first reduce the basis of depreciable property by all or any portion of the excluded discharge income. n272 The general rule prohibiting a taxpayer from reducing the basis of depreciable property below the amount of the taxpayer's remaining undischarged liabilities n273 does not apply to elections under *I.R.C. section 108(b)(5)*. n274 The election, therefore, allows the taxpayer to reduce the entire basis of its depreciable property, but not below zero. n275 The taxpayer's aggregate adjusted bases of depreciable property will be determined (and the basis reduction will be made) as of the first day of the taxable year following the taxable year in which the discharge occurs. n276 The amount of discharge income remaining, if any, will reduce the tax attributes in accordance with the general ordering rules. n277

The term "depreciable property" means any property of a character subject to the allowance for depreciation including, if the taxpayer elects, real property that is stock in trade or inventory under *I.R.C. section 1221(1)*. n278 For the purposes of this provision, stock in a subsidiary held by a parent corporation is treated as depreciable property if the corporations file a consolidated return for the taxable year in which the discharge occurs and the subsidiary agrees to a corresponding reduction in the basis of its depreciable property or real property held as inventory. n279 The term "depreciable property" only includes property with respect to which actual depreciation or amortization deductions would be allowable for the taxable year immediately following the year of reduction. n280 For example, if a lessor could not claim depreciation deductions with respect to leasehold improvements because the lessee is obligated to restore the value of the property at the termination of the lease, then the lessor could not reduce the basis of the improvements under *I.R.C. section 108(b)(5)*. n281

An election to reduce basis in depreciable property under this provision must be made on the taxpayer's timely filed (including extensions) Federal income tax return for the taxable year in which the discharge occurs. Once made, the election can be terminated only with the Commissioner's consent. n282 The regulations provide that the election to reduce basis is made by entering the appropriate information on Form 982, "Reduction of Tax Attributes Due to Discharge of Indebtedness (and section 1082 Basis Adjustment)" and attaching the form to the tax return. n283 Currently, the IRS has the discretion, upon a showing of reasonable/good cause, to grant an extension of time to file a late election under the so-called "9100" administrative regulations. n284 The IRS has recently exercised this authority to grant an extension of time to file a late *I.R.C. section 108(b)(5)* election. n285

The election to reduce the basis of depreciable property first offers planning opportunities that a financially troubled taxpayer should consider. For example, a taxpayer holding depreciable property with a substantial number of years of depreciation remaining should consider this election. By making the election, the taxpayer would, in effect, accelerate depreciation deductions into the year of discharge. If the property is subsequently held for a number of years, the recognition of the ordinary "recapture" income would be deferred until the taxable year of disposition. n286 Further, by reducing the basis of property before reducing net operating losses, the taxpayer may have a greater amount of net

operating loss carryovers available to offset operating income generated in taxable years immediately after the discharge. n287 Under these circumstances, the election would permit the taxpayer to generate a greater amount of after-tax cash flow in the first few years after the discharge. In contrast, a taxpayer faced with an expiring net operating loss carryover, or a corporation facing a *I.R.C. section 382* "ownership change" n288 should not make this election.

[f] Recapture on Disposition of Assets Subject to Basis Reduction

If a taxpayer excludes discharge income under *I.R.C. section 108(a)* and reduces the basis of property under the general attribute reduction rule of *I.R.C. section 108(b)(2)(D)* or the special election under *I.R.C. section 108(b)(5)*, any gain realized on a subsequent disposition of reduced basis, non-*I.R.C. section 1250* property n289 will be treated as the "recapture" of depreciation under *I.R.C. section 1245* to the extent of the basis reduction. n290 The recapture rule applies to any reduced basis property, even if the disposition of such property would not otherwise be subject to recapture under *I.R.C. section 1245* or *1250*. n291 Thus, the gain realized on disposition will be treated as ordinary income to the extent of the basis reduction. n292 There is a special rule for *I.R.C. section 1250* property that ensures that the taxpayer has only obtained a postponement of recognition of discharge income and eventually will realize ordinary income on the disposition of property. n293 For example, if a parent corporation reduced the basis of its subsidiary's stock by \$1,000, the gain realized on a subsequent sale of the stock would be ordinary income to the extent of the \$1,000 reduction.

There is a special rule for depreciable real property subject to the qualified real property business indebtedness election of *I.R.C. section 108(a)(1)(D)*. Upon the disposition of depreciable real property, the basis of which was reduced due to the special election, the *I.R.C. section 1250* depreciation recapture rule applies with the following modifications: (1) any basis reduction is treated as a depreciation deduction, and (2) the determination of the amount of depreciation that would have been claimed under the straight line method is made as if no basis reductions had occurred. n294 The effect is to reduce the amount of the basis reduction recaptured as ordinary income as the taxpayer continues to hold the property and forego the future depreciation deductions taken away by the basis reduction. n295

[5] Other Issues Relating to Application of I.R.C. section 108

[a] Corporate Capital Contributions

Absent another provision in the Internal Revenue Code to the contrary, a contribution of indebtedness held by a shareholder to a corporation would not trigger discharge of indebtedness income to the debtor corporation because of the general rule excluding contributions to capital from a corporation's income. n296 Congress believed this general rule should not apply to discharge income realized by corporate debtors. Accordingly, *I.R.C. section 108(e)(6)* provides that *I.R.C. section 118* does not apply if a shareholder contributes indebtedness to the debtor corporation. Instead, the corporation is treated as if it purchased the indebtedness for an amount equal to the shareholder's tax basis in the debt. n297 Therefore, a corporation will realize discharge of indebtedness income to the extent that the adjusted issue price of the debt exceeds the contributing shareholder's basis in that debt. n298

For example, if an accrual basis corporation accrued but did not pay a \$10,000 salary expense to an officer/shareholder and the cash basis officer/shareholder thereafter forgave the indebtedness, the corporation would be treated as having paid zero for the debt (because the cash basis officer never included the amount in income) and would therefore realize \$10,000 of discharge of indebtedness income. If the corporation was neither insolvent nor in bankruptcy, it would recognize \$10,000 of ordinary income. If, however, the officer/shareholder was an accrual basis taxpayer who had previously included the payment in income (and had not written off all or any portion of the debt under *I.R.C. section 166*), the debtor corporation would not realize any amount of discharge of indebtedness income because it would be treated as having acquired the debt for full value.

The Senate Report n299 explains this rule was intended to reverse the holding in *Putoma Corp. v. Commissioner*. n300

The Senate Report also makes it clear that the contribution-to-capital rule will apply only if the cancellation of a debt by a shareholder is related to his or her status as a shareholder of the debtor corporation (as opposed to a creditor merely attempting to maximize the recovery on a claim). n301 Accordingly, if the parties seek contribution-to-capital treatment, it may prove beneficial to hold and document a special meeting of the Board of Directors that acknowledges the shareholder's contribution of indebtedness to the capital of the debtor corporation. n302 It must be cautioned that, although not authority, the IRS recently ruled that *I.R.C. section 108(e)(6)* applies only where the debtor corporation does *not* issue stock. n303

I.R.C. section 108(e)(6) may serve as a beneficial alternative for solvent corporations that do not qualify for the stock for debt exception under *I.R.C. section 108(e)(10)* as it existed prior to 1995. n304 Thus, if a shareholder/creditor has a tax basis in excess of the fair market value of the debt, then a lesser amount of discharge income will be recognized by the debtor corporation under *I.R.C. section 108(e)(6)* than under *I.R.C. section 108(e)(8)*.

The application of *I.R.C. section 108(e)(6)* to an S corporation presents unique issues. *I.R.C. section 108*, as amended by the Bankruptcy Tax Act of 1980, did not specifically address the treatment of indebtedness contributed to the capital of an S corporation. In 1982, Congress substantially revised subchapter S. n305 Under the revised subchapter S, a shareholder's basis in indebtedness of an S corporation could be reduced (but not below zero) by losses passed through to the shareholder in excess of the shareholder's stock basis. n306 Before 1984, it was not clear whether an S corporation shareholder contributing debt to the corporation's capital had to use the basis of that debt computed under subchapter S for purposes of *I.R.C. section 108(e)(6)*. In 1984, recognizing the need to coordinate *I.R.C. section 108* and the revised subchapter S, Congress amended *I.R.C. section 108(d)* by adding *I.R.C. section 108(d)(7)*. n307 *I.R.C. section 108(d)(7)(C)* provides that a shareholder's basis in S corporation indebtedness for purposes of *I.R.C. section 108(e)(6)* is not reduced for corporate losses and other adjustments made under *I.R.C. section 1367(b)(2)*.

It is unclear whether *I.R.C. section 108(d)(7)(C)* applies to a "regular" C corporation that was formerly an S corporation. For example, in 1990, ABC, Inc. then an S corporation, had one shareholder, Oscar. ABC was indebted to Oscar within the meaning of *I.R.C. section 1367(b)(2)* in the amount of \$1,000. In 1990, ABC recognized losses that, under *I.R.C. section 1367(b)(2)*, reduced Oscar's basis in his stock to zero and reduced Oscar's basis in indebtedness of ABC from \$1,000 to \$600. ABC revoked its S election for 1991. In 1991, Oscar contributed the ABC indebtedness to the capital of ABC. If *I.R.C. section 108(d)(7)(C)* applies, ABC will have no discharge of indebtedness income (\$1,000 (adjusted issue price of debt)–\$1,000 (amount deemed paid to Oscar to satisfy the debt)). If *I.R.C. section 108(d)(7)(C)* does not apply, then ABC will have \$400 of discharge of indebtedness income (\$1,000 (face amount of debt)–\$600 (amount deemed paid to Oscar to satisfy the debt)). The issue arises because ABC was an S corporation when it incurred the \$1,000 loss that reduced Oscar's basis in the debt, but was not an S corporation when Oscar contributed the debt to ABC.

The resolution of this issue depends on the Congressional purposes behind the enactment of *I.R.C. section 108(e)(6)*. The legislative history suggests that Congress intended to restore a symmetry between income and deductions that had been lost after the Tax Court's decision in *Putoma Corp.* n308 In *Putoma Corp.*, the Tax Court held that a corporation did not have income when its shareholders forgave salaries and interest previously deducted by the corporation. n309 As the following example from the legislative history illustrates, *I.R.C. section 108(e)(6)* changes this result:

[A]ssume 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, then it must apply the \$1,000 debt discharge amount to reduce tax attributes ... If the debtor is a solvent corporation outside bankruptcy, then it can elect to reduce basis of depreciable assets ... 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. n310

If Congress enacted *I.R.C. section 108(e)(6)* to restore symmetry between income and deductions, then permitting ABC to use *I.R.C. section 108(d)(7)(C)* would not violate that purpose. Indeed, if ABC cannot use *I.R.C. section 108(d)(7)(C)*, there is a potential for double taxation. Because *I.R.C. section 1367(b)(2)* required Oscar to reduce basis in the debt by \$400 (from \$1,000 to \$600), the deduction available to Oscar under either *I.R.C. section 165(g)* or *I.R.C. section 166* will be only \$600. If ABC cannot use *I.R.C. section 108(d)(7)(C)*, it will have to recognize \$400 of discharge of indebtedness income. In effect, \$400 would be taxed twice because Oscar would lose \$400 of deductible loss and ABC, now a C corporation, will pay tax on the \$400 of discharge of indebtedness income.

[b] Treatment of Partnership Debt

Like other items of partnership income or gain, the characterization of a discharge (or reduction) of a partnership debt as a sale or exchange or a discharge of indebtedness is determined at the partnership level. n311 However, the determination of whether discharge income realized by the partnership can be excluded under *I.R.C. section 108(a)* is made at the partner, not the partnership, level. n312 As a result, the fact that a debtor partnership is in a title 11 case, is insolvent or has obtained a discharge of qualified farm indebtedness will have no effect on the federal income tax treatment of discharge income realized by the partnership and passed through to its partners.

Discharge income realized by a partnership is treated as a separately allocated item of income to each partner under *I.R.C. section 702(a)(8)*. n313 A mechanical application of the pertinent provisions of subchapter K will result in an allocation of an amount of debt discharge income increasing a partner's basis in his or her partnership interest. n314 However, because of the reduction in the partner's share of partnership liabilities caused by the discharge, the partner will receive a deemed distribution of money under *I.R.C. section 752(b)*, which distribution will cause the basis of the partner's interest to be correspondingly decreased. n315 Assuming that the discharge income is allocated in the same manner as the debt is shared by the partners under *I.R.C. section 752*, these adjustments should cancel each other out and should not cause a net change in the partner's basis. n316

The tax treatment of a partner's allocable share of discharged partnership debt will depend upon whether that partner is solvent or (1) is in a title 11 case, (2) is insolvent, (3) satisfies the qualified farm indebtedness exception, or (4) makes an election with respect to qualified real property business indebtedness. For example, if a partner is in a title 11 case at the time the partner realizes his or her allocable share of the partnership discharge income (generally, this should occur on the last day of the partnership's taxable year), the debt discharge amount will be excluded from income under *I.R.C. section 108(a)(1)(A)* and will reduce the partner's tax attributes under *I.R.C. section 108(b)* unless the partner elects to first reduce the basis of depreciable property. On the other hand, if the partner is solvent, then the debt discharge amount will be fully includable in income under the general rule of *I.R.C. section 61(a)(12)*. n317 Because the Tax Reform Act of 1986 repealed the qualified business indebtedness exception for discharges occurring after 1986, a solvent partner will not be able to avoid recognition by reducing the basis of his or her partnership interest or other depreciable property, unless the partner is eligible to make an election under *I.R.C. section 108(c)* with respect to qualified real property business indebtedness. n318

[c] S Corporations

Unlike the rules governing partnership indebtedness, the rules of *I.R.C. section 108* apply at the S corporation level. n319 Thus, an S corporation that realizes discharge of indebtedness income will be entitled to exclude the income under *I.R.C. section 108(a)* if it is in a title 11 case, insolvent, has obtained a discharge of qualified farm indebtedness or a discharge of qualified real property business indebtedness. The status of the S corporation's shareholders is irrelevant. Because *I.R.C. section 108* applies to S corporations, the discharge income excluded under *I.R.C. section 108* will not

pass through as ordinary income to the shareholders. On the other hand, if a solvent S corporation realizes discharge income and each of its shareholders is in a title 11 case, the shareholders will not be eligible to exclude their share of the discharge income and may therefore be subject to an immediate tax liability.

If discharge income is excluded at the S corporation level under *I.R.C. section 108(a)*, the shareholders should be entitled to increase the basis of their stock and debt under *I.R.C. section 1367* for their ratable share of excluded income for discharges on or before October 11, 2001. Under a plain reading of the statutory language, a step-up in basis is allowed for all income, including tax-exempt income. n320 Because a basis increase for excluded discharge income is not necessary to prevent taxation upon the distribution of the tax-exempt proceeds (because there are no proceeds), it appears that a step-up for excluded discharge income may provide the shareholders with an unintended benefit. n321 Using the novel reasoning that discharge income excluded at the S corporation level never "passes through" to shareholders under *I.R.C. section 1366(a)(1)(A)* and such discharge income is not tax-exempt but merely "tax-deferred," the IRS argued that shareholders' bases in their S corporation stock is not increased for excluded discharge income, with three circuit courts agreeing n322 and two holding for the taxpayer. n323 Treasury issued a proposed regulation which provides there is no step-up in basis for excluded S corporation COD income, effective for S corporation years beginning after August 17, 1998. n324

The Supreme Court granted certiorari in *Gitlitz et ux. v. Commissioner* n325 to resolve the conflict of opinion among the Circuit Courts. The Court began by rejecting the Commissioner's argument that COD was not an item of income because it was excluded from gross income. The Court held that, under a plain reading of the statute, the character of COD income as an item of income does not change just because it is excluded under *I.R.C. section 108*. Thus, excluded COD was "indeed an 'item of income,' which passes through to the shareholders and increases their basis in the stock of the S corporation." n326

Next, the Court addressed the sequencing issue--whether the pass through of income to the shareholders occurs before or after the reduction of the S corporation's tax attributes under *I.R.C. section 108(b)*. Finding for the taxpayers, the Court held that *I.R.C. section 108(b)(4)(A)* expressly provides that the reduction in tax attributes is made *after* the determination of tax imposed for the year of discharge. n327 Accordingly, shareholders must take account of their share of excluded COD income, increase their outside basis, and deduct their suspended S corporation losses, all before any attribute reduction is calculated. This means that all tax attributes are available to offset taxable income in the year of discharge and exclusion under *I.R.C. section 108*. Any excess suspended losses are treated as an NOL of the S corporation and then subject to attribute reduction as prescribed by *I.R.C. section 108(d)(7)(B)*. Overall, the opinion demonstrates the Court will follow the plain meaning of the statute, even if it raises certain policy concerns by producing a result that may be beneficial to the taxpayer. n328

However, in the Job Creation and Worker Assistance Act of 2002, n329 Congress legislatively overruled *Gitlitz*. Effective for discharges after October 11, 2001, excluded S Corporation COD is not taken into account as an item of income by any shareholder and does not increase the basis of any shareholder's stock. n330

Among the special rules for S corporations, *I.R.C. section 108(d)(7)(B)* provides that if the losses and deductions allocated to a shareholder exceed the shareholder's adjusted stock basis and are therefore not deductible in the year of discharge as provided under *I.R.C. section 1366(d)(1)*, the amount of such "suspended" loss will be treated as a net operating loss for such year which is subject to reduction under *I.R.C. section 108(b)(2)(A)*. n331 Because *I.R.C. section 1366(d)(2)* provides that losses or deductions in excess of a shareholder's stock basis "shall be treated as incurred by the corporation in the succeeding taxable year with respect to that shareholder," the amount of such carryover will be subject to reduction as a corporate attribute under *I.R.C. section 108(b)(2)(A)*. It appears that losses and deductions that pass through to a shareholder with sufficient basis, but not fully used on that shareholder's individual return and carried over to subsequent tax years, are not subject to reduction under *I.R.C. section 108(b)(2)(A)*.

[d] Tax Benefit Rule

Conceptually, the tax benefit rule and *I.R.C. section 108* can apply to the same transaction. The tax benefit rule, as set forth by the Supreme Court in *Hillsboro Nat'l Bank v. Commissioner*, n332 requires a taxpayer who previously deducted an amount to include that amount in income in a subsequent year in which there is an event "fundamentally inconsistent" with the prior deduction. n333 The corollary to the tax benefit rule, *I.R.C. section 111(a)*, provides that the "recovery" n334 of an amount deducted in a prior taxable year will be excluded from gross income to the extent the deduction did not reduce the amount of tax in the prior year. n335 *I.R.C. section 111(c)* provides that if the "recovered" deduction increased a net operating loss carryover which has not expired before the beginning of the taxable year in which the "recovery or adjustment" occurs, it is treated as an amount which reduces the tax. n336

The following example illustrates the interaction between *I.R.C. section 111* and *I.R.C. section 108*. In 1992, an accrual method taxpayer deducts but does not pay \$200 of interest on \$1,000 of indebtedness owed by the taxpayer to a creditor. In 1993, the creditor forgives both the underlying indebtedness and the \$200 of interest. If the taxpayer is in a title 11 case, insolvent (but only to the extent of insolvency) or the discharge is of qualified farm indebtedness, *I.R.C. section 108(a)* will permit the taxpayer to exclude the discharge income generated by the forgiveness of the \$1,000 principal amount. With respect to the \$200 of interest, the taxpayer first applies *I.R.C. section 111(a)* to determine whether any of the \$200 of interest "recovered" upon cancellation in 1993 can be excluded because the deduction did not reduce the amount of tax in 1992. To the extent *I.R.C. section 111* does not provide an exclusion, the taxpayer can find relief under *I.R.C. section 108* if the taxpayer qualifies under *I.R.C. section 108(a)*. n337 However, to the extent the \$200 interest deduction (1) created a tax benefit in the earlier year and (2) exceeds the amount excluded under *I.R.C. section 108(a)*, such excess will be recaptured as tax benefit income in 1993. n338

The question of the interplay between the tax benefit rule and the discharge of indebtedness rules also arises in the context of the disposition of property in satisfaction of a debt. n339 In *Allan v. Commissioner*, n340 upon the default of the debtor, the mortgagee paid the taxes on the mortgaged property and added both those taxes and accrued but unpaid interest to the principal of the nonrecourse debt. The debtor, an accrual method taxpayer, nonetheless continued to deduct the taxes and interest as they accrued. When the debtor transferred the collateral back to the mortgagee by deed in lieu of foreclosure, the IRS argued that, under the tax benefit rule, the advances made for taxes and interest should be separately "recaptured" by the debtor as ordinary income and not as part of the amount realized on the transfer. The Court of Appeals for the Eighth Circuit held that the amount of interest and taxes advanced by the mortgagee constituted a true loan that the mortgagee added to principal under the terms of the original debt instrument. Relying on *Tufts*, the court concluded that such amounts were properly included as part of the amount realized on the transfer. n341 As a result, although the debtor had previously claimed deductions for taxes and interest, none of the gain on the sale was recharacterized under the tax benefit rule as ordinary income. If applicable at all, the tax benefit rule should only apply to the items the taxpayer deducted in previous years. n342

[e] Purchase Price Adjustment

[i] Statutory Rule

I.R.C. section 108(e)(5) provides that, in certain instances, the reduction of a purchase money debt will be treated as a purchase price adjustment. In such event, the basis of the property will be reduced without application of the exclusion, attribute reduction and special gain recapture rules of *I.R.C. section 108*. Congress enacted this provision to eliminate disagreements between the IRS and the debtor regarding whether a particular debt reduction should be treated as discharge of indebtedness income or as a true purchase price adjustment. n343 In order to qualify, (1) the debt must be a purchase money debt owed by the purchaser of the property to the seller of the property; n344 (2) the reduction must not occur in a title 11 case or when the purchaser is insolvent; n345 and (3) the amount of the reduction must otherwise qualify as discharge of indebtedness income realized by the purchaser. n346 *I.R.C. section 108(e)(5)* does not require the taxpayer to make an election in order to qualify. n347 As a practical matter, the requirements of solvency and privity of the seller and buyer in *I.R.C. section 108(e)(5)* significantly limit the scope of the statutory rule. n348

Example 7:

Aaron purchases nondepreciable property from Tyler for \$100 cash and a \$1,000 promissory note. Subsequently, Tyler agrees to reduce the note from \$1,000 to \$800. At the time of the reduction, Aaron was neither insolvent nor in a title 11 case and, but for *I.R.C. section 108(e)(5)*, the taxpayer would have realized \$200 of discharge of indebtedness income. Under these circumstances, *I.R.C. section 108(e)(5)* applies and the reduction will be treated as a purchase price adjustment and not as discharge income. n349 Aaron will reduce the basis from \$1,100 to \$900.

The language of *I.R.C. section 108(e)(5)* raises several points. For example, *I.R.C. section 108(e)(5)* will apply only if the seller and buyer have retained the same position *vis-a-vis* each other (that is, the seller has not assigned the debt to a third party and the buyer has not transferred the property to a third party). n350 Under facts indicating that an *I.R.C. Section 351* exchange was part of an integrated transaction, the IRS has privately ruled that the transferee in an *I.R.C. section 351* exchange would be treated as the buyer of the property for purposes of *I.R.C. section 108(e)(5)*. n351 Also, this provision will not apply if the debt is reduced other than by a direct agreement between the seller and the buyer, such as by the running of the statute of limitations. n352 As a practical matter, it may be helpful to have a written agreement or other written correspondence signed by the seller setting forth the terms and amount of the reduction of the debt and specifically identifying the property to which the reduction relates. Unlike the other basis reduction rules, under which the reduction in basis will not be treated as a "disposition" for tax purposes, a purchase price adjustment will trigger the recapture of investment tax credit. n353

It is unclear whether solvent partners of a partnership that is insolvent or in a title 11 case are individually eligible for the benefits of *I.R.C. section 108(e)(5)* with respect to the reduction of a partnership purchase money debt. This issue is significant because if *I.R.C. section 108(e)(5)* applies at the partnership level, then the partnership will not realize discharge of indebtedness income. However, the reduction in the purchase money debt will trigger a deemed distribution to the partners under *I.R.C. sections 752(b)* and 731. In contrast, if *I.R.C. section 108(e)(5)* applies at the partner level, then the partners could argue that *I.R.C. section 108(e)(5)* prevents recognition of the deemed distribution under *I.R.C. sections 752(b)* and 731.

I.R.C. section 108(d)(6), which provides that subsections (a), (b) and (g) are applied at the partner level, creates an inference that the other provisions of *I.R.C. section 108* are to be applied at the partnership level. The IRS has issued a Technical Advice Memorandum that concludes, in effect, that *I.R.C. section 108(e)(5)* applies at the partnership level. n354 A general partnership purchased an office building under an installment contract with the seller. The contract provided that the partnership could, by paying the seller a certain sum, reduce the principal amount owed under the contract to an amount equal to what the seller owed on two mortgage notes secured by the building. The partnership took advantage of this opportunity and treated the reduction in its debt as a purchase price adjustment under *I.R.C. section 108(e)(5)*. As a result of an audit of the partnership return, an IRS agent requested technical advice on whether the transaction was a discharge of partnership indebtedness covered by *I.R.C. section 108(d)(6)*, requiring application of *I.R.C. section 108(a)* and exclusion of gross income at the partner level.

The Technical Advice Memorandum discusses both *I.R.C. section 108(d)(6)* and *I.R.C. section 108(e)(5)*, noting that different purposes motivated Congress to enact those two sections. n355 *I.R.C. section 108(d)(6)* addresses the problem of conversion of ordinary discharge of indebtedness income into capital gain. n356 *I.R.C. section 108(e)(5)* addresses the problem of when a purchase price adjustment will produce discharge of indebtedness income. The memorandum concludes that the transaction described was a reduction of purchase price covered by *I.R.C. section 108(e)(5)*. n357 As a result, the partnership did not realize discharge of indebtedness income. Because no discharge income was realized, the memorandum concludes that there was no need to apply *I.R.C. section 108(d)(6)*.

Application of the threshold requirements of *I.R.C. section 108(e)(5)* at the partnership level produces anomalous results. By providing that *I.R.C. section 108(e)(5)* will not apply if the debtor is either in a title 11 case or insolvent, Congress expressed a preference that the general rules of *I.R.C. section 108(a)* should prevail over the purchase price

reduction rule. n358 To remedy this problem, the IRS recently adopted an administrative policy to the effect that it will not challenge the application of *I.R.C. section 108(e)(5)* to a debtor partnership that is insolvent or in a title 11 case. n359

[iii] Judicial Purchase Price Adjustment

It is apparent from the legislative history that Congress did not intend to overrule prior case law and, therefore, did not enact *I.R.C. section 108(e)(5)* as the exclusive provision under which a debt reduction can be treated as a purchase price adjustment. n360 This intent is evidenced by the statement that the statutory rule was intended to help debtors by eliminating "disagreements between the [IRS] 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." n361 In addition, with respect to the basis reduction rules, the Senate Report provides that

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." n362

In dictum, one court applied the judicial purchase price exception after determining that the taxpayer failed to meet the requirements of *I.R.C. section 108(e)(5)*, n363 and the IRS apparently concurs with this analysis. n364

Early on, the courts developed a number of exceptions to the general rule that a reduction of indebtedness results in taxable income. n365 One of these exceptions is that the reduction of a purchase money debt will be treated as a non-taxable reduction in the purchase price of the property acquired. n366 For example, in *Hirsch v. Commissioner*, n367 the taxpayer purchased real estate in 1928 for \$29,000, paying \$10,000 cash and assuming a mortgage of \$19,000. In 1936, the outstanding mortgage balance was \$15,000 but the value of the real estate had declined to \$8,000. The taxpayer offered to convey the property to the mortgagee in full satisfaction of the debt. The creditor refused, but agreed to take \$8,000 cash in full payment of the \$15,000 mortgage. The court held that the taxpayer did not realize \$7,000 of discharge income because the taxpayer "received nothing of exchangeable value." n368 Instead, the debt reduction "was in its essence a reduction in purchase price from \$29,000 to \$22,000." n369 The court reasoned that, because the taxpayer still owned the property, the taxpayer's ultimate gain or loss could not (and should not) be determined until the property was sold. In short, "credits upon the cost of the investment do not become gain until we find that what is realized upon sale exceeds the total cost, after deducting such voluntary [purchase price] reductions." n370

The purchase price exception has been applied to indebtedness assumed by the purchaser n371 as well as seller financing. n372 The exception should apply to all types of property acquired, including real estate, n373 stock or securities n374 and partnership interests. n375 Further, it applies without regard to the purchaser-debtor's financial status, that is, even if the purchaser is solvent. n376 The exception can be based upon disagreements arising out of the purchase transaction, such as alleged fraudulent misrepresentations that induced the purchaser to buy the property, n377 or upon the subsequent decline in value of the property. n378 The purchase money indebtedness must relate to and be secured by the purchased property, so that the property could not be sold without being encumbered by the indebtedness. n379

It is unclear whether the judicial purchase money debt rules apply to a reduction of a construction loan. Arguably, if a taxpayer borrows money to construct improvements, and the construction lender subsequently agrees to reduce the loan principal, the exception should apply. n380

If the debtor "buys" the purchase money note from the seller at a discount because of a decline in value of the note, the exception has been held inapplicable because the discount had nothing to do with the purchase price or value of the property acquired. n381 Thus, the exception will not apply when the collateral retained by the debtor has a value equal to or in excess of the indebtedness. n382 In effect, the debt can be reduced to an amount equal to the fair market value

of the collateral, but not below it. Finally, the exception will not apply when there is no evidence that the parties intended to reduce the purchase price. n383

[iii] Mechanics of a Price Adjustment

Although there are many cases that discuss the purchase price adjustment rule, there is surprisingly little authority on how the adjustment is actually made. The most reasonable operating rules are as follows. n384 The adjustment should only be made in the asset (or assets) acquired in the transaction in which the purchase money indebtedness was incurred. n385 The adjustment should be made in the purchaser's taxable year in which there is sufficient evidence indicating an agreement between the purchaser and seller to reduce the purchase price. If the purchase price reduction occurs in the purchaser's taxable year subsequent to the year of purchase, because of the annual tax accounting principle, prior taxable years should not be adjusted.

The amount of the adjustment is applied to reduce the adjusted tax basis (the unadjusted original tax basis less the cost recovery allowance, depreciation or amortization previously allowed or allowable in prior taxable years) of the applicable asset(s) as of the first day of the purchaser's taxable year. The purchaser then determines the amount of cost recovery, depreciation or amortization in accordance with the redetermined adjusted tax basis for the subject (and subsequent) taxable year. n386 The adjusted tax basis should not be reduced below zero. n387 Any excess should be realized by the purchaser as discharge of indebtedness income. n388

[f] Cancellation of Amounts That Would Have Been Deductible

A taxpayer will not realize discharge income to the extent that, had the taxpayer paid the debt, the taxpayer would have been entitled to a deduction. n389 For example, if a cash basis taxpayer engaged in a trade or business owes Landlord \$1,000 for rent and Landlord forgives the debt, the taxpayer will not realize discharge of indebtedness income. The reason, of course, is that a formal application of the federal income tax rules would produce a "wash" due to the deductibility of the payment. n390 This provision may be beneficial to a cash basis business debtor such as a service-provider with a significant number of trade creditors if the payment of those trade debts would have been deductible under *I.R.C. section 162*. n391 A non-business debtor would look to *I.R.C. section 212* for qualification under this exception. An accrual method taxpayer that had not been entitled to a deduction because the required "economic performance" had not yet occurred, n392 should also be entitled to the benefits of *I.R.C. section 108(e)(2)*. The fact that an item is otherwise deductible but may be subject to a timing delay, such as by reason of the passive activity loss rules under *I.R.C. section 469*, should not affect the application of *I.R.C. section 108(e)(2)*.

The interaction between *I.R.C. sections 108(e)(2)* and *163(d)* is unclear. *I.R.C. section 163(d)* limits the deduction of "investment interest" n393 to the amount of a taxpayer's "net investment income" n394 for the taxable year. If a cash method taxpayer obtains a discharge of accrued but unpaid interest incurred with respect to property held for investment, and thus subject to *I.R.C. section 163(d)*, does the discharge also generate "investment income" within the meaning of *I.R.C. section 163(d)(4)(B)*? The answer should be yes, so that *I.R.C. section 163(d)* does not create an unreasonable and unintended limit on the application of *I.R.C. section 108(e)(2)*. Thus, the taxpayer will have "investment income" equal to the amount of "investment interest," and, had the taxpayer been able to pay the interest, *I.R.C. section 163(d)* would not have limited the interest deduction.

It is similarly unclear whether *I.R.C. section 108(e)(2)* applies to a taxpayer that receives a discharge from an obligation to pay "personal interest" covered by *I.R.C. section 163(h)*. There appear to be two ways to analyze this question: (1) would the taxpayer be able to deduct the interest if the taxpayer had paid the interest when due; or (2) would the taxpayer be able to deduct the interest if the taxpayer had paid the interest in the year of the discharge. The second approach is more consistent with tax accounting principles because it respects the integrity of each taxable year. If a cash method taxpayer did not pay the "personal interest" due in a year in which it would have been fully deductible but instead actually paid the interest in a year in which *I.R.C. section 163(h)* denied some or all of the deduction, the

taxpayer would be subject to the law in effect in the year of payment. Therefore, a taxpayer should not obtain any more benefit under *I.R.C. section 108(e)(2)* than would be available if the taxpayer paid the interest in the year of the discharge.

[g] Disposition of an Entire Interest in a Passive Activity

When a taxpayer disposes of an entire interest in a passive activity, n395 *I.R.C. section 469(g)(1)(A)* provides that losses previously generated in that activity are no longer suspended under *I.R.C. section 469*. n396 If the disposition of an entire interest in a passive activity involves discharge of indebtedness, the interaction of *I.R.C. sections 108(b)* and *469(g)(1)* becomes important. Suppose Owner owns rental real estate subject to recourse debt of \$25,000, with an adjusted basis of \$20,000 and a fair market value of \$10,000. The rental real estate is *I.R.C. section 1231* property, and the rental is a passive activity within the meaning of *I.R.C. section 469*. Owner transfers the real estate to Lender in full satisfaction of Owner's debt to Lender. n397 Owner is insolvent within the meaning of *I.R.C. section 108(a)(1)(B)* and (d)(3) because Owner's total liabilities exceed the fair market value of Owner's assets by \$100,000 immediately before the transfer. What are Owner's income tax consequences as a result of the transfer?

The Treasury Regulations provide that Owner must bifurcate the transaction. n398 For purposes of computing gain or loss under *I.R.C. section 1001* on the disposition of the property, Owner disregards the discharge of indebtedness income generated by the transaction. n399 Owner's amount realized is \$10,000, Owner's adjusted basis is \$20,000, so Owner has a \$10,000 loss as a result of the transfer to Lender. n400 Owner also has \$15,000 of discharge of indebtedness income (\$25,000 (discharged debt)--\$10,000 (fair market value of property)). Normally, Owner would exclude the \$15,000 under *I.R.C. section 108(a)(1)(B)* and reduce tax attributes as required by *I.R.C. section 108(b)*. However, because *I.R.C. section 469* applied to the rental activity, does *I.R.C. section 469(g)(1)(A)* override *I.R.C. section 108* and require Owner to net the \$15,000 discharge income with the \$10,000 loss?

The threshold question is whether *I.R.C. section 469(g)(1)(A)* applies to a disposition that generates discharge of indebtedness income to which *I.R.C. section 108* would ordinarily apply. The question arises because *I.R.C. section 469(g)(1)(A)* provides that *I.R.C. section 469(g)* will not apply unless the taxpayer recognizes *all* gain or loss realized on the disposition of the interest. The legislative history of that provision explains that: n401

The scope of a disposition triggering suspended losses under the passive loss rule includes an abandonment, constituting a fully taxable event under present law, of the taxpayer's entire interest in a passive activity. Thus, for example, if the taxpayer owns rental property which he abandons in a taxable event which would give rise to a deduction under section 165(a) of present law, then the abandonment constitutes a taxable disposition that triggers the recognition of suspended losses under the passive loss rule.

Thus, ordinarily, a disposition of the type described in the example would be a "disposition" for purposes of *I.R.C. section 469(g)(1)(A)*. However, if *I.R.C. section 108(a)(1)(B)* applies, Owner cannot recognize the \$15,000 of discharge income generated by the transaction, and the disposition may not be "a fully taxable event." The resolution of this problem lies in understanding the purpose of *I.R.C. section 469(g)(1)(A)*. The disposition rule frees suspended losses because the disposition of an entire interest in a passive activity permits determination of actual economic gain or loss on an investment. n402 Owner's transfer of the property to Lender permits determination of Owner's actual economic gain or loss on the investment in the rental property. Therefore, the IRS should treat Owner's transfer of the property to Lender as a disposition for purposes of *I.R.C. section 469(g)(1)(A)*.

Assuming *I.R.C. section 469(g)(1)(A)* applies to the transfer by Owner to Lender, the next question is whether the \$15,000 of discharge income is "net income or gain" from the passive rental activity within the meaning of *I.R.C. section 469(g)(1)(A)(ii)*. If so, Owner must net the \$15,000 against the \$10,000 loss, after which *I.R.C. section 108* presumably would require exclusion of the remaining \$5,000 of discharge income. Although the operation of the rental

activity did not generate the \$15,000, that amount is, in a sense, tied to the property because the property is security for Lender's loan to Owner. In its discussion of *I.R.C. section 469(g)*, the Senate Finance Committee Report states that, generally, gain realized on the transfer of an interest in a passive activity is treated as passive. n403 If the report is referring to gain computed under *I.R.C. section 1001*, discharge income would not be "gain" within the meaning of the language of the report. n404 This result appears correct as a matter of statutory interpretation because Congress has provided a set of rules for treatment of discharge income in *I.R.C. section 108*. There is no indication that Congress intended that *I.R.C. section 469* should override other *I.R.C.* sections and impose special treatment for a person whose discharge income arose in connection with the disposition of an interest in a passive activity. Further, unlike income or gain produced by the passive activity, discharge income has no corresponding deductions with which it ought to be matched. Thus, to the extent Congress intended the passive activity loss rules to address the problem of mismatching losses and income, treating discharge income as outside the scope of *I.R.C. section 469(g)(1)(A)* is proper.

[h] Discharge Income Realized by Corporations and the Alternative Minimum Tax

Corporations are subject to a comprehensive alternative minimum tax ("AMT"). AMT liability generally equals 20% of the corporation's alternative minimum taxable income ("AMTI") n405 and is payable to the extent it exceeds the regular tax for the taxable year. n406 AMTI is determined by making certain adjustments to the taxpayer's "regular" taxable income and adding the amount of "tax preferences" described in *I.R.C. section 57*. n407 Even if a corporation has net operating loss carryovers, only 90% of AMTI can be offset with such loss carryovers (as computed for purposes of the AMT). n408 Thus, a corporation with substantial net operating loss carryovers will be subject to a 2% tax on AMTI (i.e., AMT at a 20% rate imposed on the 10% of AMTI that cannot be offset with loss carryovers).

One of the adjustments made in determining a corporation's AMTI is an increase based on adjusted current earnings, a concept similar to earnings and profits. For taxable years beginning after 1989, a corporation's AMTI is increased by 75% of the amount, if any, that the adjusted current earnings of the corporation exceed AMTI without taking into account the adjusted current earnings adjustment or the alternative tax net operating loss deduction. n409

For the taxable years beginning before 1990, a corporation that was insolvent or in a title 11 case that realized and excluded discharge income under *I.R.C. section 108* could nonetheless be subject to AMT. Although excluded from income for the "regular" tax, discharge income increased "book income" thereby increasing its AMTI. n410 Congress subsequently amended *I.R.C. section 56* to eliminate this unnecessary trap. Specifically, any amount excluded from income under *I.R.C. section 108* (or the corresponding provisions of prior law) is not taken into account in determining a corporation's adjusted current earnings. n411 The committee report, which refers to this amendment as a "technical change," explains: "The bill provides that the ACE adjustment does not apply to amounts excluded from income under section 108 (or the corresponding provisions of prior law including the Bankruptcy Act and case law)." n412 Presumably, this means that income excluded under one of the surviving judicial doctrines, such as the purchase price adjustment n413 and stock-for-debt exception as it existed for pre-1995 transactions, n414 will also not be taken into account in determining adjusted current earnings.

[i] Discharge Income Realized by REITs

Real Estate Investment Trusts (REITs) permit investors to own professionally-managed, income producing real estate through companies that are similar to mutual funds. As such, REITs are subject to special qualification rules of formation and operation which, if met, permit the REIT to avoid corporate-level tax by distributing at least ninety percent of its taxable income as a deductible dividend to its shareholders. n415

There are a few special rules applicable to REITs in the event it realizes discharge income. *I.R.C. Section 108(e)(9)* provides that any amount included in gross income by reason of a discharge of indebtedness will not be taken into account for purposes of the REIT income and asset tests under *I.R.C. Section 856*. n416 Thus, the realization of ordinary discharge income by a REIT will not cause it to be disqualified. In addition, the REIT rules provide that, generally,

ordinary discharge income is an item of "excess noncash income" which will not be counted towards the mandatory ninety percent distribution requirement. n417 However, if the amount of discharge income is not distributed, it will be taxable to the REIT at corporate rates. n418

FOOTNOTES:

(n1)Footnote 1. *I.R.C. § 61(a)(12)*.

(n2)Footnote 2. For a detailed discussion of discharge of indebtedness issues, *see* Report of the Section 108 Real Estate and Partnership Task Force, *46 Tax Law. 209 (Fall 1992)* ("Section 108 Task Force Report-Part I") and *46 Tax Law. 397 (Winter 1993)* ("Section 108 Task Force Report-Part II").

(n3)Footnote 3. Prior to revision, *I.R.C. § 108* provided as follows:

§ 108 Income from discharge of indebtedness

No amount shall be included in gross income by reason of the discharge, in whole or in part, within the taxable year, of any indebtedness for which the taxpayer is liable, or subject to which the taxpayer holds property, if--

(1) the indebtedness was incurred or assumed--

(a) by a corporation, or

(b) by an individual in connection with property used in his trade or business, and

(2) such taxpayer makes and files a consent to the regulations prescribed under section 1017 (relating to adjustment of basis) then in effect at such time and in such manner as the Secretary by regulations prescribes. In such case, the amount of any income of such taxpayer attributable to any unamortized premium (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be included in gross income, and the amount of the deduction attributable to any unamortized discount (computed as of the first day of the taxable year in which such discharge occurred) with respect to such indebtedness shall not be allowed as a deduction.

(n4)Footnote 4. *Id.* Treas. Reg. § 1.108(a)-1(a); S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 8-9 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n5)Footnote 5. Prior to revision, *I.R.C. § 1017* provided as follows:

§ 107 Discharge of indebtedness

Where any amount is excluded from gross income under section 108 (relating to income from discharge of indebtedness) on account of the discharge of indebtedness the whole or a part of the amount so excluded from gross income shall be applied in reduction of the basis of any property held (whether before or after the time of the discharge) by the taxpayer during any portion of the taxable year in which such discharge occurred. The amount to be so applied (not in excess of the amount so excluded from gross income, reduced by the amount of any deduction disallowed under section 108) and the particular properties to which the reduction shall be allocated, shall be determined under regulations (prescribed by the Secretary) in effect at the time of the filing of the consent by the taxpayer referred to in

section 108. The reduction shall be made as of the first day of the taxable year in which the discharge occurred, except in the case of property not held by the taxpayer on such first day, in which case it shall take effect as of the time the holding of the taxpayer began.

(n6)Footnote 6. *Rev. Rul. 58-600, 1958-2 C.B. 29* .

(n7)Footnote 7. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 10 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised). The Second Circuit recently reviewed the history of the insolvency exception and concluded as follows:

Given the discredited rationales of *Kerbaugh-Empire* and *Kirby Lumber*, it is no surprise that they have left as their heritage the similarly flawed insolvency exception. Drawing heavily on the concepts of taxpayer loss and encumbered assets, the exception subjects to taxation only the portion of cancelled debt that renders a previously insolvent debtor solvent. *See Estate of Delman v. Commissioner, 73 T.C. 15, 32 (1979)* . As in *Kirby Lumber*, therefore, taxable gain from a cancelled debt turns not on whether borrowed funds were excluded from gross income when received but on the value of the debtor's remaining assets--a dubious standard, to say the least.

Estate of Newman v. Commissioner, 934 F.2d 426, 432 (2d Cir. 1991) .

(n8)Footnote 8. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 8 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised). For a discussion of *Kirby Lumber*, *see P TX6.02[2] supra*.

(n9)Footnote 9. *Fifth Avenue-Fourteenth Street Corp. v. Commissioner, 147 F.2d 453, 457 (2d Cir. 1944)* ; *Dallas Transfer & Terminal Warehouse Co. v. Commissioner, 70 F.2d 95, 96 (5th Cir. 1934)* ; *Astoria Marine Constr. Co. v. Commissioner, 12 T.C. 795 (1949)* ; *Main Properties, Inc. v. Commissioner, 4 T.C. 364, 384-85 (1944)* , *acq.*, 1945 C.B. 5 ; *Quinn v. Commissioner, 31 B.T.A. 142, 145 (1934)* ; *Rev. Rul. 58-600, 1958-2 C.B. 29* ; *Tech. Adv. Mem. 8348001 (Aug. 18, 1983)* .

(n10)Footnote 10. *See Haden Co. v. Commissioner, 118 F.2d 285 (5th Cir. 1941)* ; *Estate of Delman v. Commissioner, 73 T.C. 15, 32 (1979)* ; *Conestoga Transp. Co. v. Commissioner, 17 T.C. 506, 513 (1951)* , *acq.*, 1952-1 C.B. 2 ; *Texas Gas Distrib. Co. v. Commissioner, 3 T.C. 57, 61-62 (1944)* , *acq.*, 1944 C.B. 27 ; *Lakeland Grocery Co. v. Commissioner, 36 B.T.A. 289 (1937)* ; *Schrott v. Commissioner, 57 T.C.M. (CCH) 981, 989 (1989)* .

(n11)Footnote 11. *Estate of Newman v. Commissioner, 934 F.2d 426 (2d Cir. 1991)* . *But see Gershkowitz v. Commissioner, 88 T.C. 984 (1987)* (same facts as *Estate of Newman*); *Babin v. Commissioner, 64 T.C.M. (CCH) 1357 (1992)* , *aff'd*, 23 F.3d 1032 (6th Cir. 1994) .

(n12)Footnote 12. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 9 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. 5(b)(ii) (Matthew Bender 15th Edition Revised). The basis of the debtor's property was adjusted for the amount of indebtedness canceled under Treas. Reg. §§ 1.1016-7 and -8.

(n13)Footnote 13. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 9 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised). The basis of the debtor's property was adjusted for the amount of indebtedness canceled under Treas. Reg. §§ 1.1016-7 and -8.

(n14)Footnote 14. *See Bankruptcy Reform Act of 1978, Pub. L. No. 95-598, 92 Stat. 2549 (1978)*. In Pub. L. No. 95-598, Congress repealed the provisions of the Bankruptcy Act that governed the federal income tax consequences of the realization of discharge of indebtedness income in a bankruptcy case, effective for cases instituted on or after October 1, 1979. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 9 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n15)Footnote 15. Pub. L. No. 96-589, 94 Stat. 3389 (1980). The statutory amendments were generally effective

for title 11 cases commencing and transactions occurring after December 31, 1980. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 22-23 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n16)Footnote 16. Division A, Pub. L. No. 98-369, 98 Stat. 494 (1984).

(n17)Footnote 17. Pub. L. No. 99-514, 100 Stat. 2085 (1986).

(n18)Footnote 18. Pub. L. No. 100-647, 102 Stat. 3342 (1988) ["TAMRA"].

(n19)Footnote 19. Pub. L. No. 101-508, 104 Stat. 1388 (1990).

(n20)Footnote 20. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 9 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n21)Footnote 21. The Bankruptcy Tax Act of 1980: Hearing Before the Subcommittee on Select Revenue Measures of the House Ways and Means Committee, Statement of Daniel I. Halperin, Deputy Assistant Secretary of the Treasury for Tax Legislation, 96th Cong., 1st Sess. 3 (Sept. 27, 1979). Mr. Halperin stated that:

We are sympathetic to the basic policy of bankruptcy and would not want to discourage creditors from forgiving part of a debtor's debts by creating a tax liability that might be collectible before the amounts owing to forgiving creditors. Accordingly, we agree with the position taken in [the Bankruptcy Tax Act of 1980] that no taxpayer in bankruptcy, and no taxpayer who is insolvent after a debt is forgiven, should incur a tax liability as a result of forgiveness of indebtedness.

Id at 8 .

(n22)Footnote 22. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 10 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n23)Footnote 23. *I.R.C. § 1017(d)*. See P TX6.03[4][f] *infra*.

(n24)Footnote 24. *I.R.C. § 108(a)(1)*. Tax exemption and deferral provisions are construed narrowly by the courts. *United States v. Centennial Savings Bank FSB*, 499 U.S. 573, 111 S. Ct. 1512, 1519, 113 L. Ed. 2d 608, 621 (1991) .

(n25)Footnote 25. *I.R.C. § 1398*.

(n26)Footnote 26. See, e.g., *Tech Adv. Mem. 8348001* (Aug. 18, 1983) (applying pre-1981 law).

(n27)Footnote 27. *I.R.C. § 108(d)(7)*. A "corporation" for federal tax purposes is a business entity described in *Treas. Reg. § 301.7701-2* or a business entity that elects to be treated as a corporation under the "check-the-box" regulations. *Treas. Reg. § 301.7701-3*. See P TX6.03[5][c] *infra*.

(n28)Footnote 28. *I.R.C. § 108(d)(6)*. A "partnership" for federal tax purposes is a business entity (including a limited liability company) that is not described as a corporation and has at least two members. *Treas. Reg. §§ 301.7701-2(c), - 3(b)(1)*. See P TX6.03[5][b] *infra*.

(n29)Footnote 28a. *Treas. Reg. §§ 301.7701-1, -2 and -3, 61 Fed. Reg. 66584* (Dec. 18, 1996) .

(n30)Footnote 28b. *Treas. Reg. § 301.7701-2(a), 61 Fed. Reg. 66584* (Dec. 18, 1996) .

(n31)Footnote 28c. See *I.R.C. § 108(d)(2)*.

(n32)Footnote 29. See *Gitlitz et ux. v. Commissioner*, 531 U.S. 206, 121 S. Ct. 701, 148 L. Ed. 2d 613 (2001) (exclusion does not alter the character of cancellation of debt income as an item of income). The rules governing the determination of when the discharge of a debt produces income are not set forth in the statute. For a discussion of how the courts have made this determination, see P TX6.02[3] *supra*.

(n33)Footnote 30. *Gehl v. Commissioner*, 102 T.C. 784 (1994), *aff'd in unpublished opinion*, 50 F.3d 12 (8th Cir. 1995); *Estate of Delman v. Commissioner*, 73 T.C. 15, 39 (1979); *Correra v. Commissioner*, 74 T.C.M. (CCH) 273 (1997); *Slavin v. Commissioner*, 57 T.C.M. (C.C.H.) 343, 347-48; Tech. Adv. Mem. 96-19-002 (Jan. 31, 1996) (individual partner's discharge of partnership debt is treated as gain under I.R.C. §§ 752 and 731); 93-02-001 (August 31, 1992). For a discussion of the distinction between discharge income and gain, see P TX6.02[6] *supra*.

(n34)Footnote 31. *Treas. Reg. § 1.108-2(a)*; *Tech. Adv. Mem. 9541006* (July 5, 1995).

(n35)Footnote 32. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 20 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n36)Footnote 33. Indeed, one of the basic tenets of statutory construction is that statutory language should be ascribed its plain, obvious and ordinary meaning. See, e.g., *Old Colony R.R. Co. v. Commissioner*, 284 U.S. 552, 560, 52 S. Ct. 211, 213, 76 L. Ed. 484, 489 (1931).

(n37)Footnote 34. *Zarin v. Commissioner*, 916 F.2d 110, 113 (3d Cir. 1990).

(n38)Footnote 35. *Zarin v. Commissioner*, 916 F.2d 110, 113 (3d Cir. 1990).

(n39)Footnote 36. *Crane v. Commissioner*, 331 U.S. 1, 67 S. Ct. 1047, 91 L. Ed. 1301 (1947); see also I.R.C. § 752(c). In *Zarin v. Commissioner*, 916 F.2d 110, 113 (3d Cir. 1990), the court held that gambling chips were not "property" for purposes of subsection (B) but were merely an accounting mechanism to evidence debt.

(n40)Footnote 37. *Commissioner v. Tufts*, 461 U.S. 300, 307, 103 S. Ct. 1826, 1831, 75 L. Ed. 2d 863, 870 (1983); *Crane v. Commissioner*, 331 U.S. 1, 67 S. Ct. 1047, 91 L. Ed. 1301 (1947). For a discussion of the treatment of nonrecourse debt, see Shaviro, *Risk and Accrual: The Tax Treatment of Nonrecourse Debt*, 44 Tax L. Rev. 401 (1989).

(n41)Footnote 38. *Commissioner v. Tufts*, 461 U.S. 300, 103 S. Ct. 1826, 75 L. Ed. 2d 863 (1983); *Treas. Reg. §§ 1.1001-2(a) and (c) ex. 7*. For a discussion of this issue, see P TX6.02[6] *supra*.

(n42)Footnote 39. See P TX6.02[6][a] *supra*.

(n43)Footnote 40. *Twenty Mile Joint Venture, Ltd. v. Commissioner*, 200 F.3d 1268 (10th Cir. 1999) (reduction of nonrecourse loan and discounted cash payment triggers cancellation of debt income); *Estate of Newman v. Commissioner*, 934 F.2d 426, 431 (2d Cir. 1991) ("Indeed, Section 61(a)(12) applies to the discharge of a nonrecourse debt as well, precisely because the crucial facts--that the debtor excludes the borrowed funds from income when received and ultimately pays less than the excluded amount--are the same whether or not he has personal liability"); *Gershkowitz v. Commissioner*, 88 T.C. 984, 1004-14 (1987); *Estate of Delman v. Commissioner*, 73 T.C. 15, 38 n. 16 (1979); 1991-1 C.B. 19, Rev. Rul. 91-31, distinguished by Rev. Rul. 92-53, 1992-2 C.B. 48; Priv. Ltr. Rul. 9551036 (Sept. 28, 1995) (taxpayer realizes discharge income "upon the discounted prepayment to a lender of all or a portion of mortgage indebtedness, whether recourse or nonrecourse"). But see, *2925 Briarpark, Ltd. v. Commissioner*, 163 F.3d 313 (5th Cir. 1999) (I.R.C. § 61[a][3] gain realized on transfer of property to third party conditioned upon debt release from bank: transaction was functional equivalent of foreclosure).

(n44)Footnote 41. I.R.C. § 108(a)(1)(A).

(n45)Footnote 42. *I.R.C. § 108(a)(1)(B)*. See *Gehl v. Commissioner*, 102 T.C. 784 (1994) , *aff'd in unpublished opinion*, 95-1 U.S.T.C. P 50,191 (8th Cir. 1995).

(n46)Footnote 43. *I.R.C. § 108(a)(1)(C)*. The special rules applicable to a discharge of qualified farm debt are set forth in *I.R.C. § 108(g)*. See *P TX6.03[3][c][iii]* *infra*.

(n47)Footnote 44. *I.R.C. § 108(a)(1)(D)*. The special rules applicable to a discharge of qualified real property business debt are set forth in *I.R.C. § 108(c)*. See *P TX6.03[3][c][iv]* *infra*.

(n48)Footnote 45. *I.R.C. § 108(a)(2)*.

(n49)Footnote 46. In *Hunt v. Commissioner*, 57 T.C.M. (CCH) 919, 948 (1989) , the Tax Court stated that "Congress intended and we uphold different treatment [under *I.R.C. § 108(a)*] for those taxpayers who actually file a bankruptcy petition under Title 11 and those who do not."

(n50)Footnote 47. H.R. Rep. No. 841, 99th Cong., 2d Sess. II-325 (Sept. 18, 1986).

(n51)Footnote 48. See *P TX6.03[5][f]* *infra*.

(n52)Footnote 49. See *P TX6.03[5][e]* *infra*.

(n53)Footnote 50. See *P TX6.03[5][a]* *infra*.

(n54)Footnote 51. See *Johnson v. Commissioner*, 87 T.C.M. (CCH) 971 (2004) . Interestingly, although *I.R.C. § 108* provides less favorable treatment for taxpayers who are insolvent than it provides for taxpayers who are in a title 11 case, a debtor need not be insolvent to file a voluntary petition under chapter 7 of title 11 of the United States Code. See 2 *Collier on Bankruptcy*, P 109.02 (Matthew Bender 15th Ed. Revised).

(n55)Footnote 52. See *Firsdon v. United States*, 95 F.3d 444 (6th Cir. 1996) .

(n56)Footnote 53. *I.R.C. § 108(d)(2)* (emphasis added). See *Gracia v. Commissioner*, 87 T.C.M. (CCH) 1423 (2004) (where bankruptcy court ordered that general partner of bankruptcy partnership was "subject to the jurisdiction" of the court; held *I.R.C. § 108(a)(1)(A)* applied to partner's discharge); *Lewis v. Commissioner*, 56 T.C.M. (CCH) 1328, 1330-31 (1989) , *aff'd in unpublished opinion*, 928 F.2d 404 (6th Cir. 1991) ; *Yamamoto v. Commissioner*, 60 T.C.M. (CCH) 1050, 1061 (1990) (provision applies to debtor in title 11 case *not* to the debtor of a debtor in a title 11 case); Priv. Ltr. Ruls. 94-09-037 (Dec. 7 1993), holding (8), 92-45-023 (Aug. 7, 1992), holding (6). Interestingly, a "G" reorganization requires that one of the corporate parties to the reorganization must be in a "title 11 or similar case." *I.R.C. § 368(a)(1)(G)*. A title 11 case commences on the filing of a petition for relief and ends when the case is closed under 11 U.S.C. § 350.

(n57)Footnote 54. See *Benton v. Commissioner*, 122 T.C. No. 20 (2004) (debtor discharged at the time of plan confirmation). For the provisions governing discharges in chapter 7 and 11 cases, see 11 U.S.C. §§ 727 (liquidation), 1141 (reorganization). For a discussion of the timing of the realization of discharge income, see *P TX6.02[7][c]* *supra*.

(n58)Footnote 55. See *P TX6.03[2][a]* *supra*.

(n59)Footnote 56. *I.R.C. § 108(a)(3)*. See, e.g., Priv. Ltr. Ruls. 95-41-020 (July 10, 1995)(issue 3) 93-17-019 (Jan. 27, 1993).

(n60)Footnote 57. *I.R.C. § 108(e)(1)*. See *Gitlitz et ux. v. Commissioner*, 531 U.S. 206, 121 S.Ct. 701, 148 L. Ed. 2d 613 (2001) (statute "precludes us from relying on any understanding of the judicial insolvency exception that was not codified in 108").

(n61)Footnote 58. *I.R.C. § 108(d)(3)*. This is a factual question on which the IRS will not issue a ruling. *See, e.g., Priv. Ltr. Rul. 9251023 (Sept. 18, 1992)*.

(n62)Footnote 59. The Bankruptcy Code defines the term "insolvent" as a "financial condition such that the sum of such entity's debts is greater than all of such entity's property, at a fair valuation, exclusive of (i) property transferred, concealed, or removed with intent to hinder, delay or defraud such entity's creditors; and (ii) property that may be exempted from property of the estate under section 522 of this title" Paragraph (A) of definition of "insolvent" in 11 U.S.C. § 101. *I.R.C. Section 108(d)(3)* defines "insolvent" as "the excess of liabilities over the fair market value of assets." The legislative history of the Bankruptcy Tax Act does not indicate that Congress borrowed the bankruptcy definition of "insolvent," but the similarity between the sections is striking.

There are also slight differences in wording between *I.R.C. § 108(d)(1)* and *(d)(3)*. *I.R.C. § 108(a)(1)* refers to gross income generated by "the discharge ... of indebtedness of the taxpayer" *I.R.C. § 108(d)(1)*, in turn, defines "indebtedness of the taxpayer" as "any indebtedness (A) for which the taxpayer is liable, or (B) subject to which the taxpayer holds property." Note that the bankruptcy definition uses the word "debts," while § 108(d)(1) refers to "indebtedness ... for which the taxpayer is liable," and § 108(d)(3) refers to "liabilities." There is no evidence that Congress intended these slight differences to have any legal significance.

(n63)Footnote 60. *I.R.C. § 108(d)(3)*. *See Toberman v. Commissioner*, 294 F.3d 985 (8th Cir. 2002) (insolvency established); *Merkel v. Commissioner*, 109 T.C. 463 (1997), *aff'd*, 192 F.3d 844 (9th Cir. 1999) (taxpayer failed to prove they were insolvent); *Carlson v. Commissioner*, 116 T.C. 87 (2001) (taxpayers failed to establish insolvency because of value of exempt assets); *Miller v. Commissioner*, 91 T.C.M. (CCH) 1267 (2006) (debt being discharged must count as a liability and cannot be ignored as a "contingent liability" under *Merkel*); *Acunicus v. Commissioner*, 83 T.C.M. (CCH) 1122 (2002) (insolvency established); *Traci v. Commissioner*, 64 T.C.M. (CCH) 1515 (1992) (taxpayer established insolvency); *Babin v. Commissioner*, 64 T.C.M. (CCH) 1357 (1992), *aff'd*, 23 F.3d 1032 (6th Cir. 1994) (under pre-1980 law, court engaged in extensive analysis to determine that taxpayer was insolvent); *Slavin v. Commissioner*, 57 T.C.M. (CCH) 343, 348 (1989) (taxpayer presented no proof that he was insolvent immediately before debt discharge); *Priv. Ltr. Rul. 91-21-017 (Feb. 21, 1991)* (estimated life insurance reserves exceeded fair market value of assets: debtor did not become solvent as a result of the discharge).

(n64)Footnote 61. *See, e.g., Schrott v. Commissioner*, 57 T.C.M. (CCH) 981, 991-93 (1989).

(n65)Footnote 62. *See, e.g., Babin v. Commissioner*, 64 T.C.M. (CCH) 1357 (1992), *aff'd*, 23 F.3d 1032 (6th Cir. 1994).

(n66)Footnote 63. *See Merkel v. Commissioner*, 109 T.C. 463, 483 (1997), *aff'd*, 192 F.3d 844 (9th Cir. 1999); (taxpayer "must prove (1) with respect to any obligation claimed to be a liability, that, as of the calculation date, it is more probable than not that he will be called upon to pay that obligation in the amount claimed, and (2) that the total liabilities so proved exceed the fair market value of his assets"); *Conestoga Transp. Co. v. Commissioner*, 17 T.C. 506, 513 (1951), *acq.*, 1952-1 C.B. 2; *Main Properties, Inc. v. Commissioner*, 4 T.C. 364, 376, 383-84 (1944), *acq.*, 1945 C.B. 5; *see also Fifth Avenue-Fourteenth Street Corp. v. Commissioner*, 147 F.2d 453, 455, 458 (2d Cir. 1944). Arguably, the value of a taxpayer's assets for purposes of the *I.R.C. § 108* insolvency test should not include goodwill because the existence of goodwill in the context of a financially troubled debt is problematic at best.

(n67)Footnote 64. *See Babin v. Commissioner*, 64 T.C.M. (CCH) 1357 (1992), *aff'd*, 23 F.3d 1032 (6th Cir. 1994); *Fifth Avenue-Fourteenth Street Corp. v. Commissioner*, 147 F.2d 453, (2d Cir. 1944); *Astoria Marine Constr. Co. v. Commissioner*, 12 T.C. 798, 801 (1949) (testimony accepted that assets were worth only fraction of book value and not more than 75 percent of accounts receivable were collectable); *Main Properties, Inc. v. Commissioner*, 4 T.C. 364, (1944), *acq.*, 1945 C.B. 5.

(n68)Footnote 65. *See Schrott v. Commissioner*, 57 T.C.M. (CCH) 981, 990 (1989).

(n69)Footnote 66. *Conestoga Transp. Co. v. Commissioner*, 17 T.C. 506, 514-15 (1951) , *acq.*, 1952-1 C.B. 2 . See also *VGS Corp. v. Commissioner*, 68 T.C. 563, 591 (1977) ("Going concern value is, in essence, the additional element of value which attaches to property by reason of its existence as an integral part of a going concern.").

(n70)Footnote 67. Treas. Reg. § 1.170A-(1)(c)(2).

(n71)Footnote 68. Treas. Reg. § 20.2031-1(b). See *United States v. Cartwright*, 411 U.S. 546, 93 S. Ct. 1713, 36 L. Ed. 2d 528 (1973) .

(n72)Footnote 69. See *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982) ; *Estate of Newhouse v. Commissioner*, 94 T.C. 193, 218 (1990) , *nonacq.*, 1991-1 C.B. 1 ; *Estate of Andrews v. Commissioner*, 79 T.C. 938 (1982) .

(n73)Footnote 70. *Hamm v. Commissioner*, 325 F.2d 934, 941 (8th Cir. 1963) ; *Newaygo Portland Cement Co. v. Commissioner*, 27 B.T.A. 1097, 1106 (1933) , *aff'd*, 77 F.2d 536, 64 App. D.C. 278 (D.C. Cir. 1935) ; *Deukmejian v. Commissioner*, 41 T.C.M. (CCH) 738, 742 (1981) . See also Rev. Rul. 59-60, 1959-1 C.B. 237 (methods used to value stock of closely held corporations).

(n74)Footnote 71. *Estate of Newhouse v. Commissioner*, 94 T.C. 193, 249 (1990) ; *Cooley v. Commissioner*, 33 T.C. 223, 225 (1959) , *aff'd*, 283 F.2d 945 (2d Cir. 1960) ; Rev. Rul. 85-99, 1985-2 C.B. 83 .

(n75)Footnote 72. *Ward v. Commissioner*, 87 T.C. 78, 104-08 (1986) .

(n76)Footnote 73. *Estate of Watts v. Commissioner*, 823 F.2d 483, 485 (11th Cir. 1987) ; *Harwood v. Commissioner*, 82 T.C. 239 (1980) ; *Knott v. Commissioner*, 54 T.C.M. (CCH) 1249 (1987) ; *Estate of Harrison v. Commissioner*, 52 T.C.M. (CCH) 1306 (1987) .

(n77)Footnote 74. See, e.g., *Davis v. Commissioner*, 69 T.C. 814 (1978) (neither homestead, automobile, clothing, jewelry and insurance policy exempt from claims of creditors under Texas law nor taxpayer's special expertise or skill counted as assets of taxpayer for purposes of determining insolvency); *Cole v. Commissioner*, 42 B.T.A. 1110 (1940) , *nonacq.*, 1941-1 C.B. 13 (same holding); *Marcus Estate v. Commissioner*, 34 T.C.M. (CCH) 38 (1975) (insurance policies payable to a named beneficiary and exempted by New York law from claims of creditors of decedent not counted as assets of decedent's estate for purposes of I.R.C. § 61(a)(12)).

(n78)Footnote 75. See *Cole v. Commissioner*, 42 B.T.A. 1110 (1940) . As discussed at P TX6.02[2][a] *supra*, the "freeing of assets" theory is no longer the test applied to determine whether a taxpayer has realized discharge income under I.R.C. § 61(a)(12).

(n79)Footnote 76. *Babin v. Commissioner*, 64 T.C.M. (CCH) 1357, 1366 (1992) , *aff'd*, 23 F.3d 1032 (6th Cir. 1994) ; *Hunt v. Commissioner*, 57 T.C.M. (CCH) 919, 947-48 (1989) (although the transactions occurred on December 31, 1980, one day prior to the effective date of I.R.C. § 108 as revised by the BTA 1980, the Tax Court cited *Cole v. Commissioner*, 42 B.T.A. 1110, 1113 (1940) for the proposition that, when a taxpayer is not in title 11 case, I.R.C. § 108(d)(3) requires determination of insolvency without regard to assets exempt from creditors under state law); see also *Tech. Adv. Mem. 9130005* (March 29, 1991) (following *Hunt* and applying Alaska law), *revoked by Tech. Adv. Mem. 199935002* (May 3, 1999) (IRS believes exempt assets should be included as assets in measuring insolvency). But see *Field Service Advice 19932019* (May 10, 1999) (in nonbinding, nonprecedential advice, the IRS National Office concluded assets held as tenants by the entirety should be included as assets in measuring insolvency).

(n80)Footnote 76a. *Carlson v. Commissioner*, 116 T.C. 87 (2001) .

(n81)Footnote 77. *Hunt v. Commissioner*, 57 T.C.M. (CCH) 919, 947 (1989) .

(n82)Footnote 78. *Hunt v. Commissioner*, 57 T.C.M. (CCH) 919, 947 (1989) . In *Hunt*, the Tax Court stated:

We believe that, absent the *actual filing* for bankruptcy, Texas law would not allow the [taxpayer] the option of federal bankruptcy exemptions. Since state law controls the determination of insolvency, we concluded ... that the determination of insolvency must be made only excluding those assets exempt from the claims of creditors under Texas law. (Emphasis in original.) *Hunt v. Commissioner*, 57 T.C.M. (CCH) 919, 948 (1989) .

See Vol. 14 Collier on Bankruptcy, Introduction (Matthew Bender 15th Edition Revised) on stacking.

(n83)Footnote 79. *Hunt v. Commissioner*, 57 T.C.M. (CCH) 919, 948 (1989) .

(n84)Footnote 80. *Hunt v. Commissioner*, 57 T.C.M. (CCH) 919, 947-48 (1989) . But see *In re Wommack*, 74 B.R. 638, 640 (N.D. Fla. 1987) (no authority for exclusion of debts due on exempt assets).

(n85)Footnote 81. For an example of the various laws governing the sharing of liabilities under the community property laws, see, e.g., *Ariz. Rev. Stat. Ann. § 25-215*; *Cal. Civ. Code § 5116*; *Tex. Fam. Code Ann. § 5.61*.

(n86)Footnote 82. See, e.g., *Propstra v. United States*, 680 F.2d 1248 (9th Cir. 1982) (valuation of community property interest of decedent for estate tax purposes).

(n87)Footnote 83. The IRS has ruled privately that this result will not change if the husband and wife file a joint federal income tax return for the year of the discharge/insolvency. See *Priv. Ltr. Rul. 8920019 (Feb. 14, 1989)* ("The filing of a joint return, pursuant to [I.R.C. § 6013(b)], does not affect whether a spouse's separate assets will be used to determine the insolvency of the taxpayer.").

(n88)Footnote 84. See Report of the Section 108 Real Estate and Partnership Task Force, 46 *Tax Law.* 209, 239 (Fall 1992) ("Section 108 Task Force Report--Part I").

(n89)Footnote 85. See P TX6.02[2][b] *supra*.

(n90)Footnote 86. See *Tech. Adv. Mem. 8348001 (Aug. 18, 1983)* . For a general discussion of the rules regarding the determination of insolvency under the Bankruptcy Code, see 2 Collier on Bankruptcy, chapter 101 (Matthew Bender 15th Edition Revised).

(n91)Footnote 87. *United States v. Consolidated Edison Co.*, 366 U.S. 380, 81 S. Ct. 1326, 6 L. Ed. 2d 356 (1961) .

(n92)Footnote 88. *United States v. Consolidated Edison Co.*, 366 U.S. 380, 387, 392, 81 S. Ct. 1326, 1331, 1333, 6 L. Ed. 2d 356, 362, 364 .

(n93)Footnote 89. *United States v. Consolidated Edison Co.*, 366 U.S. 380, 390, 81 S. Ct. 1326, 6 L. Ed. 2d 356 (1961) .

(n94)Footnote 90. 11 U.S.C. § 101 (definition of "insolvent"). The term is used to determine whether a transfer constitutes a voidable preference under 11 U.S.C. § 547 and whether a judicial lien can be set aside under 11 U.S.C. § 545.

(n95)Footnote 91. 2 Collier on Bankruptcy, ch. 101 (Matthew Bender 15th Edition Revised).

(n96)Footnote 92. 2 Collier on Bankruptcy, ch. 101 (Matthew Bender 15th Edition Revised).

(n97)Footnote 93. *Treas. Reg. § 1.166-9(e)(2)*; see also *Melvin v. Commissioner*, 894 F.2d 1072 (9th Cir. 1990) (partner was personally liable for partnership loan, but amount "at risk" under I.R.C. § 465 limited to partner's *pro rata* share because of right of contribution from other partners under state law); *Rev. Rul. 84-42*, 1984-1 C.B. 194 (deduction for estate liability limited to amount paid with respect to guaranteed debt less amount of any expected reimbursement).

(n98)Footnote 94. *In the Matter of Xonics Photochemical, Inc.*, 841 F.2d 198, 200, 18 C.B.C. 2d 711 (7th Cir. 1988) ; *Covey v. Commercial Nat'l Bank of Peoria*, 960 F.2d 657 (7th Cir. 1992) (for purposes of determining insolvency under 11 U.S.C. § 548(a)(2), value of contingent liability is amount guarantor must pay times the probability of payment, not limited by the value of the guarantor's assets). *Tech. Adv. Mem. 8348001* , issue 6 (Aug. 18, 1983) (contested estate and income taxes were not counted as "liabilities" in determining insolvency for federal income tax purposes).

(n99)Footnote 94A. *Merkel v. Commissioner*, 109 T.C. 463, 482-483 , *aff'd*, 192 F. 3d 844 (9th Cir. 1999) .

(n100)Footnote 95. Without much discussion, and applying pre-1980 law, the Tax Court selected the third alternative and did not count a taxpayer's nonrecourse note in the insolvency calculation. See *Babin v. Commissioner*, 64 T.C.M. (CCH) 1357, 1366 (1992) , *aff'd*, 23 F.3d 1032 (6th Cir. 1994) ; *Rev. Rul. 92-53*, 1992-2 C.B. 48 .

(n101)Footnote 96. *Commissioner v. Tufts*, 461 U.S. 300, 307, 103 S. Ct. 1826, 1831, 75 L. Ed. 2d 863, 870 (1983) ; see also *Rev. Rul. 91-31*, 1991-1 C.B. 19 (reduction of undersecured third party nonrecourse debt treated as discharge income). This assumes that the nonrecourse debt was recognized as "true debt" for federal income tax purposes at the time the property securing the nonrecourse debt was acquired by the taxpayer. See P TX6.02[2][b] *supra*. See generally Report of the Section 108 Real Estate and Partnership Task Force, 46 Tax Law. 209, 241-47 (Fall 1992) ("Section 108 Task Force Report--Part I").

(n102)Footnote 97. *I.R.C. § 108(d)(1)(B)*.

(n103)Footnote 98. See *Rev. Rul. 92-53*, 1992-2 C.B. 48 . For a critical analysis, see Section 108 Task Force Report--Part I, 46 Tax Law. 209, 241, 47 (Fall 1992).

(n104)Footnote 99. *I.R.C. § 108(g)*. The provision is effective for discharges of indebtedness after April 9, 1986. H.R. Rep. No. 841, 99th Cong., 2d Sess. II-116 (Sept. 18, 1986). It appears that discharges of nonrecourse loans made by the Commodity Credit Corporation in connection with government price support programs for crops (or similar programs) which constitute a sale of farm products, are ineligible for exclusion under *I.R.C. § 108(g)*. Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, 194 n.11 (May 4, 1987).

(n105)Footnote 100. *I.R.C. § 108(g)(2)*. See *Lawinger v. Commissioner*, 103 T.C. 428 (1994) .

(n106)Footnote 101. H.R. Rep. No. 841, 99th Cong., 2d Sess. II-116. The Senate Finance Committee Report provides a more expansive definition: "qualified agricultural indebtedness is defined as debt incurred to finance the production of agricultural products (including timber) or livestock in the United States, or farm business debt secured by farmland or farm machinery and equipment used in agricultural production." S. Rep. No. 313, 99th Cong., 2d Sess. 272 (May 29, 1986).

(n107)Footnote 102. Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, 194 (May 4, 1987). See *Lawinger v. Commissioner*, 103 T.C. 428 (1994) ; *Campbell v. Commissioner*, 81 T.C.M. (CCH) 1241 (2001) (taxpayer did not meet the gross receipts test).

(n108)Footnote 103. *I.R.C. §§ 108(g)(1)(B)*, 49(a)(1)(D)(iv).

(n109)Footnote 104. *I.R.C. § 108(g)(1)(B)*.

(n110)Footnote 105. The term "qualified property" can also apply to certain partnership interests, stock in certain subsidiary corporations and to real property held as inventory which the taxpayer elects to treat as qualified property. *I.R.C. § 1017(b)(4)(C)*.

(n111)Footnote 106. *I.R.C. § 108(g)(3)*. However, the amount of adjusted tax attributes is determined after any attribute reduction required under *I.R.C. § 108(b)* for discharge income excluded under the insolvency exception of *I.R.C. § 108(a)(1)(B)*.

(n112)Footnote 107. Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, 194 (May 4, 1987). Interestingly, in a footnote, the Staff of the Joint Committee stated that "a technical amendment may be necessary to conform the Congress' intent that the relief for solvent farmers be as described above." Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, 194 n.13 (May 4, 1987).

(n113)Footnote 108. *See P TX6.03[3][a][iii][B] supra*.

(n114)Footnote 109. For an example, *see* Report of the Section 108 Real Estate and Partnership Task Force, 46 *Tax Law. 209, 214-215 (Fall 1992)* ("Section 108 Task Force Report--Part I").

(n115)Footnote 110. Pub. L. No. 103-66, § 13150 (1993).

(n116)Footnote 110a. This phrase should read "other than a taxable C Corporation," to permit other pass-thru entities, such as RICs and REITs that hold real estate, to qualify.

(n117)Footnote 111. *I.R.C. § 108(c)(3)*. The definition excludes qualified farm indebtedness. *See Priv. Ltr. Rul. 9840026 (Oct. 2, 1998)*. Taking an asset subject to a nonrecourse liability should also be treated as "assuming" the obligation. *See I.R.C. § 357(d)(1)(B)*.

(n118)Footnote 112. *I.R.C. § 108(c)(4)*. As an aid to understanding this language, virtually the same words appear in *I.R.C. § 144(a)(1)(A)* (definition of "qualified small issue bond").

(n119)Footnote 113. H. Rep. No. 2264, 103d Cong., 1st Sess. 185 (1993).

(n120)Footnote 113a. *See Tech. Adv. Mem. 200014007 (Dec. 13, 1999)* (less rigorous standard applies to pre-1993 debt: *I.R.C. § 108(c)(3)(A)* "in connection with" requirement satisfied if debt is secured by real estate used in a trade or business).

(n121)Footnote 114. *Priv. Ltr. Rul. 9840026 (Oct. 2, 1998)* (partnership debt secured by apartment complex qualified under *I.R.C. § 108(c)*); *Priv. Ltr. Rul. 9426006 (March 25, 1994)*. For example, for purposes of an *I.R.C. § 1031* exchange, real estate has been recognized by the IRS to include both improvements and land. *See Rev. Rul. 72-515, 1972-2C.B. 466*. *See also Treas. Reg. § 1.856-3* (defining "real property" for purposes of REIT qualification under *I.R.C. § 856(c)[5]*).

(n122)Footnote 114a. *I.R.C. § 465(b)(6)*; *Treas. Reg. Sec. 1.856-3(c)*; *I.R.C. § 170(h)(2)*.

(n123)Footnote 114b. In addition, the term "depreciable" as used in *I.R.C. § 108(c)(2)(B)*, is not limited to depreciation under Section 167. "Depreciable property" is defined in Section 1017(b)(3)(B) as "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 would otherwise be allowable for the period immediately following such reduction." (emphasis added). The language of this subparagraph is important since it implies that "depreciable" is not limited to depreciation under Section 167, but includes other forms of basis recovery such as amortization. The fact that

"depreciable" is not limited to basis recovery deductions under Section 167 must mean "depreciable" is any basis recovery deduction--depreciation, amortization, and by extension depletion. Depletion, as provided in *I.R.C. § 611*, is the basis recovery deduction that provides for natural resources and mineral interests. Moreover, the definition of "depreciable" has been restricted to Section 167 in other Treasury regulations. *Treas. Reg. § 1.1250-1(e)*. The absence of such a restriction in Section 1017 or the Section 1017 regulations lends further evidence supporting a broader definition. Applying Section 108(a)(1)(D) to mineral interests makes sense from a policy perspective, since the "cost" of the exclusion is the reduction of future depletion deductions. See *Rev. Rul. 68-226, 1968-1 C.B. 362* (oil and gas leasehold interests are interests in real property); *Priv. Ltr. Rul. 9833005 (May 12, 1998)* (oil and gas leasehold interests treated as real property for purposes of qualification under *I.R.C. § 1038*).

(n124)Footnote 115. See *Fegan v. Commissioner*, 71 T.C. 791, 814 (1979), *aff'd*, 81-1 U.S.T.C. P 9436 (10th Cir. 1981) (taxpayer in trade or business where he leased motel to closely-held corporation); *Curphy v. Commissioner*, 73 T.C. 766 (1980); *Post v. Commissioner*, 26 T.C. 1055 (1956), *acq.*, 1958-1 C.B. 5 (building managed by agent); *Hazard v. Commissioner*, 7 T.C. 372 (1946), *acq.*, 1946-2 C.B. 3 (rental of former residence held to be a trade or business); *Rev. Rul. 76-86, 1976-1 C.B. 37* (prior trade or business requirement was only intended to distinguish from an individual's personal debt--term should not be given "anything but its literal meaning"); *Rev. Rul. 72-205, 1972-1 C.B. 37*; *Tech. Adv. Mem. 2000014007 (Dec. 13, 1999)* ("trade or business" requirement under *I.R.C. § 108(c)* discussed); *Priv. Ltr. Rul. 9840026 (Oct. 2, 1998)* ("trade or business" requirement under *I.R.C. § 108(c)(3)* discussed); *Priv. Ltr. Rul. 9426006 (March 25, 1994)* (factual inquiry into scope of taxpayer's activities in connection with the property). *Priv. Ltr. Rul. 8314021 (Dec. 29, 1982)* (commercial building with offices and stores); *Tech. Adv. Mem. 8221007 (Feb. 18, 1982)* (apartment project); *Priv. Ltr. Rul. 7851138 (Sept. 26, 1978)* (development and operation of commercial and apartment properties). *But see Campbell v. United States*, 813 F.2d 694, 696 (5th Cir. 1987) (holding of farm land for investment where expenses substantially exceeded rental income did not constitute a trade or business).

(n125)Footnote 116. *Treas. Reg. § 1.108-6(a)*, T.D. 8787, 63 Fed. Reg. 56559 (Oct. 22, 1998). See P TX6.02[6][e][iii] *supra*. See also *Treas. Reg. § 1.6050P-1(c)* (Jan. 3, 1996) (for purposes of *I.R.C. § 6050P* reporting of discharge income, "indebtedness" includes interest); *Temp. Treas. Reg. § 1.163-8T(c)(2)(ii)* (under interest allocation regulation, accrued interest is allocated in the same manner as the debt).

(n126)Footnote 117. *I.R.C. §§ 108(c)(3)(C), 108(d)(9)(A)*.

(n127)Footnote 118. *Treas. Reg. § 1.108(c)-1(b)* (Dec. 11, 1996), redesignated *Treas. Reg. § 1.108-6(a)*, T.D. 8787, 63 Fed. Reg. 56559 (Oct. 22, 1998).

(n128)Footnote 119. The IRS revised Form 982 in December 1993 to apply to discharges of qualified real property business indebtedness in tax years beginning before 1994. A new Form 982 was issued in December 1994 for discharges in tax years beginning after 1993 and the form has been frequently revised to reflect changes in the law. See *Announcement 94-11, 1994-4 I.R.B. 44*.

(n129)Footnote 119a. See Form 982.

(n130)Footnote 120. *Treas. Reg. § 1.108-5*, 63 Fed. Reg. 56, 559 (Oct. 22, 1998). The election is revocable only with the consent of the Commissioner. *Treas. Reg. § 1.108-5(c)*. See *Priv. Ltr. Rul. 200712020 (December 18, 2006)* (relief granted because Form 1099-C was mailed to wrong address); *Priv. Ltr. Rul. 9815035 (April 10, 1998)* (relief granted because taxpayer reasonably relied on qualified tax professionals who failed to advise of the election); *Priv. Ltr. Rul. 9738033 (September 19, 1997)* (same); *Priv. Ltr. Rul. 9729034 (July 18, 1997)* (extension of time granted under *Treas. Reg. § 301-9100*); *Priv. Ltr. Rul. 9712007 (March 21, 1997)* (request denied); See also *Officials Discuss New Real Estate Debt Discharge Exclusion*, 60 Tax Notes 1422 (Sept. 13, 1993). See, e.g., *Denman Tire & Rubber Co.*, 192 F.2d 261 (6th Cir. 1951).

(n131)Footnote 121. *I.R.C. § 108(c)(2)(A)*; *Treas. Reg. § 1.108-6*, T.D. 8787, 63 Fed. Reg. 56559 (Oct. 22, 1998).

(n132)Footnote 122. H. Rep. No. 2264, 103d Cong., 1st Sess. 185-186 (1993).

(n133)Footnote 123. *I.R.C. § 108(c)(2)(B)*. A taxpayer's adjusted basis for each asset is determined after the allowance for depreciation for the taxable year of the discharge.

(n134)Footnote 124. *I.R.C. § 108(c)(2)(B)*.

(n135)Footnote 125. H. Rep. No. 2264, 103d Cong., 1st Sess. 186 (1993). Treasury should clarify that there is a "look-through" rule for partnerships--so that an upper tier partnership's share of the qualified real property business debt of a lower tier partnership is treated as qualified real property business debt of the upper tier partnership, and real estate subject to qualified debt that is contributed to a lower tier partnership continues to qualify. *See, e.g., Treas. Reg. § 1.704-2(k)* (tier partnership rules for minimum gain); *Treas. Reg. § 1.856-3(g)* ("look-through" rule for REIT income and asset tests); *Treas. Reg. § 1.707-5(e)* (debt in lower tier partnership retains the same character that it had with the upper tier contributing partnership); *Priv. Ltr. Rul. 9840026* (Oct. 2, 1998); *Priv. Ltr. Rul. 9426006* (March 25, 1994).

(n136)Footnote 126. H. Rep. No. 2264, 103d Cong., 1st Sess. 186 (1993). *See Treas. Reg. § 1(g)(2)(ii)*, 63 *Fed. Reg. 56559* (October 22, 1998).

(n137)Footnote 127. H. Rep. No. 2264, 103d Cong., 1st Sess. 186 (1993). *See Treas. Reg. § 1.1017-(g)(2)(i)*, 63 *Fed. Reg. 56559* (October 22, 1998). Treasury should clarify that an upper tier partnership's share of the qualified real property business debt of a lower tier partnership is treated as qualified real property business debt of the upper tier partnership. *See, e.g., Treas. Reg. § 1.704-2(k)* (tier partnership rules for minimum gain); *I.R.C. § 1017(b)(3)(B)*, (F)(i).

(n138)Footnote 128. *See I.R.C. § 1017(b)(3)(C)*, last sentence. *See also Treas. Reg. § 1.1017-1(g)(2)(i)*, 63 *Fed. Reg. 56559* (Oct. 22, 1998).

(n139)Footnote 129. H. Rep. No. 2264, 103d Cong. 1st Sess. 186 (1993).

(n140)Footnote 130. *See Treas. Reg. § 1.704-2(f)* (if there is a net decrease in partnership minimum gain, the minimum gain chargeback requirement applies); *Rev. Rul. 99-43*, 1999-2 *C.B. 506*.

(n141)Footnote 131. *See Treas. Reg. § 1.704-2(f)(5)* (by revenue ruling, the Commissioner can add additional exceptions).

(n142)Footnote 132. *I.R.C. §§ 108(d)(7)*, 1363(c).

(n143)Footnote 133. H. Rep. No. 2264, 103d Cong., 1st Sess. 187 (1993).

(n144)Footnote 134. *I.R.C. § 108(d)(7)(B)*.

(n145)Footnote 135. Pub. L. No. 111-5, § 1231, 123 Stat. 338 (2009).

(n146)Footnote 136. For the election procedures, *see Rev. Proc. 2009-37*, 2009-36 *I.R.B. 1* (Aug 17, 2009).

(n147)Footnote 137. *I.R.C. § 108(i)(1)* provides that the reacquisition must occur after December 31, 2008 and before January 1, 2011 and, if the election is made, the discharge income is included ratably over a 5-taxable-year period. Taxpayers using a fiscal year must carefully determine qualification and their taxable year deferral periods.

(n148)Footnote 138. *I.R.C. § 108(i)(1)*. This means the ratable inclusion period will run from 2014 to 2018 for calendar year taxpayers.

(n149)Footnote 139. *I.R.C. § 108(i)(3)*. *See Rev. Proc. 2009-37*, *Id* at § 2.

(n150)Footnote 140. *See, e.g., Rev. Rul. 76-86, 1976-1 C.B. 37* (intent of Congress was only to exclude elections with respect to an individual's personal debt: "There is no necessity to give the phrase property used in a trade or business anything but its literal meaning..."); *Rev. Rul. 72-205, 1972-1 C.B. 37* (real estate partnership electing); *Priv. Ltr. Rul. 8314021 (Dec. 29, 1982)* (commercial building with offices and stores); *Tech. Adv. Mem. 8221007 (Feb. 18 1982)* (apartment project); *Priv. Ltr. Rul. 7851138 (Sept. 26, 1978)* (development and operation of commercial and apartment properties).

(n151)Footnote 141. *See Snow v. Commissioner, 416 U.S. 500 (1974)* (experimental expenses held deductible even though not constituting an *I.R.C. § 162* trade or business); *Huntsman v. Commissioner, 905 F.2d 1182 (8th Cir. 1990)*; *Alves v. Commissioner, 734 F.2d 478 (9th Cir. 1984)*.

(n152)Footnote 142. *See Fegan v. Commissioner, 71 T.C. 791, 814 (1979), aff'd, 81-1 U.S. Tax Cas. (CCH) P9436 (10th Cir. 1981)* (taxpayer in trade or business where he leased motel to closely-held corporation); *Post v. Commissioner, 26 T.C. 1055 (1956), acq., 1958-1 C.B. 5* (building managed by agent); *Hazard v. Commissioner, 7 T.C. 372 (1946), acq., 1946-2 C.B. 3* (rental of former residence held to be a trade or business); *Tech. Adv. Mem. 200014007 (Dec. 13, 1999)* ("trade or business" requirement under *I.R.C. § 108(c)* discussed); *Priv. Ltr. Rul. 8314021 (Dec. 29, 1982)* (ownership and rental of commercial building is a trade or business under prior *I.R.C. § 108*).

(n153)Footnote 143. An entity should qualify if, for example, it deducts some expenses under *I.R.C. § 162* or if the interest is treated as trade or business interest under *I.R.C. § 163(h)(2)(A)*. Arguably, there should not be any inquiry into what the debt proceeds were used for. *See, e.g., Kroy v. United States, 27 F.3d 367 (9th Cir. 1994)* (business purpose in use of borrowed funds is irrelevant for purposes of determining whether loan fees are deductible under *I.R.C. § 162(a)*). *But see* Treas. Reg. § 1.163-8T (interest tracing rules).

(n154)Footnote 144. *I.R.C. § 108(i)(4)*.

(n155)Footnote 145. *See Treas. Reg. § 1.1001-3*.

(n156)Footnote 146. *I.R.C. § 108(i)(4)(B)*.

(n157)Footnote 147. H.R. Conf. Rep. No. 111-16, at 564 (2009) ("2009 Conference Report").

(n158)Footnote 148. *See Treas. Reg. § 1.1001-2(a)(2), (c) (ex. 8)*.

(n159)Footnote 149. *I.R.C. § 108(i)(2)*. *See* 2009 Conference Report at 565. The OID deferral rule applies at the entity level for a pass-through entity. *Rev. Proc. 2009-37, Id.*

(n160)Footnote 150. *I.R.C. § 108(i)(5)(B)*.

(n161)Footnote 151. *Rev. Proc. 2009-37, Id.*

(n162)Footnote 152. *I.R.C. § 108(i)(5)(B)(i)*. *See* 2009 Conference Report at 565. *Rev. Proc. 2009-37, Id.* at § 4. The IRS permits partial elections. *Id.* at § 4.04.

(n163)Footnote 153. *See Treas. Reg. § 1.61-12(c)(2); Treas. Reg. § 1.1275-1(b)*. Generally, the "adjusted issue price" is the original issue price plus accrued but unpaid original issue discount.

(n164)Footnote 154. *Rev. Proc. 2009-37, Id.* § 4.04.

(n165)Footnote 155. *I.R.C. § 108(i)(5)(B)(iii)*. *See Rev. Proc. 2009-37, Id.* at § 4.07. A "pass-thru" entity is not defined, but the term is used in other sections. *See, e.g., I.R.C. § 1(h)(10)* for a definition under *I.R.C. § 1*. For purposes of § 108(i), regulated investment companies (as defined in *I.R.C. § 851(a)*) and real estate investment trusts (as defined in § 856(a)) are not pass-through entities. *See Rev. Proc. 2009-37, Id.* at § 2.01.

(n166)Footnote 156. *I.R.C. § 108(i)(5)(C)*.

(n167)Footnote 157. *Rev. Proc. 2009-37*, *Id.* § 4.04(3).

(n168)Footnote 158. *I.R.C. § 108(i)(5)(D)*.

(n169)Footnote 159. For example, a technical termination of the partnership under *I.R.C. § 708(b)(1)(B)* should not cause an acceleration for purposes of *I.R.C. § 108(i)* with respect to the partners who did not sell or exchange their partnership interests.

(n170)Footnote 160. *I.R.C. § 108(i)(6)*.

(n171)Footnote 161. *See, e.g., Rev. Proc. 2009-37*, *Id.* § 2.08; *Rev. Rul. 99-43*, 1999-2 C.B. 506 (to extent minimum gain chargeback rules do not apply, discharge income may be allocated in accordance with rules under *Treas. Reg. § 1.704-1(b)(2)*); *Rev. Rul. 92-27*, 1992-2 C.B. 124 (debt discharge income is allocated as a separately stated item of partnership income under *I.R.C. § 702(a)*).

(n172)Footnote 162. *See, e.g., Rev. Proc. 2009-37*, *Id.* § 2.09; *Rev. Rul. 94-4*, 1994-1 C.B. 196 (deemed distribution is treated as a drawing or advance of money).

(n173)Footnote 163. *See* 2009 Conference Report at 566.

(n174)Footnote 164. *See I.R.C. § 312(l)* (excluded discharge income applied to reduce basis under *I.R.C. § 1017* does not increase E&P); *Treas. Reg. § 1.312-6* (E&P is generally determined in accordance with the taxpayer's method of accounting).

(n175)Footnote 165. *I.R.C. §§ 857(a) and (d); I.R.C. § 316(a)*.

(n176)Footnote 166. *See, e.g., Meyer v. Commissioner*, 383 F.2d 883 (8th Cir. 1967) (E&P was not increased where corporation's debt was discharged under prior Bankruptcy Act); *Rev. Proc. 2004-34*, 2004-1 C.B. 991 (advance payments received in one year could be deferred and included in income the following taxable year); *Priv. Ltr. Rul. 200817029* (taxpayer does not need to make any adjustment in E&P for advance payments properly deferred to following year).

(n177)Footnote 167. *Id.*, § 2.11.

(n178)Footnote 168. Pub. L. No. 110-142 § 2 (2007).

(n179)Footnote 169. *I.R.C. § 108(h)(2)*.

(n180)Footnote 170. *I.R.C. § 108(h)(3)*.

(n181)Footnote 171. *I.R.C. § 108(h)(5)*.

(n182)Footnote 172. *I.R.C. § 108(h)(4)*.

(n183)Footnote 173. *I.R.C. § 108(h)(1)*.

(n184)Footnote 174. *I.R.C. § 108(a)(2)(C)*.

(n185)Footnote 175. *I.R.C. § 108(b)(1)*. *See Firsdon v. United States*, 95 F.3d 444 (6th Cir. 1996) ; *Priv. Ltr. Ruls. 92-45-023* (Aug. 7, 1992) (attributes of bankruptcy estate are reduced for debtor in a bankruptcy case), *91-21-017* (Feb. 21, 1991) (in a consolidated group of corporations a separate company-by-company, rather than consolidated, approach used for attribute reduction).

(n186)Footnote 176. Under certain circumstances, it is possible for a taxpayer to permanently avoid the recognition of discharge income deferred under *I.R.C. § 108*. For example, if a corporate taxpayer obtains a discharge of its debts, then ceases to do any business, deferral is permanent. Similarly, if an unincorporated sole proprietor obtains a discharge, reduces asset bases, and then dies, *I.R.C. § 1014* transforms deferral into permanent exclusion by permitting a step-up in tax basis to the fair market value of the assets at date of death (or alternate valuation date). *See, e.g., Tech. Adv. Mem. 8348001* (no date) (step-up in basis to decedent partner).

(n187)Footnote 177. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 10 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n188)Footnote 178. *See P TX6.03[4][c] infra*.

(n189)Footnote 179. *Treas. Reg. § 1.108-7(a)*, 69 *Fed. Reg.* 26038 (May 11, 2004) . *See P TX6.03[4][e] infra*.

(n190)Footnote 180. *I.R.C. § 108(b)(2)(A)*; *Williams v. Commissioner*, 123 *T.C.* 144 (2004) . For a discussion of attribute reduction in the context of a corporate consolidated tax return, *see Treas. Reg. § 1.1502-28*, 70 *Fed. Reg.* 14395 (March 22, 2005) ; *CSI Hydrostatic Testers, Inc. v. Commissioner*, 103 *T.C.* 398 (1994) .

(n191)Footnote 181. *I.R.C. § 108(b)(2)(B)*.

(n192)Footnote 182. *I.R.C. § 108(b)(2)(B)*.

(n193)Footnote 183. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 12 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n194)Footnote 184. *I.R.C. § 108(b)(2)(C)*.

(n195)Footnote 185. *I.R.C. § 108(b)(2)(D)*.

(n196)Footnote 186. *I.R.C. § 108(b)(2)(E)*.

(n197)Footnote 187. *I.R.C. § 108(b)(2)(F)*.

(n198)Footnote 188. *I.R.C. § 108(b)(2)(G)*.

(n199)Footnote 189. *I.R.C. § 108(b)(5)*; *Treas. Reg. § 1.108-7(a)(2)*, 69 *Fed. Reg.* 26038 (May 11, 2004) . The election is made on Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment). *See Treas. Reg. §§ 1.108-4, 1.1017-1(f)*, 63 *Fed. Reg.* 56559 (Oct. 22, 1998) . Note, however, that if the taxpayer elects under *I.R.C. § 108(b)(5)* to apply the reduction first to the taxpayer's basis in its depreciable property, the limitation prohibiting the reduction of asset basis below the amount of the taxpayer's remaining undischarged liabilities does not apply. *I.R.C. § 1017(b)(2)* (last sentence). *See P TX6.03[4][e] infra*.

(n200)Footnote 190. *I.R.C. § 170(d)*. Interestingly, *I.R.C. § 1398(g)(2)* provides that this attribute passes from the debtor to the title 11 estate.

(n201)Footnote 191. *I.R.C. § 613A(d)(1)*.

(n202)Footnote 192. *I.R.C. § 465(b)(5)*. For the treatment of *I.R.C. § 469* "at risk" losses when an individual files a title 11 case, *see Treas. Reg. § 1.1398-2* (May 12, 1994).

(n203)Footnote 193. *I.R.C. § 174(b)*.

(n204)Footnote 194. *I.R.C. § 175(b)*.

(n205)Footnote 195. *I.R.C. § 194(a)*.

(n206)Footnote 196. *I.R.C. § 195*.

(n207)Footnote 197. *I.R.C. § 248*.

(n208)Footnote 198. *I.R.C. § 709(b)*.

(n209)Footnote 199. *Treas. Reg. § 1.167(a)-3*. But see, e.g., *Treas. Reg. § 1.1017-1(b)(7)* (basis reduction under pre-Bankruptcy Tax Act *I.R.C. § 1017* applied to property with respect to which a deduction for amortization is allowed under *I.R.C. §§ 168 and 169*); *Treas. Reg. § 1.1017-1(a)*, 63 *Fed. Reg.* 56559 (Oct. 22, 1998) (five categories of "property" subject to attribute reduction).

(n210)Footnote 200. *I.R.C. § 469(b)*. For the treatment of *I.R.C. § 469* passive activity losses when an individual files a title 11 case, see *Treas. Reg. § 1.1398-1* (May 12, 1994).

(n211)Footnote 201. *I.R.C. § 163(d)(2)*.

(n212)Footnote 202. *I.R.C. § 163(e)(5)*.

(n213)Footnote 203. Compare with the breadth of the rules limiting the deductibility of post-change built-in losses under *I.R.C. § 382*. *I.R.C. § 382(h)(2)(B)*, *(h)(4)* and *(h)(5)*. For a discussion of these rules, see chapter TX11 *infra*.

(n214)Footnote 204. A statutory amendment is necessary because, unlike *I.R.C. § 1398(g)(8)*, for example, Congress did not provide for a grant of authority to the Treasury to issue regulations that list "other attributes" of the debtor.

(n215)Footnote 205. See Report of the Section 108 Real Estate and Partnership Task Force, 46 *Tax Law.* 209, 250 (Fall 1992) ("Section 108 Task Force Report--Part I").

(n216)Footnote 206. *I.R.C. § 108(b)(4)(A)*. As a practical matter, tax attribute reduction occurs as of the first moment of the taxable year following the year of the discharge. See *Gitlitz et ux. v. Commissioner*, 531 U.S. 206, 121 S. Ct. 701, 148 L. Ed. 2d 613 (2001) (in the context of S corporation COD income, attribute reduction occurs after determination of tax imposed for the year of discharge); *CSI Hydrostatic Testers, Inc. v. Commissioner*, 103 T.C. 398, 414 (1994) ; *Priv. Ltr. Rul.* 9245023 (Aug. 7, 1992) , holding (8), *Priv. Ltr. Rul.* 9043073 (Aug. 8, 1990) .

(n217)Footnote 207. *Treas. Reg. § 1.108-7(b)*, 69 *Fed. Reg.* 26038 (May 11, 2004) .

(n218)Footnote 208. Subject, of course, to any limitations imposed under *I.R.C. § 382*. See ch. TX4 *infra*.

(n219)Footnote 209. *I.R.C. § 108(b)(2)(A)*. The reduction in NOLs should be unaffected by the limitations on use of those NOLs imposed by *I.R.C. § 382(a)*. However, a corporation's NOLs can also be reduced under *I.R.C. § 382(l)(5)*. See ch. TX4 *infra*. It is unclear how (or whether) attribute reduction would apply to disallowed built-in losses that are carried forward under *I.R.C. § 382(h)(4)*.

(n220)Footnote 210. *I.R.C. §§ 63 and 172*. See Temp. *Treas. Reg. § 1.108-7T(d)*, Ex. 1 68 *Fed. Reg.* 42590 (July 18, 2003) .

(n221)Footnote 211. *I.R.C. § 108(a)(1)(B)*.

(n222)Footnote 212. *I.R.C. §§ 56(a)(4)* and *56(d)*.

(n223)Footnote 213. *I.R.C. § 108(b)(4)(B)*; S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 13 (1980), *reprinted in* Vol.

E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n224)Footnote 214. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 13 n.13 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. 5(b)(ii) (Matthew Bender 15th Ed. Revised). *See I.R.C. §§ 172(b)(2)* (NOL carrybacks and carryovers), 1212(a)(1) (capital loss carrybacks and carryovers for corporations), and 1212(b)(1) (capital loss carryovers for individuals). *See Priv. Ltr. Rul. 9504032 (Oct. 31, 1994)*. Investment credit carryovers are reduced on a first-in first-out basis and other credit carryovers are reduced in the order they would be used against taxable income. *Priv. Ltr. Rul. 9504032 (Oct. 31, 1994)*. *See also I.R.C. § 38(d)* (ordering rules for business credits). For purposes of reducing credits, all limitations on the use of credits based on the debtor's income are ignored. *I.R.C. § 38(d)*

(n225)Footnote 215. *I.R.C. § 108(b)(4)(C)*. *See I.R.C. §§ 38(d), 904(c)*.

(n226)Footnote 216. *I.R.C. § 108(b)(3)(B)*.

(n227)Footnote 217. *I.R.C. § 108(b)(3)(A)*. A taxpayer reduces tax attributes by filing Form 982, Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment), Rev. 3/09.

(n228)Footnote 218. *I.R.C. §§ 108(b)(2)(E), 1017(a)*. *See Treas. Reg. § 1.1017-1(a), 63 Fed. Reg. 56559 (Oct. 22, 1998)*. Under prior law, "property" was defined as all of the debtor's property, other than money. *Treas. Reg. § 1.1016-7(b)(2)*. Presumably, the term refers to the type of property listed on a balance sheet.

(n229)Footnote 219. *I.R.C. § 1017(a)*.

(n230)Footnote 220. *I.R.C. § 1017(a)*. *See I.R.C. § 1017(b)(1)*.

(n231)Footnote 221. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 14 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n232)Footnote 222. *See Treas. Reg. §§ 1.1017-1(a), 63 Fed. Reg. 56559 (Oct. 22, 1998)*.

(n233)Footnote 223. *See Treas. Reg. § 1.1017-1(a), 63 Fed. Reg. 56559 (Oct. 22, 1998)*. *See also Treas. Reg. § 1.108-7(d), Ex. 1, 69 Fed. Reg. 26038 (May 11, 2004)*.

(n234)Footnote 224. *See Treas. Reg. § 1.1017-1(a), 63 Fed. Reg. 56559 (Oct. 22, 1998)*.

(n235)Footnote 225. *Treas. Reg. § 1.1017-1(a), 63 Fed. Reg. 56559 (Oct. 22, 1998)*.

(n236)Footnote 226. *Treas. Reg. § 1.1017-1(i), 63 Fed. Reg. 56559 (Oct. 22, 1998)*.

(n237)Footnote 227. *I.R.C. § 1017(b)(2)*; S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 13 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised); *Priv. Ltr. Rul. 8632046 (May 15, 1986)*. *See Treas. Reg. § 1.1017-1(b)(3), 63 Fed. Reg. 56559 (Oct. 22, 1998)*. The determination of the adjusted basis of depreciable property at a point in time during the debtor's taxable year presumably must take into account the depreciation deductions for that year based on the debtor's depreciation convention. *I.R.C. § 168(d)(4)*.

(n238)Footnote 228. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 13 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n239)Footnote 229. *Treas. Reg. § 1.1502-28(d), 70 Fed. Reg. 14395 (March 22, 2005)*.

(n240)Footnote 230. *Treas. Reg. § 1.1502-28(a)(1), 70 Fed. Reg. 14395 (March 22, 2005)*.

(n241)Footnote 231. *Treas. Reg. § 1.1502-28(a)(2), 70 Fed. Reg. 14395 (March 22, 2005)*.

(n242)Footnote 232. *Treas. Reg. § 1.1502-28(a)(2)*, 70 *Fed. Reg.* 14395 (March 22, 2005) .

(n243)Footnote 233. *Treas. Reg. § 1.1502-28(a)(4)*, 70 *Fed. Reg.* 14395 (March 22, 2005) .

(n244)Footnote 234. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 14 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised). See *Gitlitz et ux. v. Commissioner*, 531 U.S. 206, 219, n.9, 121 S. Ct. 701, 709, 148 L. Ed. 2d 613, 625 (2001) ("certainly the statute does not condition the exclusion under § 108(a) on the ability of the taxpayer to reduce attributes under § 108(b)").

(n245)Footnote 235. *Treas. Reg. § 1.108-7(a)(2)*, 69 *Fed. Reg.* 26038 (May 11, 2004) .

(n246)Footnote 236. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 10 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised). A taxpayer who is insolvent, but not in a title 11 case, receives a fresh start only to the extent of the taxpayer's insolvency. However, *I.R.C. § 108(g)*, added by the Tax Reform Act of 1986, and discussed at *P TX6.03[3][c][iii] infra*, provides a fresh start for solvent farmers who receive a discharge of "qualified farm indebtedness." Despite the relief provided under *I.R.C. § 108*, prior to the Revenue Reconciliation Act of 1989 ["1989 Act"], a corporation that was insolvent or in a title 11 case could be subject to the alternative minimum tax because discharge income was included in its book income, thereby increasing its alternative minimum taxable income. See *I.R.C. § 56(f)*. See generally Jacobs, *The Post-TAMRA Chapter 11 Corporate Tax Survival Kit*, 41st U.S.C. Tax Institute ch. 7 (1989). In the 1989 Act, Congress amended *I.R.C. § 56* to eliminate this unnecessary "trap." See *P TX6.03[5] infra*.

(n247)Footnote 237. A "chapter 11 case" is a case under chapter 11 of title 11 of the United States Code. Chapter 11 permits certain business debtors to attempt to reorganize troubled but potentially salvageable businesses while continuing to operate under the supervision of the bankruptcy court.

(n248)Footnote 238. See *Treas. Reg. § 1.108-7(d)*, Ex. 1, 69 *Fed. Reg.* 26038 (May 11, 2004) .

(n249)Footnote 239. The last sentence of *I.R.C. § 1017(b)(2)* provides that the limitation on reduction of asset basis imposed by *I.R.C. § 1017(b)(2)* does not apply to any reduction in basis by reason of an election under *I.R.C. § 108(b)(5)*. See, e.g., *Treas. Reg. § 1.1017-1(c)(3)*, 63 *Fed. Reg.* 56559 (Oct. 22, 1998) .

(n250)Footnote 240. *Treas. Reg. § 1.108-7(a)(2)*, 69 *Fed. Reg.* 26038 (May 11, 2004) .

(n251)Footnote 241. A "chapter 7 case" is a case under chapter 7 of title 11 of the United States Code. Chapter 7 cases are referred to as "liquidation cases" because the debtor's trustee in bankruptcy liquidates the debtor's assets.

(n252)Footnote 242. That is, an individual as opposed to a partnership or a corporation. See e.g., *I.R.C. §§ 1398(a)* (rules relating to individuals' title 11 cases) and 1398(b)(2) (§ 1398 does not apply at partnership level), 7701(a)(1) (definition of "person" includes "an individual, a trust, estate, partnership, association, company or corporation").

(n253)Footnote 243. *I.R.C. § 108(d)(8)*; S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 14 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised); *Treas. Reg. § 1.1017-1(h)*, 63 *Fed. Reg.* 56559 (Oct. 22, 1998) ; *Firsdon v. United States*, 95 F.3d 444 (6th Cir. 1996) ; *Gulley v. Commissioner*, 79 T.C.M. (CCH) 2171 (2000) (*Firsdon* followed); *Kahle v. Commissioner*, 73 T.C.M. (CCH) 2080 (1997) . The bankruptcy estate of the individual taxpayer in a chapter 7 or chapter 11 case succeeds to the tax attributes of the individual taxpayer. *I.R.C. § 1398(g)*. Commencement of a case under chapter 13 does not create a separate taxable entity. See *I.R.C. § 1399*. For a discussion, see ch. TX2 *supra*.

(n254)Footnote 244. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 14 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n255)Footnote 245. *I.R.C. § 1017(c)(1)*. Not only does the statute limit application to title 11 debtors excluding discharge income under *I.R.C. § 108(a)(1)(A)*, one court has held that the exempt property provisions of the Bankruptcy Code cannot be relied upon by an insolvent debtor (outside of a title 11 case) that excludes discharge income under *I.R.C. § 108(a)(1)(B)*. *Hunt v. Commissioner*, 57 T.C.M. (CCH) 919, 947-48 (1989) .

(n256)Footnote 246. *See P TX6.03[3][c][ii] supra*.

(n257)Footnote 247. *I.R.C. § 1017(c)(2)*; *see Rev. Rul. 81-206, 1981-2 C.B. 9* .

(n258)Footnote 248. *Treas. Reg. § 1.108-7(c)*, 1.1017-1(b)4, 69 *Fed. Reg. 26038* (May 11, 2004) (effective for discharges after May 10, 2004).

(n259)Footnote 249. *I.R.C. § 1017(b)(4)*.

(n260)Footnote 250. *I.R.C. § 1017(b)(4)(A)*.

(n261)Footnote 251. *I.R.C. §§ 108(c)(1)(A), 1017(b)(3)(F)*. *See Treas. Reg. § 1.1017-1(c)(1)*, 63 *Fed. Reg. 56559* (Oct. 22, 1998) . The election to treat real property held as inventory under *I.R.C. § 1221(1)* as depreciable property is not available. *See I.R.C. § 1017(b)(3)(F)(ii)*; *Treas. Reg. § 1.1017-1(f)*, 63 *Fed. Reg. 56559* (Oct. 22, 1998) .

(n262)Footnote 252. *I.R.C. § 1017(a)*.

(n263)Footnote 253. *I.R.C. § 1017(b)(3)(F)(ii)*.

(n264)Footnote 254. *See H.R. Rep. No. 2264, 103d Cong. 1st Sess. 187* (1993). However, the amount recaptured is reduced over time as the taxpayer forgoes future depreciation deductions due to the basis reduction. *H.R. Rep. No. 2264, 103d Cong. 1st Sess. 187* (1993).

(n265)Footnote 255. *I.R.C. § 1017(b)(3)(B)*. *See Treas. Reg. § 1.1017-1(g)(2)*, 63 *Fed. Reg. 56559* (Oct. 22, 1998) .

(n266)Footnote 256. *I.R.C. §§ 108(c)(1)(B), 1017(a)(2)*.

(n267)Footnote 257. *See Rev. Proc. 85-44, 1985-2 C.B. 504* ; *Treas. Reg. § 1.1017-1(i)*, 63 *Fed. Reg. 56559* (Oct. 22, 1998).

(n268)Footnote 258. *Treas. Reg. § 1.1017-1(a)(1)* and (2) (1956).

(n269)Footnote 259. *Treas. Reg. § 1.1017-1(a)(3)* (1956).

(n270)Footnote 260. *Treas. Reg. § 1.1017-1(g)*, *T.D. 8787*, 63 *Fed. Reg. 56559* (Oct. 22, 1998). For a complete discussion, *see P TX 3.03[1][d], supra* .

(n271)Footnote 261. *Prop. Treas. Reg. § 1-1017-1(i)*, *T.D. 8787*, 63 *Fed. Reg. 56559* (Oct. 22, 1998).

(n272)Footnote 262. *See Announcement 94-11, 1994-4 I.R.B. 44* . *See also IRS publication 4681 canceled Debts, Foreclosures, Repossessions, and Abandonments (for Individuals)*.

(n273)Footnote 263. *See P TX6.03[4][e] infra*.

(n274)Footnote 264. *I.R.C. § 108(d)(9)(A)*; *Treas. Reg. § 1.108-4*, *T.D. 8787* (Oct. 21, 1998) ; *Treas. Reg. § 1.1017-1(f)*, *T.D. 8787*, 63 *Fed. Reg. 56559* (Oct. 22, 1998). *See Priv. Ltr. Rul. 9406015* (Nov. 12, 1993) (extension of time to file granted under *Treas. Reg. § 301.9100-1(a)*).

(n275)Footnote 265. However, Form 982 (Rev. March 2009) provides (at p. 3) as follows:

When To File. File Form 982 with your Federal income tax return for a year a discharge of indebtedness is excluded from your income under § 108(a).

(n276)Footnote 266. These elections may be revoked only with the consent of IRS.

(n277)Footnote 267. There is no basis to conclude that a failure to file an information return invalidates the application of *I.R.C. § 108(a)*. See e.g., *Wilson v. Commissioner*, 20 T.C.M. (CCH) 676 (1961) (mere failure to comply with notice provisions in *Treas. Reg. § 1.368-3* does not disqualify an otherwise valid tax-free reorganization).

(n278)Footnote 268. See P TX6.03[2][a] *supra*. See, e.g., *Woltman v. United States*, 85-2 U.S.T.C. (CCH) P 9581 (S.D. Cal. 1985) (IRS motion for summary judgment granted because taxpayer failed to file consent form permitting a basis adjustment with initial tax return for 1977, the year of discharge); *Montgomery v. Commissioner*, 65 T.C. 511, 520-21 (1975) (and cases cited therein).

(n279)Footnote 269. *Treas. Reg. §§ 1.108(a)-1 and 1.108(a)-2*.

(n280)Footnote 270. See P TX6.03[3][a][iii][B] *supra*.

(n281)Footnote 271. In *Jenniges v. United States*, 90-1 U.S.T.C. (CCH) P 50,090 (Minn. 1990), the court found that a taxpayer realized discharge income, but denied exclusion under *I.R.C. § 108* because it concluded that an election required under *I.R.C. § 108(d)(8)* (currently *I.R.C. § 108(d)(9)*) was filed late. The court failed to discuss the taxpayer's insolvency and application of general attribute reduction rules of *I.R.C. § 108(b)(2)*. The court incorrectly cited Treasury Regulation § 1.108(a)-2 (promulgated in 1956) as the authority requiring a timely election for discharge income realized in tax year 1983.

(n282)Footnote 272. *I.R.C. § 108(b)(5)(A)*; *Treas. Reg. § 1.108-7(a)(2)*, 69 Fed. Reg. 26038 (May 11, 2004) .

(n283)Footnote 273. *I.R.C. §§ 108(b)(2)(E)*, 1017(b)(2).

(n284)Footnote 274. *I.R.C. §§ 108(b)(5)(B)*, 1017(b)(2). See *Treas. Reg. §§ 1.108-4*, 1.1017-1(c), T.D. 8787, 63 Fed. Reg. 56559 (Oct. 22, 1998).

(n285)Footnote 275. *I.R.C. § 108(b)(5)(B)*; S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 13 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n286)Footnote 276. *I.R.C. § 108(b)(5)(B)*; S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 14 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n287)Footnote 277. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 13 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised). See *Treas. Reg. § 1.108-7(a)(2)*, 69 Fed. Reg. 26038 (May 11, 2004) ; *Treas. Reg. §§ 1.1017-1(c)(2)*, 63 Fed. Reg. 56559 (Oct. 22, 1998) .

(n288)Footnote 278. *I.R.C. §§ 108(d)(5)*, 1017(b)(3).

(n289)Footnote 279. *I.R.C. § 1017(b)(3)(D)*. If there are lower tier subsidiaries, the reduction can be made provided the lowest tier subsidiary reduces its basis in depreciable property (or realty held as inventory). S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 13 n. 15 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n290)Footnote 280. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 13 n. 14 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised). See *Treas. Reg. §§ 1.1017-1(e)*, 63 Fed. Reg. 56559

(Oct. 22, 1998) .

(n291)Footnote 281. See *Kem v. Commissioner*, 51 T.C. 455, 460 (1968) , *aff'd*, 432 F.2d 961 (9th Cir. 1970) ; see also *Geneva Drive-In Theatre, Inc. v. Commissioner*, 67 T.C. 764, 771 (1977) , *aff'd per curiam*, 622 F.2d 995 (9th Cir. 1980) (lessor's reversionary interest in leasehold improvements was not depreciable). See *Treas. Reg. §§ 1.1017-1(e)*, 63 Fed. Reg. 56559 (Oct. 22, 1998) .

(n292)Footnote 282. See *I.R.C. § 108(d)(9)(B)*; *Treas. Reg. § 1.108-4(b)*.

(n293)Footnote 283. *Treas. Reg. § 1.108-4(b)*, T.D. 8787, 63 Fed. Reg. 56559 (Oct. 22, 1998). Form 982 (Rev. 3/09) provides a space for making the election under *I.R.C. § 108(b)(5)*.

(n294)Footnote 284. *Treas. Reg. § 301.9100-1* (June 29, 1993); *Temp. Treas. Reg. §§ 301.9100-1(a), -13T(d)*; *Rev. Proc. 92-85, 1992-2 C.B. 490* . Form 982 (Revised March 2009) provides as follows (at page 3): "If you timely filed your tax return without making either of these elections, you can still make either election by filing an amended return within six months of the due date of the return (excluding extensions). Write 'Filed pursuant to section 301.9100-2' on the amended return and file it at the same place you filed the original return."

(n295)Footnote 285. *Priv. Ltr. Rul. 9406015* (Nov. 12, 1993) . See also *Priv. Ltr. Ruls. 200234023* (Aug. 23, 2002); *200436002* (May 6, 2004).

(n296)Footnote 286. For a discussion of the characterization of gain realized with respect to dispositions of property subject to basis reduction, see *P TX6.03[4][f] infra*.

(n297)Footnote 287. The availability of a corporate taxpayer's NOLs may be subject to limitation under *I.R.C. § 382*. See ch. TX11 *infra*.

(n298)Footnote 288. For the definition of an "ownership change, " see ch. TX11 *infra*.

(n299)Footnote 289. Section 1250 property means depreciable real property (other than section 1245 property, as defined in *I.R.C. § 1245(a)(3)*). *I.R.C. § 1250(c)*.

(n300)Footnote 290. *I.R.C. § 1017(d)(1)*.

(n301)Footnote 291. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 14 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n302)Footnote 292. See *I.R.C. § 1245(a)(1)*.

(n303)Footnote 293. *I.R.C. § 1017(d)(2)*.

(n304)Footnote 294. H. Rep. No. 2264, 103d Cong., 1st Sess. 187 (1993).

(n305)Footnote 295. H. Rep. No. 2264, 103d Cong., 1st Sess. 187 (1993).

(n306)Footnote 296. *I.R.C. § 118*; See *Putoma Corp. v. Commissioner*, 66 T.C. 652, 665 (1976) , *aff'd*, 601 F.2d 734 (5th Cir. 1979) ; *Hartland Associates v. Commissioner*, 54 T.C. 1580 (1970) (cancellation of interest on debt treated as nontaxable contribution to capital). See also *Commissioner v. Fender Sales, Inc.*, 338 F.2d 924, 930 (9th Cir. 1964) ; *Utilities & Indus. Corp. v. Commissioner*, 41 T.C. 888, 910 (1964) , *acq. in result*, 1973-2 C.B. 4 (relying on *Treas. Reg. 111, § 29.22(a)-13(a)* to conclude that discharge of corporation's indebtedness to shareholder is a contribution to capital and, therefore, under the then uncodified rule, would not be included in corporate income). Cf. *Treas. Reg. § 1.166-9(c)* (no worthless debt deduction allowed if payment on guarantee represents a contribution to capital).

(n307)Footnote 297. *See, e.g.*, Priv. Ltr. Ruls. 94-04-014 (Oct. 26, 1993); 93-35-024 (June 3, 1993); 88-44-032 (Aug. 8, 1988).

(n308)Footnote 298. *See* Priv. Ltr. Ruls. 98-22-005 (May 29, 1998); (provided the adjusted basis of receivables equaled their adjusted issue price, no discharge income realized in cancellation); 94-04-014 (Oct. 26, 1993); 93-35-024 (June 3, 1993); 88-44-032 (Aug. 8, 1988).

(n309)Footnote 299. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 19 n.22 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n310)Footnote 300. *Putoma Corp. v. Commissioner*, 66 T.C. 652 (1976) , *aff'd*, 601 F.2d 734 (5th Cir. 1979) . *See* S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 19 n.22 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised). In *Putoma Corp.*, two individuals, both cash method taxpayers, who owned all of the stock of a closely held corporation, cancelled accrued but unpaid salaries and interest owed them by the corporation. *Putoma Corp. v. Commissioner*, 66 T.C. 652, 653, 658 (1976) . The Tax Court held that the corporation did not have income as a result of this cancellation of indebtedness, reasoning that the cancellation amounted to a contribution to the capital of the corporation, excludable under I.R.C. § 118. *Putoma Corp. v. Commissioner* 66 T.C. 652, 663-72 (1976) .

(n311)Footnote 301. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 19 n.22 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised). *See* Priv. Ltr. Rul. 9018006 (Nov. 15, 1989) .

(n312)Footnote 302. The issuance of additional stock to a 100% shareholder is not required because to do so would be meaningless. *Rev. Rul. 64-155, 1964-1 C.B. 138* ; *Tech. Adv. Mem. 9822005 (May 29, 1998)* ; *Priv. Ltr. Rul. 9623028 (March 7, 1996)* .

(n313)Footnote 303. *See* *Tech. Adv. Mem. 9830002 (July 24, 1998)* .

(n314)Footnote 304. The Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-65 (1993), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(k)(i) (Matthew Bender 15th Edition Revised), prospectively repealed the stock for debt exception for stock transferred after December 31, 1994, unless the issuing corporation is in a title 11 or similar case that was filed before January 1, 1995.

(n315)Footnote 305. *See* Subchapter S Revision Act of 1982, Pub. L. No. 97-354, 96 Stat. 1669 (1982).

(n316)Footnote 306. *See* I.R.C. § 1367(b)(2).

(n317)Footnote 307. *See* Deficit Reduction Act of 1984, Division A, Pub. L. No. 98-369, § 721(b), 98 Stat. 494, 966-97 (1984).

(n318)Footnote 308. *See* S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 19 n.22 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised) (discussing intent to reverse result in *Putoma Corp.*).

(n319)Footnote 309. *See* P TX6.03[3][c][ii] *supra*.

(n320)Footnote 310. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 18 n.21 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n321)Footnote 311. For a discussion of the treatment of financially troubled partnerships, *see* chapter TX13 *infra*.

(n322)Footnote 312. I.R.C. § 108(d)(6) provides that in the case of a partnership, I.R.C. § 108(a), (b) and (g) is applied at the partner level. *See* Service Center Advice 2000-11048 (March 17, 2000) (I.R.S. required to follow TEFRA deficiency procedures before making an assessment of tax attributable to partnership COD income). Under prior law,

the insolvency exception applied at the partnership level. *Estate of Newman v. Commissioner*, 934 F.2d 426 (2d Cir. 1991), rev'g, 59 T.C.M. (CCH) 543 (1990); See also Rev. Rul. 99-43, 1999-2 C.B. 506 (Oct. 18, 1999).

(n323)Footnote 313. Rev. Rul. 99-43, 1999-2 C.B. 506 (cancellation of debt income may be specially allocated under Treas. Reg. § 1.704, provided the allocation has substantial economic effect); Rev. Rul. 92-97, 1992-2 C.B. 124. See I.R.S. FSA 20028019 (July 14, 2000) (no partnership COD because debt was still a recourse liability to each partner). For a discussion of the methods a partnership may use to allocate discharge income among partners, see chapter TX13 *infra*.

(n324)Footnote 314. I.R.C. § 705(a)(1)(A); S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 21 (1980), reprinted in Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised); Tech. Adv. Mem. 9739002 (May 19, 1997). Interpreting prior law, one court held that an insolvent partner is not entitled to a basis increase for excluded discharge income. *Babin v. Commissioner*, 23 F.3d 1032 (6th Cir. 1994).

(n325)Footnote 315. I.R.C. § 733. The I.R.C. § 752(b) distribution is deemed to occur at the end of the partnership taxable year. Rev. Rul. 94-4, 1994-1 C.B.; Tech. Adv. Mem. 9619002 (Jan. 31, 1996) (Section 1001 gain realized by individual partner upon bankruptcy discharge and recognized after bankruptcy estate closed).

(n326)Footnote 316. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 21 (1980), reprinted in Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised); *Gershkowitz v. Commissioner*, 88 T.C. 984, 1009 (1987); Rev. Rul. 92-97, 1992-2 C.B. 124 (situation 1); FSA 200131013 (May 1, 2001); Tech. Adv. Mem. 9739002 (September 26, 1997); see also Treas. Reg. § 1.752-1(f).

(n327)Footnote 317. But see *Gracia v. Commissioner*, 87 T.C.M. (CCH) 1423 (2004) (where bankruptcy court ordered that general partner of bankrupt partnership was "subject to the jurisdiction" of the court; held I.R.C. § 108(a)(1)(A) applied to partner's discharge).

(n328)Footnote 318. For a complete discussion of the treatment of the discharge of partnership debt, see chapter TX13 *infra*.

(n329)Footnote 319. I.R.C. § 108(d)(7). See Tech. Adv. Mem. 9541006 (July 5, 1995). For a discussion of the application of I.R.C. § 108 to S corporations, see Eustice, *Financially Distressed S Corporations*, 53 Tax Notes 97 (Oct. 7, 1991) ["Eustice"]; R. Blau, B. Lemons & T. Rohman, *S Corporations: Federal Taxation*, § 7.08 (Callaghan 1989).

(n330)Footnote 320. I.R.C. §§ 1367(a)(1)(A), 1366(a)(1)(A). In *Winn v. Commissioner*, 73 T.C.M. (CCH) 3167 (1997), the court indicated that discharge income is an "item of income" which increases the stock basis. However, that memo was withdrawn and replaced by T.C.M. 1998-71 which follows the "no basis increase" holding in *Nelson v. Commissioner*, 110 T.C. 114 (1998). See Eustice, *Financially Distressed S Corporations*, 53 Tax Notes 98 (Oct. 7, 1991) ["Eustice"].

(n331)Footnote 321. See *Estate of Newman v. Commissioner*, 934 F.2d 426, 434 (2d Cir. 1991) (when pre-1980 insolvency exception was applied to exclude income at the partnership level, partners were not also entitled to "windfall" benefit of an increase in outside basis in their partnership interests).

(n332)Footnote 322. *Gitlitz v. Commissioner*, 531 U.S. 206, 121 S. Ct. 701, 148 L. Ed. 2d 613 (2001); *Alpert v. United States*, 481 F.3d 404 (6th Cir. 2007); *Gaudiano v. Commissioner*, 216 F.3d 524 (6th Cir. 2000); *Witzel v. Commissioner*, 200 F.3d 496 (7th Cir. 2000); Tech. Adv. Mem. 94-23-003 (Feb. 28, 1994); 95-41-006 (July 5, 1995); see Lipton, *Tax Court Rejects S Corp. Basis Step-up for COD Income in Nelson*, 88 J. Taxation 272 (May 1998).

(n333)Footnote 323. *Pugh v. Commissioner*, 213 F.3d 1324 (11th Cir. 2000); *United States v. Farley*, 202 F.3d 198 (3d Cir. 2000); *Hogue v. United States*, 2000 U.S. Dist. LEXIS 601 (D. Or. Jan. 3, 2000).

(n334)Footnote 324. Prop. Treas. Reg. § 1.1366-1(a)(viii) (Aug. 17, 1998).

(n335)Footnote 325. 531 U.S. 206 (2001) ,

(n336)Footnote 326. 531 U.S. at 212, 121 S. Ct. at 706, 148 L. Ed. 2d at 621 .

(n337)Footnote 327. 531 U.S. at 218, 121 S. Ct. at 709, 148 L. Ed. 2d at 625 .

(n338)Footnote 328. For a complete discussion, see Lipton, Supreme Court Hands Taxpayers a Victory in *Gitlitz*, But Will Congress Take It Away? 94 J. Tax'n 133 (March 2001).

(n339)Footnote 329. Pub. L. No. 107-142, § 402 (2002).

(n340)Footnote 330. I.R.C. § 108(d)(7)(A). The IRS issued proposed regulations under Treas. Reg. § 1.108-7, REG-102822-08 (Aug. 5, 2008) effective on the date final regulations are published.

(n341)Footnote 331. This provision does not apply to a discharge of qualified real property business indebtedness. I.R.C. § 108(d)(7)(B) (last sentence).

(n342)Footnote 332. *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 103 S. Ct. 1134, 75 L. Ed. 2d 130 (1983) .

(n343)Footnote 333. *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 372, 103 S. Ct. 1134, 1137, 75 L. Ed. 2d 130, 139 (1983) . See *Schwartz Rojas v. Commissioner*, 901 F.2d 810 (9th Cir. 1990) ; *Rosenberg v. Commissioner*, 96 T.C. 451, 455 (1991) ; *Weyher v. Commissioner*, 66 T.C. 825, 829 (1976) (recovery occurred upon assumption of liability); *Schlifke v. Commissioner*, 61 T.C.M. (CCH) 1697 (1991) (recovery occurred by way of application of payments for deductible amounts against principal in a subsequent year).

(n344)Footnote 334. Although I.R.C. § 111(a) uses the term "recovery," the Supreme Court in *Hillsboro Nat'l Bank* emphasized that a "recovery" is not essential to application of the tax benefit rule. *Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 380-84, 103 S. Ct. 1134, 1142-43, 75 L. Ed. 2d 130, 144-46 (1983) .

(n345)Footnote 335. See *Barnhart-Morrow Consolidated v. Commissioner*, 47 B.T.A. 590, 600-601 (1942) , *aff'd*, 150 F.2d 285 (9th Cir. 1945) (discharge income not realized from partial discharge of liability for accrued salary because deduction produced no tax benefits); *Main Properties, Inc. v. Commissioner*, 4 T.C. 364, 379-80 (1944) (no tax benefit received); *Bressi v. Commissioner*, 62 T.C.M. (CCH) 1668, 1676 (1991) , *aff'd in unpublished opinion* (3d Cir. Feb. 5, 1993) (transfer in lieu of foreclosure was a sale; taxpayer not entitled to exclusion under I.R.C. § 111(a)); *Rev. Rul. 67-200, 1967-1 C.B. 15* , *clarified by*, *Rev. Rul. 70-406, 1970-2 C.B. 16* (providing for exclusion under I.R.C. § 108 of any portion of the forgiven interest not excludable under I.R.C. § 111 if taxpayer consents to adjustment of basis in property).

(n346)Footnote 336. The following example illustrates the operation of I.R.C. § 111(c). If an accrual basis taxpayer purchases an item of inventory and deducts, but does not pay, the cost in 1992 and the creditor forgives that obligation in 1993, the forgiveness of the inventory obligation will result in taxable income if the deduction in 1992 either decreased the taxpayer's tax or, if the taxpayer owed no tax, increased an operating loss in 1992.

(n347)Footnote 337. See *Rev. Rul. 67-200, 1967-1 C.B. 15* , *clarified by*, *Rev. Rul. 70-406, 1970-2 C.B. 16* . Although these rulings predate the Bankruptcy Tax Act of 1980 and thus no longer reflect the precise result under I.R.C. § 108, they reflect the proper relationship between I.R.C. §§ 111 and 108.

(n348)Footnote 338. See *Helvering v. Jane Holding Corp.* 109 F.2d 933, 941-42 (8th Cir. 1940) (an obligation for interest, deducted but not paid, represents taxable income in year cancelled); *Montgomery v. Commissioner*, 65 T.C. 511, 522 (1975) (value of building, which was secured by purchase money debt, was deducted in 1969 as a casualty

loss; subsequent debt reduction in 1970 held ordinary income). The IRS has privately ruled that a taxpayer may not exclude the excess tax benefit income under one of the other exclusion rules set forth in *I.R.C. § 108(e)*, particularly, the purchase price adjustment rule of *I.R.C. § 108(e)(5)*. *Priv. Ltr. Rul. 9037033 (June 18, 1990)*. For a discussion of this ruling, see Weindruch & Brown, *Scope of Purchase Price Exception to COD Income Questioned in New Ruling*, 74 *J. Tax.* 302, 306 (May 1991). The conclusion reached in *Priv. Ltr. Rul. 9037033* on this point is inconsistent with *Allan v. Commissioner*, n.225 *infra* and accompanying text.

(n349)Footnote 339. For a discussion of dispositions of property in satisfaction of a debt, see *P TX6.02[6] supra*.

(n350)Footnote 340. *Allan v. Commissioner*, 856 F.2d 1169 (8th Cir. 1988) ; see *P TX6.02[6][e] supra*.

(n351)Footnote 341. *Allan v. Commissioner*, 856 F.2d 1169, 1174 (8th Cir. 1988) .

(n352)Footnote 342. See Cunningham, *Reprise; Characterization of Income Recovered Under the Tax Benefit Doctrine*, 43 *Tax Law.* 121, 148 (1989).

(n353)Footnote 343. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 16 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n354)Footnote 344. *I.R.C. § 108(e)(5)(A)*; see also *Preslar v. Commissioner*, 167 F.3d 1323 (10th Cir. 1999) (loan settlement with bank lender did not qualify because mortgage holder was not the seller of the property); *Armco Inc. v. Glenfed Financial Corp.* 720 F. Supp. 1129, 1135-36 (D.N.J. 1989) (transaction qualified under *I.R.C. § 108(e)(5)*); *O'Malley v. Commissioner*, 93 T.C.M. (CCH) 1064 (2007) (not a reduction of purchase money debt to the seller); *Rev. Rul. 92-99, 1992-2 C.B. 35* (transaction did not qualify because debt not "to the seller"). In *Zarin v. Commissioner*, 92 T.C. 1084, 1100 (1980), *rev'd*, 916 F.2d 110 (3d Cir. 1990), the Tax Court held that a gambler's settlement with a casino did not qualify as a "purchase money debt reduction." For a discussion of the Tax Court's decision in *Zarin*, see Shaviro, *The Man Who Lost Too Much: Zarin v. Commissioner and the Measurement of Taxable Consumption*, 45 *Tax. L. Rev.* 215 (1990).

(n355)Footnote 345. *I.R.C. § 108(e)(5)(B)*.

(n356)Footnote 346. *I.R.C. § 108(e)(5)(C)*.

(n357)Footnote 347. See *Zarin v. Commissioner*, 92 T.C. 1084, 1100 (1980), *rev'd*, 916 F.2d 110 (3d Cir. 1990) ; *Brantley v. Commissioner*, 70 T.C.M. (CCH) 1430 (1995) (IRS conceded *I.R.C. § 108(e)(5)* applied to reduction of stock purchase note); *House v. Commissioner*, 69 T.C.M. (CCH) 2005, 2022 (1995) . A taxpayer can use *I.R.C. § 108(e)(5)* as a backstop by first reducing debts to become solvent and then entering into a purchase price reduction. Because *I.R.C. § 108(e)(5)* does not require the taxpayer to elect its benefits, if the taxpayer properly orders the sequence of its debt reduction transactions so that the taxpayer becomes solvent before entering into a purchase price reduction, the insolvency exception of *I.R.C. § 108(a)(1)(B)* should protect the initial reduction from recognition and *I.R.C. § 108(e)(5)* should protect the balance. See *Priv. Ltr. Rul. 9037033 (June 18, 1990)* .

(n358)Footnote 348. For a critical discussion, see Report of the Section 108 Real Estate and Partnership Task Force, 46 *Tax Law.* 397, 401 (Winter 1993) ("Section 108 Task Force Report--Part II").

(n359)Footnote 349. See *Priv. Ltr. Rul. 9511045 (Dec. 21, 1994)* . Cf. *Bressi v. Commissioner*, 62 T.C.M. (CCH) 1668, 1674 (1991), *aff'd in unpublished opinion*, (3d Cir. Feb. 5, 1993) (no evidence that debt reduced was debt owed by purchaser to seller); *Juister v. Commissioner*, 53 T.C.M. (CCH) 1079, 1080 (1987), *aff'd in unpublished opinion*, 875 F.2d 864 (6th Cir. 1989) (*I.R.C. § 108(e)(5)* held inapplicable to reduction of nonpurchase money indebtedness).

(n360)Footnote 350. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 16-17 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised); see also *Preslar v. Commissioner*, 167 F.3d 1323

(10th Cir. 1999) (bank lender was not seller); *Sutphin v. United States*, 88-1 U.S.T.C. (CCH) P 9269 (Cls. Ct. 1988) (I.R.C. § 108(e)(5) held inapplicable to bank lender who was not the seller). *But see, e.g., I.R.C. § 1038(a)(2)* (statute granting nonrecognition treatment to seller on reacquisition of real property does not require privity between original buyer and seller; only original seller required).

(n361)Footnote 351. *Priv. Ltr. Rul. 9037033 (June 18, 1990)* . *But see, e.g., Rev. Rul. 86-120, 1986-2 C.B. 145 (I.R.C. § 1038 held inapplicable to shareholder who received a purchase money note in a pre-1986 liquidation of selling corporation).*

(n362)Footnote 352. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 16-17 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised). *See Priv. Ltr. Rul. 9338029 (June 25, 1993)* .

(n363)Footnote 353. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 20 n.24 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised). *See Priv. Ltr. Rul. 9338029 (June 25, 1993)* .

(n364)Footnote 354. *Tech. Adv. Mem. 8429001 (March 12, 1984)* .

(n365)Footnote 355. *Tech. Adv. Mem. 8429001 (March 12, 1984)* .

(n366)Footnote 356. For a discussion of *I.R.C. § 108(d)(6)*, *see P TX6.03[5][b] supra*.

(n367)Footnote 357. *See Tech. Adv. Mem. 8429001 (March 12, 1984)* .

(n368)Footnote 358. The policy justification for this preference is not clear. *I.R.C. Section 108(e)(5)* serves to ensure that a true purchase price reduction, although technically generating discharge of indebtedness income, will not fall under the general recognition rule of *I.R.C. § 61(a)(12)*. The benefit of *I.R.C. § 108(e)(5)* is based on a reduction in the price of a specific asset and should not depend on the debtor's financial status.

(n369)Footnote 359. *Rev. Proc. 92-92, 1992-2 C.B. 505* . *See also Priv. Ltr. Rul. 200336032 (June 10, 2003)* (under *Rev. Proc. 92-92* , partnership may treat discharge as a purchase price adjustment); *Tech. Adv. Mem. 8429001 (March 18, 1984) (I.R.C. § 108(e)(5) to be applied at the partnership level).*

(n370)Footnote 360. Congress expressly overruled the prior judicial insolvency exception, for example. *See I.R.C. § 108(e)(1)* ("except as otherwise provided in this section, there shall be no insolvency exception from the general rule that gross income includes income from discharge of indebtedness").

(n371)Footnote 361. S. Rep. No. 1035, 96th Cong., 2d Sess. 8,16 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised). The Senate Report also provides that "if the debt has been transferred by the seller to a third party ... , or if the property has been transferred by the buyer to a third party ... , *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.*" (emphasis added.). S. Rep. No. 1035, 96th Cong., 2d Sess. 8,16 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n372)Footnote 362. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 20 n.24 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n373)Footnote 363. *Sutphin v. United States*, 14 Cls. Ct. 585, 88-1 U.S.T.C. (CCH) P 9269 (Cls. Ct. 1988).

(n374)Footnote 364. *See Rev. Rul. 92-99, 1992-2 C.B. 35* ; *But see Preslar v. Commissioner*, 167 F.3d 1323, 1332-33 (10th Cir. 1999) (*dicta* indicating common law rule many not remain viable).

(n375)Footnote 365. For a discussion of the judicial exceptions, *see P TX6.02[2] supra*.

(n376)Footnote 366. *OKC Corp. & Subs. v. Commissioner*, 82 T.C. 638, 647 (1984) ; see also *Freedom Newspapers, Inc. v. Commissioner*, 36 T.C.M. (CCH) 1755, 1757 (1977) (payments received by purchaser from a third party intended to reduce the purchase price treated as a nontaxable reduction in basis of property acquired).

(n377)Footnote 367. *Hirsch v. Commissioner*, 115 F.2d 656 (7th Cir. 1940) .

(n378)Footnote 368. *Hirsch v. Commissioner*, 115 F.2d 656, 658 (7th Cir. 1940) .

(n379)Footnote 369. *Hirsch v. Commissioner*, 115 F.2d 656 (7th Cir. 1940) .

(n380)Footnote 370. *Hirsch v. Commissioner*, 115 F.2d 656 (7th Cir. 1940) . Although, as discussed at P TX6.02[2][a] *supra*, the Supreme Court's definition of income in *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170, 46 S. Ct. 449, 70 L. Ed. 886 (1926) is no longer followed, the Court's reasoning in *Kerbaugh-Empire* regarding an analysis of the "transaction as a whole" to determine whether the taxpayer has realized a gain or loss remains valuable to explain a nontaxable reduction in purchase price. See, e.g., Report of the Section 108 Real Estate and Partnership Task Force, 46 Tax Law. 397, 408 (Winter 1993). Not surprisingly, the IRS has adopted a more restrictive view of the current scope of the common law exception. See *Preslar v. Commissioner*, 167 F.3d 1323, 1333 (10th Cir. 1999) (purchase price reduction applies only to direct seller; *Rev. Rul. 92-99* followed); *Rev. Rul. 92-99, 1992-2 C.B. 35* .

(n381)Footnote 371. *Rev. Rul. 92-99, 1992-2 C.B. 35* . But see *Rev. Rul. 91-31, 1991-1 C.B. 19* (reduction of undersecured third party nonrecourse indebtedness treated as discharge of indebtedness income).

(n382)Footnote 372. *Helvering v. Killian*, 128 F.2d 433 (8th Cir. 1942) .

(n383)Footnote 373. *Helvering v. Killian*, 128 F.2d 433 (8th Cir. 1942) .

(n384)Footnote 374. *Nutter v. Commissioner*, 7 T.C. 480, 483 (1946) ; *Gehring Publishing Co. v. Commissioner*, 1 T.C. 345, 353-54 (1942) .

(n385)Footnote 375. *Wener v. Commissioner*, 242 F.2d 938, 946-47 (9th Cir. 1957) .

(n386)Footnote 376. *Gehring Publishing Co. v. Commissioner*, 1 T.C. 345, 353-54 (1942) .

(n387)Footnote 377. *Commissioner v. Sherman*, 135 F.2d 68 (6th Cir. 1943) .

(n388)Footnote 378. *Helvering v. Killian*, 128 F.2d 433 (8th Cir. 1942) ; *Hirsch v. Commissioner*, 115 F.2d 656 (7th Cir. 1940) . But see *Rev. Rul. 92-99, 1992-2 C.B. 35* (purchase price reduction must be based on an infirmity that clearly relates back to the original sale).

(n389)Footnote 379. *Edwards v. Commissioner*, 19 T.C. 275, 280 (1952) (mere pledge of stock insufficient).

(n390)Footnote 380. See *Des Moines Improvement Co. v. Commissioner*, 7 B.T.A. 279 (1927) (reduction of construction note treated as reduction of cost basis). For an interesting analogy, see *Rev. Rul. 81-277, 1981-2 C.B. 14* (payment by builder to buyer in release of claims for failure to fulfill contract is not income to buyer but represents a return of capital). See, e.g., *I.R.C. § 1034(c)(2)* (residence that is "constructed or reconstructed" by the taxpayer is treated as purchased by the taxpayer).

(n391)Footnote 381. *Commissioner v. Coastwise Transp. Corp.*, 71 F.2d 104, 105 (1st Cir. 1934) ; *Fidelity-Philadelphia Trust Co. v. Commissioner*, 23 T.C. 527, 533 (1954) (unclaimed deposits were income to bank and not a reduction of purchase price of assets of acquired bank); see also *Fifth Avenue-Fourteenth Street Corp. v. Commissioner*, 147 F.2d 453, 457 (2d Cir. 1944) (purchase price exception held inapplicable where certificates representing beneficial interests in the mortgage debt were acquired in the open market).

(n392)Footnote 382. *Sutphin v. Commissioner*, 14 Cls. Ct. 585, 88-1 U.S.T.C. P 9269 (Cls. Ct. 1988); *Montgomery v. Commissioner*, 65 T.C. 511, 521 (1975) ; *Londagin v. Commissioner*, 61 T.C. 117, 124-25 (1973) ; *L.D. Coddon & Bros., Inc.* 37 B.T.A. 393, 398-99 (1938) .

(n393)Footnote 383. See *Northern Trust Co. of Chicago v. United States*, 193 F.2d 127, 130 (7th Cir. 1951) (no evidence presented of agreement to reduce the purchase price or forgive the debt); *Lockwood v. Commissioner*, 94 T.C. 252, 261 (1990) (IRS argument that note reduction constituted a purchase price adjustment was rejected because there was no evidence of an agreed reduction); *OKC Corp. & Subs. v. Commissioner*, 82 T.C. 638, 646-52 (1984) (debt cancelled was a "payment" for lost profits in settlement of a lawsuit, not a purchase price adjustment); *Lime Cola Co. v. Commissioner*, 22 T.C. 593, 602 (1954) ; *Denman Tire & Rubber Co. v. Commissioner*, 14 T.C. 706, 715 (1950) , *aff'd*, 192 F.2d 261 (6th Cir. 1951) .

(n394)Footnote 384. This section focuses on the purchaser's adjustment in the assets acquired. For a discussion of the consequences to a seller reporting the sale under the installment method, see P TX6.02[7][f] *supra* and *Jerpe v. Commissioner*, 45 B.T.A. 199 (1941) , *acq.*, 1942-1 C.B. 9 .

(n395)Footnote 385. See *Rev. Rul. 81-277*, 1981-2 C.B. 14 ; *Rev. Rul. 76-96*, 1976-1 C.B. 23 ; *Priv. Ltr. Rul. 8839027* (June 29, 1988) . But see *Armco Inc. v. Glenfed Financial Corp.*, 720 F. Supp. 1129, 1136-37 (D.N.J. 1989) (purchase price reduction effected by reducing the basis of assets other than those giving rise to the price adjustment). Presumably, if some or all of the assets have been disposed of by the purchaser in the meantime, the amount of basis eligible for reduction would also be reduced. This might not be the case, however, if the assets were disposed of in exchange for other property in a tax-free transaction, such as a like kind exchange under *I.R.C. § 1031*.

(n396)Footnote 386. See Prop. Treas. Reg. § 1.168-2(d)(3), 49 Fed. Reg. 5940 (1984) .

(n397)Footnote 387. A taxpayer cannot reduce the basis of property below zero under *I.R.C. § 1017*, and no greater (or different) benefits should be available under the non-statutory rule. See *I.R.C. § 1017(b)(2)*; see also *Commissioner v. Tufts*, 461 U.S. 300, 310 n. 11, 103 S. Ct. 1826, 1833 n. 11, 75 L. Ed. 2d 863, 872 n. 11 (1983) ("the tax law has not recognized negative basis"); *Montgomery v. Commissioner*, 65 T.C. 511, 522 (1975) . But see *Armco Inc. v. Glenfed Financial Corp.*, 720 F. Supp. 1129, 1136-37 (D.N.J. 1989) (excess price adjustment used to reduce basis of other assets).

(n398)Footnote 388. See, e.g., *Rev. Rul. 67-200*, 1967-1 C.B. 15 , *explained*, *Rev. Rul. 70-406*, 1970-2 C.B. 16 .

(n399)Footnote 389. *I.R.C. § 108(e)(2)*; *Priv. Ltr. Rul. 97-33-019* (Aug. 15, 1997) , holding 12. See Section 108 Task Force Report--Part I, 46 Tax Law. 209, 254 (Fall 1992). Although unclear, this provision should be interpreted to generally apply at the partnership level, in order to carry out the purpose of the statute.

(n400)Footnote 390. S. Rep. No. 1035, 96th Cong., 2d Sess. 8, 20 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n401)Footnote 391. See *Priv. Ltr. Ruls. 92-51-023* (Sept. 18, 1992), 78-45-004 (July 26, 1978).

(n402)Footnote 392. *I.R.C. § 461(h)*.

(n403)Footnote 393. *I.R.C. § 163(d)(3)(A)* defines "investment interest" as "any interest allowable as a deduction under this chapter ... which is paid or accrued on indebtedness properly allocable to property held for investment."

(n404)Footnote 394. *I.R.C. § 163(d)(4)(A)* defines "net investment income" as the "excess of--(i) investment income, over (ii) investment expenses." *I.R.C. § 163(d)(4)(B)* defines "investment income" as "the sum of--(i) gross income (other than gain taken into account under clause (ii)) from property held for investment, and (ii) any net gain attributable to the disposition of property held for investment." *I.R.C. § 163(d)(4)(C)* defines "investment expenses" as

"the deductions allowed under this chapter (other than interest) which are directly connected with the production of investment income."

(n405)Footnote 395. A passive activity is a business activity in which the taxpayer does not "materially participate." *I.R.C. § 469(c)(1)*.

(n406)Footnote 396. As part of the technical corrections to TRA 1986 made in 1988, Congress amended *I.R.C. § 469(g)(1)* to read:

(g) Dispositions of Entire Interest in Passive Activity. --If during the taxable year a taxpayer disposes of his entire interest in any passive activity (or former passive activity), the following rules shall apply:

(1) Fully taxable transaction.--

(A) In general. --If all gain or loss realized on such disposition is recognized, the excess of--

(i) the sum of--

(I) any loss from such activity for the taxable year (determined after application of subsection (b) [carryover of previously disallowed losses]), plus

(II) any loss realized on such disposition, over

(ii) net income or gain for such taxable year from all passive activities(determined without regard to losses described in clause (i)), shall be treated as a loss which is not from a passive activity.

...

(C) Income from prior years. --To the extent provided in regulations, income or gain from the activity for preceding taxable years shall be taken into account under subparagraph (A)(ii) for the taxable year to the extent necessary to prevent avoidance of this section.

Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647, § 1005(a)(2)(A), 102 Stat. 3342, 3387-88 (1988). These amendments are effective as if included in the Tax Reform Act of 1986. *Id.* at § 1019, 102 Stat. 3342, 3593. The legislative history of the 1988 amendment explains that the amendment "restates the rules applicable to the allowance of suspended losses upon a disposition of an interest in a passive activity." H.R. Rep. No. 795, 100th Cong.,

2d Sess. 32 (1988). The legislative history also explains the purpose behind new *I.R.C. § 469(g)(1)(C)*:

In addition, the bill provides that, pursuant to regulations, to the extent necessary to prevent avoidance of the provision, income or gain from a passive activity in taxable years preceding the taxpayer's disposition of the activity is taken into account in determining the amount of the loss allowed against non-passive income upon disposition. Regulatory authority might appropriately be exercised, for example, in situations where passive activities produce taxable passive income in the initial years of an investment and then a loss upon disposition, such as where the investment is structured so that income is recognized in years prior to the allowance of related deductions.

For a comprehensive discussion of *I.R.C. § 469*, see R. Lipton & D. Evaul, *Passive Activity Losses*, *CCH Tax Transactions Library* (1990).

(n407)Footnote 397. Assume that Owner purchased the property from someone other than Lender so that even if Owner were solvent, the discharge could not be a purchase price adjustment within the meaning of *I.R.C. § 108(e)(5)*.

(n408)Footnote 398. *Treas. Reg. § 1.1001-2(a)(2), (c)* (ex. 8).

(n409)Footnote 399. *Treas. Reg. § 1.1001-2(c)* (ex. 8).

(n410)Footnote 400. If Owner has no other *I.R.C. § 1231* gains or losses, the loss will be an ordinary loss. *I.R.C. § 1231(a)(2)*. The loss limitations imposed by *I.R.C. § 1211* would not apply to the loss. *I.R.C. § 1231(a)(4)(ii)*. Because the loss would not be a "net capital loss" for the taxable year, *I.R.C. § 108(b)(2)(C)* (reduction of tax attributes) would not apply to the loss.

(n411)Footnote 401. H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. II-143 (1986).

(n412)Footnote 402. S. Rep. No. 313, 99th Cong., 2d Sess. 725 (1986). See also Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 225 (Comm. Print 1987).

(n413)Footnote 403. S. Rep. No. 313, 99th Cong., 2d Sess. 725 (1986).

(n414)Footnote 404. *Treas. Reg. § 1.1001-2(a)(2), (c)* (ex. 8).

(n415)Footnote 405. *I.R.C. § 55(b)*.

(n416)Footnote 406. *I.R.C. § 55(a)*.

(n417)Footnote 407. *I.R.C. § 55(b)(2)*.

(n418)Footnote 408. *I.R.C. § 56(d)*. See *Priv. Ltr. Rul. 9503007* (Oct. 17, 1994).

(n419)Footnote 409. *I.R.C. § 56(g)(1)*. S corporations are excluded from the rule. *I.R.C. § 56(g)(6)*.

(n420)Footnote 410. See *I.R.C. § 56(f)*, prior to repeal by Pub. L. No. 101-508, § 11801(a)(3) (Nov. 5, 1990); *Tech. Adv. Mem. 9402003*. See generally Jacobs, *The Post-TAMRA Chapter 11 Corporate Tax Survival Kit*, 41 U.S.C. Tax Instit. ch. 7 (1989).

(n421)Footnote 411. *I.R.C. § 56(g)(4)(B)(i)*. See *Priv. Ltr. Rul. 9037033* (June 18, 1990).

(n422)Footnote 412. H.R. Rep. No. 247, 101st Cong., 1st Sess. 1344 (1989).

(n423)Footnote 413. See *P TX6.03[5][e][ii]* *supra*.

(n424)Footnote 414. See chapter TX8 *infra*. The Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-65 (1993), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(k)(i) (Matthew Bender 15th Ed. Revised), prospectively repealed the stock for debt exception for stock transferred after December 31, 1994, unless the issuing corporation is in a title 11 or similar case that was filed before January 1, 1995.

(n425)Footnote 415. See *I.R.C. § 857(a)*.

(n426)Footnote 416. See *I.R.C. § 856(c)(2)* and (3).

(n427)Footnote 417. *I.R.C. §§ 857(a)(1)(B), (e)(2)(D)*.

(n428)Footnote 418. *I.R.C. § 857(e)(1)(B)*.



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CHAPTER TX6 Discharge of Indebtedness and I.R.C. Section 108 Relief

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CHAPTER TX6 Discharge of Indebtedness and I.R.C. Section 108 Relief

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P TX6.50 Form: Section 108 Flow Chart

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CHAPTER TX6 Discharge of Indebtedness and I.R.C. Section 108 Relief

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P TX6.51 Checklist and Summary: Section 108(i) Reacquisition of an Applicable Debt Instrument In 2009 and 2010

A. Is COD eligible for exclusion under Section 108(i) as a reacquisition of an Applicable Debt Instrument:

1. Has Taxpayer realized discharge of indebtedness (COD) income under Section 61(a)(12)?

2. The term "Applicable Debt Instrument" means:

a. Bond, note, certificate or any other contractual arrangement constituting indebtedness (within Section 1275(a)(1)),

b. Issued by

i. A C corporation, or

ii. Any other person in connection with the conduct of a trade or business by such person.

1) The term has been interpreted broadly and should be a low-minimal threshold. *See Snow v. Commissioner, 416 U.S. 500 (1974) ; Huntsman v. Commissioner, 905 F.2d 1182 (8th Cir. 1990) .*

2) May not apply to investment partnerships.

3) Courts have adopted low "trade or business" threshold for real estate. *See Hazard v. Commissioner, 7 T.C. 372 (1946) (rental of former residence held to be trade or business); PLR 8314021 (Dec. 29, 1982)*

3. The term "reacquisition" means:

a. Any "acquisition" of the debt instrument by the debtor/issuer or a related person after December 31,

2008 and before January 1, 2011.

b. An "acquisition" shall include, "without limitation":

- i. Cash purchase.
- ii. Exchange of debt-for-debt (including a significant modification).
- iii. Exchange of debt-for-equity--stock, a partnership interest or a contribution to capital,
and
- iv. Complete forgiveness by the holder.

B. Taxpayer makes an election "with respect to any applicable debt instrument" on Form 982 with timely filed tax return for year (including extensions). See generally Treas. Reg. Section 1.108(c)-1 (Dec. 11, 1996), redesignated as Section 1.108-5 (Oct. 22, 1998).

1. Election for pass thru entities made by entity.
2. Election is irrevocable (and other § 108 provisions will not apply).
3. Other § 108 provisions are preempted and will not apply.

C. COD income is deferred and ratably included as ordinary income.

1. 2009: 5 year deferred, then 20% a year recognized for next five years.
2. 2010: 4 year deferred, then 20% a year recognized for next five years.
3. No basis or attribute reduction.



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CHAPTER TX6 Discharge of Indebtedness and I.R.C. Section 108 Relief

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P TX6.52 Checklist and Summary: Section 108(c) Real Property Business Indebtedness

A. Is COD eligible for exclusion under Section 108(a)(1)(D) as Qualified Real Property Business Indebtedness (QRPBI):

1. Has Taxpayer realized discharge of indebtedness (COD) income under Section 61(a)(12)?
2. Taxpayer is not a C corporation.
3. Debt must be incurred or assumed in connection with real estate used in the taxpayer's trade or business (land used in a trade or business should qualify).
4. Debt must be secured by that real estate.
5. Debt is either:
 - a. Incurred or assumed by the taxpayer before 1/1/93, or
 - b. Qualified Acquisition Debt (QAI)-debt incurred to acquire, construct, reconstruct or substantially improve the real estate secured by the debt (including refinanced QAI to extent amount does not exceed original principal amount).
6. Debt is not qualified farm indebtedness.

B. Even if the COD is eligible, there are two limits on exclusion:

1. Amount excluded cannot exceed excess of (a) outstanding principal balance of subject debt (immediately before and after the discharge), over (b) the FMV (determined immediately before discharge and without regard to Section 7701(g) of the subject real estate, reduced by the outstanding principal amount of any other QRPBI securing the property before and after the discharge. *Treas. Reg. Section 1.108-6.*

2. Amount excluded cannot exceed the aggregate adjusted bases of depreciable real estate (after reductions under Section 108(b) and (g) for the same taxable year) on the first day of the next taxable year (or on disposition, if earlier), held by the taxpayer immediately before the discharge, but excluding depreciable real estate acquired "in contemplation" of the discharge.

C. Taxpayer must make election on Form 982 with timely filed tax return for year (including extensions). *Treas. Reg. Section 1.108-5*.

D. Partners may need to follow consent procedures under *Treas. Reg. § 1.1017-1(g)*.

E. For additional information, see Form 982 and IRS Publication 4681, Canceled Debts, Foreclosures, Repossessions, and Abandonments (for individuals).



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CHAPTER TX7 Tax Treatment of Creditors

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CHAPTER TX7 Tax Treatment of Creditors

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P TX7.01 Introduction

The federal income tax treatment of creditors holding claims in a title 11 or similar case (as well as in a nonbankruptcy workout) will vary depending on many factors. One factor is the tax classification of the creditor, for example, whether the creditor is an individual, corporation or partnership. The tax treatment of the satisfaction of a claim will also depend on the creditor's method of accounting, tax residence, the origin or genesis of its claim, and tax classification of the debtor. Another general factor is whether the transaction in which the creditor receives compensation for its claim qualifies as a tax-free or taxable transaction.

This chapter will focus on the federal income tax treatment of U.S. resident persons, both entities and individuals, who are creditors of a debtor in a title 11 case. It will only touch briefly on the treatment of foreign persons and financial institutions. n1

FOOTNOTES:

(n1)Footnote 1. For a detailed discussion of these topics, see R. Rhoades & M. Langer, U.S. International Taxation and Tax Treaties (Matthew Bender) and KPMG, LLP, Taxation of Financial Institutions (Matthew Bender).



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CHAPTER TX7 Tax Treatment of Creditors

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P TX7.02 Tax Classification of Creditors

A major factor in the tax treatment of a creditor holding a claim is the classification of such creditor for tax purposes. There are many different aspects involved in such classification that can affect the tax consequences of the satisfaction of the creditor's claim. The starting point is determining the organizational type of the creditor. Is the creditor an individual, a partnership for tax purposes (including certain limited liability companies), n1 an entity taxable as a "regular" corporation pursuant to subchapter S of the Internal Revenue Code, n2 or an entity taxable as a corporation pursuant to subchapter C n3 of the Internal Revenue Code? Furthermore, the creditor may be a financial institution such as a bank, a thrift or an insurance company, each of which has its own unique set of rules governing taxation under the Internal Revenue Code.

A second aspect involved in classifying a creditor for tax purposes is its method of accounting. The two principal general accounting methods, although there are many variations, are the cash method n4 and the accrual method. n5 In general, since 1976, only individuals, certain very simple partnerships and certain small corporations are permitted to utilize the cash method. n6 Obviously, the creditor's method of accounting will have a good deal to do with the timing of the recognition of income, losses and deductions. An accrual method taxpayer will often recognize income, losses and deductions earlier than a cash method taxpayer.

A third aspect of creditor classification is the tax residence of the creditor. In general, if a creditor has a tax residence outside of the territorial United States, that creditor will be treated as a foreign person for income tax purposes. n7 For a foreign person "engaged in a trade or business" in the United States, the net income that is "effectively connected" with the conduct of that trade or business is taxed in the same manner as net income earned by a U.S. resident person. Thus, the tax treatment of a foreign creditor will often depend upon whether such creditor is engaged in a trade or business in the United States, as well as the foreign country of which such creditor is a resident. n8 The tax treatment of foreign persons is dictated by various provisions of the Internal Revenue Code as well as treaties between the United States and the country in which such foreign person resides. n9

A fourth aspect of creditor classification is the tax characterization of the claim that the creditor holds. Is the claim a capital asset in the creditor's hands or is it a right to receive ordinary income? If the claim is an ordinary income right, did it result from the provision of services or from the sale of goods or merchandise to the debtor?

As will be seen in the remainder of this chapter, all of the above factors will affect the tax treatment of a creditor.

FOOTNOTES:

(n1)Footnote 1. *See Treas. Reg. §§ 301.7701-1, -2 and -3* (certain entities that would be treated as tax partnerships under a default rule may elect to be taxed as a C corporation). The partnership is taxable as a passthrough entity. Thus, income, deduction and credit items of the partnership are passed through to the partners and treated as items on the partners' tax returns.

(n2)Footnote 2. *I.R.C. §§ 1361-1379*. An S corporation is taxable as a passthrough entity. Thus, income, deduction and credit items of the S corporation are passed through to the shareholders and treated as items on the shareholders' tax returns.

(n3)Footnote 3. *I.R.C. §§ 301-385*. A C corporation is taxable on its own income, deduction and credit items.

(n4)Footnote 4. In general (and there are many exceptions to this generalization), a taxpayer using the cash (or cash receipts and disbursements) method of accounting includes items in income in the taxable year when cash or property is actually or constructively received. *Treas. Reg. § 1.451-1(a)*. Items are deductible, generally (with multiple exceptions) in the taxable year when cash or property is actually paid. *Treas. Reg. § 1.461-1(a)(1)*. Deductions are also allowed for depreciation, depletion and certain losses that do not involve cash disbursements in the current year (because the cash was paid in a prior year and a deduction was not then permitted). *Treas. Reg. § 1.461-1(a)(1)*.

(n5)Footnote 5. If a taxpayer uses an accrual method of accounting, an item is includible in income when all the events have occurred that fix the right to receive such income and the amount thereof can be determined with reasonable accuracy. *Treas. Reg. § 1.451-1(a)*. Thus, an accrual basis taxpayer will often recognize income before payment is received. In general (and there are many exceptions to this generalization), an expense is deductible under the accrual method in the taxable year in which all the events have occurred that establish the liability, the amount thereof can be determined with reasonable accuracy, and economic performance has occurred with respect to the liability. *Treas. Reg. § 1.461-1(a)(2)*. Capital expenditures are only deductible when and to the extent the depreciation rules would allow such deductions. *Treas. Reg. § 1.461-1(a)(2)*.

(n6)Footnote 6. *See I.R.C. § 448*.

(n7)Footnote 7. *See I.R.C. § 7701(a)(1) and (5); Treas. Reg. § 301.7701-5*.

(n8)Footnote 8. For a thorough discussion of the income tax treatment of foreign persons, *see* T. Bissell, U.S. Income Taxation of Nonresident Alien Individuals, 907 Tax Mgmt. Foreign Income Portfolios (BNA) and J. Katz & C. Plambeck, U.S. Income Taxation of Foreign Corporations, 908 Tax Mgmt. Foreign Income Portfolios (BNA).

(n9)Footnote 9. *See, e.g., I.R.C. §§ 871, 881, and 882*.



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CHAPTER TX7 Tax Treatment of Creditors

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P TX7.03 Creditors of a Corporate Debtor

[1] Tax-Free Reorganizations

A creditor may receive consideration from a corporate debtor in a transaction that qualifies as a tax-free reorganization under *I.R.C. section 368(a)*. Generally, in the context of the receipt of consideration from a financially troubled debtor corporation, the transaction most often will be characterized as either a one-corporation tax-free recapitalization of the debtor qualifying under section 368(a)(1)(E) ("E reorganizations") or a two-corporation asset transfer/divisive reorganization qualifying under section 368(a)(1)(G) ("G reorganizations"). n1

[a] Receipt of Stock or Tax Securities

A creditor holding a claim constituting a tax security, as explained below, who receives only stock or tax securities, the principal amount of which does not exceed the principal amount of the old tax security, in a tax-free reorganization does not recognize gain or loss on the exchange. n2 There is also an exception to non-recognition to the extent that stock or securities received are attributable to accrued interest on the old security. n3 Therefore, in order to qualify for non-recognition treatment, the claim held by the creditor must constitute a tax security *and* the consideration received in exchange for such claim must also constitute a tax security.

The Internal Revenue Code does not define the term "security." However, bonds or debentures with an original term in excess of five years have generally been held to be tax securities. n4 On the other hand, instruments with a five year term or less rarely qualify as tax securities. n5

The above "rules of thumb," however, may give way to the facts and circumstances surrounding the origin and nature of a particular claim and its maturity date. The courts have also considered the following factors in determining whether notes are securities: n6

- Were the notes an integral part of the corporation's forming and financing?
- Did the rights created by the notes constitute permanent contributions to the corporation's business, not merely temporary advances of rights to be used for current needs?
- Were the noteholders assuming a substantial risk of the corporation's enterprise and, on the date of

issuance, inextricably and indefinitely tied up with the success of the venture, in some respects similar to stockholders?

- Were the notes and stock merely different forms of a general participation in the risks of the business enterprise? n7

Creditors who do not hold tax securities or who do not receive stock or securities in a tax-free reorganization are treated in the same manner as creditors in a taxable transaction. n8

[b] Receipt of Boot

Property other than qualified stock and securities, including securities representing the excess of principal amount over the old securities, is known as "boot." A creditor that receives boot consideration in an otherwise tax-free reorganization will recognize any gain realized on the exchange to the extent of the amount of boot received. n9 However, a creditor receiving boot is not permitted to recognize a loss, if any, on the exchange. n10 The amount of boot is equal to the amount of cash, the fair market value of property and, probably, the issue price of any debt instruments qualifying as boot received in the exchange. n11

The amount of gain realized by a creditor is equal to the "amount realized" less the creditor's tax basis in the claim. n12 The amount realized, for cash and accrual basis taxpayers, is the amount of cash plus the issue price of any debt instruments, plus the fair market value of all other property received. n13 The issue price is determined by the original issue discount ("OID") rules. n14

[c] Character of Gain

In the case of a creditor whose existing claims constitute capital assets in the creditor's hands, n15 the gain required to be recognized will be classified as a capital gain, except to the extent of interest (including amounts related to accrued market discount). n16 In this regard, it should be noted that *I.R.C. section 582(c)* provides that the sale or exchange of a bond, debenture, note or certificate, or other evidence of indebtedness by a bank or certain other financial institutions shall not be considered the sale or exchange of a capital asset. Accordingly, any gain recognized by such creditors as a result of an exchange will be ordinary income notwithstanding the nature of their claims.

Any capital gain or loss recognized by a creditor will be long-term capital gain or loss with respect to such claims for which the creditor's holding period is more than one year n17 and short-term capital gain or loss with respect to such claims for which the creditor's holding period is one year or less. n18 Currently, there may be a favorable differential tax rate applied to capital gains for individuals depending on their marginal tax bracket. n19

[d] Tax Basis and Holding Period of Stock and Securities Received

The aggregate tax basis of any stock and securities received by a creditor, other than amounts received on account of interest, will be a substituted basis equal to the creditor's basis in the claim surrendered (other than any claims in respect of accrued interest), increased by any gain recognized on the exchange and decreased by the amount of any cash and the fair market value of any property received. n20 This aggregate basis will, in turn, be allocated among the stock and securities received in proportion to the fair market values (at the time of the exchange) of each class of stock and securities received. n21 The excess of the issue price of debt obligations received over the creditor's tax basis in the debt obligations surrendered may constitute market discount. Any gain recognized by the creditor upon a subsequent sale or exchange of such debt obligations will be ordinary income to the extent of any accrued market discount. n22

The creditor's holding period for the stock or tax securities received will include the period during which such creditor held the tax security exchanged therefor, if such tax security was a capital asset in the creditor's hands. n23

[e] Tax Basis and Holding Period of Other Property Received

The tax basis of property other than qualified stock and securities received in a tax-free reorganization is the fair market value of such property at the time of the exchange. n24 The holding period for such property begins on the day after the date of the exchange. n25

[2] Taxable Transactions

Creditors who receive consideration in transactions that do not qualify as tax-free reorganizations and creditors who either do not exchange stock or securities or receive qualified stock or securities in an otherwise tax-free reorganization will recognize gain or loss in these transactions. n26 Such gain or loss is the difference between the amount realized (*i.e.*, the issue price of indebtedness received, n27 plus the cash and the fair market value of property received) less any amounts allocable to interest, and such creditor's basis in the claims surrendered. n28

Gain or loss will be characterized in the same way as described above. n29 The tax basis of any property received will equal the amount realized (*i.e.*, the amount of cash, the issue price of debt obligations, and the fair market value of other property received) with respect to such property in the exchange. n30 The holding period of property received will begin on the day after the date of the exchange. n31

FOOTNOTES:

(n1)Footnote 1. The requirements for qualification as a tax-free reorganization are discussed in detail in chapter TX10 *infra*.

(n2)Footnote 2. *I.R.C. §§ 354(a)(1)-(2)(A)(i)*.

(n3)Footnote 3. *I.R.C. § 354(a)(2)(B)*.

(n4)Footnote 4. *See, e.g., Rev. Rul. 59-98, 1959-1 C.B. 76 (1959) (bonds with average life of 61/2 years)*.

(n5)Footnote 5. *See Neville Coke & Chem. Co. v. Commissioner, 148 F.2d 599 (3d Cir. 1945), cert. denied, 326 U.S. 726, 66 S. Ct. 32 (1945)*. This case is the most often cited for the proposition that bonds with 5-year maturities or less are not securities. *See, e.g., D'Angelo Assocs., Inc. v. Commissioner, 70 T.C. 121 (1978)*. In so holding, the *Neville* court stated that the maturity date was not determinative and stressed that the bondholder was not a party to the reorganization but was instead an assignee of the parties. *Neville Coke & Chem. Co. v. Commissioner, 148 F.2d 599, 602-603 (3d Cir. 1945), cert. denied, 326 U.S. 726, 66 S. Ct. 32 (1945)*. The continuity of interest analysis in the case is criticized in Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders* 12-42 (WGL 7th ed. 2000). Note, however, that a debt instrument with a term of less than five years can qualify as a tax security when received in a reorganization in exchange for a similar debt instrument (albeit with a sufficiently different interest rate that would cause it to constitute a significant modification under *Treas. Reg. § 1.1001-3*). with the same maturity date that had an original term of more than five years and qualified as a tax security. *Rev. Rul. 2004-78*.

(n6)Footnote 6. Positive responses tend to support the conclusion that the obligation is a security.

(n7)Footnote 7. *See United States v. Mills, 399 F.2d 944, 947 (5th Cir. 1968) (quoting from Camp Wolters Enters. v. Commissioner, 230 F.2d 555 (5th Cir. 1956)) (holding that one year notes that were renewed twice were securities)*. *See also Lagerquist v. Commissioner, 53 T.C.M. (CCH) 530 (1987)*. These cases indicate that indebtedness issued by a troubled company, when repayment is in doubt, can be treated as a security, even if the term of such indebtedness would not otherwise lead to such a conclusion.

(n8)Footnote 8. *See P TX7.03[2] infra.*

(n9)Footnote 9. *I.R.C. § 356(a)(1) and (d).*

(n10)Footnote 10. *I.R.C. § 356(c).*

(n11)Footnote 11. *I.R.C. § 356(a)(1).* The statute can be read literally to include the fair market value of securities. Given the increasing prevalence of attempts to coordinate various aspects of the Internal Revenue Code involving indebtedness with the original issue discount ("OID") rules, however, this area appears to be another appropriate place for substituting the issue price of a debt instrument for the term "fair market value."

(n12)Footnote 12. *I.R.C. § 1001(a).*

(n13)Footnote 13. *I.R.C. § 1001(b);* Treas. Reg. § 1.1001- 1(g)(1).

(n14)Footnote 14. *I.R.C. §§ 1272-1275.* Chapter TX9 *infra* contains a detailed discussion of these rules.

(n15)Footnote 15. *I.R.C. § 1221* defines a capital asset as all property held by a taxpayer (whether or not connected with his trade or business) except for the following:

- (1) inventory or other property held by the taxpayer primarily for sale to customers in the ordinary course of business;
- (2) depreciable property or real property used in the trade or business;
- (3) a copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property held by the creator of such property or (in the case of a letter, memorandum or similar work) by the person for whom the property was prepared or produced;
- (4) accounts or notes receivable acquired in the ordinary course of trade or business for services rendered or from the sale of property described in paragraph (1);
- (5) a publication of the United States Government obtained other than by purchase at the price at which it is offered for sale to the public;
- (6) any commodities derivative financial instrument held by a commodities derivatives dealer (subject to certain exceptions);
- (7) any hedging transaction which is clearly identified as such before the close of the day on which it was acquired, originated, or entered into (or such other time as the IRS may by regulations prescribe); or
- (8) supplies of a type regularly used or consumed by the taxpayer in the ordinary course of a trade or business of the taxpayer.

(n16)Footnote 16. The exclusion for amounts allocable to interest is necessary to prevent the double inclusion of income. If the amount realized for purposes of determining the amount of capital gain includes the amount allocable to interest, then such amount would be included as additional capital gain (or reduction in capital loss) as well as interest income.

(n17)Footnote 17. *I.R.C. § 1222(3) and (4).*

(n18)Footnote 18. *I.R.C. § 1222(1) and (2).*

(n19)Footnote 19. *I.R.C. § 1(h).*

(n20)Footnote 20. *I.R.C. § 358(a)(1).*

(n21)Footnote 21. *Treas. Reg. § 1.358-2(a)(3)* (for a security holder who owned securities, all of one class, before the exchange). *But see* Prop. Treas. Reg. § 1.358-2 (allowing a security holder to trace or designate which stock or security was received in exchange for a particular security).

(n22)Footnote 22. *See P TX7.07 infra.*

(n23)Footnote 23. *I.R.C. § 1223(1).*

(n24)Footnote 24. *I.R.C. § 358(a)(2).*

(n25)Footnote 25. *Cates v. Commissioner*, 716 F.2d 1387, 1389 (11th Cir. 1983) ; *Fogel v. Commissioner*, 203 F.2d 347 (5th Cir. 1953) ; *Rev. Rul. 70-598*, 1970-2 C.B. 168 .

(n26)Footnote 26. Exchanges of property are generally taxable under the Internal Revenue Code, unless a specific nonrecognition provision applies to the exchange. *I.R.C. § 1001(c)* and *Treas. Reg. § 1.1002-1(a)*.

(n27)Footnote 27. The issue price is determined by the OID rules in *I.R.C. §§ 1272-1275*. Chapter TX9 *infra* contains a detailed discussion of these rules.

(n28)Footnote 28. *I.R.C. § 1001(a), (b)*; *Treas. Reg. § 1.1001- 1(g)(1)*.

(n29)Footnote 29. *See P TX7.03[1][c] supra.*

(n30)Footnote 30. *I.R.C. § 1012* and *Treas. Reg. § 1.1012-1(a)*.

(n31)Footnote 31. *Rev. Rul. 66-97*, 1966-1 C.B. 190 (1966) .



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CHAPTER TX7 Tax Treatment of Creditors

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P TX7.04 Creditors of a Non-Corporate Debtor

A creditor of a non-corporate debtor should be treated in the same way as a creditor of a corporate debtor participating in a taxable transaction. n1 Such creditor will generally recognize gain or loss on the transaction. n2

A creditor of a tax partnership may be entitled to non-recognition treatment if the creditor receives an interest in the partnership in exchange for its claim. n3 If, however, the creditor's claim is for services rendered to the tax partnership and such creditor receives a capital interest in the partnership, the creditor will recognize income equal to the fair market value of the partnership interest. n4 If such creditor receives only a profits interest in the tax partnership, the tax consequences to the creditor are less clear. n5

FOOTNOTES:

(n1)Footnote 1. *See P TX7.03[2] supra.*

(n2)Footnote 2. Exchanges of property are generally taxable under the Internal Revenue Code, unless a specific nonrecognition provision applies to the exchange. *I.R.C. § 1001(c)* and *Treas. Reg. § 1.1002-1(a)*.

(n3)Footnote 3. *I.R.C. § 721. See also chapter TX13 infra* for a further discussion of partnerships.

(n4)Footnote 4. *Treas. Reg. § 1.721-1(b)(1)*.

(n5)Footnote 5. *Compare Treas. Reg. § 1.721-1(b)(1) with Campbell v. Commissioner, 59 T.C.M. (CCH) 236 (1990), rev'd in part, 943 F.2d 815 (8th Cir. 1991) and Rev. Proc. 93-27, 1993-2 C.B. 343 (1993). See also Diamond v. Commissioner, 56 T.C. 530 (1971), aff'd, 492 F.2d 286 (7th Cir. 1974). But see Notice 2005-43 and Prop. Treas. Reg. § 1.83-3(e), (l) (proposing to treat a service provider's receipt of a profits interest as property under I.R.C. Section 83), subject to a safe harbor valuation provision.*



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CHAPTER TX7 Tax Treatment of Creditors

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P TX7.05 Bad Debt Deduction

I.R.C. section 166 provides for the treatment of worthless and partially worthless indebtedness. *I.R.C. section 166* does not apply to public (*i.e.*, issued with interest coupons or in registered form) corporate or governmental indebtedness ("securities"). n1 If such a security is held as a capital asset by the creditor and becomes worthless during the taxable year, the creditor must treat the loss as if it resulted from the sale or exchange of a capital asset on the last day of the taxable year. n2

Non-corporate creditors holding indebtedness that is not connected with their trade or business ("nonbusiness debts") may only take a short-term capital loss in the taxable year in which the nonbusiness debt becomes wholly worthless. n3

It has been held that an individual can be in the trade or business of being an employee. n4 Thus, a bad debt arising out of a loan from an employee to his or her employer can be treated as a business bad debt for the employee. n5 The test established by the Treasury Regulations is whether the debt is proximately related to the trade or business of the creditor. n6 This issue often requires a difficult factual analysis in situations involving shareholder-employee creditors. Since a loan by a shareholder, in the capacity as a shareholder, would be proximately related to an investment interest and not a trade or business, bad debts arising out of shareholder loans are non-business bad debts. n7 When an individual is both a shareholder and an employee of the debtor, the shareholder-employee's relationship with the debtor must be characterized to determine the status of the bad debt. The Supreme Court has held that in order for a shareholder-employee to take a business bad debt deduction, the *dominant* motivation, not just a significant motivation, of the individual in making the loan must have been to protect his or her employment or some aspect of employment (*e.g.*, salary). n8 In the factual analysis necessary in determining the dominant motivation test, a significant factor is the relationship between the amounts of the loan, the equity investment, and the salary of the individual shareholder-employee. n9

Even if a shareholder-employee is successful in treating a bad debt as a business bad debt deduction, such deduction should be treated as an employee business deduction. n10 As such, it will be a miscellaneous itemized deduction, n10a subject to the two percent of adjusted gross income floor, n11 as well as being excluded for alternative minimum tax purposes. n12

The remainder of this discussion relates to indebtedness other than securities and nonbusiness debts.

[1] Wholly Worthless Debts

I.R.C. section 166 permits a deduction for indebtedness that becomes wholly worthless during a taxable year. n13 The amount of the deduction is the creditor's adjusted basis in the indebtedness at the time of the worthlessness. n14 In order to prove the worthlessness of the debt, the taxpayer must establish the existence of an "identifiable event" indicating worthlessness. n15 A bankruptcy filing by the debtor is an identifiable event, but may only indicate partial worthlessness of an unsecured debt. n16 Any prospect of recovery should eliminate a claim of total worthlessness.

[2] Partially Worthless Debts

A creditor may take a deduction for a debt that is partially worthless (*i.e.*, the debt has a prospect of some recovery, but such recovery will be less than the tax basis of such indebtedness). n17 In order for a creditor to take a deduction for a partially worthless debt, the creditor is required to charge off on its books the portion of the indebtedness that is partially worthless. n18 As is required with wholly worthless debts, there should be an identifiable event, such as the filing of bankruptcy by the debtor, indicating partial worthlessness. n19 In addition, the creditor must be able to substantiate the amount of partial worthlessness. n20

The case law appears to require that an analysis of recovery by the creditor be performed by a person familiar with the debtor's business and industry. n21 That person could be the creditor itself or an investment banker, accountant or appraiser if such person can be considered an expert with respect to the debtor's business. This analysis should, at a minimum, include an analysis of the debtor's balance sheet and a liquidation analysis. n22 In addition, if it appears that the debtor may continue as a going concern, a going concern valuation should be performed. n23 Consideration should also be given to the value of the collateral supporting the debt. n24

[3] Recapture of Loss or Deduction

The creditor's tax basis in its debt is reduced by the amount of the deduction allowed under *I.R.C. section 166(a)*. A recovery (either by sale or repayment of the indebtedness) in excess of the basis of the debt should result in ordinary income to the creditor, at least to the extent of the prior reduction. n25 Furthermore, if the creditor receives stock of the corporate debtor for its claim, the amount of any deduction taken pursuant to *I.R.C. section 166(a)* on the original claim is subject to recapture as ordinary income on the disposition of such stock. n26 If the stock is later exchanged in a tax-free reorganization, the recapture "taint" will carry over to the new securities received and ordinary income will be recognized to the extent of gain recognized pursuant to *I.R.C. section 356*. n27

[4] Retirement of Debt

It appears that the bad debt provisions in *I.R.C. section 166* conflict at times with *I.R.C. section 1271* when a debtor retires a partially worthless debt that is not a security but is held as a capital asset. n28 *I.R.C. section 166* appears to allow the creditor to deduct the partially worthless debt if the creditor is a corporation or the debt is not a "nonbusiness debt." n29 *I.R.C. section 1222*, however, appears to require a creditor to recognize a capital loss upon sale or exchange of such debt, and therefore *I.R.C. section 1271(a)*, which treats retirement as an exchange, appears to require the creditor to recognize a capital loss upon the retirement of that debt. n30

The courts' resolution of this apparent conflict hinges on when the debt is charged off and whether the charge-off is independent of the retirement. *I.R.C. section 166(a)(2)* requires the taxpayer to charge off the worthless part of the debt in order to qualify for the deduction, and courts have held that a taxpayer may not invoke *I.R.C. section 166(a)(2)* to deduct a partially worthless debt that is charged off after the taxpayer no longer owns the debt. n31 After the debt is sold, exchanged, or retired, the debt is no longer the taxpayer's property and taxpayers cannot charge off debts that they no longer hold.

Some jurisdictions also require that the charge-off be independent of a subsequent sale, exchange, or retirement for the taxpayer to claim a bad debt deduction. n32 Independence is possible even if the charge-off occurs in the same tax year as the sale, exchange, or retirement. n33 Independence is not, however, guaranteed by charging off the debt in the tax year prior to the sale, exchange, or retirement. n34

Therefore, to avoid a capital loss when a debt might be retired, a creditor should try to apply *I.R.C. section 166*, if possible: The creditor should charge off the debt before it is retired, the charge-off should be independent of the subsequent retirement, and the creditor must satisfy the criteria for partial worthlessness under *I.R.C. section 166*. n35

FOOTNOTES:

(n1)Footnote 1. *I.R.C. §§ 166(e) and 165(g)(2)(C)*.

(n2)Footnote 2. *I.R.C. § 165(g)(1)*.

(n3)Footnote 3. *I.R.C. § 166(d)*. See *P TX7.05[1] infra* for a discussion of wholly worthless debt.

(n4)Footnote 4. *United States v. Generes*, 405 U.S. 93, 101, 92 S. Ct. 827, 832, 31 L. Ed. 2d 62, 69 (1972) ; *Rev. Rul. 71-561*, 1971-2 C.B. 128 .

(n5)Footnote 5. *Id.*

(n6)Footnote 6. *Treas. Reg. § 1.166-5(b)*.

(n7)Footnote 7. See *United States v. Generes*, 405 U.S. 93, 100, 92 S. Ct. 827, 832, 31 L. Ed. 2d 62, 69 (1972) .

(n8)Footnote 8. *United States v. Generes*, 405 U.S. 93, 103, 92 S. Ct. 827, 833, 31 L. Ed. 2d 62, 70 (1972) .

(n9)Footnote 9. See, e.g., *United States v. Generes*, 405 U.S. 93, 106-07, 92 S. Ct. 827, 834-35, 31 L. Ed. 2d 62, 72 (1972) .

(n10)Footnote 10. *I.R.C. § 162(a)*.

(n11)Footnote 10a. *I.R.C. § 62(a)(1)*.

(n12)Footnote 11. *I.R.C. § 67*.

(n13)Footnote 12. *I.R.C. § 56(b)(1)(A)(i)*.

(n14)Footnote 13. *I.R.C. § 166(a)(1)*.

(n15)Footnote 14. *I.R.C. § 166(b)*.

(n16)Footnote 15. See *Estate of Mann v. United States*, 731 F.2d 267, 276 (5th Cir. 1984) ; *Crown v. Commissioner*, 77 T.C. 582, 598 (1981) , *acq.*, 1982-2 C.B. 1 ; *Julicher v. Commissioner*, T.C. Memo 2002-55 ; *Hubble v. Commissioner*, 42 T.C.M. (CCH) 1537, 1544 (1981) .

(n17)Footnote 16. *Treas. Reg. § 1.166-2(c)(1)*.

(n18)Footnote 17. *I.R.C. § 166(a)(2)*.

(n19)Footnote 18. *Treas. Reg. § 1.166-3(a)(2)*.

(n20)Footnote 19. The determination of partial worthlessness requires convincing evidence such that the IRS will, in its discretion, permit a deduction. *Treas. Reg. § 1.166-3(a)(2)(iii)*. It would be reasonable to assume that the IRS will require an identifiable event as evidence of the partial worthlessness. The Tax Court has, however, relaxed the standards for identifiable events. See *Bledsoe v. Commissioner*, 70 T.C.M. (CCH) 1136 (1995) (failure of significant project of debtor, combined with stated inability to pay principal or interest on debt, permitted partial worthlessness deduction prior to debtor's discharge in bankruptcy five years later).

(n21)Footnote 20. See *Brimberry v. Commissioner*, 588 F.2d 975, 977 (5th Cir. 1979) ; and *Austin v. Commissioner*, 71 T.C. 955, 971 (1979) , *acq.*, 1979-2 C.B. 1 .

(n22)Footnote 21. See, e.g., *Austin Co. v. Commissioner*, 71 T.C. 955 (1979) .

(n23)Footnote 22. See, e.g., *Austin Co. v. Commissioner*, 71 T.C. 955 (1979) .

(n24)Footnote 23. See *Sika Chem. Corp. v. Commissioner*, 64 T.C. 856 (1975) , *aff'd per curiam*, 538 F.2d 320 (3d Cir. 1976) .

(n25)Footnote 24. *Jessup v. Commissioner*, 36 T.C.M. (CCH) 1145 (1977) .

(n26)Footnote 25. *Treas. Reg. § 1.166-1(f)*.

(n27)Footnote 26. *I.R.C. § 108(e)(7)*. Recapture will be allowed to the extent the deduction is not already recognized as income and only if the stock is disposed of in a transaction in which gain is recognized, to the extent of such recognition. *I.R.C. § 108(e)(7)*.

(n28)Footnote 27. *I.R.C. §§ 108(e)(7)(A) and 1245(b)(3)*.

(n29)Footnote 28. Garlock, *Federal Income Taxation of Debt Instruments*, 4th ed., § 13.06[C].

(n30)Footnote 29. *I.R.C. § 166(a), (d)*.

(n31)Footnote 30. This apparent conflict was created and expanded when Congress enacted the precursor to *I.R.C. § 1271* and broadened its coverage to include virtually all debt instruments. In tax years when *I.R.C. § 1271* or its precursors did not exist or did not apply to the type of debt held by the taxpayer, retirement was not treated as a sale or exchange and therefore did not generate capital loss under § 1222, even when the debt was a capital asset. Instead, loss was ordinary. *Fairbanks v. United States*, 306 U.S. 436 (1939) ; *Mitchell v. Commissioner*, 187 F.2d 706 (2d Cir. 1951) ; *Adam v. Commissioner*, 3 T.C.M. (CCH) 649 (1944) . To the extent that such cases hold that retirement of debt held as a capital asset generates an ordinary loss, these cases have been legislatively overruled by the current version of *I.R.C. § 1271*.

(n32)Footnote 31. See, e.g., *McClain v. Commissioner*, 311 U.S. 527 (1941) (disallowed bad debt deduction when debt charged off after it was retired); *Wachovia Bank and Trust Co. v. United States*, 288 F.2d 750 (4th Cir. 1961) (disallowed bad debt deduction when debt charged off after sale); *Von Hoffmann Corp. v. Commissioner*, 253 F.2d 828 (8th Cir. 1958) (same); *Benedum v. Granger*, 180 F.2d 564 (3d Cir. 1950) (disallowed bad debt deduction when debt charged off after it was exchanged in a bankruptcy reorganization); *Stoddard v. Commissioner*, 141 F.2d 76 (2d Cir. 1944) (same); *Reed v. Commissioner*, 129 F.2d 908 (4th Cir. 1942) (disallowed bad debt deduction when debt not charged off before it was exchanged in a non- recognition transaction); *J. E. Hawes Corp. v. Commissioner*, 44 T.C. 705 (1965) ; *Ardela, Inc. v. Commissioner*, T.C. Memo 1969-83 ; *Levy v. Commissioner*, 46 B.T.A. 423 (1942) , *aff'd*, 131 F.2d 544 (2d Cir. 1942) ; P.L.R. 9253003 .

(n33)Footnote 32. See, e.g., *Mitchell v. Commissioner*, 187 F.2d 706 (2d Cir. 1951) .

(n34)Footnote 33. *Levine v. Commissioner*, 31 T.C. 1121 (1959) .

(n35)Footnote 34. In *John Wanamaker Philadelphia v. Commissioner*, 1 T.C. 937 (1943) , the Tax Court disallowed a bad debt deduction because the charge-off was related to a bankruptcy reorganization. When the creditor charged off the debt, it was participating in developing a reorganization plan that was confirmed in the following tax year. Compare *IDI Management, Inc. v. Commissioner*, T.C. Memo 1977-369 .

(n36)Footnote 35. See P TX7.05[2] *supra*.



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CHAPTER TX7 Tax Treatment of Creditors

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P TX7.06 Receipt of Interest

Consideration attributable to accrued but unpaid interest n1 will be treated as ordinary income, regardless of whether the creditor's existing claims are capital assets in the creditor's hands or the exchange is pursuant to a tax-free reorganization.

A creditor (i) whose accounting method did not previously require that interest attributable to existing claims be included in income accrued but unpaid, and (ii) who exchanges his or her interest claim for cash, property, stock or indebtedness pursuant to a plan of reorganization, will be treated as receiving ordinary interest income to the extent of any consideration so received allocable to such interest, regardless of whether that creditor realizes an overall gain or loss as a result of the exchange of his or her existing claims. n2 However, a creditor who had previously included in income accrued but unpaid interest attributable to existing claims will recognize a loss (generally deductible in full against ordinary income) to the extent such accrued but unpaid interest is not satisfied in full. n3

It is important for creditors to determine whether the debtor plans to accrue and deduct postpetition interest. Otherwise they may be surprised when they receive a Form 1099-INT for such interest after the effective date of the plan of reorganization. n4

It is uncertain whether a debtor may provide in a bankruptcy plan of reorganization for the allocation of payments in satisfaction of claims to interest. If such allocation is possible, the plan may provide that consideration is allocable first to principal and then to interest, thus minimizing the interest income to creditors. On the other hand, the plan could provide that consideration is allocable first to interest and then to principal; this would maximize the creditors' interest income, but possibly also maximize the deductions for the debtor. In *Treasury Regulation sections 1.446-2(e)* and *1.1275-2(a)*, the IRS states that payments on indebtedness are to be allocated to accrued interest first. The House Report to the Bankruptcy Tax Act of 1980, however, indicates that an allocation of value between satisfaction of the principal and accrued interest components of a claim under a chapter 11 plan of reorganization may be binding for federal income tax purposes. n5 It is thus unclear whether the Treasury Regulations should be applied in the chapter 11 context. n6

FOOTNOTES:

(n1)Footnote 1. For purposes of this discussion, "accrued" interest means interest that was accrued while the underlying

claim was held by the creditor. *See I.R.C. §§ 354(a)(2)(B) and 355(a)(3)(C).*

(n2)Footnote 2. *I.R.C. §§ 354(a)(2)(B) and (3)(B) and 355(a)(3)(C) and (4)(B).*

(n3)Footnote 3. S. Rep. No. 1035, 96th Cong., 2d Sess. 38 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised); *Priv. Ltr. Rul. 200345049* ; *Priv. Ltr. Rul. 9629016* .

(n4)Footnote 4. If a debtor wants to substantiate and validate its postpetition interest deduction, it will send Form 1099-INT to the appropriate creditors so that it can show the IRS that the interest has been properly reported to the "recipients." Obviously, cash basis creditors do not have to include such interest in their income until it is paid. Remember, however, that (as described above) interest can be paid as part of a tax-free reorganization and even in a transaction in which the creditor realizes a loss. Thus, the debtor, by accruing postpetition interest, can exacerbate the problem in which a creditor has interest income and an unrecognized loss in a tax-free reorganization.

(n5)Footnote 5. H.R. Rep. No. 833, 96th Cong., 2d Sess. 33 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed Revised).

(n6)Footnote 6. It should be noted that the House Report is not the law.



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CHAPTER TX7 Tax Treatment of Creditors

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P TX7.07 Original Issue Discount and Market Discount

The Tax Reform Act of 1984 provided extensive new rules respecting the creation, recognition and reporting of interest (including original issue and market discount) on debt obligations. n1 In general, the new rules expanded the instances of discount and unstated interest, both on original issue and subsequent disposition of the obligation. Despite the issuance of final Treasury Regulations in 1994, n2 the applicability of some of these original issue discount ("OID") rules to many contingent debt instruments remained unclear until June 1996. n3 The OID rules effectively require that all applicable debt instruments bear a minimum rate of interest that accrues regularly over time. n4 To the extent that the terms of a debt instrument do not provide for such accrual, the OID rules convert "principal" into interest and deem it to accrue regularly over time, regardless of when it is actually paid. Even if a debt instrument bears sufficient interest, if such interest is not paid regularly, the OID rules require that the interest be accrued so that it is spread regularly over the term of the debt instrument. Thus, the OID rules may require a holder of a debt instrument to report income in excess of cash interest received, even when no cash interest is received. In addition, the IRS has taken the position in a Technical Advice Memorandum n5 that a holder of an OID obligation must continue to accrue OID even if there is no prospect of payment of the obligation. Even if this position is correct, which is highly questionable, n5a the holder may be able to offset such OID accrual by claiming a deduction for such accrual as part of a claim for total worthlessness or partial worthlessness of the obligation. n6

A crucial factor in determining the OID consequences on the issuance of new indebtedness is whether the claims surrendered have traded or the new indebtedness will trade on an "established securities market." If they have or will so trade within a reasonable period before or after the effective date of the plan of reorganization (or out-of-court workout), the issue price of the new indebtedness will be governed by *I.R.C. section 1273*, which basically uses a fair market value for the issue price. If public trading does not exist, the issue price of the new indebtedness will be governed by *I.R.C. section 1274*. *I.R.C. section 1274*, in general, uses a minimum rate of interest to determine if obligations to which it applies bear OID. If the yield to maturity on the new indebtedness equals or exceeds the applicable federal rate ("AFR") for the month of issuance, the new indebtedness will have an issue price equal to its stated principal amount. n7 In general, a debt instrument governed by *I.R.C. section 1273* will have more OID than a debt instrument with the same terms that is governed by *I.R.C. section 1274*. n8 Even if the issue price of new indebtedness is equal to its stated principal amount (under either *I.R.C. section 1273* or *1274*), the OID rules may require income to be recognized by a holder prior to the receipt of cash interest payments such that the holder recognizes income on the basis of a fixed yield multiplied by the outstanding principal amount over time. n9

A corporate holder of new indebtedness that bears OID and qualifies as a "high yield discount obligation" n10 may be entitled to a dividends received deduction for a portion of the OID it is required to report. n11

In addition, to the extent that a creditor has a lower tax basis in the debt obligations received in a tax reorganization transaction than the principal amount of such obligations for tax purposes, the difference may constitute market discount under *I.R.C. section 1276*.

FOOTNOTES:

(n1)Footnote 1. *I.R.C. §§ 1271 through 1278*. For a complete discussion of these issues, see ch. TX9 *infra*.

(n2)Footnote 2. *Treas. Reg. §§ 1.1271-0 through 1.1275-5*. Sections 1.1275-4, 1.1275-6 and 1.1275-7 were added in 1996.

(n3)Footnote 3. See *Treas. Reg. § 1.1275-4*.

(n4)Footnote 4. This regular accrual is an economic accrual based on a minimum yield to maturity of the debt instrument. *I.R.C. § 1272*.

(n5)Footnote 5. *Tech. Adv. Mem. 9538007 (June 13, 1995)*. See also F.S.A. 200018017.

(n6)Footnote 5a. See, e.g., Martin D. Pollack, et al., Uncollectible OID: To Accrue or not to Accrue?, 84 *J. Taxation* 157.

(n7)Footnote 6. See *P TX7.05 supra*.

(n8)Footnote 7. *Treas. Reg. § 1.1274-1(b)(1)*.

(n9)Footnote 8. This is because the market will generally impute a higher rate of interest than the AFR in pricing a debt instrument.

(n10)Footnote 9. This is because *I.R.C. § 1273(a)(1)* states that OID is the difference between the stated redemption price at maturity and the issue price. If interest is not paid in regular periodic intervals, such interest is added to the stated redemption price at maturity and becomes OID.

(n11)Footnote 10. *I.R.C. § 163(i)*.

(n12)Footnote 11. *I.R.C. § 163(e)(5)(B)*.



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CHAPTER TX7 Tax Treatment of Creditors

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P TX7.08 Installment Method

If a creditor must recognize gain as a result of the satisfaction of its claim in a workout or a bankruptcy reorganization, it is often to the creditor's advantage to defer as much of the gain as possible for as long as possible. *I.R.C. section 453* permits a taxpayer to report gain on the sale of property on the installment method, unless the taxpayer elects to report the gain currently. The installment method requires recognition of gain at the time of and in proportion to the payments made in satisfaction of a claim. A creditor cannot use the installment method of reporting to the extent that the debt instruments received are readily tradable on an established securities market. n1 In addition, a creditor will likely not be able to use the installment method if the creditor's claim is based on the sale of personal property of the type that the creditor normally sells on the installment plan or treats as inventory or real property, if the creditor is a dealer in real property. n2 If the value of a creditor's claim exceeds \$150,000, the creditor may be required to pay interest on the deferred taxes resulting from the installment method and may be required to treat as installment payments any proceeds received on indebtedness secured by the installment obligation. n3

Under *I.R.C. section 453B(a)*, a creditor that holds a claim as an installment obligation will generally be required to recognize gain in full upon the disposition of such installment obligation. *I.R.C. section 453B(a)* however does not apply to distributions that satisfy *I.R.C. section 337(a)*. n4 In addition, *I.R.C. section 453B(a)* does not apply to an exchange that both (a) qualifies as a non-recognition transaction under some other provision of the Code, n5 and (b) does not constitute a satisfaction of the obligation. n6 For example, a creditor holding an installment obligation will not recognize gain when transferring such installment obligation to an entity other than the debtor in a tax-free reorganization. n7 If, however, the creditor holding the installment obligation transfers such obligation to the debtor in exchange for the debtor's stock, *I.R.C. section 453B(a)* probably will apply and the creditor will probably be required to recognize gain in full, even if the transaction satisfies the requirements of a tax-free recapitalization under *I.R.C. section 368(a)(1)(E)*. n8

FOOTNOTES:

(n1)Footnote 1. *I.R.C. § 453(f)(4)*.

(n2)Footnote 2. *I.R.C. § 453(b)(2)* and (l).

(n3)Footnote 3. *I.R.C. § 453A*. This provision only applies to the extent that the creditor holds installment

indebtedness for disposition of property with sales price in excess of \$150,000, that, in the aggregate, exceeds \$5 million. Section 453A states that if a taxpayer has aggregate installment obligations in excess of \$5 million for any year, then the taxpayer must pay interest on the deferred tax liability and the obligation is subject to the anti-pledging rules. The interest is due as an addition to tax (but is treated as an interest payment for all tax purposes) each year the installment obligation remains outstanding. The interest is calculated at the tax underpayment rate on the tax (calculated at the highest marginal rate) on the previously untaxed gain, multiplied by the "applicable percentage." The applicable percentage is the amount of the installment obligation outstanding at the end of the tax year in excess of \$5 million, divided by the amount of the installment obligation outstanding at the end of the tax year. The anti-pledging rules provide that if the installment obligation is used as security for indebtedness, payment on the installment obligation will be deemed to be received on the later of the time the obligation is pledged or the time the proceeds of the secured indebtedness are received.

(n4)Footnote 4. *I.R.C. § 453B(d)*.

(n5)Footnote 5. *Treas. Reg. § 1.453-9(c)*. This regulation interprets *I.R.C. § 453(d)* prior to its amendment by the Installment Sales Revision Act of 1980, P.L. 96-471, which moved the text of that subsection to *I.R.C. § 453B* and modified some of its terms. As the modifications do not pertain to the relationship between *I.R.C. § 453B* and sections that provide for nonrecognition such as *I.R.C. §§ 351, 361, and 721*, and as the legislative history of the Installment Sales Revision Act of 1980 does not suggest that Congress intended to change the taxation of installment obligations in transactions that satisfy a non-recognition provision, *Treas. Reg. § 1.453-9(c)* is used to interpret *I.R.C. § 453B*. See, e.g., *P.L.R. 9853013* (distribution under *I.R.C. § 731*); *P.L.R. 9620020* (distribution under *I.R.C. § 731*); *P.L.R. 9253011* (E reorganization involving exchange of installment obligation for new debt instrument).

(n6)Footnote 6. *Rev. Rul. 73-423* (gain recognized when installment obligation contributed to debtor in a transaction that satisfies *I.R.C. § 351*); *P.L.R. 9412013* (gain recognized when installment obligation exchanged for debtor's stock in a transaction that satisfies *I.R.C. § 368(a)(1)(E)*). But see *P.L.R. 9253011* (no gain recognized when installment obligation transferred to debtor in exchange for new debt obligation in a transaction that satisfies *I.R.C. § 368(a)(1)(E)*).

(n7)Footnote 7. *P.L.R. 8105045* (D reorganization).

(n8)Footnote 8. See *P TX7.08 n6 supra*.



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CHAPTER TX7 Tax Treatment of Creditors

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P TX7.09 Withholding

A creditor may not receive all of the consideration payable as a result of its claim if the consideration is subject to withholding under the I.R.C. In fact, if there is not sufficient cash to satisfy the withholding obligation, a debtor will usually have to retain the non-cash consideration otherwise payable to the creditor until either the creditor pays the debtor sufficient cash to satisfy the withholding obligation or the non-cash consideration generates sufficient cash proceeds to satisfy the withholding obligation.

If a creditor is a U.S. resident person, the proceeds received from a bankruptcy reorganization will only be subject to federal income tax withholding or "backup withholding" if the payment in question is a "reportable payment" n1 and if:

- (1) the creditor fails to furnish the disbursing agent with the creditor's taxpayer identification number ("TIN") in the manner required;
- (2) the IRS notifies the debtor or disbursing agent that the TIN furnished by the creditor is incorrect;
- (3) with respect to reportable interest payments, the IRS notifies the debtor or disbursing agent that the creditor has been underreporting income; or
- (4) with respect to interest payments on readily tradable instruments, the creditor has not certified under penalty of perjury that he or she has not been notified by the IRS that he or she has underreported income. n1a

A reportable payment with respect to payments of claims will generally be attributable to only a few things. First, payments of interest (of at least \$10) on public debt instruments are reportable payments. n2 Second, payments (of at least \$600) of trade claims relating to services (as opposed to the sale of goods or merchandise) are reportable payments. n3 Third, payments on claims are reportable payments if the debtor or disbursing agent is treated as a "broker" under *I.R.C. section 6045*. A debtor will not be considered a broker if it "issues and discharges long-term debt on an irregular basis." n4 Payments to corporate creditors are not reportable payments. n5

Obviously, payments to employee creditors for wage claims are subject to normal wage withholding. As noted above, however, if there is insufficient cash in the package to be paid to the employee, the employee can choose from three

alternatives: (1) pay the debtor the deficiency in the withholding and receive the non-cash consideration; (2) permit the debtor to sell enough of the non-cash consideration to pay the withholding and receive the remaining non-cash consideration; or (3) have the debtor retain the non-cash consideration until the amount of cash generated therefrom equals the withholding obligation.

FOOTNOTES:

(n1)Footnote 1. *I.R.C. § 3406(b)*.

(n2)Footnote 1a. *I.R.C. § 3406(a)*.

(n3)Footnote 2. *I.R.C. § 6049*.

(n4)Footnote 3. *I.R.C. § 6041* and *Treas. Reg. § 1.6041-3(c)*.

(n5)Footnote 4. *Treas. Reg. § 1.6045-1(b)*, Example (2)(vi).

(n6)Footnote 5. *Treas. Reg. § 1.6049-4(c)(1)(ii)(A)*; *Treas. Reg. § 1.6041-3(p)* (except with respect to payments made to corporations for attorneys' fees and for payments to certain corporations providing medical and health care services or billing and collecting for such services); and *Treas. Reg. § 1.6045-1(c)(3)(i)(B)(1)*.



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CHAPTER TX8 Exchange of Corporate Stock for Debt

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CHAPTER TX8 Exchange of Corporate Stock for Debt

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P TX8.01 Introduction

Historically, under the so-called "stock for debt" exception, a corporation did not realize discharge of indebtedness income if it issued its own stock in exchange for claims held by its creditors. n1 The stock for debt exception was developed by the courts, but its scope and application has been substantially limited by various amendments to the Internal Revenue Code, beginning in 1980.

Under current law, the stock for debt exception does not apply to stock transferred after December 31, 1994 in satisfaction of debt, unless the issuing corporation is in a title 11 or similar case filed before January 1, 1994. n2 Thus, except for corporations included in pre-1994 title 11 filings, the stock for debt exception is no longer applicable, and a corporation that issues stock in exchange for claims held by its creditors will be treated as having satisfied the debt with an amount of money equal to the fair market value of its stock. n3 Consequently, for most stock for debt exchanges occurring after 1994, a corporation will recognize discharge of indebtedness income to the extent the adjusted issue price of the indebtedness exceeds the fair market value of the stock issued in the exchange. While the discharge income will be excluded from taxable income of a corporation in a title 11 case or to the extent of its insolvency under *I.R.C. Section 108*, n4 the amount of such excluded income will be applied to reduce the corporation's tax attributes under *I.R.C. Section 108(b)*, beginning with its net operating loss carryovers. n5

For pre-1995 transactions, the common law stock for debt exception is available to a debtor corporation in a title 11 case or to the extent of insolvency, n6 but is limited in several important ways. First, the stock for debt exception does not apply when the stock issued in the exchange is "disqualified stock." n7 Second, the exception does not apply in two *de minimis* cases: (1) when "nominal or token" shares are issued in the exchange; n8 or (2) when stock is received by an unsecured creditor and the ratio of the value of the stock received to the indebtedness canceled or exchanged is less than 50 percent of a similar ratio computed for all unsecured creditors participating in the exchange. n9 Finally, in a case in which the special title 11 exception to *I.R.C. Section 382* applies under *I.R.C. Section 382(l)(5)*, any net operating loss or credit carryovers must be reduced by 50% of the amount excluded from income under the stock for debt exception. n10

If the stock for debt exception applies, the debtor corporation does not realize any discharge of indebtedness income in the exchange. Because there is no gross income to exclude, the debtor corporation's tax attributes are not reduced under *I.R.C. Section 108(b)*. The absence of attribute reduction is an important benefit to qualification under the stock for debt exception.

FOOTNOTES:

(n1)Footnote 1. *Motor Mart Trust v. Commissioner*, 4 T.C. 931, 936 (1945) , *aff'd*, 156 F.2d 122 (1st Cir. 1946) , *acq.*, 1947-1 C.B. 3 ; *Capento Securities Corp. v. Commissioner*, 47 B.T.A. 691, 694 (1942) , *aff'd*, 140 F.2d 382 (1st Cir. 1944) , *nonacq.*, 1943 C.B. 28 .

(n2)Footnote 2. Omnibus Budget Reconciliation Act of 1993, § 13226, Pub. L. No. 103-66(1993).

(n3)Footnote 3. *I.R.C. § 108(e)(8)*.

(n4)Footnote 4. *See* chapter TX6 *supra*.

(n5)Footnote 5. *See P TX6.03[4][a] supra*.

(n6)Footnote 6. This limitation to the common law rule was added by the Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 1175 (1984) § 59(a), generally effective for transfers after July 18, 1984.

(n7)Footnote 7. The "disqualified stock" limitation was added to *I.R.C. § 108(e)(10)(B)* by the Revenue Reconciliation Act of 1990, Pub. L. No. 101-508, 109 Stat. 1388 (1990), effective November 5, 1990. This provision was repealed by the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66 (1993). Prior to the repeal "disqualified stock" was defined in *I.R.C. § 108(e)(10)(B)(ii)*.

(n8)Footnote 8. *I.R.C. § 108(e)(8)(A)*, prior to repeal by Pub. L. No. 103-66, § 13226 (a)(1)(A)-(B) (1993).

(n9)Footnote 9. *I.R.C. § 108(e)(8)(B)*, prior to repeal by Pub. L. No. 103-66, § 13226 (a)(1)(A)-(B) (1993).

(n10)Footnote 10. *I.R.C. § 382(l)(5)(C)*. *See* chapter TX11 *infra* for a discussion of this limitation.



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CHAPTER TX8 Exchange of Corporate Stock for Debt

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P TX8.02 History of Stock for Debt Exception; Prebankruptcy Tax Act Cases

[1] Introduction

I.R.C. Section 61(a) provides that gross income includes income from the discharge of indebtedness. This provision codified the concept established by the Supreme Court in *United States v. Kirby Lumber Co.* n1 A discharge of indebtedness occurs when a debt is forgiven or canceled, or when a creditor accepts payment of less than the unpaid balance in complete satisfaction thereof. Numerous judicial and statutory exceptions to the general rule of income recognition exist. n2 Prominent among them has been the "stock for debt" exception applicable to debtor corporations.

The stock for debt exception to the *Kirby Lumber* rule originated in a series of cases decided in the 1940s, beginning with *Capento Securities Corp. v. Commissioner*. n3 These cases essentially held that a corporate taxpayer does not realize discharge of indebtedness income when it issues its own common stock in exchange for outstanding debt, even when such stock has a value substantially less than the debt being canceled. The issuance of preferred stock having a liquidation preference equal to the debt canceled is also within the exception. n4 Overall, the stock for debt exception has been applied to exchanges involving common stock n5 and stock issued by a corporation acquiring the debtor corporation's assets in a bankruptcy reorganization, n6 and to solvent debtors. n7

While the IRS initially opposed the stock for debt exception, it eventually accepted the doctrine in 1947, when it issued a series of acquiescences. n8 The stock for debt exception survived essentially unrestricted until the Bankruptcy Tax Act of 1980.

[2] Creation of Judicial Exception

The stock for debt exception first emerged in *Capento Securities*. In that case, the taxpayer corporation retired \$500,000 face amount of outstanding debentures with \$500,000 par value six percent noncumulative preferred stock, which had a value of not more than \$50,000. The accrued but unpaid interest on the debentures was canceled as part of the transaction. The Board of Tax Appeals (the predecessor to the Tax Court) held that the exchange was a recapitalization and that no discharge of indebtedness income was realized by the taxpayer corporation. n9 The Board of Tax Appeals articulated two theories to support its newly created stock for debt exception: a "substitution of liability" theory and a "subscription price" theory.

The Board explained the substitution of liability theory:

It is hard to see that gain was in fact realized. The corporation had a liability ... [on the discharged debt] having presumably borrowed that amount. While it discharged that liability, it created a new stock interest which became a balance sheet liability called capital stock. This is plainly different from the discharge of its indebtedness by the payment of money in a less amount than the indebtedness, as in *United States v. Kirby Lumber Co.*, 284 U.S. 1, 52 S. Ct. 4, 76 L. Ed. 131, 72 Ct. Cl. 739, and the cases which have followed it. To substitute a capital stock liability for a bonded indebtedness may have its advantages, as this case illustrates, but it cannot be called a present realization of gain n10

Thus, the "substitution of liability" theory is based on the rationale that a substitution of corporate stock for outstanding debt is a continuation of an investment in the corporation in essentially the same economic form. n11 Stated differently, a substitution of a capital stock liability for a debt liability is not a realization event for federal income tax purposes because the transaction between the debtor corporation and the creditor/shareholder is not closed. The transaction simply involves a nontaxable downgrading of the investment from a debt interest to an equity interest.

As an alternative theory supporting the stock for debt exception, the Board of Tax Appeals characterized the stock for debt exchange as similar to a subscription for shares of the debtor corporation's stock:

Gain is not realized by a corporation in the receipt of the subscription price of its shares ... and this would seem to be no less true when the subscription price, instead of being newly paid, is the amount which has already been paid in as the principal of a bond loan n12

The "subscription price" theory is based on the rationale that the transfer of a debt by a creditor to the debtor corporation is the equivalent of payment of the subscription price for the stock given in the exchange. n13 Under this theory, the difference between the face amount of the debt canceled and the value of the stock issued is treated as a premium paid by the creditor on issuance of the stock. Gain is not recognized, however, since a corporation generally does not recognize gain or loss on transactions in its own stock. n14

The Board's decision in *Capento Securities* was affirmed by the Court of Appeals for the First Circuit. n15

Virtually all of the cases that have followed *Capento Securities*, have done so on the basis of the "substitution of liability" theory. n16 Indeed, in a 1988 technical advice memorandum, the IRS observed that subsequent cases have relied exclusively on the "substitution of liability" theory. n17 This observation, however, appears to be at odds with *Motor Mart Trust v. Commissioner*, n18 and positions of the IRS in prior technical advice memoranda. n19

In *Motor Mart Trust*, a Massachusetts trust, taxable as a corporation, filed for bankruptcy reorganization. The plan of reorganization provided for the exchange of certain outstanding debt for a package of new issues of convertible preferred stock and common stock. The IRS took the position that the exchange was a realization event. The Court of Appeals for the First Circuit rejected this position, concluding that no debt cancellation occurred under the "subscription price" theory:

The offer of stock, with its accompanying equity rights in the company, was good consideration for the surrender of the bonds; and this is so whether the par value of the stock or its then market value was greater or less than the face value of the bonds. The transaction may be considered a form of payment for the bonds, not cancellation. n20

Overall, at least two cases, *Capento Securities* and *Motor Mart Trust*, have utilized the "subscription price" theory to support the stock for debt exception.

The only court to have rejected the stock for debt exception since *Capento Securities* was the Court of Appeals for the Seventh Circuit in *Claridge Apts. Co. v. Commissioner*. n21 In reversing the decision of the Tax Court, the court of

appeals concluded:

The acceptance of the stock for the bonds wiped out a direct debt liability, enforceable by legal action. The debt carried an interest obligation and priority of rights. The [common] stock carried no right to interest and not even to dividends, unless surplus existed, and a declaration of distribution had been made. It carried no right to collect the sum represented by the investment therein. At best it is a right only to a proportionate distribution of the assets over and above all debts of the corporation, in case of liquidation. n22

Finding a realization event, the court applied Section 270 of the former Bankruptcy Act to reduce the taxpayer's basis.

On appeal, the Supreme Court reversed the Seventh Circuit's decision. n23 Although some confusion exists as to whether the Court implicitly affirmed the stock for debt exception (the Court's opinion only addressed the question whether Section 270 was retroactive or not), the Tax Court has read the opinion as upholding the exception. n24

FOOTNOTES:

(n1)Footnote 1. 284 U.S. 1, 52 S. Ct. 4, 76 L. Ed. 131 (1931) . See P TX6.02[1] *supra*.

(n2)Footnote 2. See chapter TX6 *supra*.

(n3)Footnote 3. 47 B.T.A. 691 (1942) , *aff'd*, 140 F.2d 382 (1st Cir. 1944) , *nonacq.*, 1943 C.B. 28 ; *Claridge Apts. Co. v. Commissioner*, 1 T.C. 163 (1942) , *aff'd in part, rev'd in part*, 138 F.2d 962 (7th Cir. 1943) , *rev'd on other grounds*, 323 U.S. 141, 65 S. Ct. 172, 89 L. Ed. 139 (1944) , *acq.*, 1947-1 C.B. 2 ; *Alcazar Hotel Inc. v. Commissioner*, 1 T.C. 872 (1943) , *acq.*, 1943 C.B. 1 ; *Motor Mart Trust v. Commissioner*, 4 T.C. 931 (1945) , *aff'd*, 156 F.2d 122 (1st Cir. 1948) , *acq.*, 1947-1 C.B. 3 ; *Tower Bldg. Corp v. Commissioner*, 6 T.C. 125 (1948) , *acq.*, 1943 C.B. 4 . See also *Los Angeles Shipbuilding & Drydock Corp. v. United States*, 289 F.2d 222 (9th Cir. 1961) ; *Woodmont Corp. v. Commissioner*, 5 T.C.M. (C.C.H.) 291 (1946); *Potter & Rayfield v. Commissioner*, 5 T.C.M. (C.C.H.) 119 (1948); 1959-1 C.B. 80, *Rev. Rul.* 59-222 . Thus, the stock for debt exception is really the product of four regular decisions of the Tax Court and one decision of its predecessor, the Board of Tax Appeals. See generally *Silverman & Keyes, Corporate Debt Restructuring: Stock-for-Debt Exchanges and Other Workout Scenarios--Part II*, 19 J. Corp. Tax. 1987 (1992); Asofsky, *Discharge of Indebtedness in Bankruptcy After the Bankruptcy Tax Act of 1980*, 27 St. Louis U.L.J. 583 (1983).

(n4)Footnote 4. See *Capento Securities Corp. v. Commissioner* 47 B.T.A. 691 (1942) , *aff'd*, 140 F.2d 382 (1st Cir. 1944) , *nonacq.*, 1943 C.B. 28 .

(n5)Footnote 5. See, e.g., *Claridge Apts. Co. v. Commissioner*, 1 T.C. 163 (1942) , *aff'd in part, rev'd in part*, 138 F.2d 962 (7th Cir. 1943) , *rev'd on other grounds*, 323 U.S.141, 65 S. Ct. 172, 89 L. Ed. 139 (1944) , *acq.*, 1947-1 C.B. 2 ; *Alcazar Hotel Inc. v. Commissioner*, 1 T.C. 872 (1943) , *acq.*, 1943 C.B. 1 ; *Tower Bldg. Corp v. Commissioner*, 6 T.C. 125 (1948) , *acq.*, 1943 C.B. 4 .; *Motor Mart Trust v. Commissioner*, 4 T.C. 931 (1945) , *aff'd*, 156 F.2d 122 (1st Cir. 1948) , *acq.*, 1947-1 C.B. 3 .

(n6)Footnote 6. *Claridge Apts. Co. v. Commissioner*, 1 T.C. 163 (1942) , *aff'd in part, rev'd in part*, 138 F.2d 962 (7th Cir. 1943) , *rev'd on other grounds*, 323 U.S. 141, 65 S. Ct. 172, 89 L. Ed. 139 (1944) , *acq.*, 1947-1 C.B. 2 ; *Alcazar Hotel Inc. v. Commissioner*, 1 T.C.872 (1943) , *acq.*, 1943 C.B. 1 .

(n7)Footnote 7. In a number of technical advice memoranda, the IRS observed that prior to the Tax Reform Act of 1984, the stock for debt exception was available for use by solvent debtor corporations. See Tech. Adv. Memos. 87-38-003 (May 22, 1987); 87-35-007 (May 28, 1987); 87-35-006 (May 18, 1987).

(n8)Footnote 8. See 1947-1 C.B. 2 (*acq.* in *Claridge Apts.*); 1947-1 C.B. 3 (*acq.* in *Motor Mart Trust*); 1947-1 C.B. 4 (*acq.* in *Tower Bldg.*); 1943 C.B. 1 (*acq.* in *Alcazar Hotel*). Acquiescence in a court decision adverse to the position of the IRS indicates its formal acceptance of the adverse conclusion. As a formal statement of the IRS, IRS personnel (but not the courts) are bound by an acquiescence. See 1991-2 C.B. 1.

(n9)Footnote 9. See *Capento Securities Corp. v. Commissioner* 47 B.T.A. 691 (1942) , *aff'd*, 140 F.2d 382 (1st Cir. 1944) , *nonacq.*, 1943 C.B. 28 .

(n10)Footnote 10. *Capento Securities Corp. v. Commissioner* 47 B.T.A. 691, 695 (1942) , *aff'd*, 140 F.2d 382 (1st Cir. 1944) , *nonacq.*, 1943 C.B. 28 .

(n11)Footnote 11. This reasoning, however, does not explain why a downgrading of debt interest to an equity interest, essentially representing an exchange of two quite different interests, does not trigger a realization event for tax purposes. See, e.g., P TX9.02 *infra* regarding the definition of material modification of a debt for tax purposes.

(n12)Footnote 12. *Capento Securities Corp. v. Commissioner* 47 B.T.A. 691, 695 (1942) , *aff'd*, 140 F.2d 382 (1st Cir. 1944) , *nonacq.*, 1943 C.B. 28 .

(n13)Footnote 13. The "subscription price" theory has been criticized as an "obvious fiction" since "[c]reditors generally do not view the money advanced in a nonconvertible loan transaction as a prepaid subscription price for stock to be issued at an undetermined time in the future." Zachary and Greenwald, *An Analysis of the Stock-for-Debt Exception to Cancellation of Indebtedness Income*, 18 J. Corp. Tax. 144, 147 (1991).

(n14)Footnote 14. *Capento Securities Corp. v. Commissioner* 47 B.T.A. 691, 695 (1942) , *aff'd*, 140 F.2d 382 (1st Cir. 1944) , *nonacq.*, 1943 C.B. 28 . See I.R.C. § 1032.

(n15)Footnote 15. 140 F.2d 382 (1st Cir. 1944) . While the First Circuit found the Board's reasoning "persuasive," its affirmance was based primarily on the now defunct Dobson rule, which required appellate courts to defer to the special expertise of the Tax Court on certain issues of tax law. See *Dobson v. Commissioner*, 320 U.S. 489, 498, 64 S. Ct. 239, 88 L. Ed. 248 (1943) .

(n16)Footnote 16. See *Claridge Apts. Co. v. Commissioner*, 1 T.C. 163 (1942) , *aff'd in part, rev'd in part*, 138 F.2d 962 (7th Cir. 1943) , *rev'd on other grounds*, 323 U.S. 141, 65 S. Ct. 172, 89 L. Ed. 139 (1944) , *acq.*, 1947-1 C.B. 2 ; *Alcazar Hotel Inc. v. Commissioner*, 1 T.C. 872 (1943) , *acq.*, 1943 C.B. 1 ; *Woodmont Corp. v. Commissioner*, 5 T.C.M. (C.C.H.) 291 (1946).

(n17)Footnote 17. *Tech. Adv. Mem.* 8837001 (May 10, 1988) .

(n18)Footnote 18. 4 T.C. 931 (1945) , *aff'd*, 156 F.2d 122 (1st Cir. 1948) , *acq.*, 1947-1 C.B. 3

(n19)Footnote 19. See *Tech. Adv. Mem.* 87-38-003 (May 22, 1987); 87-35-007 (May 28, 1987); 87-35-006 (May 18, 1987). See also Pollack and Goldring, *Can Cancellation of Indebtedness Income Be Avoided With Parent Stock*, 2 Corp. Tax'n 18, 19 n.12 (1990).

(n20)Footnote 20. 156 F.2d 122, 127 (1st Cir. 1948) .

(n21)Footnote 21. 138 F.2d 962 (7th Cir. 1943) .

(n22)Footnote 22. 138 F.2d 962, 965 (7th Cir. 1943) .

(n23)Footnote 23. 323 U.S. 141, 65 S. Ct. 172, 89 L. Ed. 139 (1944) .

(n24)Footnote 24. See generally Asofsky, *Discharge of Indebtedness in Bankruptcy After the Bankruptcy Tax Act*

of 1980, 27 *St. Louis U.L.J.* 583, 605-07 (1983), for a discussion of *Claridge Apts.* and its place in the development of the stock for debt doctrine.



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Collier on Bankruptcy Taxation

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CHAPTER TX8 Exchange of Corporate Stock for Debt

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P TX8.03 Statutory Framework and Limitations on Exception

[1] Introduction

The stock for debt exception has been one of the most favorable exceptions to the general rule that a taxpayer realizes discharge of indebtedness income upon a satisfaction of a liability for less than the full amount due. n1 The benefits have been generally two-fold: if, prior to January 1, 1995, a corporation issued its stock to a creditor in a transaction that qualified for the stock for debt exception, the debtor corporation would (1) permanently avoid the recognition of discharge income and (2) generally avoid any reduction in its tax attributes (such as its net operating loss carryovers and basis of its assets). n2 The absence of attribute reduction is significant because reduction is generally required in the case of discharge income excluded under *I.R.C. Section 108(a)*. n3

[2] Existence of Exception Under Current Law

[a] No Exception for Stock Transferred After 1994

In the Omnibus Budget Reconciliation Act of 1993, n4 the stock for debt exception was repealed for stock transferred after December 31, 1994 in satisfaction of debt, unless the issuing corporation is in a title 11 or similar case filed on or before December 31, 1993. Since the stock for debt exception prevented the debtor corporation from realizing discharge income when it issued its stock to creditors in satisfaction of outstanding debt, no corresponding reductions of the debtor's tax attributes were required under *I.R.C. Section 108(b)*. With its repeal, the issuance of stock will be treated the same as any other transfer of property to a creditor: as if the debtor corporation satisfied its debt with an amount of money equal to the fair market value of the stock so issued. The difference between the adjusted issue price of the canceled debt and the value of the stock issued in satisfaction thereof will be realized as discharge of indebtedness income. While the discharge income is excluded from taxable income under *I.R.C. Section 108(a)* by a debtor corporation in a title 11 case or to the extent that it is insolvent, n5 the "price" of exclusion is a corresponding reduction in tax attributes under *I.R.C. Section 108(b)*. n6 Thus, unless grandfathered, all post-1994 stock for debt exchanges which are eligible for *I.R.C. Section 108* relief will result in the full application of the attribute reduction rules.

The practical impact can be substantial: a debtor corporation's net operating loss carryovers and the tax basis in its assets may be substantially reduced or eliminated. In such event, the debtor corporation's cash flow will be reduced because a greater portion of its post-reorganization earnings will become taxable.

Example 1

In 1995, Debtco falls on hard economic times. It is insolvent to the extent of \$50,000 (unsecured debt outstanding of \$90,000 owed to Creditor, less assets with a fair market value of \$40,000) and its only tax attributes are net operating loss carryovers of \$10,000 and capital assets with an adjusted tax basis equal to value, or \$40,000. In 1995, Debtco proposes and Creditor accepts the following: Debtco issues a new note with an issue price of \$10,000 and common stock with a fair market value of \$20,000 (a less than 50% stock interest which does not result in an *I.R.C. Section 382* ownership change) in full satisfaction of the outstanding \$90,000 indebtedness.

The tax consequences are as follows: Debtco realizes \$60,000 of discharge income (\$90,000 debt less the Note issue price of \$10,000 and \$20,000 worth of stock). Of the \$60,000, an amount up to its insolvency or \$50,000 will be excluded under *I.R.C. Section 108(a)(1)(B)*. The \$10,000 balance is fully taxable ordinary income recognized under *I.R.C. Section 61(a)(12)*. The amount excluded under *I.R.C. Section 108(a)* must be applied to reduce Debtco's tax attributes, after Debtco's taxable income for 1995 is determined. Thus, the \$10,000 net operating loss can be applied to offset the \$10,000 of discharge income recognized (assume it's Debtco's only income for 1995).ⁿ⁷ Next, applying the attribute reduction rules, the \$50,000 excluded will be applied to reduce Debtco's only remaining tax attribute, the \$40,000 basis in its property.ⁿ⁸ Because the reduction cannot reduce the basis below the amount of liabilities which remain outstanding, the basis will be reduced to \$10,000. Thus, the basis of its assets will be reduced by \$30,000 and the remaining \$20,000 of excluded discharge income in excess of Debtco's tax attributes will "disappear."ⁿ⁹ Beginning on the first day of the next taxable year, in this case January 1, 1996, Debtco will have lost most of its tax attributes (only \$10,000 of basis remains) and associated tax benefits. Thus, a greater portion of its income will be taxable and its cash flow will be reduced.

[b] Stock Transferred Before January 1, 1995

As discussed above,ⁿ¹⁰ the judicially developed stock for debt exception provides that a corporation will not realize discharge of indebtedness income when it issues its own stock in exchange for its outstanding debt, even if the stock has a value less than the debt satisfied. In the Bankruptcy Tax Act of 1980, Congress did not expressly codify the stock for debt exception. Instead, Congress acknowledged in the legislative history that, although the availability of the judicial exception was statutorily limited in the 1980 legislation (by the enactment of *I.R.C. Section 108(e)(8)*), it intended to preserve the existing common law rule:

The committee bill generally does not change the present common law rule developed by the courts governing whether income is recognize[d] if a corporation issues its own stock to its creditor for 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 encourages reorganization, rather than liquidation, of financially distressed companies that have a potential for surviving as operating concerns.ⁿ¹¹

The existence of the stock for debt exception under current law is clear. For example, the IRS has recently acknowledged the continuing vitality of the common law stock for debt exception.ⁿ¹² Beginning in 1980, Congress enacted four limitations on the common law stock for debt exception. The exception was inapplicable (1) to a solvent corporation outside of a title 11 case,ⁿ¹³ (2) when only a nominal or token amount of stock is issued,ⁿ¹⁴ (3) with respect to a particular unsecured creditor when that creditor receives a disproportionately low percentage of stock as compared to the amount of stock received by all of the unsecured creditors participating in the exchange,ⁿ¹⁵ and (4) when a corporation issued certain types of so-called "disqualified stock," that is, stock (typically preferred stock) with a stated redemption price and certain other debt-like characteristics.ⁿ¹⁶ In addition, in a case in which *I.R.C. Section 382(l)(5)* applied (which permits the shareholders and historic creditors to acquire stock of a loss corporation in a title 11 case without triggering the limitations on net operating loss carryovers imposed under *I.R.C. Section 382*),ⁿ¹⁷ the

corporate debtor's tax attributes (such as its net operating loss carryovers and basis of its assets) were "scaled back" or reduced by 50 percent of the amount of discharge income excluded under the stock for debt exception. n18

[3] Exception Limited to Insolvent and Title 11 Debtor-Taxpayer

Prior to 1984, the stock for debt exception was available to all corporations, including those that were financially healthy. In 1984, Congress recognized that the existence of the stock for debt exception created a significant difference in tax result depending on how a corporation discharged its debts.

Example 2

Sol-Vent Corporation owes a creditor \$100,000, and the creditor is willing to settle the debt for \$80,000. If Sol-Vent raised \$80,000 by issuing new stock, then used the \$80,000 cash proceeds to pay the creditor, Sol-Vent would realize \$20,000 of discharge of indebtedness income. However, if Sol-Vent issued \$80,000 of its stock directly to the creditor in exchange for the \$100,000 debt and the stock for debt exception applied, the corporation would neither recognize any discharge of indebtedness income nor have its tax attributes reduced. n19

The stock for debt exception also allowed a corporation which retired existing indebtedness for stock and then issued new indebtedness with a lower principal amount and a higher interest rate to obtain a larger interest deduction, notwithstanding that total debt payments (principal and interest) may have remained unchanged. n20

Concluding that these differences in result were inappropriate, Congress added *I.R.C. Section 108(e)(10)* as part of the Deficit Reduction Act of 1984. n21 *I.R.C. Section 108(e)(10)*, as it existed prior to its repeal in 1993, n22 repealed the stock for debt exception for all transactions except those involving a corporation in a title 11 case or to the extent the debtor was insolvent. Specifically, *I.R.C. Section 108(e)(10)(A)* provided that if a solvent debtor corporation issued stock in exchange for debt, the corporation would be treated as having repurchased the debt for an amount of cash equal to the fair market value of the stock. Thus, the debtor corporation would recognize discharge of indebtedness income to the extent the adjusted issue price of the debt satisfied exceeded the fair market value of stock issued in the exchange. This rule applied whether the exchange occurs pursuant to agreement or through the exercise of a conversion right. n23

I.R.C. Section 108(e)(10)(B), as it existed prior to its repeal in 1993, n24 in effect, preserved the stock for debt exception for debtors in title 11 cases and insolvent debtors to the extent of their insolvency. n25 A "title 11 case" is defined as a case under the Bankruptcy Code, in which the debt cancellation is approved by the court. n26 Thus, the debt discharge should be documented as part of the bankruptcy court's approved reorganization plan or by court order. "Insolvency" is defined as the excess of liabilities over the fair market value of assets and the amount thereof is determined immediately prior to the debt cancellation. n27

Example 3

In 1990, Sol-Vent, a financially healthy corporation, issues its stock worth \$50,000 in exchange for debt with a face amount of \$125,000. The general rule of *I.R.C. Section 108(e)(10)(A)* will treat Sol-Vent as having satisfied the debt for \$50,000--and Sol-Vent will recognize \$75,000 of discharge of indebtedness income under *I.R.C. Section 61(a)(12)*.

Example 4

In 1993, Sol-Vent is no longer financially healthy and files for protection under title 11. If, as part of its reorganization plan, Sol-Vent issues its "qualified" common stock worth \$50,000 in exchange for the cancellation of \$125,000 of debt in a transaction that satisfies the *de minimis* rules of *I.R.C. Section 108(e)(8)*, Sol-Vent will not recognize any discharge of indebtedness income under the stock for debt exception. As a result, Sol-Vent's net operating losses and other tax attributes will not be reduced (assuming that *I.R.C. Section 382(1)(5)(C)* does not otherwise apply).

In Revenue Ruling 92-52, n28 the IRS indicated how it will apply the stock for debt exception to an insolvent debtor outside of a title 11 case. In the facts given, the corporate debtor, X, is insolvent (as provided under *I.R.C. Section 108(d)(3)*) to the extent of \$50,000. X owes an unsecured debt with an adjusted issue price of \$90,000. In satisfaction of this debt, X issues (1) its own debt instrument with an issue price of \$10,000 and (2) its common stock with a fair market value of \$20,000. As a consequence of this exchange, X potentially has \$60,000 of discharge of indebtedness income (\$90,000 debt less the sum of the \$10,000 issue price of X's new debt instrument and the \$20,000 fair market value of X's stock). n29 However, because X is insolvent by \$50,000 immediately before the discharge, X realizes only \$10,000 of discharge of indebtedness income. n30 The IRS concluded that for purposes of allocating the discharge of indebtedness attributable to insolvency, X is treated as issuing its new debt instrument of \$10,000 in exchange for \$10,000 of indebtedness and its stock with a \$20,000 fair market value in exchange for the remainder of the indebtedness. n31 As a result, an amount of discharge of indebtedness equal to the amount of X's insolvency, \$50,000, is allocated to the stock for debt exchange, and X, therefore, is not required to reduce its tax attributes under *I.R.C. Sections 108(b)* and *1017*. The \$10,000 balance of discharge income realized in the transaction in excess of its insolvency (\$60,000 less insolvency of \$50,000) must be recognized.

[4] De Minimis Limitation

Even if a debtor corporation that made a pre-1995 stock for debt transfer is in a title 11 case or insolvent as required under the old *I.R.C. Section 108(e)(10)(B)*, the two *de minimis* rules of *I.R.C. Section 108(e)(8)* may have denied the debtor corporation nonrecognition under the stock for debt exception. n32 *I.R.C. Section 108(e)(8)* provided that the exception would not apply (1) if the corporation issued "nominal" or "token" shares n33 or (2) if, with respect to an unsecured creditor, the ratio of the value of the stock received by the creditor to the amount of debt canceled or exchanged for stock was less than 50 percent of a similar ratio computed for all unsecured creditors participating in the workout (the "proportionality" test). n34 Congress intended these rules to prevent a corporation from issuing a nominal amount of stock to creditors so that the stock issued did not represent a real equity interest in the corporation or from issuing stock to a particular group of unsecured creditors and not to the class of unsecured creditors as a whole. n35

[a] "Nominal" or "Token" Stock

[i] In General

I.R.C. Section 108(e)(8)(A) did not define the terms "nominal" or "token" shares. These terms can be traced to the House version of the 1980 Act. The House Report explained that "the value of the stock received may not be very small when compared to the total amount of the creditor's claim, so that the debt forgiveness rules will not be circumvented by the issuance of token shares to a creditor with no real equity interest in the corporation." n36 Although the House version of *I.R.C. Section 108* significantly limited the stock for debt exception, the Senate version generally left the stock for debt exception intact. Nevertheless, the Senate version included a *de minimis* rule similar to that in the House bill. The Senate Report states that one must determine what is "nominal" and "token" on the basis of all of the facts and circumstances of each case. n37

In a 1988 technical advice memorandum, n38 the IRS addressed the question of the meaning of the terms "nominal" and "token." In the ruling, the unsecured creditors of a debtor corporation received, under a confirmed reorganization plan, cash and preferred stock in satisfaction of their claims against the debtor. The preferred stock was worth approximately ten percent of the amount of the debt discharged--the amount by which the unsecured creditors' claims exceeded the cash they received. Three years after issuance, the preferred stock was convertible at the option of the holder into common stock of another corporation that owned 95 percent of the voting power of the stock of the debtor corporation. Beginning five years after the issuance of the preferred stock, the debtor corporation had the option to redeem the preferred stock for a price equal to its liquidation value. The unsecured creditors who received the preferred stock represented a large and diverse group unrelated to the debtor corporation.

On the foregoing facts, the IRS ruled that stock issued to the unsecured creditors was neither "nominal" nor "token" within the meaning of *I.R.C. Section 108(e)(8)(A)*. Based on an examination of the legislative history and of the rationale for the stock for debt exception as judicially developed prior to the Bankruptcy Tax Act of 1980, n39 the IRS concluded that Congress intended *I.R.C. Section 108(e)(8)(A)* to apply to prevent sham transactions that created no meaningful capital stock liability in favor of the creditor from qualifying for the exception. The IRS indicated that the "nominal or token" determination should be based on the following:

It follows from the legislative history ... that the determination as to whether an amount of stock is "nominal or token" is to be based on the facts and circumstances of a particular case, especially those relevant to the economic substance of the stock for debt exchange and the creation of a real equity interest. Accordingly, consideration must be given to those factors which indicate arms length bargaining, including such elements as the existence of sufficiently adverse economic interests on each side of the exchange, the value of the stock exchanged in comparison to the face amount of the debt canceled, and the value of the stock received in comparison to the total consideration received in discharge of the debt. n40

[iii] 1990 Proposed Regulations

On December 7, 1990, the IRS issued Proposed Regulation § 1.108-1 and a release dealing with the application of the *de minimis* test. n41 The Proposed Regulations applied to exchanges that occurred on or after December 6, 1990. n42 However, the release indicated that the underlying principles of the Proposed Regulations will be applied retroactively. n43

The 1990 Proposed Regulations provided that, in determining whether stock issued to a creditor is nominal or token, all relevant facts and circumstances must be considered. n44 In making this determination, "a nonexclusive list of relevant factors" is provided consisting of three ratio tests:

- (1) "Stock to Debt Ratio." This ratio is a comparison of the fair market value of stock transferred to a creditor to the amount of discharged indebtedness allocable to that stock. A low Stock to Debt Ratio is evidence that the shares issued in the exchange are nominal or token. The Proposed Regulations state that this ratio is the most important factor in the determination of whether stock is nominal or token.
- (2) "Stock to Total Consideration Ratio." This ratio is a comparison of the fair market value of stock transferred to a creditor to the fair market value of the total consideration received by the creditor in the exchange. A low Stock to Total Consideration Ratio is evidence that stock given in the exchange is nominal or token.
- (3) "Stock to Total Stock Ratio." This ratio is a comparison of the fair market value of the stock transferred to the creditors as a group to the total fair market value of all of the outstanding stock of the corporation after the bankruptcy reorganization or insolvency workout. A low Stock to Total Stock Ratio is evidence that the shares issued in the exchange are nominal or token. n45

The accompanying release provided "proposed standards" for applying the ratios set forth in the 1990 Proposed Regulations. The proposed standards indicated that stock is not nominal or token when:

- (1) The Stock to Debt Ratio for each class of preferred stock and for the aggregate of all other stock equals or exceeds ten percent, and the Stock to Total Consideration Ratio equals or exceeds 25 percent;
- (2) The Stock to Total Consideration Ratio equals or exceeds 25 percent, and the Stock to Total Stock Ratio equals or exceeds 25 percent; or

(3) The unsecured creditors receive only stock and the Stock to Total Consideration Ratio when applied to the unsecured creditors is at least 90 percent. n46

The 1990 Proposed Regulations and the accompanying release were criticized by commentators. Much of the criticism was based on the fact that the 1990 Proposed Regulations and proposed standards deviated from prior interpretations given to the words "nominal" and "token" in the tax law or any general understanding of the meaning of similar words, and were unsupported by the legislative history to *I.R.C. Section 108*. n47

[iii] Final Regulations

In December 1992, the IRS withdrew the 1990 Proposed Regulations and proposed new regulations under *I.R.C. Sections 108(e)(8)(A) and (B)*. n48 With a few minor changes, the 1992 proposed regulations were adopted as final regulations in March 1994 (the "Final Regulations"). n49 The Final Regulations incorporated a number of changes; principally, they made the nominal or token determination based on whether the stock issued for unsecured debt is, in the aggregate, not nominal or token (as opposed to the creditor-by-creditor approach used in the 1990 regulations), and they provided guidance for applying the *I.R.C. Section 108(e)(8)(B)* proportionality test. The Final Regulations only applied to stock issued for debt on or before December 31, 1994 (the stock for debt exception is generally repealed after 1994) and, where the debtor corporation is in a title 11 case (as defined in *I.R.C. Section 368(a)(3)(A)*) filed on or before December 31, 1993, to any stock issuance pursuant to a plan confirmed after May 17, 1994, or if there is no title 11 case, pursuant to an insolvency workout in which all stock issuances occur after May 17, 1994. n50

The Final Regulations provided that the determination whether stock issued for unsecured debt is "nominal or token" was based on relevant facts and circumstances. n51 Common and preferred stock issued for debt were tested separately. The determination for common stock was based on the aggregate of all common stock issued for unsecured debt in the title 11 case or insolvency debt workout (and preferred is separately aggregated and tested).

Although no factors are listed, the preamble indicates the IRS issued *Revenue Procedure 94-26*, n52 to provide one safe harbor on when common stock is not nominal or token. n53 Thus, common stock issued for secured debt is not nominal or token if the stock to total stock ratio for all common stock issued for unsecured debt in the title 11 case or insolvency workout is at least 15 percent. n54 The stock to total stock ratio is the ratio of (i) the value of all common stock issued for unsecured debt to (ii) the value of all stock outstanding (including preferred and disqualified stock) after the title 11 case or insolvency workout. n55

Example 5

Prior to January 1, 1995, debtor corporation issues common stock (its only class of stock outstanding) with an aggregate value of \$150,000 in satisfaction of \$1,500,000 of unsecured debt in a title 11 case. The total value of all the debtor's common stock after the title 11 case is \$1,000,000. The Stock to Total Stock ratio is 15% (\$150,000/\$1,000,000) and the common stock issued will meet the "nominal or token" ruling requirement.

The Final Regulations provided some special definitions. n56 "Common stock" was all stock other than disqualified stock (as defined in the old *I.R.C. Section 108(e)(10)(B)(ii)*) and preferred stock. "Preferred stock" was any nondisqualified stock that had a limited or fixed redemption price or liquidation preference and did not at the time of issuance have a right to participate in corporate growth to a meaningful extent. Preferred stock that is convertible into common stock was not treated as preferred for these purposes if the conversion right represents, in substance, a meaningful right to participate in corporate growth. n57 The "amount of indebtedness" was generally the adjusted issue price of the debt, increased by accrued but unpaid stated interest. n58 "Undersecured debt" was debt secured by property with a value less than its adjusted issue price. It was treated as two separate debts--a secured debt with an adjusted issue price equal to the value of the security, and an unsecured debt with an adjusted issue price equal to the balance. Generally, the value of the security was presumed equal to (a) the issue price of any new secured debt issued in

the exchange, plus (b) the value of any other consideration (excluding stock or new secured debt) received by the holder. n59

Example 6

Prior to January 1, 1995, debtor corporation has one secured debt outstanding with an adjusted issue price of \$100,000. Debtor exchanges the debt for new secured debt with an issue price of \$70,000, \$10,000 cash and debtor common stock of \$10,000. The outstanding debt is separated into a secured debt of \$80,000 (\$70,000 issue price of new debt plus \$10,000 cash), and an unsecured debt of the balance, \$20,000.

[b] Stock Ratio Rule Applicable to Each Unsecured Creditor--Proportionality

Even if the "overall" stock for debt transaction met the "nominal or token" standard discussed above, an additional test applied to each unsecured creditor receiving stock in the transaction. Specifically, *I.R.C. Section 108(e)(8)(B)* provided that the stock for debt exception will not apply with respect to an unsecured creditor if the ratio of the value of stock received by the creditor to the amount of debt canceled or exchanged for stock was less than 50 percent of a similar ratio computed for all unsecured creditors participating in the exchange. n60 For this purpose, a creditor was treated as a secured creditor only to the extent of the fair market value of the property securing such creditor's claim. n61 Any claim against the debtor in excess of such value was treated as a separate claim of an unsecured creditor. n62 The following example illustrates the operation of *I.R.C. Section 108(e)(8)(B)*:

Example 7

If the debtor corporation intends to transfer one share of its stock worth \$70 for each \$100 of claims held by the unsecured creditors, then the stock for debt exception will not apply to the claims held by each unsecured creditor unless that creditor receives at least fifty percent of its pro rata share or, in this example, \$35 of stock under the plan or reorganization. n63

The Revenue Reconciliation Act of 1990 ("RRA 1990") amended *I.R.C. Section 108(e)(8)* to clarify that "disqualified" stock was not to be treated as stock under the proportionality test. n64 The RRA 1990 amendment was generally effective for exchanges occurring on or after October 9, 1990 and before January 1, 1995. n65

The Final Regulations provided guidance on the proportionality test. The regulations tested proportionality using a debt-by-debt approach. Thus, the stock for debt exception did not apply to an unsecured debt satisfied with stock if the individual stock ratio did not at least equal one-half of the group stock ratio. n66 Common stock and preferred stock issued in satisfaction of unsecured debt were tested separately. n67 Assuming common stock was issued, the "individual common stock ratio" was the value of the common stock issued over the amount of unsecured debt allocated to the stock. The amount of debt allocated was the adjusted issue price of the debt satisfied with the stock, with an appropriate increase for accrued but unpaid interest, reduced by the amount of other consideration, if any, given in exchange for the debt including (a) cash, (b) the issue price of any new debt, (c) the amount of debt allocated to preferred stock, and (d) the value of any other property, including the value of any disqualified stock. n68 The "group common stock ratio" was the aggregate value of all common stock issued for unsecured debt in the title 11 case or insolvency workout over the aggregate amount of unsecured debt allocated to the stock. The amount of unsecured debt allocated was the aggregate adjusted issue price of all unsecured debt satisfied with stock or canceled in the title 11 case or workout, reduced by the amount of other consideration, if any, given in exchange for the debt including (a) cash, (b) the issue price of any new debt, (c) the amount of debt allocated to preferred stock, and (d) the value of any other property, including the value of any disqualified stock. n69

The Final Regulations provided the following example:

Example 8

(A) X Corporation has three outstanding debts. Debts 1 and 2 are unsecured and each has a \$100,000

adjusted issue price. Debt 3 is also unsecured, with a \$90,000 adjusted issue price and accrued but unpaid interest of \$10,000. In a title 11 case, the first indebtedness is exchanged for \$50,000 cash and \$20,000 of common stock, Debt 2 is exchanged for \$10,000 cash, and Debt 3 is exchanged for \$5,000 common stock. The individual common stock ratio for the first indebtedness is 40 percent, which is determined by comparing the value of the common stock issued for the indebtedness (\$20,000) to the amount of unsecured indebtedness allocated to that stock (\$50,000) (\$100,000 adjusted issue price less \$50,000 cash received). The individual common stock ratio for Debt 2 is 0 percent because no stock is received in exchange for the indebtedness. The individual common stock ratio for Debt 3 is 5 percent, which is determined by comparing the value of the common stock issued for the indebtedness (\$5,000) to the amount of unsecured indebtedness allocated to that stock (\$100,000--\$90,000 adjusted issue price plus \$10,000 of accrued but unpaid interest).

(B) The group common stock ratio is 10.4 percent, which is determined by comparing the value of all of the common stock issued for unsecured indebtedness in the title 11 case (\$25,000) to the amount of unsecured indebtedness allocated to the stock (\$240,000) (\$290,000 aggregate adjusted issue price of all indebtedness exchanged for stock or canceled in the title 11 case plus \$10,000 accrued but unpaid interest, less \$60,000 cash received). Accordingly, Section 108(e)(8)(B) is satisfied only with respect to the common stock issued for Debt 1. The stock for debt exception does not apply to Debt 2 or 3, because both are below one-half of the group stock ratio of 5.2 percent.

[5] Definition of Stock

[a] Introduction

So-called "plain" or "straight" common stock, for which there are no limitations on the right to share in the economic performance of the corporation, clearly qualified for the stock for debt exception. On the other hand, options or warrants to acquire common stock would not qualify because they do not confer immediate stock ownership rights. n70 However, prior to 1990, little guidance was available on the parameters of the characteristics of a class of stock (typically, although not exclusively, preferred stock) that qualified for the stock for debt exception. Prior to the repeal of the exception affecting transfers taking place after December 31, 1994, two developments-- the addition of the "disqualified stock" limitation to *I.R.C. Section 108(e)(10)(B)* in the RRA 1990 and the issuance of Regulations on "nominal or token" stock--imposed significant limitations on the availability of the stock for debt exception, particularly when preferred stock is issued in a stock for debt exchange.

[b] Disqualified Stock

In the RRA 1990, Congress amended *I.R.C. Section 108(e)(10)(B)* to restrict the use of stock that had certain debt-like characteristics in a qualifying stock for debt exchange. n71 Under that law, the stock for debt exception did not apply where the stock exchanged was "disqualified stock." n72 Disqualified stock was defined as any stock that has a stated redemption price and that either: (1) has a fixed redemption date; (2) is callable by the issuer; or (3) grants the stockholder a "put" option back to the issuing corporation. n73 The amendment generally applies to exchanges occurring after October 9, 1990, but prior to January 1, 1995. n74

Accordingly, if disqualified stock was issued in satisfaction of debt, the issuing debtor corporation realized discharge of indebtedness income to the extent of the difference between the fair market value of the stock and the adjusted issue price of the debt discharged. n75 Further, when a combination of "qualifying" stock and disqualified stock was issued in satisfaction of debt, the disqualified stock was not treated as stock for purposes of determining whether the statutorily prescribed *de minimis* tests are satisfied. n76

Example 9

Debtor corporation, pursuant to its title 11 plan of reorganization, issues callable preferred stock with a

stated redemption price and a fair market value of \$20,000 to Creditor in satisfaction of \$100,000 of debt. Debtor also issues "straight" or unrestricted common stock to other creditors under the plan. This transaction must be analyzed in two parts: First, because the preferred stock is disqualified stock under *I.R.C. Section 108(e)(10)(B)*, the issuance of such stock will not qualify under the stock for debt exception. Therefore, Debtor corporation will realize \$80,000 of discharge of indebtedness income (debt discharged of \$100,000 less the fair market value of the preferred stock of \$20,000) which, although excluded from income under *I.R.C. Section 108(a)*, will reduce Debtor's tax attributes under *I.R.C. Section 108(b)*. Second, whether the common stock will qualify for the stock for debt exception depends upon whether the *de minimis* tests under *I.R.C. Section 108(e)(8)* are satisfied. For this purpose, the disqualified preferred stock issued by Debtor cannot be counted.

[c] Preferred Stock

[i] History

Prior to 1990, neither the courts nor the IRS provided any meaningful guidance concerning the use of preferred stock in stock for debt exchanges. A number of key cases in the development of the stock for debt exception involved preferred stock, but the courts in those cases did not explicitly address the special issues raised by the use of preferred stock. These issues arise because preferred stock often possesses many debt-like characteristics (such as a fixed liquidation preference).

For example, it was unclear whether the issuance of preferred stock with a liquidation preference below the amount of debt canceled in the exchange would have any affect on qualification under the stock for debt exception. In *Capento Securities*,ⁿ⁷⁷ the court held that preferred stock that had a liquidation preference equal to the amount of the debt being canceled qualified for the stock for debt exception without addressing the importance of the amount (or existence) of the liquidation preference. Similarly, in *Motor Mart Trust*,ⁿ⁷⁸ a package of preferred and common stock was issued, but the court, in holding that the stock for debt exception applied, did not consider the affect that the liquidation preference of the preferred stock might have on the application of the stock for debt exception.

Despite the fact that the courts have not addressed the issue, some support can be found in the so-called "subscription price" theory for treating preferred stock as qualifying for the exception to the full extent of the canceled debt, regardless whether the preferred stock has a liquidation preference that is less than the amount of the debt canceled.ⁿ⁷⁹ Under the "subscription price" theory, nonrecognition under the stock for debt exchange is analogous to the nonrecognition permitted when a corporation receives the subscription price for its shares--and the delay between the initial debt issuance and later stock for debt exchange should not change the result.ⁿ⁸⁰ It appears that the "subscription price" theory might support the qualification of so-called "straight" preferred stock (*i.e.*, a class of preferred that is nonparticipating, nonconvertible and with fixed redemption and liquidation rights)ⁿ⁸¹ under the stock for debt exception.

However, unlimited qualification of preferred stock for the stock for debt exception under the other theory supporting nonrecognition, the "substitution of liability" theory, is not so clear. It appears that the nontaxable substitution of the equity interest for the debt interest may be limited to the amount of any fixed redemption and liquidation price provided for by the applicable preferred stock.

In several private rulings involving stock for debt exchanges, the IRS appeared to accept the "subscription price" theory as a valid alternative rationale supporting the stock for debt exception.ⁿ⁸² However, in a 1988 technical advice memorandum, the IRS held that the cases which follow *Capento Securities* did so on the basis of the "substitution of liability" theory, and concluded that "[t]he sole reliance of these cases on the substitution of liability theory casts some doubt as to the continued viability of the subscription price theory of *Capento*." ⁿ⁸³

[iii] Importance of Liquidation Preference Amount Prior to Repeal of Exception

The final "nominal or token" regulationsⁿ⁸⁴ also included special rules applicable to preferred stock. Specifically, the final regulations provided that preferred stock (defined as stock (1) with a limited or fixed redemption price or liquidation preference and (2) which does not at the time of issuance have a right to participate in corporate growth to a meaningful extent) that was not otherwise treated as "disqualified stock" under *I.R.C. Section 108(e)(10)(B)(ii)*ⁿ⁸⁵ was deemed to discharge an amount of debt in a stock for debt exchange equal to the greater of (1) its fair market value or (2) the lowest redemption price or liquidation preference, whichever was less.ⁿ⁸⁶

Prior to the issuance of the final "nominal or token" regulations, the IRS issued *Revenue Ruling 90-87*ⁿ⁸⁷ which sets forth the IRS's view on the use of preferred stock in stock for debt exchanges. *Revenue Ruling 90-87*, a corporation under the jurisdiction of a bankruptcy court in a title 11 case owed \$500,000 to C, an unrelated creditor. Pursuant to a plan of reorganization approved by the court, the corporation issued preferred stock to C in exchange for the \$500,000 claim. The preferred stock had a redemption price of \$300,000 and was limited and preferred as to liquidation proceeds ("liquidation preference") to the extent of \$300,000.

The IRS ruled that the stock for debt exception only applied to the extent of the \$300,000 liquidation preference. Thus, the corporation realized \$200,000 of discharge of indebtedness--the amount by which the debt canceled exceeded the liquidation price of the preferred stock. Based on the "substitution of liability" theory, the IRS concluded that, because of the liquidation preference, the amount of the tax-free substitution of capital for debt was limited to the \$300,000 preference amount.ⁿ⁸⁸

As discussed above, the conclusion reached in *Revenue Ruling 90-87* was basically incorporated into the final "nominal or token" regulations issued under *I.R.C. Section 108*.

[d] Parent Stock

It is clear from the case law that stock of a successor to the debtor qualified for the stock for debt exception.ⁿ⁸⁹ The more difficult, and as yet unresolved, issue is whether stock of the debtor corporation's parent qualified for the exception. A subsidiary-debtor corporation will often issue stock of its controlling parent corporation to its creditors. Unfortunately, neither the courts nor the IRS have issued any formalⁿ⁹⁰ guidance on point. This uncertainty regarding the eligibility of parent stock for the application of the stock for debt exception at the subsidiary corporation level creates a practical roadblock to the use of triangular "G" reorganizations, despite their authorization by the Bankruptcy Tax Act of 1980.ⁿ⁹¹

Persuasive arguments may be made that parent stock should qualify for purposes of the stock for debt exceptionⁿ⁹² and that such a result is implicit in *I.R.C. Section 108* and the "G" reorganization provisions enacted in the Bankruptcy Tax Act of 1980.ⁿ⁹³ However, it appears that Congress has recently added to the uncertainty on this issue. Although the language was inserted into the statute without explanation in the RRA 1990, *I.R.C. Section 108(e)(10)(B)(i)* (applicable to transactions after October 9, 1990 and prior to January 1, 1995) provided that the stock for debt exception applied "to any transfer of *stock of the debtor* " corporation (emphasis added). Therefore, in the absence of direct statutory or regulatory relief, caution is advised when considering the use of parent stock in a stock for debt exchange.

It should be noted that the legislative history of *I.R.C. Section 108* is ambiguous on the question. The House version of what became the Bankruptcy Tax Act of 1980 includes a provision limiting the types of debt covered by the stock for debt exception. The House Ways and Means Committee Report explains that the stock for debt exception will apply to stock of a parent corporation.ⁿ⁹⁴ However, the Senate Finance Committee amended the House bill by deleting the House provision relating to the stock for debt exception. The Senate Finance Committee Report states, somewhat cryptically, that

[t]he 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 n95

Although this language suggests the Finance Committee may have considered and rejected the Ways and Means Committee conclusion that parent stock could qualify for the stock for debt exception, the Senate Report does not indicate that the Finance Committee intended that result.

FOOTNOTES:

(n1)Footnote 1. For a general discussion, see chapter TX6 *supra*.

(n2)Footnote 2. See 1992-2 C.B. 34, Rev. Rul. 92-52 ; S. Rep. No. 1035, 96th Cong., 2d Sess.11 (1980), *reprinted in* 1980-2 C.B. 625 ; ("If the stock-for-debt exception applies to prevent the debtor's realization of discharge of indebtedness income, no corresponding reduction of the debtor's tax attributes is required under sections 108(b) and 1017."). See also Rev. Rul. 92-52, 1992-2 C.B. 4 ; Priv. Ltr. Rul. 94-09-037 (Dec. 7, 1993) , holding 9(b).

(n3)Footnote 3. I.R.C. § 108(b)(1). See P TX6.03[4] *supra*. Attribute reduction can be required in a stock for debt transaction under special circumstances unrelated to I.R.C. § 108. See I.R.C. § 382(l)(5)(C).

(n4)Footnote 4. Pub. L. No. 103-66, § 13226 (1993).

(n5)Footnote 5. See P TX6.03[3][c] *supra*.

(n6)Footnote 6. See P TX6.03[4] *supra*.

(n7)Footnote 7. I.R.C. § 108(b)(4)(A). See *Gitlitz et. ux. v. Commissioner*, 531 U.S. 206, 121 S. Ct. 701, 148 L. Ed.2d 613 (2001) (attribute reduction is made after the determination of the tax imposed for the year of discharge). Due to the 90 percent limitation on the net operating loss deduction, Debtco may be subject to the alternative minimum tax imposed under I.R.C. Section 55. See P TX6.03[5][h] *supra*.

(n8)Footnote 8. See *Treas. Reg. § 1.1017-1(a)* (last sentence).

(n9)Footnote 9. I.R.C. § 1017(b)(2). See P TX6.03[4][b][iii] *supra*.

(n10)Footnote 10. See P TX8.02 *supra*.

(n11)Footnote 11. S. Rep. No. 1035, 96th Cong., 2d Sess. 11 (1980), *reprinted in* Collier on Bankruptcy, App. Pt. 5(b)(iii) (Matthew Bender 15th ed. Rev.). One commentator observed that "one of the most protracted and acrimonious controversies surrounding the enactment of the Bankruptcy Tax Act involved the so-called stock for debt exception" Asofsky, *Discharge of Indebtedness Income in Bankruptcy After the Bankruptcy Tax Act of 1980*, 27 St. Louis U.L.J. 583, 600 (1983).

(n12)Footnote 12. 1992-2 C.B. 34, Rev. Rul. 92-52 .

(n13)Footnote 13. I.R.C. § 108(e)(10)(B)(i), prior to repeal by Pub. L. No. 103-66 (1993).

(n14)Footnote 14. I.R.C. § 108(e)(8)(A), prior to repeal by Pub. L. No. 103-66 (1993).

(n15)Footnote 15. I.R.C. § 108(e)(8)(B), prior to repeal by Pub. L. No. 103-66 (1993).

(n16)Footnote 16. I.R.C. § 108(e)(10)(B)(ii), prior to repeal by Pub. L. No. 103-66 (1993).

(n17)Footnote 17. *See P TX11.04 infra.*

(n18)Footnote 18. *I.R.C. § 382(l)(5)(C).*

(n19)Footnote 19. Staff of Joint Comm. on Taxation, 98th Cong. 2d Sess., General Explanation of the Deficit Reduction Act of 1984, at 167 (Comm. Print 1984) (the "1984 General Explanation").

(n20)Footnote 20. Staff of Joint Comm. on Taxation, 98th Cong. 2d Sess., General Explanation of the Deficit Reduction Act of 1984, at 167 (Comm. Print 1984) (the "1984 General Explanation").

(n21)Footnote 21. Staff of Joint Comm. on Taxation, 98th Cong. 2d Sess., General Explanation of the Deficit Reduction Act of 1984, at 167 (Comm. Print 1984) (the "1984 General Explanation").

(n22)Footnote 22. The Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66 (1993).

(n23)Footnote 23. *See* 1984 General Explanation at 168 ; *see also* Priv. Ltr. Rul.90-18-005 (Nov. 15, 1989) .

(n24)Footnote 24. The Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66 (1993).

(n25)Footnote 25. As initially enacted in 1984, *I.R.C. § 108(e)(10)* included a third subparagraph, designated "C," providing that the stock-for-debt exception applied to a "qualified workout" by a corporation whose "cash flow and credit problems" created a "substantial threat of involuntary proceedings relating to insolvency or bankruptcy." Deficit Reduction Act of 1984, Pub. L. No. 98-369, § 59(b), 98 Stat. 494, 576 (1984), *reprinted in* 1984-3 C.B. (Vol. 1) at 84. Congress subsequently repealed *I.R.C. Section 108(e)(10)(C)* as part of the Tax Reform Act of 1986. TRA 1986, Pub. L. No. 99-514, § 621(e)(1), 100 Stat.2085, 2266 (1986), *reprinted in* 1986-3 C.B. (Vol. 1) at 183.

(n26)Footnote 26. *I.R.C. § 108(d)(2)*; *see* Priv. Ltr. Ruls. 95-16-025 (January 18,1995); 92-20-039 (Feb. 14, 1992); 91-05-042 (Feb. 27, 1990), holding (5). For a general discussion, *see P TX6.03[3][c][i] supra*. It should be noted that a "G" reorganization contains a broader definition that includes a "title 11 or similar case." *I.R.C. § 368(a)(1)(G)*. *See P TX10.03[2] infra*.

(n27)Footnote 27. *I.R.C. § 108(d)(3)*. For a general discussion, *see P TX6.03[3][c][ii] supra*.

(n28)Footnote 28. 1992-2 C.B. 34, *Rev. Rul.* 92-52 .

(n29)Footnote 29. *See I.R.C. §§ 108(e)(10) and (11)*.

(n30)Footnote 30. *See I.R.C. §§ 108(a)(3) and 108(e)(10)(B)(i)*.

(n31)Footnote 31. *See P TX8.04[1] infra*.

(n32)Footnote 32. *I.R.C. § 108(e)(8)* was amended by the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13226(a)(1)(B) (1993). The amendment substituted provisions relating to indebtedness satisfied by a corporation's stock for provisions directing that the stock for debt exception shall not apply in de minimis cases.

(n33)Footnote 33. *I.R.C. § 108(e)(8)(A)*.

(n34)Footnote 34. *I.R.C. § 108(e)(8)(B)*. The legislative history of the Bankruptcy Tax Act of 1980 explains that a "workout" includes "a title 11 case (within the meaning of Code§ 368(a)(3)(A)) or other transaction or series of transactions involving a significant restructuring of the debt of a corporation in financial difficulty." S. Rep. No. 1035, 96th Cong., 2d Sess. 17, n.20 (1980), *reprinted in* 1980-2 C.B. at 629 n.20 .

(n35)Footnote 35. *See* S. Rep. No. 1035, 96th Cong., 2d Sess. 17 (1980), *reprinted in* 1980-2 C.B. at 628-29 .

(n36)Footnote 36. H.R. Rep. No. 833, 96th Cong., 2d Sess. 14 (1980), *reprinted in* Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th ed. Rev.).

(n37)Footnote 37. S. Rep. No. 1035, 96th Cong., 2d Sess. 17 (1980), *reprinted in* Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th ed. Rev.).

(n38)Footnote 38. *Tech. Adv. Mem. 8837001 (May 10, 1988)* ; *see also* Priv. Ltr. Ruls.92-16-019 (Jan. 17, 1992); 90-19-036 (Feb. 9, 1990).

(n39)Footnote 39. For a discussion, *see P TX8.02[2] supra*.

(n40)Footnote 40. *Tech. Adv. Mem. 8837001 (May 10, 1988)* .

(n41)Footnote 41. Prop. Reg. § 1.108-1, CO-76-90, 1990-2 C.B. 690, 55 Fed. Reg. 50,568(Dec. 7, 1990) .

(n42)Footnote 42. Prop. Reg. § 1.108-1(c), 55 Fed. Reg. 50,568 (Dec. 7, 1990) .

(n43)Footnote 43. 1990-2 C.B. at 690 .

(n44)Footnote 44. Prop. Reg. § 1.108-1(b)(1), 55 Fed. Reg. 50,568 (Dec. 7, 1990) .

(n45)Footnote 45. Prop. Reg. § 1.108-1(b)(1), 55 Fed. Reg. 50,568 (Dec. 7, 1990) .

(n46)Footnote 46. 1990-2 C.B. 690, 692 .

(n47)Footnote 47. *See Comments Concerning Proposed Standards for Determining Whether Shares Are "Nominal or Token" Under Section 108(e)(8)(A)*, ABA Section of Taxation, 50 Tax Notes 995 (March 4, 1991); *Report on the Proposed Rules for Determining Whether Stock Issued in Exchange for Indebtedness Is Nominal or Token Under Section 108*, Association of the Bar of the City of New York, Committee on Taxation of Corporations, 51 Tax Notes 481, 492 (April 29, 1991).

(n48)Footnote 48. Prop. Reg. § 1.108-1, CO-76-90, 1992-2 C.B. 612 (Dec. 14, 1992) .

(n49)Footnote 49. *Treas. Reg. § 1.108-1*, T.D. 8532, 1994-1 C.B. 21 F.R. 12830 (March 18, 1994).

(n50)Footnote 50. *Treas. Reg. § 1.108-1(e)*.

(n51)Footnote 51. *Treas. Reg. § 1.108-1(b)*.

(n52)Footnote 52. 1994-1 C.B. 612 .

(n53)Footnote 53. 1994-1 C.B. 21, T.D. 8532 .

(n54)Footnote 54. 1994-1 C.B. 612, Rev. Proc. 94-26 , § 3.

(n55)Footnote 55. 1994-1 C.B. 612, Rev. Proc. 94-26 , § 3.

(n56)Footnote 56. *Treas. Reg. § 1.108-1(d)*.

(n57)Footnote 57. *Treas. Reg. § 1.108-1(d)(4)*.

(n58)Footnote 58. *Treas. Reg. § 1.108-1(d)(5)*.

(n59)Footnote 59. *See Treas. Reg. § 1.108-1(d)(6)*.

(n60)Footnote 60. See Priv. Ltr. Ruls. 94-09-037 (Dec. 7, 1993); 92-16-020 (Jan. 17, 1992);91-05-042 (Feb. 27, 1990).

(n61)Footnote 61. S. Rep. No. 1035, 96th Cong., 2d Sess. 17, n.19 (1980), *reprinted in* Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th ed. Rev.).

(n62)Footnote 62. As the legislative history points out, this approach is consistent with 11 U.S.C. § 506. See S. Rep. No. 1035, 96th Cong., 2d Sess. 17, n.19 (1980), *reprinted in* Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th ed. Rev.).

(n63)Footnote 63. S. Rep. No. 1035, 96th Cong., 2d Sess. 17, (1980), *reprinted in* Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th ed. Rev.).

(n64)Footnote 64. I.R.C. § 108(e)(10)(B)(ii), repealed in the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66 (1993).

(n65)Footnote 65. Pub. L. No. 101-508, 101st Cong., 2d Sess. § 11325(c)(2), 104 Stat. 1388(1990). It is unclear whether creditors who did not receive any debtor stock consideration in a transaction (but had their debt canceled for other consideration that was less than the adjusted price of the debt) should be taken into account in applying the proportionality test. The 1992 Proposed Regulations (as adopted unchanged on this issue in the Final Regulations) took the approach that unsecured debt canceled or satisfied with non-stock consideration is counted in the denominator of the group common stock ratio. See preamble at 1992-2 C.B. at 614 .

(n66)Footnote 66. *Treas. Reg. § 1.108-1(c)(1)*.

(n67)Footnote 67. *Treas. Reg. § 1.108-1(c)(1)* and (2).

(n68)Footnote 68. *Treas. Reg. § 1.108-1(c)(1)(ii)*.

(n69)Footnote 69. *Treas. Reg. § 1.108-1(c)(1)(iii)*. See *Priv. Ltr. Rul. 9516025 (January 19, 1995)* .

(n70)Footnote 70. See, e.g., 1967-2 C.B. 298, *Rev. Rul. 67-269* .

(n71)Footnote 71. Pub. L. No. 101-508, 101st Cong., 2d Sess. § 11325(b), 104 Stat. 1388(1990), *reprinted in* Collier on Bankruptcy, App. Pt. 41(h)(ii) (Matthew Bender 15th ed. Rev.).

(n72)Footnote 72. I.R.C. § 108(e)(10)(B)(i), repealed in the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66 (1993).

(n73)Footnote 73. I.R.C. § 108(e)(10)(B)(ii), repealed in the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66 (1993). See *Priv. Ltr. Rul. 9408020 (Nov. 29, 1993)* (option to purchase stock issued to unsecured creditors at fair market value will not cause stock to be classified as disqualified stock).

(n74)Footnote 74. Pub. L. No. 101-508, 101st Cong., 2d Sess. § 11325(b), 104 Stat. 1388(1990), *reprinted in* Collier on Bankruptcy, App. Pt. 41(h)(ii) (Matthew Bender 15th ed. Rev.). The amendment generally applies to stock transferred in satisfaction of debt after October 9, 1990, but prior to January 1, 1995, unless either the exchange occurs in a title 11 or similar case which was filed before October 10, 1990, or the stock is issued pursuant to a written binding contract in effect on October 9, 1990, or pursuant to a transaction that was described in documents filed with the SEC before October 10, 1990.

(n75)Footnote 75. S. Rep. No. 3209, 101st Cong., 2d Sess. 177 (1990); H.R. Rep. No. 5835, 101st Cong., 2d Sess. 106 (1990).

(n76)Footnote 76. *I.R.C. § 108(e)(8)*, prior to repeal by Pub. L. No. 103-66 (1993). *See P TX8.03[4] supra* for a discussion of the *de minimis* tests.

(n77)Footnote 77. *Capento Securities Corp. v. Commissioner* 47 B.T.A. 691 (1942) , *aff'd*, 140 F.2d 382 (1st Cir. 1944) , *nonacq.*, 1943 C.B. 28 . *See P TX8.02[2] supra*.

(n78)Footnote 78. *Motor Mart Trust v. Commissioner*, 4 T.C. 931 (1945) , *aff'd*, 156 F.2d 122 (1st Cir. 1948) , *acq.*, 1947-1 C.B. 3 . *See P TX8.02[2] supra*.

(n79)Footnote 79. *See P TX8.02[2] supra*.

(n80)Footnote 80. *See P TX8.02[2] supra*.

(n81)Footnote 81. For a definition of so-called "straight" preferred stock, *see I.R.C. § 1504(a)(4)*.

(n82)Footnote 82. *See, e.g.*, Tech. Adv. Mem. 87-38-008 n.4 (June 17, 1987); 87-35-006 n.4 (May 18, 1987); 87-35-003 n.6 (May 10, 1987).

(n83)Footnote 83. *Tech. Adv. Mem. 8837001 (May 10, 1988)* . *Tech. Adv. Mem. 8837001* , the IRS applied the exception to voting participating preferred that was convertible into common stock at the debtor parent's option and redeemable at the issuer's option at its liquidation price. The IRS did not identify which characteristics of the preferred stock allowed it to qualify for the stock for debt exception.

(n84)Footnote 84. *Treas. Reg. § 1.108-1* (March 18, 1994). *See P TX8.03[4][a] supra*.

(n85)Footnote 85. *Treas. Reg. § 1.108-1(d)(4)*. For a discussion of "disqualified stock," *see P TX8.03[5][b] supra*.

(n86)Footnote 86. *Treas. Reg. § 1.108-1(c)(2)(ii)*.

(n87)Footnote 87. 1990-2 C.B. 32, *Rev. Rul. 90-87* .

(n88)Footnote 88. Two commentators have noted that (1) the IRS ignored the "subscription price" theory in *Rev. Rul. 90-87* , a theory that would not restrict the use of even "straight" preferred under the stock for debt exception and (2) *Capento Securities* is cited in the ruling as if to indicate that the ruling's holding has been well established law since 1942, when in fact, the *Capento Securities* court never addressed the issue raised in the ruling since the redemption price and liquidation preference equaled the amount of the debt being canceled. *See Pollack and Goldring, The Stock for Debt Exception-- New Restrictions on the Use of Preferred Stock*, 3 Corp. Tax'n 14, 16-17 (1991).

(n89)Footnote 89. *Alcazar Hotel Inc. v. Commissioner*, 1 T.C. 872 (1943) , *acq.*, 1943 C.B.1 ; *Claridge Apts. Co. v. Commissioner*, 1 T.C. 163 (1942), *acq.*, *aff'd in part, rev'd in part*, 138 F.2d 962 (7th Cir. 1943), *rev'd on other grounds*, 323 U.S. 141, 65 S. Ct. 172, 89 L. Ed. 139 (1944).

(n90)Footnote 90. Informally, the I.R.S. has issued a private ruling approving the use of parent stock issued to subsidiary creditors. *See Priv. Ltr. Rul. 9516025 (January 18, 1995)* ; *Priv. Ltr. Rul. 9333048 (May 28, 1993)* .

(n91)Footnote 91. For a discussion of triangular "G" reorganizations, *see P TX10.03[5] infra*.

(n92)Footnote 92. For a discussion of these arguments, *see generally* Pollack and Goldring, *Can Cancellation of Indebtedness Income Be Avoided With Parent Stock*, 2 Corp. Tax'n 18(1990); Asofsky, *Uncertain Limits: The Stock-for-Debt Exception to Discharge of Indebtedness Income*, 1 Corp. Tax'n. 59 (1988).

(n93)Footnote 93. *See, e.g.*, *I.R.C. § 108(e)(7)(C)* (for purposes of recapture rule on subsequent disposition of stock received by a creditor, parent stock received is treated as stock of the debtor corporation). *See PP TX10.03[5] and*

TX10.05[5][c] infra .

(n94)Footnote 94. See H.R. Rep. No. 833, 96th Cong., 2d Sess. 15, n.22 (1980), *reprinted in* Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th ed. Rev.).

(n95)Footnote 95. S. Rep. No. 1035, 96th Cong., 2d Sess. 17 (1980), *reprinted in* Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th ed. Rev.) (emphasis added).



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CHAPTER TX8 Exchange of Corporate Stock for Debt

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P TX8.04 Miscellaneous Issues

[1] Issuance of a Package of Stock and Other Property in Exchange for Debt

The Internal Revenue Code has been silent on the question of how a combination of stock and other property given in satisfaction of a debt should be treated under the stock for debt exception. The question was discussed by both the House Committee on Ways and Means and the Senate Finance Committee during passage of the Bankruptcy Tax Act of 1980, with inconsistent conclusions being reached.

The House version of *I.R.C. Section 108* contained a separate subsection dealing with exchanges of stock for debt. Unlike *I.R.C. Section 108(e)(10)*, the House version eliminated the stock for debt exception to the *Kirby Lumber* rule in most instances. n1 However, the wording of the general rule in both the House version and *I.R.C. Section 108(e)(10)(A)* is virtually identical. n2 The House Report contains the following statement in connection with an exchange of a debtor corporation's stock and other property for its debt:

If both stock and other property are issued for a debt evidenced by a security, then the stock is to be treated as issued for a proportion of the debt equal to its proportion of the value of the total consideration. For example, if \$30 cash and \$20 worth of stock is issued to cancel a \$100 bond, then the cash is to be treated as satisfying \$60 of the debt (resulting in a debt discharge amount of \$30 to which the rules of the bill apply), and the stock is to be treated as issued for the other \$40 of the debt (with no income resulting or attribute reduction required). n3

In contrast, the Senate Finance Committee Report, presumably interpreting the same general rule that appeared in the House version, asserts that if the corporation issues a package of stock and other property in exchange for the cancellation of debt, then the cash and other property will first reduce the debt in an amount equal to the cash and the value of the other property. n4 According to the Senate Report, the stock will be treated as satisfying the remaining balance of the debt. n5 This treatment would eliminate the need for an allocation of values among the respective assets given in exchange for the stock. The Senate Report concludes that, "[c]onsequently, 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." n6

The Senate Finance Committee Report reaches the result most consistent with the congressional decision, embodied in the old *I.R.C. Section 108(e)(10)(B)*, to permit the stock for debt exception to apply to insolvent corporate debtors and

corporate debtors in title 11 cases. In Revenue Ruling 92-52, n7 the IRS has adopted the approach of the Senate Finance Committee, described above.

[2] Recapture of Gain on Subsequent Sale of Stock

Stock of the debtor corporation n8 received by a creditor in exchange for debt, will be treated as *I.R.C. Section 1245* recapture property. As such, the aggregate amount of any bad debt deductions claimed by the creditor under *I.R.C. Section 166* or loss deductions claimed with respect to the exchange will be treated as "depreciation" which will be recaptured as ordinary income upon the subsequent disposition of the stock. n9 The creditor must reduce the bad debt or loss deductions by the amount, if any, included in the creditor's income as a result of the exchange of stock for debt. n10 Thus, *I.R.C. Section 108(e)(7)* prevents the creditor from obtaining a potential "mismatching" benefit of an immediate ordinary loss deduction and capital gain treatment on any gain realized on the subsequent sale of stock received in a stock for debt exchange.

The following example illustrates the operation of *I.R.C. Section 108(e)(7)*:

Example 10

Lender made a \$1,000 short-term loan to In-Sol-Vent, Inc. in 1990, and Lender claimed an \$800 deduction for a partially worthless bad debt under section 166(a) in 1992. In 1993, In-Sol-Vent issued "qualifying" common stock worth \$500 to Lender in complete satisfaction of the debt. In that exchange, Lender realized a gain of \$300 (\$500-\$200 basis in debt). If Lender later sells the In-Sol-Vent stock for \$1,500, then \$500 of Lender's gain will be treated as ordinary income (\$800 bad debt deduction less the \$300 gain realized on receipt of the stock). In the alternative, if Lender disposes of the stock in a tax-free transaction, then the potential recapture will carry over to the stock received. n11

If a creditor receives stock of the parent corporation of a corporate debtor, then that stock will be treated as stock of the subsidiary/debtor corporation and will be subject to the recapture rules. n12 *I.R.C. Section 108(e)(7)(E)* provides that, under regulations to be issued by Treasury, similar recapture rules will apply to the indebtedness of a partnership. n13

[3] Overlap of I.R.C. Section 108(e)(6) and (e)(10)

It is unclear whether *I.R.C. Section 108(e)(6)* or *(e)(10)* governed when a shareholder/creditor exchanged a corporation's debt for additional stock in the corporation. n14 The version of *I.R.C. Section 108* enacted by the Bankruptcy Tax Act of 1980 did not include the present *I.R.C. Section 108(e)(10)*. As noted earlier, *I.R.C. Section 108(e)(10)* was the congressional response to perceived inequities in the operation of the judicially crafted stock for debt rule. In contrast, Congress enacted *I.R.C. Section 108(e)(6)* to restore symmetry between income and deductions. For that reason, the proper result is that *I.R.C. Section 108(e)(6)* should apply if the shareholder's basis in the debt has been reduced. If the shareholder has taken a deduction related to the debt reducing the shareholder's basis, then the corporation should realize discharge of indebtedness income as provided under *I.R.C. Section 108(e)(6)*. In all other situations, the form selected by the parties to the transaction should govern.

[4] Alternative Minimum Tax

For taxable years beginning after 1989, any amount of discharge income excluded under the stock for debt exception should also be excluded from income for purposes of the alternative minimum tax applicable to corporations. n15 However, for exchanges occurring in taxable years prior to 1990, even though the stock for debt exception applied, the discharge of indebtedness may in some cases give rise to book income, which may trigger the alternative minimum tax. n16

FOOTNOTES:

(n1)Footnote 1. H.R. Rep. No. 833, 96th Cong., 2d Sess. 14 (1980), *reprinted in* Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th ed. Rev.). Proposed *I.R.C. § 108(f)(1)(C)* of the House version provided an exception for debt (1) which had interest coupons or was in registered form on the later of the issue due or October 1, 1979, and (2) which constituted a "security" for the purpose of *I.R.C. § 354*. S. Rep. No. 1035, 96th Cong., 2d Sess. 17 (1980), *reprinted in* Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th ed. Rev.) (emphasis added).

(n2)Footnote 2. Compare § 108(f)(1)(A) of the House version with *I.R.C. § 108(e)(10)(A)* prior to its amendment in 1993.

(n3)Footnote 3. H.R. Rep. No. 833, 96th Cong., 2d Sess. 14 (1980), *reprinted in* Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th ed. Rev.).

(n4)Footnote 4. S. Rep. No. 1035, 96th Cong., 2d Sess. 17, *reprinted in* Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th ed. Rev.).

(n5)Footnote 5. S. Rep. No. 1035, 96th Cong., 2d Sess. 17, *reprinted in* Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th ed. Rev.).

(n6)Footnote 6. S. Rep. No. 1035, 96th Cong., 2d Sess. 17, *reprinted in* Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th ed. Rev.).

(n7)Footnote 7. 1992-2 C.B. 34, *Rev. Rul.* 92-52 ; *see also* *Priv. Ltr. Rul.* 9216020 (Jan. 17, 1992) .

(n8)Footnote 8. Stock of a corporation that owns 80% or more of the stock of the debtor corporation (as provided under *I.R.C. § 368(c)*) is treated as stock of the debtor corporation and the term "debtor corporation" includes a successor corporation. *I.R.C. § 108(e)(7)(C), (D)*.

(n9)Footnote 9. *I.R.C. § 108(e)(7)(A)*.

(n10)Footnote 10. *I.R.C. § 108(e)(7)(A)*.

(n11)Footnote 11. S. Rep. No. 1035, 96th Cong., 2d Sess. 18, *reprinted in* Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th ed. Rev.). *See, e.g., Treas. Reg. § 1.1245-2(c)(2)*.

(n12)Footnote 12. *I.R.C. § 108(e)(7)(C)*.

(n13)Footnote 13. It is uncertain whether the IRS will take the position that *I.R.C. § 108(e)(7)(E)* is self-executing. For a discussion of the IRS's position that *I.R.C. § 108(e)(4)* is self-executing, *see P TX6.02[4][b][i] supra*.

(n14)Footnote 14. *I.R.C. § 108(e)(10)* was repealed generally for stock for debt transfers after December 31, 1994. *See P TX8.03[2][a] supra*.

(n15)Footnote 15. *See I.R.C. § 56(g)(4)(B)(i)*. *See P TX6.03[5][h] supra*.

(n16)Footnote 16. *See P TX6.03[5][h] supra*.



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CHAPTER TX9 Debt for Debt Exchanges

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CHAPTER TX9 Debt for Debt Exchanges

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P TX9.01 Introduction

This chapter focuses on one of the crucial issues in any debt restructuring--whether changes to the terms of outstanding debt typically sought by lenders would constitute a deemed exchange of the debt pursuant to *Internal Revenue Code Section 1001* n1 and the corresponding Treasury regulations. n2 The first part of the chapter discusses the regulations. The second part of the chapter discusses the adverse tax consequences to debt holders of a deemed debt exchange under the regulations, including the collateral effects of a possible recharacterization of the modified debt as equity. The third part of the chapter discusses the tax consequences if modified debt is subject to the original issue discount ("OID") rules. Finally, the chapter discusses strategies to avoid the pitfalls commonly associated with debt exchanges.

FOOTNOTES:

(n1)Footnote 1. All references to the Internal Revenue Code are to the Internal Revenue Code of 1986, as amended ("I.R.C." or the "Code"), unless specifically noted.

(n2)Footnote 2. *Treas. Reg. § 1.1001-3*, added by *T.D. 8675, 1996-29 I.R.B. 5 (June 26, 1996)* .



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CHAPTER TX9 Debt for Debt Exchanges

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P TX9.02 Deemed Exchanges of Debt

[1] Regulations

Many of the modifications commonly sought by lenders to the terms of troubled debt would cause a deemed exchange of the debt; in many cases, a single modification would be sufficient to cause a deemed exchange. However, several provisions in the regulations represent a significant extension of case law and rulings insofar as the regulations would trigger a deemed exchange of debt where no exchange would otherwise occur. n1 Proposed regulations were issued on December 2, 1992, in response to the Supreme Court's decision in *Cottage Savings Association v. Commissioner*, n2 that a deemed exchange of property occurs if the "legal entitlements" of the exchanged properties are not identical. That decision significantly lowered the threshold for deemed exchanges. n3 The proposed regulations, with certain changes, were finalized on June 26, 1996, effective for any alteration of the terms of a debt instrument on or after September 24, 1996. Taxpayers, however, may rely on the final regulations for alteration of the terms of a debt instrument after December 2, 1992 and before September 24, 1996. n4

[a] Modifications

The regulations employ a two-part test to determine whether a deemed exchange occurs when debt is modified. Under this test a specific change to a debt instrument triggers a deemed exchange if the change constitutes a "modification," and the modification is "significant." n5 As a threshold matter it is important to note that although the modifications made to debt in a workout context where debt is in default often address unique issues, the Internal Revenue Service (the "IRS") has generally treated the context in which modifications are made as irrelevant. n6 This past practice is continued in the regulations, which provide that a deemed exchange may not be avoided simply because the borrower is insolvent or bankrupt. n7 The regulations broadly define a modification as any change in a legal right or obligation of the issuer or holder of the debt instrument, with some exceptions. n8

A change that occurs pursuant to the original terms of a debt instrument is not a modification. n9 An alteration that occurs by operation of the terms may occur automatically (for example, an annual resetting of the interest rate based on the value of an index or a specified increase in the interest rate if the value of the collateral declines from a specified level) or may occur as a result of the exercise of an option provided to an issuer or a holder to change a term of a debt instrument.

The following alterations, however, are modifications even if the alterations occur by operation of the terms of a debt

instrument:

1. An alteration that results in the substitution of a new obligor, n10 the addition or deletion of a co-obligor, or a change (in whole or in part) in the recourse nature of the instrument (from recourse to nonrecourse or from nonrecourse to recourse); n11
2. An alteration that results in an instrument or property right that is not debt for federal income tax purposes unless the alteration occurs pursuant to a holder's option under the terms of the instrument to convert the instrument into equity of the issuer; n12 and
3. An alteration that results from the exercise of an option provided to an issuer or a holder to change a term of a debt instrument unless:
 - a. The option is unilateral; and
 - b. In the case of an option exercisable by a holder, the exercise of the option does not result in (or, in the case of a variable or contingent payment, is not reasonably expected to result in) a deferral of, or a reduction in, any scheduled payment of interest or principal. n13

An option is unilateral only if, under the terms of the instrument or under local law, (i) at the time the option is exercised, or as a result of the exercise, there is no right of the other party to alter or terminate the instrument or put the instrument to a person related to the issuer; n14 (ii) the exercise of the option does not require the consent or approval of the other party, a person related to the other party, or a court or arbitrator; and (iii) the exercise of the option does not require consideration (other than incidental costs and expenses relating to the exercise of the option), unless, on the issue date of the instrument, the consideration is a *de minimis* amount, a specified amount, or an amount that is based on a formula that uses objective financial information.

An issuer's failure to perform its obligations under a debt instrument is also not a modification. n15 An agreement by the holder to stay collection or temporarily waive an acceleration clause or similar default right (including such a waiver following the exercise of a right to demand payment in full) is not a modification unless and until the forbearance remains in effect for a period that exceeds two years following the issuer's initial failure to perform; and any additional period during which the parties conduct good faith negotiations or during which the issuer is in a Title 11 or similar case. n16

Although a change in the currency denomination of a debt instrument is generally considered a modification, Treasury regulations provide an exception for a change in denomination to the euro. n17 The advent of the euro, on January 1, 1999, as the single currency of participating members of the European Union n18 initially raised concerns that the conversion of the national currencies of those members ("legacy currencies") to the euro would be a taxable exchange. n19 Responding to those concerns, the IRS issued temporary and then final regulations providing nonrealization treatment for the conversion of a legacy currency to the euro. n20 The regulations apply broadly to a change in rights and obligations denominated in a legacy currency if the change results solely from the conversion of the legacy currency to the euro. n21 For example, a change in the currency denomination of a bond from French francs to euro as a result of the conversion of the franc to the euro is not a "modification" under the *I.R.C. section 1001* regulations. n22

If a party to a debt instrument has an option to change a term of an instrument, the failure of the party to exercise that option is not a modification. n23

A modification is tested when the parties agree to a change even if the change is not immediately effective. n24 The regulations provide exceptions for a change in a term that is agreed to by the parties but is subject to reasonable closing conditions or that occurs as a result of bankruptcy proceedings. n25 In these cases, a modification occurs on the date the

change in the term becomes effective. Thus, if the conditions do not occur (and the change in the term does not become effective), a modification does not occur.

[b] Significant Modifications

As stated above, a modification must be "significant" to trigger a deemed exchange. The regulations describe categories of modifications that generally would be considered significant and add a new general rule for types of modifications for which specific rules are not provided. n26 Under this general rule (the general significance rule), 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. n27 When testing a modification under the general significance rule, all modifications made to the instrument (other than those for which specific 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. n28 The general significance rule also applies to a type of modification for which specific rules are provided if the modification is effective upon the occurrence of a substantial contingency. n29 Moreover, the general significance rule will apply for certain types of modifications that are effective on a substantially deferred basis. n30

[i] Changes in Yield

The regulations provide that a change in yield is significant if the change exceeds the greater of 25 basis points or 5% of the original yield on the instrument. This bright-line rule is limited to fixed rate and variable rate debt instruments. Because of the difficulties in developing appropriate mechanisms for measuring changes in the yield of other debt instruments (for example, contingent payment debt instruments), the regulations provide that the significance of changes in the yield of those other instruments is determined under the general significance rule, described above. n31 A commercially reasonable prepayment penalty generally is not taken into account in determining the yield of the modified instrument. n32

Example 1 :

ABC Corp. issues to L a debt instrument bearing a 10% annual interest rate. ABC Corp. and L agree to a modification of the debt instrument that reduces the yield to 9.25%. The 75 basis point reduction in yield is a significant modification because it exceeds 50 basis points (*i.e.*, the greater of 25 basis points or the product of 5% and the original yield of 10%). To avoid a significant modification from a change in yield, the yield should not be reduced below 9.5%.

[ii] Changes in Timing and Amount of Payments

A modification that changes the timing of payments (including any resulting change in the amount of payments) due under a debt instrument is a significant modification if it results in the material deferral of scheduled payments. n33 The deferral may occur either through an extension of the final maturity date of an instrument or through a deferral of payments due prior to maturity. The materiality of the deferral depends on all the facts and circumstances, including the length of the deferral, the original term of the instrument, the amounts of the payments that are deferred, and the time period between the modification and the actual deferral of payments.

The regulations allow the deferral of payments within a safe-harbor period (the lesser of five years or 50% of the original term of the instrument) if the deferred amounts are unconditionally payable at the end of that period. n34 The terms of an instrument are determined without regard to options to extend the original maturity and deferrals of *de minimis* payments. n35 If the safe-harbor period exceeds the actual deferral period, the excess remains a safe-harbor period available for any subsequent deferral of payments on the debt instrument. n36

Example 2 :

On January 1, 1988, ABC Corp. issued to L a debt instrument scheduled to mature on December 31,

1996, with an option to extend the maturity to December 31, 2000. L allows ABC Corp. to refinance the debt and extends the maturity to December 31, 1997. The one-year extension is not a significant modification because it falls within the safe-harbor period of four years (*i.e.*, the lesser of (i) five years or (ii) 50% of the original term of eight years, without regard to the option to extend the maturity 4 years). Because the deferral period of one year is less than safe-harbor period, ABC Corp. and L may agree to a further extension of three years without triggering a deemed exchange. Notably, the 3-year unused portion of the safe-harbor period exceeds the safe-harbor of 1/2 year calculated based on the new term of the instrument (lesser of 5 years or 50% of one year).

The proposed regulations provided four rules for determining whether a change in the timing or amount of payments would result in a significant modification. First, such a change was a significant modification if it materially deferred payments due under an instrument. n37 Second, an extension of the maturity date beyond the lesser of (i) five years or (ii) 50% of the original term of the instrument was a significant modification. n38 Third, the prepayment or forgiveness of a portion of a debt instrument was generally not a significant modification unless such prepayment or forgiveness caused more than a 25 basis point change in the instrument's yield. n39 Fourth, the addition or deletion of a put or call right with significant value when added or deleted was a significant modification. n40

If the terms of any debt instrument issued on or after August 13, 1996, are modified to defer one or more payments in a manner that does not cause a deemed exchange under section 1001, then solely for purposes of the OID rules under sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the modification date for an amount equal to the instrument's adjusted issue price on that date. n41 As a result, a deferral of interest payments that is not a significant modification under section 1001 could nevertheless cause a non-OID instrument to be reissued as an OID instrument if interest payments cease to constitute "qualified stated interest." n42

[iii] Changes in Obligor or Security

A change in the obligor on a nonrecourse debt instrument is not a significant modification. n43 The regulations provide that a change in the obligor on a recourse instrument is a significant modification unless the change results from a tax-free reorganization or liquidation, or from a transaction in which the new obligor acquires substantially all of the assets of the original obligor. n44 Each exception must meet the following requirements; (i) other than the substitution of a new obligor, the transaction must not result in any alteration that would be a significant modification but for the fact that it occurs by operation of the terms of the instrument (a "significant alteration"); and (ii) the transaction must not result in a change in payment expectations. n45

The regulations also provide that the filing of a petition in a title 11 or similar case by itself does not result in the substitution of a new obligor. n46 The substitution of a new obligor on a tax-exempt bond is not a significant modification if the new obligor is a related entity to the original obligor and the collateral securing the instrument continues to include the original collateral. n47 The substitution of a new obligor is also not a significant modification if the acquiring corporation becomes the new obligor pursuant to a section 381 transaction, the transaction does not result in a change in payment expectations, and the transaction does not result in a significant alteration. n48 An election under section 338, following a qualified stock purchase of an issuer's stock, does not result in the substitution of a new obligor. n49

A change in payment expectations occurs if there is a substantial enhancement or impairment of the obligor's capacity to meet its payment obligations under the instrument and the enhancement or impairment results in a change to an adequate capacity from a speculative capacity or vice versa. n50 There is no change in payment expectations, however, if the obligor has at least an adequate capacity to meet its payment obligations both before and after the modification. n51

The regulations apply the payment expectations test to determine whether the addition or deletion of a co-obligor is a

significant modification. n52 Similarly, the regulations provide that whether certain other modifications are significant is determined by reference to whether the modifications result in a change in payment expectations. Those modifications include: (i) the release, substitution, addition, or other alteration of the collateral for, a guarantee on, or other form of credit enhancement for recourse debt; and (ii) a change in the priority of a debt instrument. n53

A modification that releases, substitutes, adds, or otherwise alters a substantial amount of the collateral for, a guarantee on, or other form of credit enhancement for a nonrecourse debt instrument is a significant modification. n54 If the collateral is fungible, however, or is in the form of a commercially available credit enhancement, a substitution of the collateral is not a significant modification. Improvements to the property serving as collateral for a nonrecourse debt also do not give rise to a significant modification. n55

Example 3 :

DH Partnership ("DHP") owns the Taj Mahal Hotel, which has a fair market value of \$500,000 and is subject to a \$1,000,000 nonrecourse bank loan. With the bank's consent, DHP exchanges the Taj Mahal for a new hotel with a fair market value of \$500,000. The substitution of collateral is a significant modification even though the new collateral is worth the same amount as the old collateral.

Example 4 :

Assume the same facts as in Example 3 except that instead of exchanging the Taj Mahal for a new hotel, DHP renovates the Taj Mahal, increasing the hotel's fair market value to \$600,000. The improvements to the collateral are not considered a significant modification of the nonrecourse debt.

[iv] Changes in the Nature of a Debt Instrument

A modification to a debt instrument that causes the instrument not to be treated as debt is a significant modification. n56 Unless there is a substitution of a new obligor or the addition or deletion of co-obligor, any deterioration in the financial condition of the issuer is not considered in determining whether the modified instrument is properly characterized as debt. n57

As under the proposed regulations, the change of a debt instrument from nonrecourse to recourse or recourse to nonrecourse was a significant modification. n58 However, the final regulations limit this 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. n59 The regulations also provide two exceptions. First, a defeasance of a tax-exempt bond permitted by the terms of the instrument generally is not a significant modification. n60 Second, 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 payment expectations. n61 If the collateral is fungible, substitution of collateral with new collateral of a similar type and value is not considered a change in the original collateral.

Although much of the regulations turn on the distinction between recourse and nonrecourse debt, the regulations do not define the terms "recourse" and "nonrecourse." In some cases, such as a loan to a special purpose vehicle that is secured by all of the entity's assets, the distinction may be without meaning. If form governs, taxpayers may essentially be able to elect the classification of such debt by characterizing it as one or the other in the loan documents. n62 Another example of this blurred distinction is a recourse loan to a disregarded entity. Such a loan should not be considered a nonrecourse loan to the entity's owner where the rights of the parties under state law do not change. n63 Hopefully, additional guidance will be forthcoming on the pivotal recourse-nonrecourse question. In the absence of guidance, the recourse or nonrecourse nature of a loan should not be affected by limited exceptions that are unlikely to apply, such as nonrecourse loan provisions allowing recourse to the borrower in cases of fraud or misapplication of funds, or local law requiring a lender that forecloses on collateral for a secured recourse loan to waive any right to a deficiency judgment.

[2] Comparison of Regulations and Case Law/Rulings

[a] Increased Principal Amount

The IRS generally has not viewed an increase in the principal amount of debt attributable to accrued, unpaid interest as causing a deemed exchange. The regulations, by contrast, treat capitalization of accrued but unpaid interest as a deemed exchange if the capitalization changes the yield on the debt instrument by more than the greater of 25 basis points or 5% of the original yield on the instrument. n64 The issue of whether an increase in the principal amount of a debt instrument triggers a deemed exchange often arises in debt restructurings, where it is common for accrued, but unpaid, interest payments to be capitalized and added to the principal amount of the restructured debt. n65

[b] Change from Annual Pay to Monthly Pay

Debt is often modified in restructurings to change annual arrears interest payments to monthly advance payments. In most cases, a change from annual pay to monthly pay without a corresponding decrease in interest rate will cause more than a 25 basis point increase in the annual yield of the debt. Before the regulations were adopted, the IRS took the position that a more than *de minimis* change in yield caused a deemed exchange. n66 Under the regulations, the change from annual to monthly pay (without a reduction in interest rate) will cause a deemed exchange of the debt, since any change of more than 25 basis points in the annual yield of a debt instrument causes a deemed exchange. n67 This type of change is often engendered by the borrower's use of funds earmarked for debt service to satisfy more immediate cash needs.

[c] Forbearance of Remedies

While lenders often continue to reserve their right to charge default interest after a borrower's failure to make its annual interest payment has matured into a default, a debt restructuring may include a waiver of the right to charge such default interest. Under case law and the IRS's ruling position, the forbearance of remedies (including a waiver of the current payment of interest continuing to accrue) generally does not cause a deemed exchange. n68 Under the regulations, a party's waiver of a right under an instrument will cause a deemed exchange unless the waiver is unilateral and, in the case of an option exercisable by a holder, the exercise does not result in a deferral of, or reduction in, any scheduled payment of interest or principal. n69 Absent a written or oral agreement to alter other terms of the instrument, an agreement by the holder to stay collection or temporarily waive an acceleration clause or similar default right is not a modification unless and until the forbearance remains in effect for a period that exceeds two years following the issuer's initial failure to perform, and any additional period during which the parties conduct good faith negotiations or during which the issuer is in a Title 11 or similar case. n70

[d] Extension of Maturity Date

Almost every restructuring includes some extension of the maturity date on the debt. Under case law and IRS rulings predating the regulations, an extension of maturity did not cause a deemed exchange of the debt. n71 Under the regulations, an extension of the maturity date on the debt is a significant modification if it results in the material deferral of scheduled payments. n72 The regulations allow the deferral of payments within a safe-harbor period (the lesser of five years or 50% of the original term of the instrument) if the deferred amounts are unconditionally payable at the end of that period. n73 Thus, meaningful extensions of the term of debt will be severely curtailed under the regulations. In particular, there may be virtually no ability to extend maturity under the regulation rule where debt being restructured has already been refinanced for only a short term. Moreover, even if a deferral does not trigger a deemed exchange of the debt, deferring interest may transform non-OID debt into OID debt. n74

[e] Changes in Obligor or Collateral

The IRS has not viewed the addition of a guarantee as triggering a deemed exchange. n75 Although there is no authority

regarding the release of a guarantee, by analogy such a release should not trigger a deemed exchange according to the IRS view. Under the regulations, the release of a guarantee of nonrecourse debt generally causes a deemed exchange of the debt instrument, whereas the release of a guarantee of recourse debt causes a deemed exchange of the debt instrument only if the modification results in a change in payment expectations. n76 Lenders often agree to release guarantees of either interest or principal in connection with a debt restructuring, generally because the guarantees are of little practical value due to the fact that the guarantors (often related parties) are also in financial distress. A change in the amount of nonrecourse debt collateral that is not substantial generally will not result in a deemed exchange under either IRS rulings, n77 or the regulations. n78

[3] Potential for Equity Recharacterization

[a] Basis for Recharacterization

The possibility of recharacterization of modified debt as equity consequent to a deemed debt exchange for borrowers and for foreign lenders carries with it a host of adverse tax consequences. This issue arises because the regulations provide that a deemed exchange occurs if and when a restructured debt instrument no longer qualifies as debt for tax purposes. n79 The implication of this provision is that modified debt is subject to equity recharacterization under general debt-equity principles even under circumstances where the form of a debt instrument is not recast as equity, and the issue presents itself under the regulations whenever the value of the collateral securing a loan is less than the outstanding principal amount of debt being restructured and there is a change in obligor(s) under the restructured debt. As a practical matter, either the IRS or the borrower, as the withholding agent for foreign lenders, could treat modified debt as equity of the borrower following a deemed debt exchange.

The retesting contemplated by the regulations is a clear departure from current law; the IRS has not historically attempted to recharacterize a deemed exchanged debt instrument as equity solely because the value of the collateral securing the debt has declined since the issue date. Nevertheless, IRS representatives stated, shortly after the proposed regulations were released, that they were considering whether it is proper to retest debt under general principles after a deemed debt exchange, when the debt would continue to qualify as debt but for the decline in value of the collateral. n80 The IRS has carved out these circumstances from retesting under the regulations, but only when the obligor remains the same on the restructured debt. Consequently, it is not clear why a change to (or addition of) an affiliated obligor provides a proper basis for retesting debt.

When the IRS seeks to challenge the tax treatment of modified debt, its character as debt or equity presumably would be determined under all of the relevant facts and circumstances at the time of the deemed debt exchange. n81 For an instrument to be debt, facts must exist to support a reasonable expectation that the debt will be serviced in accordance with its terms, which terms include stated dates for the payment of principal and interest. n82 The factors relevant in determining whether an instrument satisfies this standard and qualifies as debt include (i) the intent of the parties to create a debtor-creditor relationship, n83 (ii) the expectation of the ability of the borrower to obtain funds from operations or outside sources to service the debt, (iii) the ratio of debt to equity in the capital structure of the borrower, (iv) the risk involved in the loan, and (v) the source of payments on the loan. n84 Courts applying these factors have historically held that even advances to an insolvent borrower may be respected as debt when the creditor had a "genuine expectation of repayment" notwithstanding current financial problems of the borrower. n85

One Tax Court Memorandum opinion highlights the Tax Court's continued reluctance to adopt the IRS position of testing each of several subsequent loans between the same borrower and lender separately and without regard to the long-standing debtor-creditor relationship. n86 In *Foretravel*, the Tax Court was presented with the IRS argument that the latter part of a series of loans between related parties were, in substance, capital contributions as a result of the borrower's increasingly poor financial condition. n87 The Tax Court refused to examine each advance separately under general debt-equity principles, terming that approach "artificial." n88 Instead, the court examined the series of advances together and held that each of the loans constituted debt, notwithstanding the borrower's poor financial condition. n89

When lenders ease the payment terms of debt instead of making further advances, this same intent to continue the debtor-creditor relationship exists. Absent an expectation of eventual repayment of the debt on the restructured terms, a creditor would have a strong economic incentive to force a sale of the collateral in order to terminate its relationship with the borrower. Lenders engaging in this calculus do not view themselves as equity holders, but they may need to refocus their approach to loan restructurings if the IRS proceeds with equity recharacterization. If the IRS fails to respect the parties' continued debtor-creditor relationship after a deemed debt exchange, foreign lenders may be particularly reluctant to engage in debt restructurings. Faced with uncertainty as to whether modified debt is in fact treated as equity, increasing numbers of such lenders may seek to foreclose on their collateral, which would in turn prompt borrowers to seek protection of the automatic stay from foreclosure in bankruptcy.

To date, the IRS has offered no explanation as to why a deemed exchange of debt that includes a change (or addition) of an obligor provides an appropriate occasion for retesting debt under general debt-equity principles; retesting debt upon a deemed exchange clearly contravenes the "once debt, always debt" principle that has historically been a basic tenet of debt-equity treatment.ⁿ⁹⁰ This is particularly true in light of the fact that the value of collateral for debt typically will have fallen below the outstanding principal amount of the debt it secures by the time the debt is restructured. As a result, a reexamination of whether the debt is still good debt would commonly yield a negative answer due solely to the effect of reduced collateral value on the borrower's debt-equity ratio. While it is certainly appropriate to give due weight to the value of collateral when debt is originally incurred, this factor should be accorded little, if any, weight in the context of restructuring troubled borrowers' debt where a long-standing debtor-creditor relationship exists.

Moreover, sustaining equity recharacterization in the context of a deemed debt exchange requires either that the parties' historical debtor-creditor relationship be ignored, or the implicit conclusion that collateral always constitutes a wasting asset. As discussed above, the Tax Court has refused to separate individual loans from the historical relationship of the parties. Moreover, the cyclical nature of real estate values is one example that contravenes the conclusion that the value of collateral will not subsequently increase; lenders may quite reasonably expect eventual principal repayment of restructured debt as their collateral value increases. In light of the continuing debtor-creditor relationship that typically underlies a debt restructuring, any IRS attempt to recharacterize modified debt as equity on the basis of a decline in collateral value should fail. The exclusion of this factor from the retesting equation (absent the substitution of a new obligor) in the final regulationsⁿ⁹¹ is a welcome signal that the IRS agrees with this conclusion. However, limiting the exclusion to exchanges where the obligor does not change significantly limits troubled issuers' reorganization options.

Equity recharacterization also stands in curious contrast to the treatment of "equity-flavored debt" elsewhere in the Internal Revenue Code. In *I.R.C. sections 163(e) and (h)*, for example, an issuer's deduction for OID on high yield debt instruments is deferred until interest is paid, and in cases where the debt instrument most resembles equity, a portion of the interest deduction is disallowed.ⁿ⁹² Similarly, the "earnings-stripping" rules in *I.R.C. section 163(j)* disallow an issuer deduction for interest paid on equity-flavored debt held by foreign and tax-exempt persons, but the rules do not recharacterize the underlying debt instrument as equity. Finally, the contingent debt regulations clearly contemplate that obligations qualify as debt even where the repayment of some portion is at best uncertain. In none of these cases, however, is the actual debt instrument in question recharacterized as equity. Ultimately, the best reason for retaining debt or equity status may be the far-reaching consequences of recharacterizing that status.

[b] Consequences to Borrowers

The provisions in the regulations give no hint as to the type of equity interest a lender would be deemed to hold in a borrower if and when debt is recharacterized as equity. A prime question is whether recharacterization would cause part or all of a lender's note to be treated as equity. In other contexts courts have bifurcated notes into part debt and part equity, and such bifurcation would certainly be appropriate in the context of a deemed debt exchange to the extent the Treasury is determined to proceed with equity recharacterization.ⁿ⁹³

Other crucial questions will obviously include whether lenders will be treated as holding an equity interest in the borrower, or whether the lender will be treated as holding a direct interest in the borrower's asset in the case of single-asset borrowers. A third possibility is that the type of equity interest will depend on the classification of the borrower. Since the asset of a single-asset partnership borrower would typically have collateralized the borrower's obligation under the loan, equity recharacterization would be tantamount to a foreclosure on the borrower's collateral. Moreover, even if the IRS determines that a lender will take an equity interest in the borrower rather than an interest in the collateral, that interest may be tantamount to a direct interest in the asset in the case of certain single asset borrowers.

For example, since the outstanding balance due on recharacterized debt would typically exceed the value of the sole asset of a partnership borrower, the lender could theoretically be viewed as acquiring 100% of the equity interests in the borrower partnership. Under those facts, one would assume the partnership would terminate for tax purposes, n94 leaving the lender holding a direct interest in the partnership asset(s). If the lender is instead treated as acquiring less than 100% of the equity interests in a single asset partnership, query whether the other partners would be treated as relieved of their share of the partnership debt now treated as equity, and if so, whether the potential deemed distribution of cash and additional cancellation of debt income ("COD") could cause the non-lender partners to recognize additional phantom income for tax purposes. n95

A panoply of issues would also arise in connection with the recharacterization of debt of a borrower with multiple assets (often corporate), where a lender might presumably be treated as holding a deemed equity interest in the borrower entity after an equity recharacterization. For example, would the lender's priority rights under the deemed equity instrument dictate that the lender receive a preferred interest in the borrower entity? If so, a number of additional issues would arise. For example, within affiliated groups of corporations, it is often the subsidiaries, rather than the common parent corporation, who are the borrowers. As a threshold matter, a deemed preferred stock interest in a borrower subsidiary would typically be worth less than its liquidation value (which might reasonably equal the stated redemption price of the modified debt instrument), and the lender might be required to accrete the liquidation "premium" on the deemed preferred stock under *I.R.C. section 305*. Ironically, this result could obtain even under circumstances where a deemed exchange of non-publicly traded debt would not produce OID (or COD).

Additional and perhaps more serious consequences could result if the I.R.S. argues that a deemed equity interest in a borrower subsidiary would constitute participating preferred stock for purposes of *I.R.C. section 1504(a)(4)(C)*. In that case, unless such stock was nevertheless treated as *I.R.C. section 1504(a)(4)* stock the subsidiary could be treated as deconsolidated from its common parent. Although such a conclusion is not compelled by the applicable legislative history, and it is not supported by case law, the I.R.S. may be no less likely to make such an argument than to recharacterize debt as equity. n96 Deconsolidation would trigger a host of negative tax consequences for the borrower's affiliated group, including (i) triggering of deferred gains with respect to the borrower subsidiary's stock or assets, (ii) triggering excess loss accounts with respect to such subsidiary's stock, and (iii) precluding other group members' future use of such subsidiary's net operating losses ("NOLs").

With regard to a borrower subsidiary's NOLs (which would typically have been funded in part by interest expense attributable to the recharacterized debt), query whether a deemed equity interest would also constitute participating preferred stock that would be considered stock for purposes of *I.R.C. section 382*. n97 Since the lender's "participating preferred stock" interest would logically include most of the value of the borrower subsidiary, the deemed issuance of such stock could logically be thought to trigger an ownership change for the borrower subsidiary. Such an ownership change would typically impose significant limitations on the use of the subsidiary's NOLs in light of the probable low value of the subsidiary's assets at the time of a deemed debt exchange.

[c] Consequences to Foreign Lenders

If restructured debt retains its character as non-contingent debt after a deemed exchange, foreign lenders would have no

significant adverse U.S. tax consequences. n98 On the other hand, if restructured debt is treated as equity in a partnership, foreign lenders will experience a myriad of adverse tax consequences. As a threshold matter, if restructured debt is treated as deemed equity in a borrower partnership, lenders would be treated as partners in the partnership. Under such circumstances, interest payments received by foreign lenders in their capacity as partners could be recharacterized for U.S. tax purposes as guaranteed payments for the use of capital. n99 In that case, the lenders' tax consequences would then depend on (i) whether the partnership is engaged in a U.S. trade or business, and (ii) whether such deemed guaranteed payments are characterized as interest income or as a distributive share of partnership income; support exists for each characterization. n100

If the partnership is not engaged in a U.S. trade or business, n101 guaranteed payments received by lenders not otherwise doing business in the U.S. should not be treated as effectively connected income under either characterization. In that case, if guaranteed payments are treated as interest payments, the portfolio interest exception to withholding, and reduced withholding under treaties, should continue to apply. n102 Guaranteed payments also could be treated as rental income in accordance with the nature of the partnership's income, in which case such payments would be subject to a 30% U.S. federal withholding tax as fixed and determinable annual or periodic income. n103 Although such payments could qualify for treaty-based reduced withholding, reduced withholding for rental income payments may not be available under many treaties. n104

By contrast, if the partnership borrower is engaged in a U.S. trade or business, deemed guaranteed payments that are characterized as a distributive share of the partnership's income would be income effectively connected with the partnership's U.S. business. Query whether the I.R.S. would assert that such payments would properly be subject to withholding under *I.R.C. section 1446(a)* as effectively connected income allocable to foreign partners under *I.R.C. section 704*, although such a position could be disputed in light of the fact that guaranteed payments are not allocated pursuant to *I.R.C. section 704*. n105 Were *I.R.C. section 1446* withholding to apply, partnerships could be required to withhold tax before such guaranteed payments are made. n106 This result would prove particularly harsh for borrower partnerships lacking sufficient cash flow to timely service their restructured debt, a/k/a equity, let alone pay withholding tax under *I.R.C. section 1446* (not to mention the interest and penalties occasioned by late payment of the withholding tax).

Moreover, if restructured debt is treated as equity in a partnership owning real estate, a foreign lender's receipt of proceeds from a sale or repayment of its debt may be subject to U.S. tax by attribution to such lender's deemed equity interest in the partnership. n107 Under *I.R.C. section 897* a foreign lender could be subject to 10% withholding on repayments of principal treated as payments in redemption of the lender's deemed partnership interest, because proceeds received from the sale or redemption of a foreign partner's interest in a U.S. partnership owning real property are treated as taxable proceeds from the sale of such foreign person's interest in the partnership's real property. n108

FOOTNOTES:

(n1)Footnote 1. See generally New York State Bar Association, *Tax Section, Report of Ad Hoc Committee on Provisions of the Revenue Reconciliation Act of 1990 Affecting Debt-for-Debt Exchanges*, 51 *Tax Notes* 79 (Apr. 8, 1991).

(n2)Footnote 2. 499 U.S. 554, 111 S. Ct. 1503, 113 L. Ed. 2d 589 (1991) .

(n3)Footnote 3. Prop. Treas. Reg. § 1.1001-3, 57 *Fed. Reg.* 57034 (Dec. 2, 1992) ; *Cottage Savings Association v. Commissioner*, 499 U.S. 554 (1991) . For background on the Proposed Regulations, see Lawrence H. Brenman, *Tax-Oriented Investments: Proposed Regulations Regarding Debt Modification Issued in Response to Cottage Savings*

Decision, 10 *J. Partnership Tax'n* 175 (1993); Richard M. Lipton, *IRS Issues Proposed Regulations on Debt Modifications*, 71 *Taxes* 67 (1993); Linda Z. Swartz, *Troubled Real Estate Partnerships: What Options Are Available to Foreign Lenders?*, 12 *J. Partnership Tax'n* 196 (1995).

(n4)Footnote 4. *Treas. Reg. § 1.1001-3*, added by *T.D. 8675*, 1996-29 *I.R.B.* 5 (June 26, 1996) .

(n5)Footnote 5. *Treas. Reg. § 1.1001-3*; *see also*, *Priv. Ltr. Rul. 199950022* (Sept. 16, 1999) (an investor that exchanges a pool of securities matching in number and type the securities represented by a specified number of units in an investment trust is not considered to have materially altered its ownership position in the securities, and is not required to recognize gain or loss with respect to the securities for purposes of section 1001).

(n6)Footnote 6. *Priv. Ltr. Rul. 8451012* (Aug. 23, 1984) ; (constructive sale of notes under section 1001 where maturity date and interest rate of notes was materially and involuntarily altered by the New York State Emergency Moratorium Act); *supplementing Priv. Ltr. Rul. 8052023* (Sept. 25, 1980) . By contrast, some courts have treated troubled debt restructurings more liberally than they have restructurings in the absence of economic distress. *See, e.g., Mutual Loan & Savings Co. v. Commissioner*, 184 *F.2d* 161 (5th Cir. 1950) ; *Truman v. Commissioner*, 4 T.C.M. (CCH) 576 (1945) . Moreover, the IRS Chief Counsel stated in 1977 that "as a matter of policy" the IRS will not litigate the issue of whether a deemed debt exchange has occurred when involuntary changes are made to a debt instrument that is in default, unless the bonds were acquired "in contemplation of realizing a gain from the change in terms." *G.C.M. 37002* (Feb. 10, 1977) . Although the IRS has not retracted this General Counsel Memorandum, it is doubtful whether it continues to represent the IRS's position in light of the regulations.

(n7)Footnote 7. *See* *Treas. Reg. § 1001-3(c)(6)(iii)* (providing that a "modification" occurs upon the effective date of a plan of reorganization in a title 11 or similar case if a change in a term of a debt instrument occurs pursuant to such plan); *see also* *Treas. Reg. § 1.1001-3(c)(4)* and *(d)* (Ex. 13).

(n8)Footnote 8. *Treas. Reg. § 1.1001-3(c)(1)(i)*.

(n9)Footnote 9. *Treas. Reg. § 1.1001-3(c)(1)(ii)*.

(n10)Footnote 10. Although the substitution of a new obligor may trigger a taxable exchange, if a dealer assigns its position in an interest rate, commodity swap, or a notional principal contract to another dealer, the assignment is not considered an exchange by the nonassigning party of the original contract, provided the terms of the contract permit the substitution of dealers. *Treas. Reg. § 1.1001-4(a)*.

(n11)Footnote 11. *Treas. Reg. § 1.1001-3(c)(2)(i)*. Note that the obligor of a tax exempt bond is the entity that actually issues the bond and not a conduit borrower of bond proceeds. *Treas. Reg. § 1.1001-3(f)(6)(i)*; *see also* *Priv. Ltr. Rul. 200047046* (Aug. 30, 2000) (parent obligor's removal of subsidiary as co-obligor on conduit loans securing industrial revenue bonds ("IRBs") was a modification occurring by operation of the terms of the IRBs, where the loan terms allowed the removal of the subsidiary as co-obligor without the consent of the holders of the IRBs; change-in-obligor exception did not apply, because neither the parent nor the subsidiary were considered obligors with respect to the IRBs, which are obligations of the issuing state or local governments or agencies).

Although the substitution of a new obligor may trigger a taxable exchange, if a dealer assigns its position in an interest rate or commodity swap or a notional principal contract to another dealer, the assignment is not considered an exchange by the nonassigning party of the original contract, provided the terms of the contract permit the substitution of dealers. *Treas. Reg. § 1.1001-4(a)*.

(n12)Footnote 12. *Treas. Reg. § 1.1001-3(c)(2)(ii)*.

(n13)Footnote 13. *Treas. Reg. § 1.1001-3(c)(2)(iii)*.

(n14)Footnote 14. *Treas. Reg. § 1.1001-3(c)(3)*. It should be noted that this is an absolute test--even an economically insignificant right of the other party to alter the instrument may prevent the option from being unilateral. Obviously, a de minimis exception in this regard would be welcome.

(n15)Footnote 15. *Treas. Reg. § 1.1001-3(c)(4)(i)*.

(n16)Footnote 16. *Treas. Reg. § 1.1001-3(c)(4)(ii)*.

(n17)Footnote 17. *Treas. Reg. § 1.1001-5*.

(n18)Footnote 18. Only eleven members of the European Union initially participated in the conversion of their national currencies to the euro. The eleven members were: Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, The Netherlands, Portugal and Spain. Today, sixteen of the twenty-seven member states of the European Union have adopted the euro as their official currency.

(n19)Footnote 19. *See, e.g., Deloitte & Touche Joins Microsoft and Others in Seeing Euro Conversion as "Non-Event,"* 98 TNT 93-35 (Apr. 30, 1998).

(n20)Footnote 20. *Treas. Reg. § 1.1001-5(a)*; 1998-33 I.R.B. 6, T.D. 8776 (July 29, 1998) (temporary regulations); 2001-11 I.R.B. 807, T.D. 8927 (Jan. 10, 2001) (final regulations).

(n21)Footnote 21. *Treas. Reg. § 1.1001-5(b)* (effective for tax years ending after July 29, 1998).

(n22)Footnote 22. *Treas. Reg. § 1.1001-5(b)*.

(n23)Footnote 23. *Treas. Reg. § 1.1001-3(c)(5)*.

(n24)Footnote 24. *Treas. Reg. § 1.1001-3(c)(6)(i)*.

(n25)Footnote 25. *See Treas. Reg. § 1.1001-3(c)(6)(ii), (iii)*.

(n26)Footnote 26. *Treas. Reg. § 1.1001-3(e)*.

(n27)Footnote 27. *Treas. Reg. § 1.1001-3(e)(1)*.

(n28)Footnote 28. *Treas. Reg. § 1.1001-3(e)(1)*; *Rev. Rul. 81-169, 1981-1 C.B. 429* (holding that reduction in interest rate, extension of maturity and elimination of sinking fund requirement, "taken together," constituted a material modification); *Priv. Ltr. Rul. 9844021 (Oct. 30, 1998)* (modifications of the terms of bonds involving interest, repayment, security, and redemption rights conferred legally distinct entitlements sufficient to trigger a deemed exchange under section 1001); FSA 1999-665 (Aug. 9, 1993) (during the time period the proposed debt exchange regulations were outstanding, the IRS stated that a significant modification due to a change in yield can result from a change in either the amount or timing of payments); *but see Priv. Ltr. Rul. 98-19-043 (May 8, 1998)* (ruling that a proposed modification of notes did not constitute a significant modification because each step in the series of modifications did not alter the legal rights and obligations of the parties to any economically significant degree).

(n29)Footnote 29. *Treas. Reg. § 1.1001-3(f)(1)(ii)*.

(n30)Footnote 30. *Treas. Reg. § 1.1001-3(f)(1)(iii)*.

(n31)Footnote 31. *Treas. Reg. § 1.1001-3(e)(1)*; *cf. Rev. Rul. 81169, 1981-2 C.B. 429* (holding that reduction in interest rate, extension of maturity, and elimination of sinking fund requirement, "taken together," constituted a material modification). *See also* FSA 1999-665 (August 9, 1993) (during the time period the proposed debt exchange regulations were outstanding, the I.R.S. stated that a significant modification due to a change in yield can result from a change in

either the amount or timing of payments).

(n32)Footnote 32. *Treas. Reg. § 1.1001-3(e)(2)(iii)(B)*.

(n33)Footnote 33. *Treas. Reg. § 1.1001-3(e)(3)(i)*. The regulations do not address acceleration of payments, which presumably would be a modification, but not a significant modification. Query whether the sale of coupon rights back to the issuer would be treated simply as prepayments or a modification of the entire debt instrument. Such a sale may also be treated as a bond-stripping transaction under *I.R.C. Section 1286*. See James M. Peaslee, *Modifications of Non-Debt Financial Instruments as Deemed Exchanges*, 95 *Tax Notes* 737, 771-73 (Apr. 29, 2002).

(n34)Footnote 34. *Treas. Reg. § 1.1001-3(e)(3)(ii)*.

(n35)Footnote 35. *Treas. Reg. § 1.1001-3(e)(3)(i)*.

(n36)Footnote 36. *Treas. Reg. § 1.1001-3(e)(3)(i)*.

(n37)Footnote 37. *Prop. Treas. Reg. § 1.1001-3(e)(2)(i)*.

(n38)Footnote 38. *Prop. Treas. Reg. § 1.1001-3(e)(2)(ii)*.

(n39)Footnote 39. *Prop. Treas. Reg. § 1.1001-3(e)(2)(iii) and (g), Ex. 3*.

(n40)Footnote 40. *Prop. Treas. Reg. § 1.1001-3(e)(2)(iv)*.

(n41)Footnote 41. *Treas. Reg. § 1.1275-2(j)*.

(n42)Footnote 42. See *P TX9.04 infra* for a more detailed description of the OID rule.

(n43)Footnote 43. *Treas. Reg. § 1.1001-3(e)(4)*.

(n44)Footnote 44. *Treas. Reg. § 1.1001-3(e)(4)(i)*. See, *Priv. Ltr. Rul. 2007-42-016 (October 19, 2007)* (ruling that substituting the guarantor as the primary obligor and releasing the borrower from liability was a significant modification).

(n45)Footnote 45. *Treas. Reg. § 1.1001-3(e)(4)(i)(B), (C), (E)*. See, e.g., *Priv. Ltr. Rul. 9711024 (Mar. 14, 1997)* (ruling that in a tax-free spinoff under section 355, the substitution of the controlled corporation for the distributing corporation as obligor was not a significant modification; because the transaction was an acquisition of substantially all the assets of distributing corporation under *Treas. Reg. § 1.1001-3(e)(4)(i)(C)*; it did not result in a significant alteration, and payment expectations did not change). See also *Priv. Ltr. Rul. 2007-09-013 (March 2, 2007)* (ruling that there was not a significant modification of the debt of a company that converted from a corporation to a limited liability company and was partially acquired by a third-party because under state law there was no change in the creditors' rights against the company or the company's obligations under state law and each step of the transaction where a new obligor was substituted qualified for an exception under *Treas. Reg. § 1.1001-3(e)(4)(i)(B) or (C)*).

(n46)Footnote 46. *Treas. Reg. § 1.1001-3(e)(4)(i)(G)*.

(n47)Footnote 47. *Treas. Reg. § 1.1001-3(e)(4)(i)(D)*.

(n48)Footnote 48. *Treas. Reg. § 1.1001-3(e)(4)(i)(B)*.

(n49)Footnote 49. *Treas. Reg. § 1.1001-3(e)(4)(i)(F)*.

(n50)Footnote 50. *Treas. Reg. § 1.1001-3(e)(4)(vi)(A)*.

(n51)Footnote 51. *Treas. Reg. § 1.1001-3(e)(4)(vi)(B)*. An obligor's capacity includes any source for payment, including collateral, guarantees or other credit enhancement.

(n52)Footnote 52. *Treas. Reg. § 1.1001-3(e)(4)(iii)*.

(n53)Footnote 53. *Treas. Reg. § 1.1001-3(e)(4)(iv)(A), (v)*.

(n54)Footnote 54. *Treas. Reg. § 1.1001-3(e)(4)(iv)(B)*. It is not clear whether the term "substantial amount of" qualifies only the collateral for a nonrecourse debt or also the guarantee or other credit enhancement for the debt. Arguably, only an alteration of a substantial amount of a guarantee on or credit enhancement for a nonrecourse debt should trigger a deemed exchange, and a fungibility concept should apply so that a substitution of a guarantor that produces an equally valuable guarantee, *e.g.*, same credit quality, should not be a significant modification.

(n55)Footnote 55. *Treas. Reg. § 1.1001-3(e)(4)(iv)(B)*.

(n56)Footnote 56. *Treas. Reg. § 1.1001-3(e)(5)(i)*.

(n57)Footnote 57. *Treas. Reg. § 1.1001-3(e)(5)(i)*.

(n58)Footnote 58. *Prop. Treas. Reg. § 1.1001-3(e)(4)(iv)*. Under the proposed regulations, each of the following changes was a significant modification: (i) changing a fixed rate instrument to a variable rate or contingent payment instrument; (ii) changing a variable rate instrument to a fixed or contingent rate instrument; (iii) changing a contingent payment instrument to a fixed rate or variable rate instrument; or (iv) changing the currency in which payment under the debt instrument is made. *Prop. Treas. Reg. § 1.1001-3(e)(4)(ii)*. The final regulations lack these bright-line rules, so that the significance of any change in method of calculating payments is determined under the general significance rule.

(n59)Footnote 59. *Treas. Reg. § 1.1001-3(e)(5)(ii)(A)*.

(n60)Footnote 60. *Treas. Reg. § 1.1001-3(e)(5)(ii)(B)(1)*. The defeasance will not be a significant modification if it occurs pursuant to the terms of the indenture for the original bonds and the issuer places in trust government securities or tax-exempt government bonds reasonably expected to provide interest and principal to cover payment obligations under the bonds.

(n61)Footnote 61. *Treas. Reg. § 1.1001-3(e)(5)(ii)(B)(2)*.

(n62)Footnote 62. For arguments in favor of allowing taxpayers to choose classification of debt, *see* James M. Peaslee, *Modifications of Non-Debt Financial Instruments as Deemed Exchanges*, 95 *Tax Notes* 737 (Apr. 29, 2002).

(n63)Footnote 63. *See Priv. Ltr. Rul. 2006-30-002 (June 28, 2006)* (conversion of old parent of consolidated group into a limited liability company owned by new parent does not result in modification of nonrecourse debt issued by old parent where holders' legal rights against old parent with respect to payment and remedies, and old parent's obligations and covenants to the holders, were unchanged under state law); *Priv. Ltr. Rul. 2003-15-001 (Sept. 19, 2002)* (same).

(n64)Footnote 64. *Treas. Reg. § 1.1001-3(e)(2)*.

(n65)Footnote 65. *See FSA 2000-06-003 (Feb. 11, 2000)* (U.S. corporation liable for withholding tax for accrued but unpaid interest when interest was contributed as paid in capital by the foreign parent).

(n66)Footnote 66. *See, e.g., Rev. Rul. 89-122, 1989-2 C.B. 200* (holding that reduction in annual interest rate from 10% to 6.25% constituted a material modification); *Rev. Rul. 87-19, 1987-1 C.B. 249* (holding that waiver of right to receive increase in interest rate from 7% to 8.56% resulted in a deemed exchange); *TAM 9127003 (Mar. 18, 1991)* (holding that 87.5 basis point reduction constituted a material modification under section 1001); *Priv. Ltr. Rul.*

8834090 (June 3, 1988) (assuming for ruling purposes that 20 basis point change in yield constituted a material modification); *cf.* *Priv. Ltr. Rul.* 8932067 (May 17, 1989) (ruling that a less than 12.5 basis point change in yield did not constitute a material modification); *Priv. Ltr. Rul.* 8835050 (June 8, 1988) (ruling that reduction in yield by less than 3 basis points was *de minimis*).

(n67)Footnote 67. *Treas. Reg.* § 1.1001-3(e)(2)(ii).

(n68)Footnote 68. *Priv. Ltr. Rul.* 8920047 (Feb. 17, 1989); *see also* *West Missouri Power Co. v. Commissioner*, 18 T.C. 105 (1952), *acq.*, 1952-2 C.B. 3; *Motor Products Corp. v. Commissioner*, 47 B.T.A. 983 (1942), *aff'd*, 142 F.2d 449 (6th Cir. 1944), *acq.*, 1946-1 C.B. 3; *Farmers Trust Co. v. Hoey*, 52 F. Supp. 665 (S.D.N.Y. 1942), *aff'd*, 138 F.2d 1023 (2d Cir. 1943).

(n69)Footnote 69. *See* *Treas. Reg.* § 1.1001-3(c)(2)(iii).

(n70)Footnote 70. *See* *Treas. Reg.* §§ 1.1001-3(c)(4).

(n71)Footnote 71. *See* *Rev. Rul.* 73-160, 1973-1 C.B. 365; *see also* *Priv. Ltr. Rul.* 90-43-060 (Aug. 1, 1990); *Priv. Ltr. Rul.* 8848033 (Sept. 1, 1988); *Priv. Ltr. Rul.* 8829028 (Apr. 20, 1988); *Priv. Ltr. Rul.* 8753014 (Oct. 2, 1987); *Priv. Ltr. Rul.* 8742032 (July 20, 1987); *Priv. Ltr. Rul.* 8731011 (May 1, 1987); *Priv. Ltr. Rul.* 8708017 (Nov. 21, 1986); *Priv. Ltr. Rul.* 8534064 (May 28, 1985); *Priv. Ltr. Rul.* 8346104 (Aug. 18, 1983). In a 1989 private ruling, deferral of interest payments was permitted under a net cash flow workout where deferred interest bore interest on a compound basis. *Priv. Ltr. Rul.* 8920047 (Feb. 17, 1989) (citing *Motor Products Corp. v. Commissioner*, 47 B.T.A. 983 (1942), *aff'd per curiam*, 142 F.2d 449 (6th Cir. 1944); and *West Missouri Power Co. v. Commissioner*, 18 T.C. 105 (1942), *acq.*, 1952-2 C.B. 3).

(n72)Footnote 72. *Treas. Reg.* § 1.1001-3(e)(3)(i).

(n73)Footnote 73. *Treas. Reg.* § 1.1001-3(e)(3)(ii).

(n74)Footnote 74. *Treas. Reg.* § 1.1275-2(j).

(n75)Footnote 75. *Priv. Ltr. Rul.* 8534064 (May 28, 1985).

(n76)Footnote 76. *Treas. Reg.* § 1.1001-3(e)(3)(iv); *see also* *Priv. Ltr. Rul.* 2000-47-046 (Aug. 30, 2000); *Priv. Ltr. Rul.* 199904017 (Oct. 29, 1998) (parent's assumption of indirect subsidiary's debt was not a significant modification because the assumption did not cause a change in payment expectations); *Priv. Ltr. Rul.* 200047046 (Aug. 30, 2000) (removal of subsidiary as guarantor was not a significant modification because the subsidiary's earnings and assets would continue to provide parent with payment capacity, causing no change in payment expectations).

(n77)Footnote 77. *See* *Priv. Ltr. Rul.* 9801047 (Oct. 3, 1997) (reducing the principal amount of U.S. Government obligations to be delivered as substitute collateral to obtain the release of a lien on real property from 125% to 100% of the outstanding balance of mortgage loan was not a significant modification) because the amendment did not release a substantial amount of collateral and the obligation to repay the entire mortgage loan remained fully secured).

(n78)Footnote 78. *Treas. Reg.* § 1.1001-3(e)(4)(iv).

(n79)Footnote 79. *Treas. Reg.* § 1.1001-3(e)(5). *See also* FSA 1999-665 (Aug. 9, 1993) (during the time period the proposed debt exchange regulations were outstanding, the IRS stated generally that different new instruments issued in debt exchanges may have to be retested under debt-equity principles).

(n80)Footnote 80. Official Details Treasury, IRS Thinking Behind Proposed 'Cottage Savings' Regulations, *Daily Tax Report* (BNA), March 5, 1993, at G-4, 5 (Mar. 5, 1993).

(n81)Footnote 81. See *I.R.C. § 385(b)*.

(n82)Footnote 82. See, e.g., *Gilbert v. Commissioner*, 248 F.2d 399, 406 (2d Cir. 1957) .

(n83)Footnote 83. See, e.g., *Cerand & Co., Inc. v. Commissioner*, T.C. Memo 2001-271 (inadequate evidence to support a finding of true debtor-creditor relationship where there were no debt instruments or signed agreements, no fixed maturity date or repayment schedule, and repayments were inconsistent and appeared dependent on financial success); see also *FSA 2000-03-001 (Jan. 21, 2000)* (holding taxpayer to its chosen form and refusing to recharacterize foreign parent loans to U.S. subsidiaries as equity rather than debt).

(n84)Footnote 84. See, *Fin Hay Realty Co. v. United States*, 398 F.2d 694, 696 (3d Cir. 1968) ; *Laidlaw Transportation, Inc. v. Commissioner*, T.C. Memo 1998-232 (1998) ; *Nestle Holdings, Inc. v. Commissioner*, T.C. Memo 1995-441 (1995) ; see also *I.R.C. § 385(b)* (listing debt-equity factors which could be taken into account in issuing regulations).

(n85)Footnote 85. See, e.g., *Santa Anita Consol., Inc. v. Commissioner*, 50 T.C. 536, 552 (1968) ; *American Processing and Sales Co. v. United States*, 371 F.2d 842, 856-57 (Ct. Cl. 1967) ; *Drachman v. Commissioner*, 23 T.C. 558, 562-563 (1954) .

(n86)Footnote 86. *Foretravel, Inc. v. Commissioner*, T.C. Memo 1995-494 (1995) .

(n87)Footnote 87. *Foretravel, Inc. v. Commissioner*, T.C. Memo 1995-494 (1995) .

(n88)Footnote 88. *Foretravel, Inc. v. Commissioner*, T.C. Memo 1995-494 (1995) .

(n89)Footnote 89. *Foretravel, Inc. v. Commissioner*, T.C. Memo 1995-494 (1995) .

(n90)Footnote 90. See, e.g., *Fin Hay Realty Co. v. United States*, 398 F.2d 694 (3d Cir. 1968) ; see generally *Plumb, The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 *Tax L. Rev.* 369, 499- 503 (1971).

(n91)Footnote 91. *Treas. Reg. § 1.1001-3(e)(5)* (providing that any deterioration in the financial condition of the obligor between the issue date of the unmodified debt instrument and the modification date is not taken into account unless there is a substitution of a new obligor or an addition or deletion of a co-obligor).

(n92)Footnote 92. See discussion in text below regarding high yield debt instruments.

(n93)Footnote 93. See, e.g., *Pleasant Summit Land Corp. v. Commissioner*, 863 F. 2d 263 (3d Cir. 1988) .

(n94)Footnote 94. A partnership terminates for tax purposes if 50% or more of the total interest in partnership capital and profits is sold or exchanged within a 12-month period. *I.R.C. § 708(b)(1)(B)*.

(n95)Footnote 95. See *I.R.C. § 731*.

(n96)Footnote 96. See *New York State Bar Association, Tax Section, Report on Section 305 Proposed Regulations*, 94 *TNT* 219-10 n.5 (Nov. 8, 1994) .

(n97)Footnote 97. See *I.R.C. § 382(k)*.

(n98)Footnote 98. Most foreign lenders could continue to treat interest paid as portfolio interest not subject to U.S. withholding tax (as long as the modified debt is not contingent). See *I.R.C. § 871(h)(4)* (interest paid on contingent debt no longer qualifies as portfolio interest). Foreign lenders would not be subject to U.S. tax on gain attributable to the deemed debt exchange (and losses could not be used to shelter U.S. income) unless such lenders are otherwise currently

engaged in a related U.S. trade or business or separately subject to U.S. tax. *See Treas. Reg. § 1.1445-1(b)(1)*.

(n99)Footnote 99. The lenders could also be separately treated as having the right to a distributable share of partnership profits.

(n100)Footnote 100. *See Treas. Reg. § 1.707-1(c)* (guaranteed payments for use of capital generally treated as a partner's distributive share of the partnership's ordinary income); *Priv. Ltr. Rul. 8728033 (Apr. 13, 1987)* (guaranteed payments made by a partnership to a real estate investment trust retain the underlying character of the partnership's income, i.e., rental income, for purposes of determining the nature of the income in recipient's hands); *Priv. Ltr. Rul. 86-39-035 (June 27, 1986)* (same). *But see Miller v. Commissioner*, 52 T.C. 752 (1969) (guaranteed payments treated as earned income); *Carey v. United States*, 427 F. 2d 763 (Ct. Cl. 1970) ; *G.C.M. 38133 (Oct. 10, 1979)* (guaranteed payments treated as interest); *G.C.M. 36702 (Apr. 12, 1976)* (same).

(n101)Footnote 101. *Rev. Rul. 88-3, 1988-1 C.B. 268* (determination of whether a taxpayer is engaged in a U.S. trade or business is highly factual and IRS will generally not rule on this issue in advance).

(n102)Footnote 102. *See I.R.C. §§ 871(a)(1)(A) and 881(a)(1)*.

(n103)Footnote 103. *See I.R.C. §§ 871(a)(1)(A) and 881(a)(1)*.

(n104)Footnote 104. For example, if guaranteed payments were treated as real property rental income, the U.S. withholding tax on such payments probably could not be reduced under the interest provisions of the United States-Japan tax treaty, because the treaty provides no relief for real property rental income. *See Convention Between the Government of the United States of America and the Government of Japan for Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income*, Nov. 6, 2003, U.S.-Japan, Senate Treaty Doc. No. 108-14, at 11 ("U.S.-Japan Tax Treaty"). Income from the rental of tangible personal property, by contrast, may be eligible for reduced withholding under the "royalties" or "Business Profits" article of an applicable tax treaty if the income is not attributable to a permanent establishment of the foreign partner in the source country. *See, e.g., U.S. Model Income Tax Treaty* (1981), at art. 7(1) (exempting business profits from source-State taxation if not connected to a permanent establishment in such source State), (5) (defining business profits to include income derived from rental of tangible personal property); *see generally* Richard Anderson, *Analysis of United States Income Tax Treaties* P4.02[4][a], [b].

(n105)Footnote 105. *See I.R.C. §§ 1441(a) and 1446(b)(2)(A)*. Presumably withholding would be required under either *I.R.C. section 1441* or *section 1446*.

(n106)Footnote 106. *I.R.C. Section 1446(a)* requires withholding on guaranteed payments on the earlier of the date a payment is made, or 3 months and 14 days after a guaranteed payment is due. *See Rev. Rul. 89-17, 1989-1 C.B. 268*.

(n107)Footnote 107. *See Treas. Reg. § 1.897-1(d)(1)*. Gain would be subject to U.S. tax at generally applicable rates, and a purchaser of the debt generally would be required to withhold 10% of the amount paid for the debt as a prepayment of the tax. *I.R.C. § 1445(e)(5)*.

(n108)Footnote 108. *See I.R.C. § 897(g)*. An interest in a partnership (i) in which U.S. real property interests represent 50% or more of the value of its direct or indirect gross assets, and (ii) in which U.S. real property interests plus any cash represent 90% or more of the value of its gross assets, is treated as entirely a U.S. real property interest for purposes of section 1445. By contrast, for section 897(g) purposes, such a partnership interest is treated as a U.S. real property interest only to the extent that gain on the disposition is attributable to U.S. real property interests. *Temp. Treas. Reg. § 1.897-7T(a)*.



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Collier on Bankruptcy Taxation

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CHAPTER TX9 Debt for Debt Exchanges

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[1] Borrower Tax Consequences of Debt Exchanges

A borrower will recognize COD income upon certain actual or deemed debt-for-debt exchanges if the issue price of the new debt is less than the adjusted issue price n1 of the old debt. This result obtains because the new debt issue price is treated as the amount paid for the old debt. n2 Specifically, the borrower will recognize COD income in any exchange where the issue price of the new debt plus the fair market value of any property, stock and cash received in satisfaction of the old debt is less than the adjusted issue price of the old debt. n3

If neither the old debt nor the new debt is publicly traded, and the new debt bears "adequate stated interest," the new debt issue price will equal its stated principal amount (for debt instruments governed by section 1274) or its stated redemption price, *i.e.*, the adjusted issue price of the old debt, and no COD income will be recognized. n4 The avoidance of COD income under these circumstances is the sole remaining exception to COD recognition in connection with an exchange of debt for property after the repeal of the stock-for-debt exception to COD income in 1993. By contrast, if an issuer exchanges non-publicly traded debt for non-publicly traded *contingent payment* debt, the issuer will ordinarily recognize COD income because the issue price of such a non-publicly traded contingent payment debt instrument does not include any amounts that are contingent. n5

If either the old or new debt is publicly traded, the issue price of the new debt will be the trading price of the debt, *i.e.*, the fair market value of the property. n6 If the modified debt is treated as equity, the borrower's tax consequences would be the same as on a deemed exchange of publicly-traded debt--the borrower would recognize COD income equal to the difference between the outstanding balance on the old debt and the fair market value of the equity received, *i.e.*, the fair market value of the property. n7 This result would presumably obtain without regard to whether COD would have been avoided if the debt were not recharacterized as equity.

If the debt is discharged in a title 11 case, the taxpayer is not required to recognize the COD income. n8 If the debt discharge occurs when the taxpayer is insolvent, the taxpayer is not required to recognize the COD income to the extent of its insolvency. n9 A taxpayer is considered insolvent if and to the extent its liabilities exceed the fair market value of its assets, as determined immediately prior to the debt discharge at issue. n10 There is significant uncertainty concerning the extent to which contingent liabilities are taken into account in determining solvency. According to the Ninth Circuit, contingent obligations constitute a liability for these purposes only when it is "more likely than not" that

the taxpayer will be required to pay such liability. n11

Any taxpayer that excludes COD amounts from gross income because of the title 11 or insolvency exception is required to reduce its tax attributes to the extent of the excluded amount. n12 A taxpayer may elect to first reduce the basis of depreciable property. n13 Otherwise, the tax attributes will be reduced in the following order: (i) NOLs; n14 (ii) general business credit; n15 (iii) minimum tax credit; n16 (iv) capital loss carryovers; n17 (v) basis of assets; n18 (vi) passive activity loss and credit carryovers; n19 (vii) foreign tax credit carryovers. n20 Attributes are reduced after tax is determined for the taxable year of the debt discharge. n21 As a result, NOLs may be used to shelter operating income (including COD income not excluded under an exception) in the year the debt is discharged.

A partnership borrower is not subject to tax on any COD income it recognizes upon a debt restructuring. n22 Instead, the borrower generally is required to allocate its income or gain among its partners in proportion to the partners' shares of the canceled debt under *I.R.C. section 752*. n23 *Revenue Ruling 92-97* provides that other allocations of COD income will also be respected if the allocations have (or are deemed to have) "substantial economic effect" under the rules of *I.R.C. section 704(b)* and the corresponding Treasury Regulations. While the application of the *I.R.C. section 752* rules and the "substantial economic effect" test are less than clear in a workout context, most allocations of COD income in accordance with a partnership's governing documents should be respected, provided the allocations in those documents would otherwise pass muster with the IRS. Partnership COD income that is effectively connected taxable income allocable to foreign partners is subject to U.S. withholding tax; foreign corporate partners currently are subject to U.S. withholding tax at a 35% rate. n24

The obligation section 1446 imposes on a partnership to withhold tax on effectively connected COD income allocable to foreign partners creates a serious practical dilemma in the debt restructuring context. Where an investor is willing to invest new money in an insolvent U.S. partnership in exchange for a partnership interest, a portion of the contribution must be used to fund the withholding tax relating to the COD income allocable to the partnership's solvent foreign partners. This situation is frequently unacceptable to a prospective investor who expects that the entirety of its investment will be used to rebuild the business. n25

Recently finalized regulations provide limited relief from this dilemma. n26 The regulations permit a foreign partner who meets the so-called "good driver" requirement n27 to certify to the partnership that it has deductions and losses from prior years that it reasonably expects to be available to reduce its U.S. income tax liability on its allocable share of effectively connected income from the partnership. n28 If the foreign partner properly provides the requisite certification, the partnership may consider certain partner-level deductions in computing its withholding obligation with respect to the certifying partner. n29 A partnership that reasonably relies on such certification is not liable for penalties if it is later determined that the certificate is defective or if the partnership subsequently receives an updated certificate, although the partnership remains liable for the substantive section 1446 tax liability. n30

Each partner may shelter its allocable share of COD income or gain with any available losses. In addition, a bankrupt or insolvent partner could qualify for the *I.R.C. section 108(a)* exception to the inclusion of COD income since the bankruptcy or insolvency exception is determined at the partner level for partnerships. n31 However, this exclusion is limited to the amount by which the taxpayer is insolvent. n32 For these purposes, insolvency is defined as "the excess of liabilities over the fair market value of assets." n33 There has been significant uncertainty regarding the extent to which contingent liabilities are taken into account in determining solvency. Recently, the Ninth Circuit affirmed a Tax Court decision, holding that a contingent obligation constitutes a liability for these purposes only when it is "more likely than not" that the taxpayer will be required to pay such liability. n34

Partners who avoid COD income recognition under the title 11 or insolvency exception must reduce tax attributes by the amount of avoided COD income. n35 Solvent partners other than C corporations may also elect to exclude COD income attributable to the cancellation of "qualified real property business indebtedness." n36 Partners making this election must reduce basis in their depreciable property by the amount of COD income excluded. n37 The amount of COD

income that a partner may exclude under the election is limited to a partner's aggregate basis in its depreciable real property immediately prior to the COD income-producing event. n38

Example 5 :

Sumi, a Japanese company, and Venture Co., a U.S. corporation, are 50% partners in the SV Partnership ("SV"), a U.S. real estate development business. In 1988, SV issues to L an 8-year \$1,000 nonrecourse note secured by an office building in lower Manhattan. L syndicates the note, a substantial amount of which was first sold to the public at \$700. When SV encounters financial difficulties in 1996, the noteholders agree to extend the maturity of the debt for five years, triggering a deemed exchange. The old debt is publicly traded at \$800. Unlike SV, Sumi and Venture Co. are solvent.

Because the old debt is publicly traded, the issue price of the new debt is \$800. SV has \$200 of COD income (\$1,000 adjusted issue price of old debt minus \$800 issue price of new debt). Sumi and Venture Co. will each recognize their allocable share of COD income flowing through from SV and neither can benefit from the *I.R.C. section 108(a)* exclusion because they are each solvent in their individual capacities. SV must withhold tax at a rate of 35% on the COD income allocable to its foreign corporate partner, Sumi, because the COD income is effectively connected with the conduct of SV's U.S. trade or business.

The noteholders recognize \$100 of gain (\$800 issue price of new debt minus \$700 tax basis in old debt) and must accrue \$200 of OID in income (\$1,000 stated redemption price at maturity of new debt minus \$800 issue price of new debt) over the 5-year term of the new debt, regardless of their regular method of tax accounting. SV will be entitled to a corresponding deduction for OID.

In the consolidated return context, COD income may be triggered if an intercompany obligation is transferred outside the consolidated group. If a creditor member sells an intercompany obligation to a nonmember, the obligation is deemed satisfied immediately before the sale for the amount of the sale price. n39 The debt is then deemed reissued to the nonmember immediately after the sale for an amount equal to such sale price. n40 Similarly, if an intercompany obligation is transferred outside the group because the creditor or debtor leaves the group, the obligation is deemed satisfied for cash in an amount equal to the debt's fair market value immediately before the member leaves the group and is then deemed reissued for cash equal to the debt's fair market value. n41 COD income would arise if the sale price for the debt, or the fair market value of the debt at the time the creditor or debtor leaves the group, were less than the adjusted issue price of the original debt. n42 In computing consolidated taxable income, any COD income of the borrower would be offset by a corresponding ordinary deduction for the creditor. n43

COD income may also arise if an obligation that is not an intercompany obligation becomes one. If, for example, a third party lender joins the consolidated group of the borrower, the obligation is deemed satisfied *immediately after* the obligation is transferred into the group. n44 The borrower is then deemed to issue a new obligation to the holder of the debt for an amount equal to the fair market value of the debt. n45 All attributes from the deemed satisfaction of the debt are determined on a separate entity basis, rather than by treating the borrower and lender as divisions of a single corporation, notwithstanding the fact that the deemed satisfaction occurs after the lender joins the borrower's consolidated group. n46 As a result, if the debt is deemed satisfied for less than its adjusted issue price, the lender's loss may be a capital loss even though the borrower's corresponding amount of COD income would be ordinary.

Two temporary provisions were enacted recently to provide relief from COD income recognition to certain taxpayers. First and foremost, Congress enacted section 108(i), which permits a taxpayer to defer recognition of COD income when the taxpayer or a related person "reacquires" an "applicable debt instrument" in 2009 or 2010 pursuant to the American Recovery and Reinvestment Act. n47 At the taxpayer's election, the COD income may be deferred until 2014 and then included ratably over a period of five years. n48 Once made, the election is irrevocable. n49 Generally, a taxpayer that elects to defer COD income through section 108(i) may not benefit from any other COD exclusions, including the title 11 and insolvency exclusions, with respect to the same debt instrument, or portion thereof, to which

the election applies, for the tax year in which the election is made or any subsequent tax year. n50

Section 108(i) defines an applicable debt instrument as a debt instrument issued by a C corporation or by any other person in connection with the conduct of a trade or business by that person. n51 An applicable debt instrument is "reacquired" if the debtor, or a related person to the debtor, "acquires" the debt, which is defined to include an acquisition (i) for cash, (ii) in exchange for another debt instrument (including an exchange resulting from a modification of the debt instrument), (iii) in exchange for corporate stock or a partnership interest, and (iv) as a contribution to capital. A debt instrument is also treated as acquired if it is completely forgiven by the holder. n52

As discussed below, Revenue Procedure 2009-37 provides both additional guidance on theoretical questions the statute did not address and procedures for making the election. n53 More specifically, an election is generally made on an instrument-by-instrument basis, and a taxpayer may make a partial election for only a portion of COD income realized with respect to one or more instruments. n54 Revenue Procedure 2009-37 confirms that a taxpayer that makes a partial section 108(i) election and defers only a portion of COD income realized with respect to a debt instrument may exclude from income the remaining portion of COD income under another applicable COD exclusion, such as the insolvency exception. n55 In addition, if a taxpayer elects to defer COD income under section 108(i), OID deductions in respect of the debt instrument issued to reacquire an applicable debt instrument n56 will be deferred until the five year period during which the taxpayer takes the COD income into account, and then be included ratably during that five year period. n57

An election under section 108(i) to defer COD income is made by including with the taxpayer's income tax return for the tax year in which the debt instrument is acquired a statement that provides (i) the name and any applicable taxpayer identification numbers of the issuer(s) of the debt instrument; (ii) a general description of the debt instrument; (iii) a general description and the date of the reacquisition transaction(s) generating the COD income; (iv) the amount of COD income resulting from the reacquisition and the amount of COD income the taxpayer is electing to defer; (v) in the case of a partnership or S corporation, a list of partners or shareholders, respectively, that have a deferred amount, their identifying information, and each partner's or shareholder's deferred amount or share of the deferred amount; (vi) in cases in which a new debt instrument is issued or deemed issued in exchange for the debt instrument, the issuer's name, taxpayer identification number, a general description of the new debt instrument and whether the new debt instrument has OID, a schedule of the OID that the issuer expects to accrue each taxable year on the instrument and the amount of OID that the issuer expects to defer each taxable year; and (vii) any other information required by the IRS. n58 A taxpayer that makes a section 108(i) election must also provide an information statement with its income tax returns beginning with the taxable year following the taxable year in which the taxpayer makes the election. n59 Partnerships, S corporations, and certain foreign corporations making a section 108(i) election are subject to additional reporting requirements. n60

Any COD income deferred by a partnership must be allocated among (and subsequently recognized by) the partners holding partnership interests immediately before the debt is discharged in the same manner as those amounts would have been included in the partners' income under section 704 if the COD income were immediately recognized. n61 Revenue Procedure 2009-37 provides that a partnership that makes a partial section 108(i) election may specify whether deferred or currently realized COD income is to be allocated to each partner. n62 Any decrease in the partner's share of partnership liabilities resulting from the debt discharge is only taken into account at that time to the extent it would not cause the partner to recognize gain under section 731; any excess amount subsequently taken into account by the partner at the same time, and to the extent remaining in the same amount, as the deferred COD income is recognized. n63 Practitioners have voiced concern that the rules for allocated deferred COD income, particularly in a partnership situation, are somewhat ambiguous. For example, it remains unclear how section 108(i) applies to tiered partnerships, how partial transfers or redemptions of interest will be treated, and whether any amounts of deferred COD allocated to the partners in a partnership should be reflected in the partners' capital accounts. n64

Any COD income that is deferred under section 108(i) will be accelerated if the taxpayer (i) dies, (ii) liquidates or sells

substantially all of its assets, or (iii) ceases to do business, or similar circumstances occur, to the taxable year in which the event occurs or in the case of a title 11 proceeding, the day before the petition is filed. n65 In the case of a pass-through entity, including a partnership, the COD income is also accelerated if there is a sale, exchange, or redemption of an interest in the pass-through entity by the person holding the ownership interest in the entity. n66

Congress also enacted an exception to the taxation of COD income arising from a taxpayer restructuring the debt on its principal residence or upon a foreclosure of its principal residence. n67

This exception excludes from COD income recognition "qualified principal residence indebtedness" discharged in calendar years 2007 through 2012 as a result of a decline in the value of the residence or the financial condition of the taxpayer. n68 "Qualified principal residence indebtedness" is up to \$2 million of acquisition indebtedness with respect of the taxpayer's principal residence. n69 Any excluded qualified principal residence indebtedness will reduce the taxpayer's basis in its principal residence, although not below zero. n70

[2] Holder Tax Consequences of Debt Exchanges

A holder will generally recognize gain or loss in connection with a debt exchange if its basis in the old debt does not equal the issue price of the modified debt, except in the case of a corporate issuer where the exchange qualifies as a tax-free recapitalization under *I.R.C. section 368(a)(1)(E)*.

[a] Tax-Free Debt Exchanges

A deemed or actual exchange of debt can qualify as a tax-free reorganization only if the issuer of the debt is a corporation and the original and modified debt instruments each qualify as a "security" for federal income tax purposes. n71 Although the term "security" is not defined in the Internal Revenue Code, stock, or a debt instrument due more than ten years from the date of issuance is generally thought to constitute a security. However, the precise limits are unclear and an instrument with an original term of as little as five years (or even less) may also qualify. n72

Revenue Ruling 2004-78, the IRS found that an exchange of long-term debt for a two-year debt instrument in a merger was tax free in a reorganization under Section 368(a)(1)(A). The ruling noted that although most authorities hold that a two-year note is not a security, this treatment is not appropriate when a note is issued by an acquirer in a reorganization in exchange for target debt that bears the same terms (other than the interest rate). In such a case, the ruling holds that the acquirer note represents a continuing interest in the target, and accordingly, treatment of such a note as a security is consistent with the intent of the reorganization provisions of the Code. n73 The scope of this ruling is unclear. The context of the ruling was a two-year note with only one substantive change in terms (the interest rate) in a reorganization under Section 368(a)(1)(A). Query whether a note with a maturity of less than two years, a note with more than one change in its terms or a note exchanged in any other tax-free reorganization would qualify as a security.

If a debt exchange constitutes a tax-free recapitalization, holders of debt securities who receive new securities will generally not recognize gain, subject to two exceptions discussed below, and holders generally may not recognize a loss on the exchange. n74

First, holders must recognize income to the extent that the value received for accrued interest exceeds the amount of accrued interest previously included in the holder's income for federal income tax purposes. n75 Such value may be received in the form of new debt in a deemed debt exchange, or new debt, cash or property in an actual debt exchange. The proper allocation of amounts received in a debt exchange between principal and interest is unclear, although the applicable legislative history indicates that all parties should be bound by their explicit allocation of property received in an exchange between principal and accrued interest or OID on the original debt. n76 A holder that previously included amounts in income, as interest paid on the debt instrument, that exceed the amount of cash and other property the holder receives as allocable to interest on an exchange of the debt instrument, may deduct such unpaid interest,

generally either as a loss or, in the case of certain holders such as banks, as an adjustment to a reserve for bad debts. n77

The possibility of holders recognizing losses with regard to over-accruals of interest was highlighted by the IRS's recently confirmed position that holders must continue to accrue OID even when the issuer's financial condition is so poor that there is no reason to expect that the debt instrument will be redeemed in accordance with its terms. n78

In a second requirement, holders who also receive property other than new securities in a debt exchange will recognize gain to the extent of the lesser of (i) the fair market value of the other property received, or (ii) the holder's actual gain on the exchange determined by comparing the value of all property received with the holder's adjusted tax basis in the debt exchanged. n79 Although the "dividend within gain" rule of *I.R.C. Section 356(a)(2)* applies to debt exchanges, it does not operate to transform the gain into a dividend. n80

The meaning of the term "principal amount" has been a matter of some debate in the context of tax-free reorganizations. The definition of principal amount is important because the principal amount of debt instruments exchanged by a holder acts as a ceiling on the amount of securities that can be received tax-free by the holder in a recapitalization. n81 In the case of a debt instrument that bears "adequate stated interest," principal amount should mean all amounts due under the instrument other than qualified stated interest. n82 When a debt instrument lacks adequate stated interest, however, the definition of principal amount is less clear. This lack of clarity results because the definition of principal amount predates, and is inconsistent with, the OID regime. The New York State Bar Association (the "NYSBA") has recommended that the principal amount rule be replaced with a modified version of the rule that was proposed (but not enacted) in the 1991 Tax Bill which compared the "issue price" of the new debt instrument to the "adjusted issue price" of the debt instrument being exchanged to determine a holder's gain. n83 However, the NYSBA recommendation would sensibly limit the gain a holder would be required to recognize to either (i) the difference between the fair market values of the two debt instruments, or (ii) the gain that would be recognized under the current principal amount rule.

A holder's aggregate basis in a security received in a tax-free debt exchange (other than any amount received for interest) will equal the holder's basis in the modified debt instrument (other than basis attributable to accrued interest), reduced by the amount of cash and the fair market value of other property received for such debt instrument (other than property received for accrued interest), and increased by the amount of gain recognized on the exchange. n84 The holding period for a new debt instrument received in a tax-free debt exchange will include the period the holder held the original debt instrument, provided the debt instrument was held as a capital asset on the date of the exchange. n85

[b] Taxable Debt Exchanges

An exchange of debt characterized as a security for debt not so qualified (or vice versa), and an exchange of debt not issued by a corporation, would each not qualify as a tax-free recapitalization. Thus, for example, any deemed or actual exchange of debt that includes at least one non-security will be a taxable event for the holders. In the event of such a taxable exchange, holders will recognize gain or loss equal to the difference between a holder's adjusted tax basis in its debt and the holder's "amount realized" on the exchange. n86 If the amount realized is greater than the holder's adjusted tax basis in its debt, the holder will recognize taxable income as a result of the exchange. n87 A holder's amount realized will equal the sum of the amount of cash received and the fair market value of stock and other property received, *e.g.*, generally the issue price of a new debt instrument. n88 The amount realized upon receipt of a debt instrument will differ depending on the circumstances under which the debt instrument is issued. n89 For example, the amount realized with respect to a nonpublicly traded new debt instrument without adequate stated interest received by an accrual basis holder (other than in a potentially abusive situation) will be its imputed principal amount. n90 By contrast, the amount realized with respect to the same debt instrument received by a cash basis holder would be its fair market value. n91 Moreover, if the same debt instrument is issued in a debt exchange that constitutes a "potentially abusive situation," an accrual basis holder's amount realized would be the fair market value of the instrument. n92

The calculation of a holder's amount realized will produce a surprising result for accrual basis holders of nonpublicly

traded debt that such holders acquired at a discount shortly before a taxable deemed or actual debt exchange. Such holders will be treated as receiving property with a value equal to the imputed principal amount of such debt, even though the fair market value of such debt (as evidenced by the terms of the holder's recent purchase) may be significantly lower. As a result, a recent purchaser would recognize a significant amount of phantom taxable gain in connection with an exchange of the debt. A different, more beneficial, result would obtain for the same holder if the new debt issued in the exchange is treated as issued under "potentially abusive" circumstances as a result of the recent sale of the old debt. n93 In that case, the amount realized on the debt exchange is computed with reference to the fair market value of the newly-issued debt. n94 Curiously, when an investor purchases such a note at a deep discount and immediately restructures the debt, the application of the usually detrimental "potentially abusive" rules would benefit the new holder by reducing the holder's amount realized on the exchange of the old debt instrument from its imputed principal amount to the instrument's lesser fair market value. Of course, the potentially abusive rules would not provide relief to longtime holders of debt, such as banks, who have a low basis in debt of troubled issuers as a result of a partial write down of such debt.

A tax deduction for partial worthlessness of the old debt would soften the blow of phantom gain recognition. To be entitled to a tax deduction, however, the holder must charge off the uncollectible portion of the debt from its books during the taxable year. n95 If the holder charged off a portion of the debt in a prior year, a second charge-off during the taxable year of gain recognition is not possible unless the holder restores the prior charge-off by increasing its basis in the debt. Although the phantom gain increases the tax basis of the debt, regulatory and accounting principles do not allow a corresponding increase in basis for book purposes. n96 Cognizant of this problem, the I.R.S. issued regulations under *I.R.C. section 166* in conjunction with its issuance of regulations under *I.R.C. section 1001*. n97 Under the regulations, a holder required to recognize gain because of a significant modification of a debt instrument is allowed a deemed charge-off of the debt during the taxable year of gain recognition if the holder claimed a deduction for partial worthlessness in a prior year. n98 The deemed charge-off is the amount by which the tax basis of the debt exceeds the greater of the debt's fair market value or net book value, and is limited to the gain recognized as a result of the significant modification. n99 It should be noted, however, that because the temporary regulations require a prior charge-off, they do not help holders that have a low basis in the old debt because they acquired the debt at a discount (rather than at par) and so did not take the requisite bad debt deductions for partial worthlessness. n100

A holder's adjusted tax basis in a debt instrument will generally be its cost (which, in the case of a note purchased with a foreign currency, will be the U.S. dollar value of the purchase price on the date of purchase), n101 increased by (i) the amount of any OID, n102 (ii) market discount (or acquisition discount, in the case of a short-term debt instrument) included in the holder's income with respect to the debt instrument, and (iii) the amount, if any, of income attributable to *de minimis* OID included in the holder's income with respect to the debt instrument, and reduced by (x) the amount of any payments on the debt instrument that are not qualified stated interest payments, n103 and (y) the amount of any amortizable bond premium applied to reduce interest income attributable to the debt instrument. n104 The tax basis of property (including new debt) received by a holder in an exchange of debt will equal the portion of the fair market value of such property that was included in the holder's amount realized on the exchange. n105 For purposes of this rule, the tax basis of new debt received in an exchange is generally the issue price of such new debt. n106 The holding period for property received in the exchange will begin on the day following the exchange. n107

The character of any gain or loss recognized by a holder in a debt exchange as capital or ordinary, and, in the case of capital gain or loss, as short term or long term, will depend on a number of factors, including: (i) the tax status of the holder of the debt instrument; (ii) whether the holder is a U.S. financial institution; n108 (iii) whether the debt instrument is a capital asset in the hands of the holder; (iv) whether the debt instrument has been held for more than one year; (v) the extent to which the holder previously claimed a loss, bad debt deduction, or charge to a reserve for bad debts with respect to the debt instrument; and (vi) whether, in the case of certain debt instruments for which no election was made to currently include market discount in income, the difference between the holder's basis in the debt instrument immediately after it was acquired and the amount of the debt instrument that exceeded any then unaccrued original issue discount (by more than the *de minimis* amount). n109

In the case of a holder whose note constitutes a capital asset, the gain required to be recognized on a debt exchange generally will be classified as a capital gain under the rules discussed above, except to the extent of interest. n110 Any capital gain recognized by a holder will be long-term capital gain with respect to those notes held for more than one year, and short-term capital gain for notes held for one year or less. n111 However, holders of original notes that constitute market discount obligations will be required to treat as ordinary income any gain recognized upon the exchange of their old notes to the extent of the market discount accrued during the holder's period of ownership, unless the holder elected to include such market discount in income as it accrued. n112 Any additional gain recognized by the holder would be characterized in accordance with the general rules described above. Any accrued market discount not treated as ordinary income upon an exchange of old notes for new notes in which gain or loss is not recognized in whole or in part should carry over to the new notes received in the exchange. n113 On disposition of such new notes, any gain recognized generally would be treated as ordinary income to the extent of the amount of accrued market discount carried over. n114

The statutory provision governing the character of gain on notes attributable to market discount applies only to bonds with a term of more than one year. n115 However, the IRS has recently taken the position that the portion of the amount realized on the sale of customer notes with a term of a year or less that is attributable to accrued market discount is also ordinary income. n116 With respect to the accretion of market discount, the Service has held that market discount on a customer note with a term of 12 months or less could be treated as accruing ratably each day, or under any other method of accounting that would clearly reflect income. n117

FOOTNOTES:

(n1)Footnote 1. The adjusted issue price of a debt instrument is its issue price, increased by the portion of any OID previously includible in gross income of any holders and decreased by the portion of any bond premium previously included in the gross income of the borrower. *I.R.C.* §§ 1272(a)(4); 108(e)(3). See *P TX9.04* below for a more detailed description of the OID rules.

(n2)Footnote 2. See *I.R.C.* § 108(e)(10) (issue price of debt instrument issued in satisfaction of debt is determined under section 1273 or 1274); see also FSA 1999-665 (Aug. 9, 1993) (during the time period the proposed debt exchange regulations were outstanding, the IRS position was that COD income in debt exchanges is properly measured based on the respective issue prices of the debt instruments, even for the debt exchanges occurring prior to the effective date of section 108(e)(10) or its predecessor).

For a thorough history of *I.R.C.* § 108(e)(10), as well as a discussion of certain tax issues that arise in the case of "hung" bridge loans, see Charles Morgan, *Bridge Loans -- Confronting Tax Issues Triggered by the Recent Economic Downturn*, 7 J. Tax'n Fin'l Products 4 (2009).

(n3)Footnote 3. See *I.R.C.* § 61(a)(12); *Treas. Reg.* § 1.61-12(c)(3); *Rev. Rul.* 77-437, 1977-2 C.B. 28. Section 61(a)(12) codifies the rule of *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931), that a debtor recognizes taxable income upon a satisfaction of its indebtedness for less than its adjusted issue price because the satisfaction of a liability at a discount enriches the debtor and should therefore be treated as income; *TAM* 9822005 (Jan. 16, 1998) (wholly-owned subsidiary did not realize COD income upon cancellation of its debt to its parent).

(n4)Footnote 4. *I.R.C.* §§ 1273(b)(4), 1274(a)(1).

(n5)Footnote 5. See *Treas. Reg.* § 1.1274-2(g). See *P TX9.04[8]* *infra* for a detailed discussion of contingent payment debt instrument rules.

(n6)Footnote 6. *I.R.C. § 1273(b)(3)*.

(n7)Footnote 7. *I.R.C. § 108(e)(8)*. See *P TX9.02[3] supra* for a detailed discussion of the collateral consequences to an issuer when debt is recharacterized as equity.

(n8)Footnote 8. *I.R.C. § 108(a)(1)(A)*. A title 11 case means a case under title 11 of the United States Code relating to bankruptcy. In addition, for this exception to apply, the taxpayer must be under the jurisdiction of the court and the discharge of indebtedness must be granted by the court or be pursuant to a plan approved by the court.

(n9)Footnote 9. *I.R.C. §§ 108(a)(1)(B) and (a)(3)*.

(n10)Footnote 10. *I.R.C. § 108(d)(3)*.

(n11)Footnote 11. *Merkel v. Commissioner*, 192 F.3d 844 (9th Cir. 1999) , *aff'g* 109 T.C. 463 (1997) . See also Raby and Raby, *Measuring Assets and Liabilities for DOI Purposes*, 1999 TNT 189-34 (Sept. 29, 1999).

(n12)Footnote 12. *I.R.C. § 108(b)(1)*.

(n13)Footnote 13. *I.R.C. § 108(b)(5)*. The section 108(b)(5) election must be made on the taxpayer's tax return for the year of the debt discharge. *I.R.C. § 108(d)(9)*.

(n14)Footnote 14. Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year in the order in which the loss arose, by a dollar for each dollar excluded,. *I.R.C. §§ 108(b)(2)(A), (b)(3)(A), (b)(4)(B)*.

(n15)Footnote 15. Any general business credit carryover to or from the taxable year of a debt discharge is reduced in the order it would be used against taxable income, by 33 1/3 cents for each dollar excluded. *I.R.C. §§ 108(b)(2)(B), (b)(3)(B), (b)(4)(C)*.

(n16)Footnote 16. The amount of any minimum tax credit available under section 53(b) as carryover from the year of the debt discharge will be reduced, by 33 1/3 cents for each dollar excluded. *I.R.C. §§ 108(b)(2)(C), (b)(3)(B), (b)(4)(A)*.

(n17)Footnote 17. Net capital losses from the taxable year of discharge, and any capital loss carryovers, from the year of discharge and then in the order in which they arose are reduced by a dollar for each dollar excluded. *I.R.C. §§ 108(b)(2)(D), (b)(3)(A), (b)(4)(B)*.

(n18)Footnote 18. The basis of the property of the taxpayer is reduced by a dollar for each dollar excluded. *I.R.C. §§ 108(b)(2)(E), (b)(3)(A)*.

(n19)Footnote 19. Any passive activity losses or credit carryovers that have been suspended under the passive activity loss rules are reduced, by 33 1/3 cents for each dollar excluded for credit carryovers. *I.R.C. §§ 108(b)(2)(F), (b)(3)(B)*.

(n20)Footnote 20. Foreign tax credit carryovers to or from the taxable year of the discharge in the order in which they arose, by 33 1/3 cents for each dollar excluded. *I.R.C. §§ 108(b)(2)(G), (b)(3)(B)*.

(n21)Footnote 21. *I.R.C. § 108(b)(4)(A)*.

(n22)Footnote 22. *I.R.C. §§ 61(a)(12) and 1001*.

(n23)Footnote 23. *Rev. Rul. 92-97, 1992-2 C.B. 124* .

(n24)Footnote 24. *I.R.C. § 1446(a)* and *(b)(2)(B)*. Recently issued regulations under *I.R.C. Section 1441* provide that a lender is not required to withhold tax on COD income that is triggered when the lender forgives a loan to a foreign borrower. *Treas. Reg. § 1.1441-2(d)* (effective with respect to payments made after December 31, 1999 [*Rev. Proc. 98-16* , § 3, I.R.B. 1998-15]). By cancelling a debt, the lender is not considered to have "custody or control" over money or property of the borrower from which a withholding tax liability could be satisfied, even if the lender receives payment from the borrower in partial satisfaction of the loan. *Id.* COD income of a partnership, however, is still governed by *I.R.C. Section 1446*, which requires withholding on a foreign partner's allocable share of the partnership's effectively connected taxable income. *See, Rev. Proc. 89-31, 1989-1 C.B. 895* (providing guidance under Section 1446).

(n25)Footnote 25. As discussed below, the foreign partner may not qualify for the section 108(a) insolvency exclusion since the insolvency exception is determined at the individual partner level. *I.R.C. § 108(d)(6)*; *see Marcaccio v. Commissioner, T.C. Memo 1995-174 (1995)* .

(n26)Footnote 26. *Treas. Reg. § 1.1446-6*; *2008-21 I.R.B. 988, T.D. 9394 (Apr. 29, 2008)* .

(n27)Footnote 27. *Treas. Reg. § 1.1446-6(b)*. A foreign partner may satisfy the "good driver" requirement by providing (i) valid documentation to the partnership to which a certification is submitted, (ii) that it has timely filed or will file a U.S. federal income tax return in each of the partner's preceding three taxable years, and (iii) that it has timely filed or will file a U.S. income tax return for the taxable year in which certification is provided to the partnership.

(n28)Footnote 28. *Treas. Reg. § 1.1446-6(c)(1)(i)*. A foreign partner may also certify that its investment in the partnership is (and will be) the only investment or activity that will give rise to effectively connected items for the foreign partner's taxable year. *Treas. Reg. § 1.1446-6(c)(1)(ii)*. A partnership that receives this certificate is not required to pay section 1446 withholding tax with respect to any such partner that the partnership estimates that the annualized section 1446 tax will be less than \$1,000. *Treas. Reg. § 1.1446-6(c)(1)(ii)*.

(n29)Footnote 29. *Treas. Reg. § 1.1446-6(c)(1)(i)*.

(n30)Footnote 30. *Treas. Reg. § 1.1446-6(d)(2)*.

(n31)Footnote 31. *I.R.C. § 108(d)(6)*.

(n32)Footnote 32. *I.R.C. § 108(a)(3)*.

(n33)Footnote 33. *I.R.C. § 108(d)(3)*.

(n34)Footnote 34. *Merkel v. Commissioner, 192 F.3d 844 (9th Cir. 1999)* . *See also* Raby and Raby, *Measuring Assets and Liabilities for DOI Purposes*, 1999 TNT 189-34 (Sept. 29, 1999) .

(n35)Footnote 35. *I.R.C. § 108(a)(2)*.

(n36)Footnote 36. *I.R.C. § 108(c)*. Qualified debt generally includes debt incurred or assumed in connection with the acquisition or substantial improvement of real property used in a trade or business, and secured by such real property. *I.R.C. § 108(c)(3)*. Debt incurred or assumed before January 1, 1993 will constitute qualified debt if it is simply secured by real property used in a trade or business at the time the debt is incurred or assumed. *I.R.C. § 108(c)(3)(B)*; *see also TAM 2000-14-007 (Dec. 13, 1999)* .

(n37)Footnote 37. *I.R.C. § 108(a)(1)(D)*; 1017.

(n38)Footnote 38. *I.R.C. § 108(c)*.

(n39)Footnote 39. *Treas. Reg. § 1.1502-13(g)(3)(ii)*. An intercompany obligation is considered satisfied for U.S.

federal income tax purposes if a consolidated group member realizes an amount (other than zero) of income, gain, deduction or loss from the assignment or extinguishment of all or part of its rights or obligations under the intercompany obligation. If the obligation remains outstanding, the regulations treat the obligation as reissued. *Treas. Reg. § 1.1502-13(g)(3)(i)*. Recently issued proposed regulations adopt a new method, which deems the following sequence of events to occur immediately before, and independent of, the actual transaction: (i) the debtor is deemed to satisfy the obligation for cash in an amount equal to the obligation's fair market value; and (ii) the debtor is deemed to immediately reissue the obligation to the original creditor for the same cash amount. The debtor and the creditor are then treated as engaging in the actual transaction with respect to the new obligation. *See Prop. Treas. Reg. § 1.1502-13(g)* (issued Sept. 28, 2007).

(n40)Footnote 40. *Treas. Reg. § 1.1502-13(g)(3)(iii)*. If the debt is sold for cash, the debt is treated as a new debt issued by the debtor immediately after the sale for that amount of cash. If the debt is sold for property, it is treated as new debt issued for that property.

(n41)Footnote 41. *Treas. Reg. § 1.1502-13(g)(3)(ii), (iii)*.

(n42)Footnote 42. *Treas. Reg. § 1.61-12(c)(2)*; *Treas. Reg. § 1.1502-13(g)(5)*, Ex. 2(b). The new debt that is deemed issued will have OID if its face amount exceeds the sales price or fair market value of the original debt, as the case may be. *See, Treas. Reg. § 1.1502-13(g)(5)*, Ex. 2(c).

(n43)Footnote 43. *See Treas. Reg. § 1.1502-13(c), (d)* (providing "matching" and "acceleration" rules to ensure that the intercompany items of one member and the corresponding items of another member are taken into account to produce the same effect on consolidated taxable income as if the members were divisions of a single corporation).

(n44)Footnote 44. *Treas. Reg. § 1.1502-13(g)(4)(ii)(B)*.

(n45)Footnote 45. *Treas. Reg. § 1.1502-13(g)(4)(ii)(B)* (referencing Treasury regulation section 1.108-2(f) for determination of issue price of new debt).

(n46)Footnote 46. *Treas. Reg. § 1.1502-13(g)(4)(ii)(C)*.

(n47)Footnote 47. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (2009); *I.R.C. § 108(i)(1)*.

A related person is a person that would be related to the taxpayer under section 108(e)(4). *I.R.C. § 108(i)(5)(A)*.

(n48)Footnote 48. *I.R.C. § 108(i)(1)*; *I.R.C. § 108(i)(3)(A)*.

An election to defer COD income is made by including with the taxpayer's income tax return for the tax year in which the debt instrument is acquired a statement that clearly identifies the debt instrument and includes the amount of deferred income and any other information required by the IRS. *I.R.C. § 108(i)(5)(B)(i)(II)*. The election is made on an instrument-by-instrument basis, and once made, the election is irrevocable. *I.R.C. § 108(i)(5)(B)(ii)*.

(n49)Footnote 49. *I.R.C. § 108(i)(5)(B)(ii)*.

(n50)Footnote 50. *I.R.C. § 108(i)(5)(C)*.

(n51)Footnote 51. *I.R.C. § 108(i)(3)(A)*. A debt instrument is defined to include a bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness within the meaning of section 1275(a)(1). *I.R.C. § 108(i)(3)(B)*.

(n52)Footnote 52. *I.R.C. § 108(i)(4)(A), (B)*.

(n53)Footnote 53. Rev. Proc. 2009-37, 2009-36 I.R.B. 309.

(n54)Footnote 54. I.R.C. § 108(i)(5)(C).B(ii); Rev. Proc. 2009-37, 2009-36 I.R.B. 309.

(n55)Footnote 55. Rev. Proc. 2009-37, 2009-36 I.R.B. 309.

(n56)Footnote 56. If the proceeds of a debt instrument are used directly or indirectly by the issuer to reacquire an applicable debt instrument of the issuer, the debt instrument will be treated as issued for the applicable debt instrument. If only a portion of the proceeds are used, the OID deferral rule will only apply to that portion of the debt instrument. *I.R.C. § 108(i)(2)*.

(n57)Footnote 57. If the OID accruals during the five year deferral period exceed the deferred COD income, the OID deductions are disallowed in the order the OID is accrued. *I.R.C. § 108(i)(2)*.

(n58)Footnote 58. I.R.C. § 108(i)(5)(B)(i)(II); Rev. Proc. 2009-37, 2009-36 I.R.B. 309.

(n59)Footnote 59. See Rev. Proc. 2009-37, 2009-36 I.R.B. 309 (providing a description of, and the time and manner for reporting, the additional information).

(n60)Footnote 60. See Rev. Proc. 2009-37, 2009-36 I.R.B. 309.

(n61)Footnote 61. *I.R.C. § 108(i)(6)*.

(n62)Footnote 62. Rev. Proc. 2009-37, 2009-36 I.R.B. 309.

(n63)Footnote 63. *I.R.C. § 108(i)(6)*.

(n64)Footnote 64. See Jenks et al., *Emerging Issues Analysis on the New COD Deferral Election* (LexisNexis).

(n65)Footnote 65. *I.R.C. § 108(i)(5)(D)(i)*.

(n66)Footnote 66. *I.R.C. § 108(i)(5)(D)(ii)*.

(n67)Footnote 67. *I.R.C. § 108(a)(1)(E)*; H.R. Rep. No. 110-356, at 56 (2007).

(n68)Footnote 68. The exception does not apply to debt discharged on account of services performed for the lender or any other factor not directly related to the decline in the value of the residence or the financial condition of the taxpayer. *I.R.C. § 108(a)(1)(E)*, as amended by the Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142 (2007), and extended by the Emergency Economic Stabilization Act of 2008, Pub. L. No. 110-343 (2008); *I.R.C. § 108(h)(3)*.

If a portion of a discharged loan is not qualified principal residence indebtedness, section 108(a)(1)(E) applies only to the extent that the amount discharged exceeds the non-qualifying portion of the loan (as determined immediately prior to the discharge). *I.R.C. § 108(h)(4)*.

(n69)Footnote 69. *I.R.C. § 108(h)(2)*. Acquisition indebtedness includes any debt incurred to acquire, construct or substantially improve the taxpayer's principal residence if the debt is secured by the residence, as well as any refinancing of that debt to the extent of the prior debt. *I.R.C. § 163(h)(3)(B)*.

Principal residence has the same meaning as when used in section 121. *I.R.C. § 163(h)(5)*.

(n70)Footnote 70. *I.R.C. § 108(h)(1)*.

(n71)Footnote 71. *I.R.C. § 368(a)(1)(E)*.

(n72)Footnote 72. *See, e.g., Camp Wolters Enterprises, Inc. v. Commissioner*, 22 T.C. 737, 750-53 (1954) , *aff'd*, 230 F.2d 555 (5th Cir.) , *cert. denied*, 352 U.S. 826 (1956) (notes maturing in 5 to 9 years held to be securities); *Commissioner v. Freund*, 98 F.2d 201 (3d Cir. 1938) (mortgage bonds maturing serially over 6 years held to be securities); *George A. Nye v. Commissioner*, 50 T.C. 203, 212-14 (1969), *acq.*, 1969-2 C.B. 320 (10-year promissory notes held to be securities); *D'Angelo Assocs., Inc. v. Commissioner*, 70 T.C. 121, 134 (1978) (short-term notes may be considered securities when the stated maturity is unrealistic or ignored by the parties); *Prenti's v. United States*, 273 F. Supp. 460 (S.D.N.Y. 1967) (notes with six-month term qualified as securities because they were part of a plan for delayed issuance of preferred stock); *Priv. Ltr. Rul. 200139009* (June 27, 2001) (expressing no opinion on whether debt having a term of less than ten years is a security for federal tax purposes, in ruling that no gain or loss will be recognized by holders on the exchange of old debt constituting securities for new debt constituting securities, I.R.S. cautioned that it expressed no opinion on whether debt having a term of less than ten years is a security for federal tax purposes); *cf. Bradshaw v. United States*, 683 F.2d 365, 231 Ct. Cl. 144 (Ct. Cl. 1982) (installment notes payable over 2 1/2-6 1/2 years did not constitute securities); Martin Lipton & George A. Katz, "Notes" Are Not Always Securities, 30 *Bus. Law.* 763 (1975).

It has been argued that the IRS should treat even short-term debt of troubled issuers as "securities" because the legislative history to section 368(a)(1)(E) illustrates Congress's desire to "encourage legitimate reorganizations required to strengthen the financial condition of a corporation," *see* Los Angeles County Bar Association Taxation Section Corporate Tax Committee, *Restructuring the Debt of Financially Troubled Companies*, BNA Daily Tax Report (May 9, 2003) (arguing that imposing tax on a deemed or actual modification of even short-term debt of a troubled issuer contravenes Congressional purpose by discouraging private debt restructurings and increasing the likelihood of bankruptcies that are more costly to the parties and to the economy).

(n73)Footnote 73. *Rev. Rul. 2004-78, 2004-31 I.R.B. 108* . The scope of this ruling is unclear. The context of the ruling was a two-year note with only one substantive change in terms (the interest rate) in a reorganization under section 368(a)(1)(A). Query whether a note with a maturity of less than two years, a note with more than one change in its terms or a note exchanged in any other tax-free reorganization would qualify as a security. For an excellent discussion of the implications of this ruling, *see* Simon Friedman, *Debt Exchanges after Rev. Rul. 2004-78* , 105 *Tax Notes* 979 (Nov. 15, 2004).

(n74)Footnote 74. *I.R.C. § 354(a)(1)*.

(n75)Footnote 75. *I.R.C. § 354(a)(2)(B)*; *see also I.R.C. §§ 483; 1274*.

(n76)Footnote 76. *See H.R. Rep. No. 96-833*, at 33 (1980).

(n77)Footnote 77. *See generally I.R.C. §§ 165; 166*.

(n78)Footnote 78. *TAM 9538007* (June 13, 1995) ; *FSA 2000-18-017* (Jan. 13, 2000) . *See P TX9.04[3][b] infra* for a discussion of OID accrual cases of doubtful collectibility.

(n79)Footnote 79. *I.R.C. §§ 354(a)(2)(A); 356(d)(2)(B)*.

(n80)Footnote 80. *Rev. Rul. 71-427, 1971-2 C.B. 183* .

(n81)Footnote 81. *I.R.C. § 356(d)*.

(n82)Footnote 82. *See Treas. Reg. § 1.1274-(2)(b)(1)*.

(n83)Footnote 83. New York State Bar Association, Tax Section. *Report on Excess Principal Amount of Securities*

under Section 356, 95 TNT 31-25 (Feb. 15, 1995).

(n84)Footnote 84. *I.R.C. § 358.*

(n85)Footnote 85. *I.R.C. § 1223(1).*

(n86)Footnote 86. *I.R.C. § 1001(a) and (c); Treas. Reg. § 1.1001-1(g).*

(n87)Footnote 87. *I.R.C. § 1001(a).* This result may occur, for example, where a holder had accrued interest income not yet reported on the cash method of tax accounting, when all or a portion of the debt had been deducted by the holder as a bad debt, or when a holder acquired the debt (usually after issuance) at a deep discount.

(n88)Footnote 88. *Treas. Reg. § 1.1001-1(g).*

(n89)Footnote 89. *See P 9.04[2] below for a more detailed discussion of issue price.*

(n90)Footnote 90. *See Rev. Rul. 89-122, 1989-2 C.B. 200 .*

(n91)Footnote 91. *See Rev. Rul. 79-292, 1979-2 C.B. 287 ; Rev. Rul. 73-328, 1973-2 C.B. 296 .*

(n92)Footnote 92. *I.R.C. § 1274(b)(3)(A).*

(n93)Footnote 93. *I.R.C. § 1274(b)(3)(B)(ii)(I); Treas. Reg. § 1.1274-3(a)(2)(i).*

(n94)Footnote 94. *I.R.C. § 1274(b)(3)(A).*

(n95)Footnote 95. *Treas. Reg. § 1.166-3(a)(2).*

(n96)Footnote 96. *See T.D. 8767, 1998-15 I.R.B. 5 (Jan. 28, 1998) (preamble to the final regulations); T.D. 8676, 1996-30 I.R.B. 4 (June 24, 1996) (preamble to the temporary regulations).*

(n97)Footnote 97. *See Treas. Reg. § 1.166-3(a)(3) (effective Sept. 23, 1996).*

(n98)Footnote 98. *Treas. Reg. § 1.166-3(a)(3)(ii)(A).* The regulations apply only if (i) a significant modification of a debt instrument results in gain recognition under Treasury regulation section 1.1001-1(a), and (ii) debt was previously charged off and deducted by the taxpayer, satisfying the requirements of Treasury regulation section 1.166-3(a)(1) and (2).

(n99)Footnote 99. *Treas. Reg. § 1.166-3(a)(3)(iii).*

(n100)Footnote 100. *See Treas. D. 8763, 1998-15 I.R.B. 5, 6 (Jan. 28, 1998) (rejecting commentators' requests to allow a deemed charge-off for debt acquired at a discount and for which a prior owner claimed a deduction for partial worthlessness, including debt purchased at a discount by one member of a consolidated group by another member).*

(n101)Footnote 101. *Treas. Reg. § 1.988-2(b)(5)(ii), (9) (examples 4 and 5).*

(n102)Footnote 102. *Treas. Reg. § 1.1272-1(g).*

(n103)Footnote 103. *Treas. Reg. § 1.1272-1(g).*

(n104)Footnote 104. *Treas. Reg. § 1.171-1(b)(2).*

(n105)Footnote 105. *Treas. Reg. § 1.1012-1(a).*

(n106)Footnote 106. *Treas. Reg. § 1.1012-1(g)*.

(n107)Footnote 107. *I.R.C. § 1223(1)*.

(n108)Footnote 108. *I.R.C. Section 582(c)* provides that the sale or exchange of a bond, debenture, note or certificate, or other evidence of indebtedness by a bank or certain other financial institutions shall not be considered the sale or exchange of a capital asset. Accordingly, any gain recognized by such holders will be ordinary income.

(n109)Footnote 109. *I.R.C. § 1276(a)(1)*.

(n110)Footnote 110. *I.R.C. § 1271(a)(1)*.

(n111)Footnote 111. *I.R.C. § 1222(1)* and (3).

(n112)Footnote 112. *I.R.C. § 1276(a)*.

(n113)Footnote 113. *See I.R.C. § 1276(c)(2)(A) and (d)(1)(B)*.

(n114)Footnote 114. *I.R.C. § 1276(a)*.

(n115)Footnote 115. *See I.R.C. § 1278(a)(1)*.

(n116)Footnote 116. *TAM 200120001 (July 28, 2000)* (citing to *United States v. Midland Ross Corp.*, 381 U.S. 54 (1965) (holding that gain on the sale of a note attributable to OID was equivalent to interest and taxable as ordinary income)); *see also* S. Rep. No. 98-169, at 155 (1984) (legislative history finding that OID and market discount are economically equivalent for a noteholder).

(n117)Footnote 117. *TAM 200120001 (July 28, 2000)* .



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Collier on Bankruptcy Taxation

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CHAPTER TX9 Debt for Debt Exchanges

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P TX9.04 Original Issue Discount ("OID") Rules

[1] General Rules

The basic rules governing OID are contained in *sections 1271 through 1275 of the Internal Revenue Code* and the Treasury Department final regulations issued in 1994 (the "OID Regulations"), which expand and illustrate the rules provided by the Internal Revenue Code. The *I.R.C. section 988* rules apply in conjunction with the OID rules to securities denominated in a foreign currency. The OID Regulations also include an anti-abuse rule that permits the IRS to apply or depart from the regulations discussed below as it deems necessary to ensure a reasonable result in light of the purposes of the OID-related sections of the Internal Revenue Code. n1

A debt instrument (sometimes referred to below as a "note") is treated as issued with OID (sometimes referred to below as a "discount note") if the excess of the note's "stated redemption price at maturity" over its issue price is greater than a *de minimis* amount. n2 The "stated redemption price at maturity" of a note is the sum of all payments provided by the note other than payments of "qualified stated interest." n3 A "qualified stated interest" payment includes any payment of stated interest on a note that is unconditionally payable at least annually at a single fixed rate (or at certain floating rates) that appropriately takes into account the length of the interval between stated interest payments. n4 Notes with an interest holiday, "cash flow" notes, and "zero coupon" notes that do not pay interest, are examples of notes that do not have qualified stated interest.

If the terms of any debt instrument issued on or after August 13, 1996, are modified to defer one or more payments in a manner that does not cause a deemed exchange under section 1001, then solely for purposes of the OID rules under sections 1272 and 1273, the debt instrument is treated as retired and then reissued on the modification date for an amount equal to the instrument's adjusted issue price on that date. n5 As a result, a deferral of interest payments that is not a significant modification under section 1001 could nevertheless cause a non-OID instrument to be reissued as an OID instrument if interest payments cease to constitute "qualified stated interest."

[2] Issue Price

Generally, the issue price of a note is the first price at which the note is sold. n6 As a result, the issue price of a note will depend on whether the note is issued for cash or property, and in the latter case, whether the notes are publicly traded. In the case of notes issued (in part or solely) for cash, the issue price of a note is the amount of consideration received from a purchaser by the issuer. n7 The same rule essentially applies in the case of publicly traded debt that is issued in

exchange for property (including outstanding debt). Where debt is exchanged for other debt, the issue price of the new debt will be the fair market value (the trading price) of the debt if either the debt or the property for which it is issued (including outstanding debt) is publicly traded. n8 A debt instrument issued in a debt-for-debt exchange will be considered publicly traded if, at any time during the 60 day period ending 30 days after the exchange, n9 the debt falls in any one of the following four categories: n10

- The debt is listed on a national securities exchange (e.g., New York Stock Exchange), an interdealer quotation system (e.g., NASDAQ), or a foreign exchange or board of trade that is designated by the IRS (e.g., the Frankfurt Stock Exchange); n11
- The debt is traded either on a board of trade designated as a contract market by the Commodities Futures Trading Commission or on an interbank market; n12
- The debt appears on a system of general circulation (including a computer listing disseminated to subscribing brokers, dealers, or traders) that provides a reasonable basis to determine fair market value by disseminating either recent price quotations (including rates, yields, or other pricing information) of one or more identified brokers, dealers, or traders or actual prices (including rates, yields, or other pricing information) of recent sales transactions (a quotation medium). A quotation medium does not include a directory or listing of brokers, dealers, or traders for specific securities, such as yellow sheets, that provides neither price quotations nor actual prices of recent sales transactions; n13
- Price quotations for the debt are readily available from dealers, brokers or traders. This is not the case if (A) no other outstanding debt instrument of the issuer (or of any person who guarantees the debt instrument) falls in the category of one of the three prior bullets; (B) the original stated principal amount of the issue that includes the debt instrument does not exceed \$25 million; (C) the conditions and covenants relating to the issuer's performance with respect to the debt instrument are materially less restrictive than the conditions and covenants included in all of the issuer's other traded debt (e.g., the debt instrument is subject to an economically significant subordination provision whereas the issuer's other traded debt is senior); or (D) the maturity date of the debt instrument is more than 3 years after the latest maturity date of the issuer's other traded debt. n14

If there is any temporary restriction on trading a purpose of which is to avoid the characterization of the property as one that is traded on an established market for federal income tax purposes, then the debt is treated as traded on an established market. n15 However, a debt instrument is not treated as traded on an established market solely because the debt instrument is convertible into property that is so traded. n16

If neither an existing debt instrument nor any debt instrument issued in a debt-for-debt exchange is publicly traded, the issue price of the newly-issued debt instrument will generally be its stated principal amount if the note bears "adequate stated interest." n17 If a nonpublicly traded note does not bear adequate stated interest, its issue price will generally be its imputed principal amount. n18 Such imputed principal amount equals the present value of all payments due under the note (including interest), using a discount rate equal to the applicable federal rate ("AFR") in effect when the note is issued. n19

Notwithstanding the above described rules, a debt instrument will have a fair market value issue price if it is issued under "potentially abusive" circumstances. n20 Because this test is fact-based, it is easily subject to challenge by the IRS. The OID regulations provide several examples of potentially abusive circumstances, including, for example, the issuance of a debt instrument with clearly excessive interest, as determined in light of the issuer's creditworthiness, among other factors. n21 An issuer's determination as to whether a debt instrument has been issued in a potentially abusive situation is binding on all holders, absent disclosure by a holder taking a contrary position. n22

Some notes that bear stated interest and are issued at par may nevertheless bear OID. For example, a note may bear OID where, among other things, (i) the note bears interest at a floating rate (a "Floating Rate Note") and provides for a maximum interest rate or a minimum interest rate that is reasonably expected as of the issue date to cause the yield on the note to be significantly less (in the case of a maximum rate) or more (in the case of a minimum rate) than the expected yield determined without the maximum or minimum rate, as the case may be; n23 (ii) the note is a Floating Rate Note that provides for significant front-loading or back-loading of interest; n24 or (iii) the note bears interest at a floating rate in combination with one or more other floating or fixed rates. n25 Many notes issued in workouts have both fixed and floating interest rate components. For example, a restructured note may provide for both the payment of interest at a fixed rate over the term of the note and also for the payment of additional interest at a floating rate that increases over time. Such a floating rate is designed to effect a "cash sweep" of available borrower funds, which are typically projected to increase over time as the borrower's fortunes improve.

Investment units, which are comprised of debt and other property, are often received by lenders in debt restructurings. The issue price of such an investment unit is determined according to the above described rules as if the investment unit were a debt instrument. The resulting issue price is then allocated between the debt instrument and other property based on their relative fair market values. n26

[3] OID Accrual Rules

Holders of notes that mature more than one year from the date of issue may be required to include OID in gross income before the receipt of cash attributable to such income, without regard to the holder's method of accounting for tax purposes. n27 The amount of OID includible in such holder's gross income is the sum of the "daily portions" of OID with respect to a note for each day during the taxable year or portion of the taxable year in which the holder holds such note ("accrued OID"). n28 The daily portion of accrued OID is determined by allocating to each day in any "accrual period," a *pro rata* portion of the OID allocable to that accrual period. n29 Under OID Regulations, accrual periods with respect to a note may be any set of periods (of varying lengths) selected by the holder as long as (i) no accrual period is longer than one year and (ii) each scheduled payment of interest or principal on the note occurs on either the first day or final day of an accrual period. n30

The amount of OID allocable to an accrual period equals the excess of (a) the product of the note's adjusted issue price at the beginning of the accrual period and the note's yield to maturity (determined on the basis of compounding at the close of each accrual period and properly adjusted for the length of the accrual period) over (b) the sum of any payments of qualified stated interest on the discount note allocable to the accrual period. n31 The "adjusted issue price" of a note at the beginning of the first accrual period is the note's issue price, and at the beginning of any accrual period thereafter is (x) the sum of the issue price of such note, the accrued OID for each prior accrual period (determined without regard to the amortization of any acquisition premium or bond premium, which are both discussed below), and the amount of any then accrued, unpaid qualified stated interest on the note, less (y) any prior payments on the note other than qualified stated interest payments. n32 The adjusted issue price at the beginning of such accrual period is reduced by the amount of any payment that is made on the first day of an accrual payment period (other than a payment of qualified stated interest). n33

Where a portion of the initial purchase price of a note is attributable to interest that accrued prior to the note's issue date, the holder may elect to decrease the issue price of the note by the amount of pre-issuance accrued interest if the first stated interest payment on the note will equal or exceed the amount of pre-issuance accrued interest and will be made within one year of the note's issue date. n34 If a holder so elects, a portion of the first stated interest payment will be treated as a return of the excluded pre-issuance accrued interest rather than as an amount payable on the note. n35

Under the OID Regulations, any reasonable method may be used to determine the amount of OID allocable to a short initial accrual period, assuming all other accrual periods are of equal length, provided that the amount of OID allocable to the final accrual period equals the excess of the amount payable at the maturity of the note (other than any final

payment of qualified stated interest) over the note's adjusted issue price as of the beginning of such final accrual period. n36 In addition, if an interval between payments of qualified stated interest on a note contains more than one accrual period, the amount of qualified stated interest payable at the end of such interval is allocated *pro rata* (on the basis of their relative lengths) between the accrual periods contained in the payment interval. n37

In general, if the excess of a note's stated redemption price at maturity over its issue price is *de minimis*, such excess constitutes " *de minimis* OID." n38 Under the OID Regulations, unless a holder elects to treat all interest as original issue discount, such a note will not be treated as issued with OID, n39 and a holder of such a note will recognize capital gain with respect to such *de minimis* OID as stated principal payments on the note are made. n40 The amount of capital gain with respect to each such payment will equal the product of the total amount of the note's *de minimis* OID and a fraction, the numerator of which is the amount of the principal payment made and the denominator of which is the stated principal amount of the note. n41

[a] OID Accrual on Short-Term Debt Instruments

Special rules apply with respect to OID on notes that mature one year or less from the date of issuance ("short-term notes"). In general, a cash basis holder of a short-term note is not required to include OID in income as it accrues for tax purposes, although such a holder may elect to do so. n42 However, accrual basis holders and certain holders, including banks, regulated investment companies, dealers in securities, n43 and electing cash basis holders who so elect n44 are required to include OID n45 in income as it accrues on short-term notes on either a straight-line basis or under the constant yield method (based on daily compounding), at the election of the holder. n46 In the case of a holder that is not required (and does not elect) to include OID in income currently, any gain realized on the sale or retirement of short-term notes will be ordinary income, generally to the extent of the OID accrued on a straight-line basis through the date of sale or retirement. n47 Holders who are not required and do not elect to include OID on short-term notes in income as it accrues will be required to defer deductions for interest on borrowing allocable to short-term notes in an amount not exceeding the deferred income until the deferred OID income is realized. n48

Any holder of a short-term note can elect to apply the rules in the preceding paragraph taking into account the amount of "acquisition discount," if any, with respect to the note (rather than the OID with respect to such note). n49 Acquisition discount is the excess of the stated redemption price at maturity of the short-term note over the holder's purchase price therefor. n50 Acquisition discount will be treated as accruing on a ratable basis or, at the election of the holder, on a constant- yield basis. n51 For purposes of determining the amount of OID subject to these rules, the OID Regulations provide that although no interest payments on a short-term note are qualified stated interest, n52 such interest payments are included in the short-term note's stated redemption price at maturity. n53

[b] OID Accrual in Cases of Doubtful Collectibility

Under case law and I.R.S. rulings, accrual method creditors may discontinue accruing interest where there is no reasonable expectation that the income will be collected. n54 By contrast, with respect to OID, the Service has taken the questionable position that creditors must continue to accrue OID income despite the doubtful collectibility of such income. n55 The Service has taken the position that the "no reasonable expectation of payment" exception should be strictly construed and interest income must be accrued until the loan becomes uncollectible. n56 In addition, the IRS has indicated that the OID provisions are intended to match the holder's income with the issuer's deductions, and cites legislative history stating that the borrower on an OID instrument is deemed to pay annual interest, which the lender is deemed to receive and then relend to the borrower. n57

The Service's argument with respect to the mismatch potential if holders need not accrue OID can easily be rebutted in light of the fact that the "doubtful collectibility" exception to the accrual of stated interest income creates the same mismatch potential as OID. In fact, an I.R.S. official has publicly acknowledged that the disparity between requiring matching OID accruals and allowing nonaccrual of coupon interest in doubtful collectibility cases is a policy question

that will eventually need to be addressed. n58

Further, the Service's reliance on the payment-then-relending construct in the legislative history appears misplaced. Another passage in the legislative history to the OID provisions indicates that the construct is used only to provide a theoretical basis for the issuer's deduction, the holder's income inclusion, and the economic accrual or compounding of interest. n59 Numerous other provisions in the legislative history clearly state that OID is to be treated as interest for tax purposes, including the accrual method of accounting, providing ample evidence of Congress's intent n60 that OID be treated as interest for all federal income tax purposes, including section 451 and the accrual method regulations thereunder. The author believes that the authorities stating that the accrual method requirements are not satisfied where interest collection is doubtful should also apply for purposes of accruing OID income. n61

As noted above, the foregoing argument may also be employed to prevent insolvent issuers from deducting OID. Although early cases held that an issuer of a debt obligation can continue to deduct interest even after there was no intention or expectation that it would ever be paid, n62 later courts have questioned this rule, and have declined to permit deductions by hopelessly insolvent obligors. n63

In addition, the I.R.S. appears to believe that issuers of undersecured nonrecourse debt may not properly deduct OID with respect to such debt. A 1987 General Counsel Memo interprets the OID legislative history as disallowing an issuer's deductions for accrued OID on nonrecourse debt when and to the extent the value of the property securing the nonrecourse debt does not exceed the principal balance of the obligation, plus the amount of OID previously deducted at the time of such deduction. n64

It is not clear whether deductions that are disallowed under this rule would be permanently lost or merely postponed until the value of the property once again exceeds the outstanding amount of the debt.

[c] Allocation of Payments Between Interest/OID and Principal

Historically, parties could control the allocation of payments between principal and interest through an arm's-length expression of intent. n65 Absent such an agreement, payments made on debt before retirement were generally applied first to accrued unpaid interest and then to principal, and payments made at maturity were applied proportionately to accrued unpaid interest and principal. n66 However, courts have held that a final payment where principal is not recovered can be allocated solely to principal. n67

The *I.R.C. section 446* regulations and the OID regulations may have curtailed, and the IRS would argue eliminated, the ability of taxpayers to control the allocation of these payments. Under these regulations, payments must be allocated first to accrued unpaid interest or OID, and then to principal. n68 It is not clear whether either or both of Treasury regulation section 1.446-2(e), which applies to "each payment under a loan," and Treasury regulation section 1.1275-2(a), which applies to "each payment under a debt instrument," are intended to cover payments made in partial or complete discharge of debt. Commentators have persuasively argued that, as a policy matter, the regulations should not apply in distressed situations where the holder does not recover the outstanding principal balance on its loan. n69 If the regulations do not apply, the case law permitting taxpayers to control the allocation of payments by agreement, as well as the case law allocating payments to principal in distressed situations, should apply. n70

For cash basis holders, allocating more of a final payment to principal would decrease the holder's ordinary interest income instead of producing a larger capital loss. Where the holder is an accrual basis taxpayer, or a final payment is made on a debt instrument with OID rather than interest, interest or OID will already have accrued (unless collection of the interest or OID was doubtful). Thus, there is an issue as to whether the loss on the debt can be treated as ordinary to the extent of prior interest or OID income accruals. While there is no direct authority for this proposition, analogous authority in the legislative history to *I.R.C. section 354(a)(2)(B)*, n71 the contingent payment debt instrument regulations, n72 the bond premium amortization regulations, n73 and the bad debt regulations n74 each provide support

for the position that losses on debt may be treated as ordinary to the extent of prior income accrual. Nonetheless, the I.R.S. may be expected to challenge ordinary loss treatment in the absence of direct authority.

[4] Debt Instruments Acquired at a Premium

A note purchased at its original issuance for an amount in excess of its issue price but less than its stated redemption price at maturity will bear "acquisition premium" equal to the difference between the purchase price and the issue price. n75 A holder of such a note that does not elect to treat all interest as OID (as described below) is permitted to reduce the daily portions of OID by a fraction, the numerator of which is the acquisition note price over the issue price, and the denominator of which is the excess of the sum of all amounts subsequently payable on the note other than payments of qualified stated interest over the note's issue price. n76 Alternatively, a holder may elect to compute OID accruals under the general OID rules, treating the holder's purchase price as the issue price. n77

Under the Code, a holder that purchases a note for an amount in excess of its principal amount n78 will not be subject to the OID rules. n79 Such a holder may elect to treat such excess as "amortizable bond premium," n80 in which case the amount of qualified stated interest that must be included in the holder's income each year with respect to interest on the note will be reduced by the amount of amortizable bond premium allocable to such year (based on the note's yield to maturity). n81 The regulations prescribe rules for making the election and amortizing premium on the constant yield method, but the regulations do not apply to certain debt instruments, including regular interests in a REMIC, qualified mortgages held by a REMIC, and certain other debt instruments (or pools of debt instruments) with payments subject to acceleration as described in *I.R.C. section 1272(a)(6)(C)*. n82 Any election by a holder to amortize bond premium is applicable to all bonds (other than bonds on which interest is excludible from gross income) held by the holder at the beginning of the first taxable year to which the election applies or thereafter acquired by the holder, and the election may not be revoked without the consent of the IRS. n83

[5] Notes Purchased at a Market Discount

A debt instrument, other than a short-term note, n84 will be treated as issued at a market discount (a "market discount note") if the issue price of the note exceeds the amount for which a holder purchased the note by more than a *de minimis* amount. n85 This *de minimis* carve-out is similar to the carve-out for *de minimis* OID described above. n86 Absent a holder election, accrued market discount is not required to be currently included in a holder's income. n87 Instead, any partial payment of principal on, or gain recognized on the maturity or disposition of, a market discount note generally will be treated as ordinary income to the extent that such gain does not exceed the accrued market discount on such note. n88 Market discount accrues on a straight-line basis unless the holder elects to accrue such discount on a constant yield to maturity basis. n89 A constant yield election is applicable only to the note with respect to which it is made and is irrevocable. n90 A holder of a market discount note that does not elect to include market discount in income currently will generally be required to defer deductions for interest on borrowings allocable to such note in an amount not exceeding the accrued market discount on such note until the maturity or disposition of such note. n91

[6] Optional Redemptions (the Put and Call Rules)

Certain issuer options to redeem a note and holder options to cause a note to be repurchased prior to the note's stated maturity will be presumed to be exercised. This result obtains if, by treating any date on which such note may be redeemed or repurchased as the maturity date for the note and the amount payable on such date in accordance with the terms of such note (the "redemption price") as the stated redemption price at maturity, the yield on the note would (i) in the case of an issuer option, be lower than its yield to stated maturity, or (ii) in the case of a holder option, be higher than its yield to stated maturity. n92 If such an option is not in fact exercised on a presumed exercise date, the note would be treated solely for OID purposes as if it were redeemed or repurchased on that date and a new note were then issued for an amount equal to the note's then adjusted issue price. n93 If the deemed reissued note has subsequent repurchase options, the above-described yield calculations would be performed once again to determine whether such

options should again be presumed exercised.

[7] Election To Treat All Interest as Original Issue Discount

Any holder may elect to include in gross income all interest that accrues on a note using the constant yield method described above under the general OID rules, with certain modifications. n94 For purposes of this election, interest includes stated interest, OID, *de minimis* OID, market discount, acquisition discount, *de minimis* market discount and unstated interest (as adjusted by any amortizable bond premium or acquisition premium). n95 If such election is made, the constant yield method is applied to a note as follows: the issue price of the note will equal the electing holder's adjusted basis in the note immediately after its acquisition, the issue date of the note will be treated as the date of its acquisition by the electing holder, and no payments on the note will be treated as payments of qualified stated interest. n96 This election is generally applicable only to the note with respect to which it is made and may not be revoked without the consent of the IRS. n97

If the election described above to apply the constant yield method to all interest on a note is made with respect to a market discount note, the electing holder will be treated as also having made the election to include market discount in income currently over the life of all other debt instruments, then held or thereafter acquired by such holder. n98

[8] Contingent Payment Debt Instruments

Four sets of proposed regulations governing contingent payment debt instruments have been issued since 1986. Final regulations were issued in 1996 that are effective for instruments issued on or after August 13, 1996. According to the preamble to the final regulations, taxpayers may use any reasonable method to account for contingent payment debt instruments issued before August 13, 1996, including a method that would have been required under the proposed regulations when the debt instrument was issued. n99 Thus, a brief description of the previous rules is in order.

Generally, for pre-August 13, 1996 instruments, contingent interest would not be includible in income until the amount of interest becomes fixed or the payment is made. Under the 1986 Proposed Regulations, debt instruments issued for cash or publicly traded property calling for contingent payments equal to or greater than the issue price were separated into a non-contingent component analyzed under normal OID rules, and a contingent component payments under which were treated as interest payments when the contingent payments were fixed. n100 The treatment of instruments subject to *I.R.C. section 1274* was governed by rules similar to the rules governing such instruments under the final regulations. n101 The 1991 Proposed Regulations provided a bifurcation method for certain instruments calling for contingent payments determined by reference to the value of publicly traded property, applying OID rules to the non-contingent component and treating the contingent component as non-debt. n102 The 1993 Proposed Regulations would have allowed a choice between five different methods of determining the amount of accrued interest on a market-based contingent payment debt instrument. n103 All three sets of proposed regulations were superseded by proposed regulations issued in 1994, n104 which set forth the "non-contingent bond method" for all contingent payment debt instruments issued for publicly traded property, and a separate rule for instruments issued for non-publicly traded property. The final regulations adopt the methods provided in the 1994 Proposed Regulations with a few changes.

The final contingent debt regulations apply to any instrument that is characterized as debt for tax purposes and provides for at least one contingent payment. n105 For this purpose, payments that are subject only to "remote" or "incidental" contingencies do not qualify as contingent payments. n106 Remote contingencies are those that are unlikely to come to pass, n107 and incidental contingencies are those that involve payments that are insignificant relative to the total projected payments under an instrument. n108

The final regulations adopt the so-called non-contingent bond method for debt instruments with issue price governed by *I.R.C. section 1273*, *i.e.*, instruments that are publicly traded or issued in exchange for publicly traded property. n109 A different method is provided for debt instruments whose issue price is governed by *I.R.C. section 1274*. The

non-contingent bond method follows the OID regulations, which take the position that the entire accrued amount (calculated as described below) in any given year is taxable to the holder as interest income, and may be deducted by the issuer, in such year. n110 In effect, the noncontingent bond method treats estimated contingent payments in the same manner as fixed payments, and requires the current accrual of such amounts consistent with the OID Regulations. n111

Implementation of the non-contingent bond method requires (i) the determination of the comparable yield at which the issuer could (and would) issue a fixed rate debt instrument with terms and conditions similar to the contingent payment debt instrument, n112 (ii) the creation of a projected payment schedule, which must produce the comparable yield, n113 (iii) the calculation of the daily interest portion, which equals the product of the comparable yield and the adjusted issue price (determined under *I.R.C. section 1273* and Treasury regulation section 1.1275-4(b)(7)) divided by the number of days in the period, n114 and (iv) a positive or negative adjustment to income or deductions to take into account differences between the projected and actual contingent payment amounts for a given year. n115

The issuer of a debt instrument must first determine the comparable yield on the instrument, which must be a reasonable yield for the issuer and must not be less than the AFR. n116 The issuer must then prepare a projected payment schedule comprised of all non-contingent payments due under a debt instrument and the projected amount of each contingent payment due under such debt instrument. n117 If a contingent payment is based on market information, the amount of the projected payment is the forward price of the contingent payment. n118 If a contingent payment is not based on market information, the amount of the projected payment is the expected value of the contingent payment determined on the issue date. n119 If the projected payment schedule does not produce the comparable yield, the issuer must adjust the payment schedule such that the comparable yield is produced. n120 A market-based payment, which is a payment derived from information on which an objective rate can be based under Treasury regulation section 1.1275-5(c)(1) or (2), n121 will in most cases be substantially similar to an option, future, or similar instrument for which forward pricing is available (or in the absence of forward pricing, spot pricing). If a contingent payment is not based on market information, the amount of the projected payment is the expected value of the contingent payment determined on the issue date. n122 Non-market based payments are payments based on indices that are not quoted in public markets, including, for example, payments based on the value of an issuer's assets. n123 If the projected payment schedule does not produce the comparable yield, the issuer must adjust the payment schedule such that the comparable yield is produced. n124 Where debt is modified in the context of workouts to include contingent payments, such payments will typically constitute non-market based payments.

An issuer's projected payment schedule binds the holder, unless the schedule can be shown to be unreasonable. n125 It should be noted that an issuer would generally prefer to create a projected payment schedule with a high rate of return, since the issuer may contemporaneously deduct amounts equal to the holders' required accruals of interest income. To the extent projected contingent prepayments are not ultimately made, holders would realize a loss when lesser contingent payments were ultimately made.

By contrast, holders would prefer that the projected payment schedule be based on a lower rate of return, so that their interest accruals would be minimized. In the case of restructurings and bankruptcies, it is most likely that the holders will prevail in their efforts to calculate projected yield on the basis of a lower rate of return. First, the holders typically have more power in the context of debt restructurings to dictate the terms of modified debt than in the case of a new issuance of debt. Second, holders of debt of troubled issuers are often less inclined to view a deduction for a troubled issuer as having significant value than in the case of a new debt issuance, in light of the fact that troubled issuers often project future operating losses. The adoption of these rules as final regulations will have an important impact on the form that workouts and bankruptcies take, including whether lenders will continue to agree to decrease the principal amount of outstanding debt in favor of adding a contingent payment feature to the modified debt.

The final step of the non-contingent bond method requires taxpayers to make positive or negative adjustments to income during taxable years in which the taxpayer either holds or is primarily liable on the debt instrument. n126 If a

contingent amount actually paid is more than the projected amount, a positive adjustment arises on the date of payment. n127 If the amount paid is less than the projected amount, a negative adjustment arises on the date of payment (or on the scheduled payment date if the payment amount is zero). n128 A net positive adjustment, *i.e.*, the amount, if any, by which total positive adjustments on a debt instrument in a taxable year exceeds the total negative adjustments on the debt instrument, is treated as additional interest for the taxable year. n129 A net negative adjustment first reduces interest accruals on the debt instrument for the taxable year, and any excess is treated by a holder as ordinary loss, and by the issuer as ordinary income to the extent that the amount of the holder's or issuer's total interest accruals on the debt instrument exceed the aggregate amount of the holder's or issuer's net negative adjustments treated as ordinary income or loss in prior taxable years. n130

If the net negative adjustment would exceed the sum of the amounts treated by the taxpayer as a reduction of interest and as ordinary income or loss on the debt instrument for the taxable year, the excess is carried forward as a negative adjustment on the debt instrument on the first day of the succeeding taxable year. n131 However, if a holder has a negative adjustment carryforward in a taxable year in which the debt instrument is sold, exchanged, or retired, the carryforward reduces the holder's amount realized on the sale, exchange, or retirement. n132 If an issuer has a negative adjustment carryforward in a taxable year in which the debt instrument is retired, the issuer takes the carryforward into account as ordinary income. n133

It should be noted that the 1994 proposed regulations treated an issuer's negative adjustment carryforward in the year in which a debt instrument is retired as COD income under *I.R.C. section 61(a)(12)*. n134

The accounting of contingent payment features in non-publicly traded debt instruments issued in a sale or exchange for non-publicly traded property is governed by Treasury regulation section 1.1275-4(c) which splits debt instruments into contingent and non-contingent payment components. n135

The non-contingent payment portion is treated as a separate debt instrument with issue price equal to the issue price of the overall debt instrument (determined under Treasury regulation section 1.1274-2(g)), and generally taxed under the rules for non-contingent debt instruments. n136 Contingent payments are treated first as payments of principal in an amount equal to the present value of the payment (discounting from the date payment was made to the issue date using the AFR), and any amount of the payment in excess of the amount treated as principal is includible in the holder's income and deductible from the issuer's income as interest when the payment is made. n137 Contingent payments that are fixed more than six months before payment is due are governed by a separate rule that treats the fixed but deferred payment as a separate debt instrument issued on the date the payment is fixed and maturing on the date payment is due. n138

In the context of debt workouts, Treasury regulation section 1.1275-4(c) is likely to apply frequently, since many debt instruments that are the subject of workouts are not publicly traded and non-publicly traded debt instruments that are deemed exchanged under section 1001 and thereafter provide for contingent payments would be subject to the rules under Treasury regulation section 1.1275-4(c). The inclusion of contingent payments in the modified debt generation would have the effect of overstating the borrower's COD, because the value of any contingent payments would not be included in the issue price of the modified debt. n139

[9] High Yield Debt Instruments

Debt instruments of a corporate issuer with more than a five-year term will constitute applicable high yield discount obligations ("HYDOs") if their yield to maturity is equal to or greater than the sum of the AFR for debt instruments at the time an instrument is issued plus five percentage points, and the notes are issued with "significant OID." n140 Significant OID exists if more than one year's interest will be accrued but unpaid at the end of five years. n141 If a debt instrument is a HYDO, an issuer will not be entitled to deduct original issue discount that accrues with respect to such a debt instrument until amounts attributable to such original issue discount are paid in cash or property other than stock or

debt of the issuer. n142 In addition, if the yield to maturity of the debt instrument exceeds the sum of the relevant AFR plus six percentage points (the "Excess Yield"), an issuer's deduction for the "disqualified portion" of the original issue discount accruing on the debt instrument will be disallowed. n143 In general, the "disqualified portion" of the original issue discount for any accrual period will be equal to the product of (i) the Excess Yield divided by the yield to maturity on the debt instrument, and (ii) the OID for the accrual period. n144

Subject to otherwise applicable limitations, holders that are U.S. corporations will be entitled to a dividends received deduction (currently at a 70% rate for holders of less than 20% of the issuer's stock) with respect to any disqualified portion of the accrued original issue discount to the extent that an issuer has sufficient current or accumulated earnings and profits. n145 If part or all of the disqualified portion exceeds the issuer's current and accumulated earnings and profits, the excess will continue to be taxed as ordinary OID income in accordance with the general OID rules described above.

In enacting the HYDO rules, the Senate Finance Committee "expect[ed] that the regulations to be issued by the Secretary of the Treasury may take into account the expected amount of any such contingent payments in determining whether an obligation is an applicable high yield obligation." n146 Treasury has yet to issue such regulations under the HYDO rules. Interestingly, the above-quoted language is followed by the reference, " Cf. Code sec. 1272(a)(6)." n147 Section 1272(a)(6) determines the yield-to-maturity on REMIC regular interests and certain other debt instruments based on the prepayment assumption the parties used to price the transaction. n148 By analogy to the payment assumption model of section 1272(a)(6), it may be reasonable to determine whether debt instruments with reasonably estimable contingent payments are HYDOs by using a yield-to-maturity based on the payment assumptions used to price the debt instrument. However, this analytic may not provide helpful guidance where troubled debtors agree to restructure debt to include contingent payments, since the absence of actual pricing under those circumstances may mean that such contingent payments are not based on reliable payment assumptions. Query whether, in the absence of regulations under the HYDO rules, using the comparable yield determined under the noncontingent bond method would also be a reasonable method of testing the HYDO status of a contingent payment debt instrument. n149 Contingent payment debt instruments governed by Treasury regulation section 1.1275-4(c) generally should not be subject to the HYDO rules by reason of such payments, since the contingent payments would generally be taken into account only when paid.

For purposes of determining whether an instrument has a term of more than five years, section 163(i) provides that any payment on a debt instrument is assumed to be made on the "last day *permitted* under the instrument." n150 At the time an instrument is drafted, it is often difficult to calculate such date. An example of this would be a loan agreement that is structured with senior and junior classes of debt and provides for payment on the junior class only after the more senior class has been repaid. In this case, the "last day permitted" under the junior debt is unknown at the time of issuance. n151 Consequently, it is unclear whether the junior class has a maturity of more than five years, thus subjecting it to the HYDO rules. n152

Another area of considerable uncertainty is the application of the HYDO provisions to issuers that are taxed as partnerships. *I.R.C. section 163(e)(5)(A)* disallows interest deductions only for HYDOs issued by corporations, and *I.R.C. section 163(e)(5)(D)* specifically exempts S corporations from the application of the HYDO rules. However, *I.R.C. Section 163(i)(5)(B)* provides that regulations may be issued to prevent the avoidance of the HYDO rules "through the use of issuers other than C corporations." Consequently, certain HYDOs issued by partnerships may be subject to the HYDO interest deferral and disallowance rules, at least in the case of a partnership issuer formed by corporations and availed of to avoid the HYDO rules.

Moreover, an example in the partnership anti-abuse regulations provides that the existence of a partnership issuer formed by two corporations will be ignored, and each corporate partner will be treated as directly issuing its allocable portion of the partnership's debt obligations for purposes of applying the HYDO rules, without regard to whether the partnership was either formed or chosen as the issuer for the purpose of avoiding the HYDO rules. n153 It should be

noted that the regulation example goes beyond the scope of the statute in its application of the HYDO rules to operating partnership issuers without regard to whether the partnership (or its partners) intended to avoid the HYDO rules through the use of such partnership. Neither the statute nor the regulation example makes clear whether the same treatment would follow for a partnership issuer with non-corporate partners, or whether the lack of a tax-avoidance motive would exempt such a partnership issuer from the HYDO rules under any (or all) circumstances.

As a general matter, the HYDO rules should only be applied, if at all, at the partner level rather than at the partnership level. n154 If a debt instrument constitutes a HYDO, corporate partners of a partnership issuer may not be entitled to deduct original issue discount that accrues with respect to such debt instrument until amounts attributable to such original issue discount are paid. n155 In addition, those partners' deductions for their allocable shares of the disqualified portion of the original issue discount accruing on the notes may be disallowed. In general, the disqualified portion of the OID for any accrual period will be equal to the product of (i) the excess yield divided by the yield to maturity on the debt instrument, and (ii) the OID for the accrual period. n156

In addition, although the issue is extremely unclear, solely for purposes of the dividends received deduction provisions of the Internal Revenue Code, it is possible that a corporate holder of a debt instrument issued by a partnership could treat as a dividend that portion of the excess yield on the instrument that is allocated to U.S. corporate partners of the partnership issuer, to the extent such amount would have been treated as a dividend if it had been distributed by each corporate partner with respect to its stock. n157

In the context of debt workouts, corporate issuers must take into account the HYDO rules. If a debt modification is a "significant modification" under section 1001, the new debt must be retested under the HYDO rules. Debt that was not a HYDO prior to the modification could become subject to the HYDO rules, or conversely (and more rarely), debt that was a HYDO prior to the modification could lose its status as such. n158

In August, 2008, amid a severe financial crisis that restricted lenders' ability to complete financings on previously contemplated terms, the IRS issued *Revenue Procedure 2008-51*. n159 The Revenue Procedure creates an exception from the HYDO rules for certain debt instruments issued by a corporation after August 8, 2008 pursuant to a binding financing commitment obtained prior to January 1, 2009 from an unrelated party (a "Financing Commitment") or in exchange for a debt instrument issued pursuant to a Financing Commitment.

The Revenue Procedure excepts from the HYDO rules debt instruments issued by a corporation pursuant to a Financing Commitment that would not have been subject to the HYDO rules if the issue price equaled the net cash proceeds actually received by the issuer (a "Pre-Committed Debt Instrument"). It also excludes from the HYDO rules certain debt instruments issued in exchange n160 for a Pre-Committed Debt Instrument, including indirectly through a prior exchange. n161

To provide additional relief, in 2009 Congress temporarily suspended the HYDO rules for most debt instruments issued in a deemed or actual exchange for a debt instrument that was not subject to the HYDO rules (or that qualified for the HYDO rules suspension) if the exchange occurs between September 1, 2008 and December 31, 2009. n162 The suspension does not apply to debt instruments issued (i) with contingent interest described in 871(h)(4) n163 or (ii) a related person within the meaning of section 108(e)(4). n164

[10] Foreign Currency Notes

If an interest payment on a note is denominated in or determined by reference to a single foreign currency, or the euro (together, a "Foreign Currency"), the amount of income recognized by a cash basis holder will be the U.S. dollar value of the interest payment, based on the exchange rate in effect on the date of receipt, regardless of whether the payment is in fact converted into U.S. dollars. n165 Accrual basis holders may determine the amount of income recognized with respect to such interest payments in accordance with either of two methods. n166

Under the first method, the amount of income recognized will be based on the average exchange rate in effect during the interest accrual period (or, with respect to an accrual period that spans two taxable years, the partial period within the taxable year). n167 Upon receipt of an interest payment (including a payment attributable to accrued but unpaid interest upon the sale or retirement of a note) determined by reference to a Foreign Currency, an accrual basis holder will recognize ordinary income or loss measured by the difference between such average exchange rate and the exchange rate in effect on the date of receipt, regardless of whether the payment is in fact converted into U.S. dollars. n168

Under the second method, an accrual basis holder may elect to translate interest income into U.S. dollars at the spot exchange rate in effect on the last day of the accrual period or, in the case of an accrual period that spans two taxable years, at the exchange rate in effect on the last day of the partial period within the taxable year. n169 Additionally, if a payment of interest is actually received within 5 business days of the last day of the accrual period or taxable year, an accrual basis holder applying the second method may instead translate such accrued interest into U.S. dollars at the spot exchange rate in effect on the day of actual receipt (in which case no exchange gain or loss will result). n170 Any election to apply the second method will apply to all of a holder's debt instruments held at the beginning of the first taxable year to which the election applies or thereafter acquired by the holder. Such election may not be revoked without the consent of the IRS. n171

Foreign Currency received as interest on a note or on the sale or retirement of a note will have a tax basis equal to its U.S. dollar value at the time such interest is received or at the time the note is sold or retired, as the case may be. n172 Any gain or loss recognized by a holder on the sale or retirement of a note that is attributable to changes in currency exchange rates will be treated as ordinary income or loss, but only to the extent of total gain or loss realized on the transaction. n173

OID for any accrual period on a note that bears OID and is denominated in a Foreign Currency will be determined in the Foreign Currency and then translated into U.S. dollars in the same manner as stated interest accrued by an accrual basis holder. n174 Upon receipt of an amount attributable to original issue discount (whether in connection with a payment of interest or the sale or retirement of a note), a holder may recognize ordinary income or loss. n175 Bond premium on a note that is denominated in a Foreign Currency will be computed in units of the Foreign Currency, and amortizable bond premium will also reduce interest income in units of the Foreign Currency. n176 At the time amortized bond premium offsets interest income on a note, a holder may realize ordinary income or loss, measured by the difference between exchange rates at that time, and at the time the notes are acquired. n177 Market discount is similarly determined in units of the Foreign Currency. n178 Accrued market discount that is required to be taken into account on the maturity or disposition of a note is translated into U.S. dollars at the exchange rate on the maturity or disposition date, as the case may be (and no part is treated as exchange gain or loss). Accrued market discount currently includible in income by an electing holder is translated into U.S. dollars at the average exchange rate for the accrual period (or the partial accrual period during which the holder held the note). Exchange gain or loss is determined on maturity or disposition of the note (as the case may be) in the same manner as the computation of exchange gain or loss on the receipt of accrued interest by an accrual method holder. n179

The IRS has announced that it intends to withdraw and repropose regulations under *I.R.C. Section 988* on contingent payment debt instruments, dual currency debt instruments, and multicurrency debt instruments. n180 The announcement explains that the Internal Revenue Service believes proposed *Treasury Regulation Section 1.988-1(a)(3), (4), and (5)* should be withdrawn because the regulations incorporate a bifurcation approach to debt instruments, rather than the non-contingent bond method adopted under *Treasury Regulation Section 1.1275-4*. In place of the withdrawn regulations, the IRS intends to issue new regulations that would apply the principles of *Treasury Regulation Section 1.1275-4(b)* in nonfunctional currencies and provide for the translation of interest and principal into functional currencies by applying principles similar to those that apply under *I.R.C. Section 988* to instruments with original issue discount.

The IRS issued regulations applying the non-contingent bond method principles n181 to nonfunctional currency contingent payment debt instruments ("CPDIs"). n182 The regulations apply to nonfunctional currency CPDIs issued for cash or publicly traded property as described in Treasury regulation section 1.1275-4(b)(1) or nonpublicly traded property as described in Treasury regulation section 1.1275-4(c)(1), including debt instruments where all principal and interest are denominated in or determined by reference to (i) a single nonfunctional currency and which have one or more non-currency related contingencies, (ii) more than one currency and which have no non-currency related contingencies, or (iii) more than one currency and which have one or more non-currency related contingencies. n183 The translation of interest and adjustments from the denominated currency to the functional currency are determined under the principles of Treasury regulation section 1.988-2(b). n184

[11] Election to Consolidate Debt Issues

Revenue Procedure 2001-21 provides an election that can be used in the case of certain debt exchanges occurring on or after March 13, 2001, to facilitate the consolidation of some or all of the debt instruments from two or more outstanding debt issues. n185 This election allows taxpayers to treat a debt substitution as a realization event even though the exchange does not result in a significant modification in order to permit the fungibility of debt issues. The election is designed to solve the problem created under Treasury regulation section 1.1275-2(j) by the creation of a different amount of OID in the new issue pursuant to the requisite OID redeterminations in certain debt exchanges, which may preclude the fungibility of old and new debt issues after an exchange. n186

Revenue Procedure 99-18, as extended by *Revenue Procedure 2000-29*, generally provided the same election for debt substitutions occurring after March 1, 1999 but before March 13, 2001. However, *Revenue Procedure 2001-21* expands the scope of the debt instruments qualifying for the election in three significant ways. *Revenue Procedure 99-18*, the election applied only to debt instruments from a single new issue that are substituted for debt instruments from two or more old issues. The election now applies also to debt instruments issued in a qualified reopening (as defined in Treasury regulations section 1.1275-2) that are substituted for debt instruments from one or more outstanding issues of debt. Also, the election now applies even if the old debt was issued with more than a de minimis amount of premium. Finally, the requirement that the substitution not result in a significant modification of the old debt may now be satisfied either as of (1) the substitution date, or (2) the date that is two days before the date on which the substitution offer commences, provided such date is no more than 30 business days before the date on which the substitution offer ends. n187

If the election is made, the issuer and the holders can treat a substitution of debt instruments as a realization event for federal income tax purposes. However, instead of recognizing a gain or loss, an electing holder will take into account any gain or loss on the date of the substitution as income or deduction over the term of the new debt instruments. Immediately after the substitution, the holder's basis and holding period with respect to the new debt is the same as the holder's adjusted basis and holding period with respect to the old debt. If the stated redemption price at maturity of the new debt exceeds the holder's basis in the new debt, the holder treats the difference as market discount on the new debt and treats the new debt as a market discount bond. If the holder's basis in the new debt is greater than the stated redemption price at maturity of the new debt, the holder treats the difference as bond premium on the new debt. The issuer must generally take any difference between the adjusted issue prices of the old debt and the new debt into account over the term (or, in the case of a qualified reopening, the remaining term) of the new debt as increased OID, reduced OID, or bond premium.

[12] Consent Fees

Few authorities discuss the treatment of consent fees paid to holders of securities in connection with debt refinancings. The Internal Revenue Service has ruled privately that a corporation's expenses for consent solicitation fees paid to holders in order to effect a restructuring (which is a capital transaction for tax purposes) must be capitalized. n188 Similarly, issuers paying consent fees in connection with debt exchanges would typically be required to capitalize such

fees as an expense incident to a capital transaction. The character of consent fees paid to holders of debt is also uncertain. Treasury regulation section 1.1273-2(g)(2) suggests that such payments made to tendering holders in connection with a disposition may increase the capital gain (or decrease the capital loss) of a holder. n189 Current market practice is to treat consent fees paid to tendering holders as additional consideration paid for the sale or exchange of a capital asset (*i.e.*, the debt instrument that is tendered).]

[13] Reopenings

On January 11, 2001, the Treasury Department issued final regulations that provide rules for determining which debt securities are part of the same "issue" as other debt securities or a "qualified reopening" of a prior issue of debt securities (which is treated as part of the original reopening). n190 The final regulations generally adopt the previously issued temporary regulations (which provided guidance with respect to Treasury securities) and proposed regulations (which provided guidance with respect to debt instruments other than Treasury securities). n191

[a] Reopenings of Treasury Securities

Prior to the issuance of the temporary regulations, in order for Treasury securities to be considered as part of the same issue as previously issued Treasury securities and have the same issue price and issue date as previously issued Treasury securities, the later issued Treasury securities needed to (i) have the same terms as the original Treasury securities, (ii) be issued within 12 months after the original Treasury securities were first issued to the public, and (iii) be issued in a reopening intended to alleviate an acute, protracted shortage of the original Treasury securities. n192 The temporary regulations and the new final regulations eliminate the requirement that the reopening be intended to alleviate an acute, protracted shortage of the original Treasury securities. n193 [Under the final regulations, a reopening of Treasury securities on or after March 13, 2001, is a qualified reopening if either (i) the reopening occurs not more than one year after the issue date of the original securities, *or* (ii) the additional Treasury securities are issued with no more than a *de minimis* amount of OID. n194 If a reopening meets these qualified reopening requirements, any discount attributed to the additional issuance of Treasury securities would constitute market discount and not OID.]

[b] Reopenings of Debt Instruments Other Than Treasury Securities

Generally, two or more debt instruments, each of which was issued on or after April 14, 1994, but before March 13, 2001, are part of the same issue if they have the same credit and payment terms and are sold "reasonably close in time" either (i) pursuant to a common plan, or (ii) as part of a single transaction or a series of related transactions. n195 The final regulations, effective for debt instruments issued on or after March 13, 2001, impose a bright-line window of thirteen days, beginning with the date on which the first debt instrument that would be part of the combined issue is issued to the public, in place of the prior "reasonably close in time" standard. n196

For debt issuances not meeting the requirements of the preceding paragraph, the final regulations provide two circumstances under which a later issuance of debt instruments will be treated as part of the same issue as previously issued debt instruments. Generally, if a reopening of debt instruments satisfies either of the two "qualified reopening" requirements, the later-issued debt instruments would be considered part of the same issue as the original debt instruments, and would (i) carry the same issue date and issue price as the original debt instruments, and (ii) carry the same adjusted issue price with respect to each holder. n197 The qualified reopening rules apply to additional debt instruments that are themselves part of a single issue and that have terms that are identical in all respects to the terms of the original debt instrument as of the reopening date. n198 Since the additional instruments would have the same issue price and redemption price at maturity, any discount attributable to the additional debt instruments (other than the amount of any discount on the original debt instruments) would be market discount rather than OID.

A subsequent issuance will constitute a qualified reopening if the following conditions are satisfied:

- the original debt instruments are publicly traded;
- the issue date of the additional instruments is not more than six months after the issue date of the original debt instruments; and
- On the earlier of the date on which the price of additional instruments is established or the announcement date, n199 the yield of the original instruments based on their fair market value is not more than 110% of the yield of the original debt instruments on their issue date (or the coupon rate, if the original debt was issued with no more than *de minimis* OID). n200

In addition, a reopening of original debt instruments that are publicly traded will also be considered a qualified reopening if the additional debt instruments are issued with no more than a *de minimis* amount of OID. n201 The final regulations do not impose a six-month limit with respect to this second test for qualified reopenings, and so, theoretically, a debt issue can be reopened at any time if this second test is met. Note, however, that this second test does not apply to reopenings of tax-exempt obligations or contingent payment debt instruments. n202

The issuer's deductions for OID on reopened debt instruments will be adjusted if the holder pays more or less than the adjusted issue price of the original debt instruments to acquire an additional debt instrument. The issuer must treat the difference as an adjustment to the issuer's interest expense for all of the original and additional debt instruments in the issue and must take the adjustment into account over the term of the instruments using constant yield principles. n203 If the holder pays more than the adjusted issue price of the original debt instrument, the issuer (but not the holder) must increase the aggregate adjusted prices of all of the original and additional debt instruments in the issue. n204 If the holder pays less than the adjusted issue price of the original debt instrument, the issuer (but not the holder), must reduce the aggregate adjusted issue prices of all of the original and additional debt instruments in the issue. n205

FOOTNOTES:

(n1)Footnote 1. *See Treas. Reg. § 1.1275-2(g).*

(n2)Footnote 2. *I.R.C. § 1273(a); see also FSA 1999-665 (Aug. 9, 1993) (I.R.S. rejected the proposition that OID deductions on a nonrecourse debt instrument should be limited to the amount by which the fair market value of the collateral securing the debt exceeds the adjusted issue price of the debt under the proposed section 1001 regulations).*

(n3)Footnote 3. *Treas. Reg. § 1.1273-1(b).*

(n4)Footnote 4. *Treas. Reg. § 1.1273-1(c).*

(n5)Footnote 5. *Treas. Reg. § 1.1275-2(j).*

(n6)Footnote 6. *I.R.C. § 1273(b)(1).*

(n7)Footnote 7. *I.R.C. § 1273(b)(1).*

(n8)Footnote 8. *I.R.C. § 1273(b)(3)(A) and (B); Treas. Reg. § 1.1273-2(b)(1) and (c)(1).*

(n9)Footnote 9. *Treas. Reg. § 1.1273-2(f)(1).*

(n10)Footnote 10. *See New York State Bar Association, Tax Section, Report on Definition of "Traded on an Established Market" within the Meaning of Section 1273, 2004 TNT 159-7 (Aug. 17, 2004), for an excellent analysis of*

these categories and recommendations for changes to the definition of "publicly traded."

(n11)Footnote 11. *Treas. Reg. § 1.1273-2(f)(2).*

(n12)Footnote 12. *Treas. Reg. § 1.1273-2(f)(3).*

(n13)Footnote 13. *Treas. Reg. § 1.1273-2(f)(4).*

(n14)Footnote 14. *Treas. Reg. § 1.1273-2(f)(5).*

(n15)Footnote 15. *Treas. Reg. § 1.1273-2(f)(6).*

(n16)Footnote 16. *Treas. Reg. § 1.1273-2(f)(7).*

(n17)Footnote 17. *I.R.C. § 1274(a)(1); Treas. Reg. § 1.1274-2(b)(1).*

(n18)Footnote 18. *I.R.C. § 1274(a)(2) and (c)(1)(D); Treas. Reg. § 1.1274-2(b)(2).*

(n19)Footnote 19. *I.R.C. § 1274(b)(1) and (2); Treas. Reg. § 1.1274-2(c).*

(n20)Footnote 20. *I.R.C. § 1274(b)(3)(A); Treas. Reg. § 1.1274-2(b)(3).*

(n21)Footnote 21. *Treas. Reg. § 1.1274-3(b)(3).* Other examples of potentially abusive circumstances include a tax shelter (as defined in section 6662(d)(2)(C)(ii)) or any other situation involving a recent sales transaction, nonrecourse financing or financing with a term in excess of the usual life of the property. *Treas. Reg. § 1.1272-3(a).*

(n22)Footnote 22. *Treas. Reg. § 1.1274-3(d).*

(n23)Footnote 23. *Treas. Reg. § 1.1275-5(b)(3).*

(n24)Footnote 24. *Treas. Reg. § 1.1275-5(c)(4).*

(n25)Footnote 25. In general, the Treasury regulations are very flexible in permitting various combinations (and even inversions) of fixed and floating rates, so long as the latter are "qualified." *See Treas. Reg. § 1.1275-5(a)(3), (c)(1), (3).* Thus, a Floating Rate Note may be most likely to bear OID when the variability of floating rates is exaggerated through multipliers, and/or compressed through the use of caps and floors. The same is true of notes with floating rates in combination with fixed rates. *See Treas. Reg. § 1.1275-5(b)(1) and (2).*

(n26)Footnote 26. *I.R.C. § 1273(c)(2); Treas. Reg. § 1.1273-2(h)(1).*

(n27)Footnote 27. *I.R.C. § 1272(a)(1) and (2)(c); Treas. Reg. § 1.1272-1(a)(1).*

(n28)Footnote 28. *I.R.C. § 1272(a)(1).*

(n29)Footnote 29. *I.R.C. § 1272(a)(3); Treas. Reg. § 1.1272-1(b)(1)(iv).*

(n30)Footnote 30. *Treas. Reg. § 1.1272-1(b)(1)(ii).*

(n31)Footnote 31. *I.R.C. § 1272(a)(3); Treas. Reg. § 1.1272-1(b)(1)(iii).*

(n32)Footnote 32. *I.R.C. § 1272(a)(4); Treas. Reg. § 1.1275-1(b).*

(n33)Footnote 33. *Treas. Reg. § 1.1272-1(b)(4)(iv).*

(n34)Footnote 34. *Treas. Reg. § 1.1273-2(m)(1).*

(n35)Footnote 35. *Treas. Reg. § 1.1273-2(m)(2)*.

(n36)Footnote 36. *Treas. Reg. § 1.1272-1(b)(4)(ii)* and *(iii)*.

(n37)Footnote 37. *Treas. Reg. § 1.1272-1(b)(4)(i)(A)*. *De minimis* OID is an amount equal to .0025 multiplied by the product of the stated redemption price at maturity and the number of complete years to maturity from the issue date. *Treas. Reg. § 1.1273-1(d)(2)*.

(n38)Footnote 38. *Treas. Reg. § 1.1273-1(d)*.

(n39)Footnote 39. *Treas. Reg. § 1.1273-1(d)(1)*.

(n40)Footnote 40. *Treas. Reg. § 1.1273-1(d)(5)(i)* and *(ii)*.

(n41)Footnote 41. *Treas. Reg. § 1.1273-1(d)(5)(i)*.

(n42)Footnote 42. *I.R.C. §§ 1283(c)(1)(A); 1281(a)(1); (b)(1)(A); 1272(a)(2)(C); Treas. Reg. § 1.1272-3(a)*.

(n43)Footnote 43. *I.R.C. § 1281(b)(1)*.

(n44)Footnote 44. *Treas. Reg. § 1.1272-3(a)*.

(n45)Footnote 45. *I.R.C. § 1283(c)(1)(A); Treas. Reg. § 1.1272-3(c)*.

(n46)Footnote 46. *I.R.C. § 1283(b), (c)(1)(B)*.

(n47)Footnote 47. *I.R.C. § 1271(a)(4)(A), (D)*.

(n48)Footnote 48. *I.R.C. § 1282(a)*.

(n49)Footnote 49. *I.R.C. § 1283(c)(2)*.

(n50)Footnote 50. *I.R.C. § 1283(a)(2)*.

(n51)Footnote 51. *I.R.C. § 1283(b)*.

(n52)Footnote 52. *Treas. Reg. § 1.1273-1(c)(5)*.

(n53)Footnote 53. *Treas. Reg. § 1.1273-1(b)*.

(n54)Footnote 54. See, e.g., *Corn Exchange Bank v. United States*, 37 F.2d 34 (2d Cir. 1930) ; *H. Liebes & Co. v. Commissioner*, 90 F.2d 932 (9th Cir. 1937) ; *European American Bank & Trust Co. v. United States*, 20 Cl. Ct. 594 (Ct. Cls. 1990) , *aff'd*, Rev. Rul. 80-361, 1980-2 C.B. 164 (referring to interest that becomes uncollectible).

(n55)Footnote 55. TAM 9538007 (June 13, 1995) ; FSA 2000-18-017 (Jan. 13, 2000) . However, citing bankruptcy law disallowing claims for post-petition interest (including OID), the I.R.S. has issued internal guidance stating that holders are not required to include (and the issuer cannot deduct) post-petition interest and OID on pre-petition unsecured debt where the issuer has filed for bankruptcy. I.R.S. Litigation Guideline Memorandum (May 6, 1996), 2000 TNT 121-83 (2000) .

(n56)Footnote 56. Rev. Rul. 2007-32, 2007-21 I.R.B. 1278 ; Rev. Rul. 80-361, 1980-2 C.B. 164 .

(n57)Footnote 57. See TAM 9538007 (June 13, 1995) (citing H.R. Rep. No. 98-432, at 1034 (1984)); FSA 2000-18-017 (Jan. 13, 2000) (same).

(n58)Footnote 58. Lee A. Sheppard, *IRS's Solomon Offers Updates on Debt Exchange Regs, Spin-offs*, 69 *Tax Notes* 531 (Oct. 30, 1995).

(n59)Footnote 59. See H.R. Rep. No. 99-87, at 4, n.4 (1985) ("The premise of the OID rules is that, for federal income tax purposes, an obligation issued at a discount should be treated like an obligation issued at par requiring current payments of interest. Accordingly, the effect of the OID rules is to treat the borrower as having paid semiannually to the lender the interest accruing on the outstanding principal balance of the loan, thereby permitting the borrower to deduct as interest expense and requiring the lender to include in income, such interest that has accrued but is unpaid. The lender is then deemed to have lent the accrued but unpaid interest back to the borrower, who in subsequent periods is deemed to pay interest on this amount as well as on the principal balance. This concept of accruing interest on unpaid interest is commonly referred to as the 'economic accrual' of interest, or interest 'compounding' ").

(n60)Footnote 60. See H.R. Rep. No. 98-432, at 1248 (1984) (OID will be "treated as interest for all purposes of the Code"); S. Rep. No. 99-83, at 5 (1985) ("the application of the OID rules will require the issuer and the holder of the debt instrument to use the accrual method of accounting for any interest [whether stated or imputed] that is not paid currently").

(n61)Footnote 61. See *Atlantic Coast Line Railroad Co. v. Commissioner*, 31 B.T.A. 73, 75 (1934) ("where the obligation is worthless at the time the 'right to receive' arises, as in the instant case, the right to receive is without substance and there is in fact nothing to accrue"); *Rev. Rul. 80-361*, 1980-2 C.B. 164 (under Treasury regulation section 1.451-1(a), interest did not properly accrue where the right to interest became fixed after the debtor's insolvency, since the interest was uncollectible at the time such right arose).

(n62)Footnote 62. See *Fahs v. Martin*, 224 F.2d 387 (5th Cir. 1955) ; *Zimmerman Steel Co. v. Commissioner*, 130 F.2d 1011 (8th Cir. 1942) ; see also *Rev. Rul. 70-367*, 1970-2 C.B. 37 .

(n63)Footnote 63. See *Kellogg v. United States*, 82 F.3d 413 (5th Cir. 1996) (no deductions allowed on accrued interest where taxpayer is so hopelessly insolvent that the interest will never be paid); *Tampa and Gulf Coast Railroad Co. v. Commissioner*, 469 F.2d 263 (5th Cir. 1972) (holding that where a parent was excluding accrued interest from income as unlikely to be collected from a debtor-subsidary, subsidiary could not accrue the deduction); *Mooney Aircraft, Inc. v. Commissioner*, 420 F.2d 400 (5th Cir. 1969) (denying deduction for amounts that may never be paid since due at a non-fixed time in the future, and questioning the ruling in *Zimmerman* as "dubious"); *Continental Vending Machine Corp.*, 77-1 U.S.T.C. P 9121 (E.D.N.Y., Nov. 19, 1976) (Chapter 11 company permitted to deduct accrued interest only on secured debt).

(n64)Footnote 64. S. Rep. No. 98-169, at 255 (Apr. 2, 1984); *G.C.M. 39668* (Oct. 1, 1987) .

(n65)Footnote 65. See *Newhouse v. Commissioner*, 59 T.C. 783 (1973) ; *Rev. Rul. 63-57*, 1963-1 C.B. 103 .

(n66)Footnote 66. See *European American Bank & Trust Co. v. United States*, 20 Cl. Ct. 594 (Ct. Cls. 1990) , *aff'd*, 92-1 U.S. Tax Cas. (CCH) P 50026 (1991); *Warner Co. v. Commissioner*, 11 T.C. 419 (1948) , *aff'd per curiam*, 181 F.2d 599 (3rd Cir. 1950) ; *Priv. Ltr. Rul. 8819068* (Feb. 17, 1988) .

(n67)Footnote 67. See *Newhouse v. Commissioner*, 59 T.C. 783 (1973) ; *Petit et al. v. Commissioner*, 8 T.C. 228 , *acquiesced*, 1947-1 C.B. 3 (1947) ; *Lackey v. Commissioner*, T.C. Memo 1977-213 (1977) ; *Drier v. Helvering*, 72 F.2d 76, 63 App. D.C. 283 (D.C. Cir. 1934) ; see also *Priv. Ltr. Rul. 8821018* (Feb. 23, 1988) (ruling that where holders of tax-exempt bonds receive only half of the bond issue price, payments must be applied to principal since holders have incentive to apply payments to tax-exempt interest and thereby increase capital loss).

(n68)Footnote 68. *Treas. Reg. §§ 1.446-2(e); 1.1275-2(a)*.

(n69)Footnote 69. See New York State Bar Association, Tax Section, "Comments on the Final OID Regulations," 64 *Tax Notes* 1747 (Sept. 26, 1994); Kevin M. Keyes, *Federal Taxation of Financial Instruments and Transactions*, P 3.02 (2000).

(n70)Footnote 70. *Priv. Ltr. Rul. 200035008* (May 23, 2000) held that in the absence of an agreement between the parties, an issuer's payments on tax-exempt bonds prior to insolvency would be applied to accrued interest first, while later payments in liquidation of the bonds made when the issuer is insolvent would be applied first to principal. Interestingly, the letter ruling did not discuss Treasury regulation section 1.446-2(e). Although it is not clear from the facts of the ruling, the omission may be due to the fact that the bonds were issued prior to April 4, 1994, the effective date of that regulation. See also 1995 FSA LEXIS 537 (October 20, 1995) (proceeds from foreclosure sale property acquired through issuance of tax-exempt bonds allocated to principal, where issuer was insolvent on the date of foreclosure).

(n71)Footnote 71. S. Rep. No. 96-1035, at 38 (1980) (stating that under *I.R.C. section 354(a)(2)(B)* an exchanging security holder that previously accrued interest or OID to which property received is allocable recognizes a loss to the extent the interest is not paid in the exchange). *TAM 95-38-007* (June 13, 1995); see Gordon D. Henderson and Stuart J. Goldring, *Failing and Failed Businesses*, P 304, n. 3 (2008).

(n72)Footnote 72. Under the contingent payment debt regulations, negative adjustments are treated as ordinary losses of the holder to the extent of prior ordinary income inclusions. *Treas. Reg. § 1.1275-4(b)(6)(iii)(B)*. See David C. Garlock, *Federal Income Taxation of Debt Instruments*, P 6.03[D][1] (5th ed. 2005); Section IV.H. below.

(n73)Footnote 73. The bond premium amortization regulations provide that the excess of allocable bond premium over qualified stated interest for a taxable year can be taken as a deduction to the extent of prior net income inclusions with respect to the bond. *Treas. Reg. § 1.171-2(a)(4)(i)(A)*.

(n74)Footnote 74. In the case of certain debt obligations, if a portion of the debt remains unsatisfied after applying proceeds from a foreclosure sale of the collateral, the creditor may generally claim the unsatisfied amount, including accrued interest previously taken into income, as an ordinary bad debt loss if the creditor is a corporation or if the debt was a "business" debt in the hands of the (noncorporate) creditor. See *I.R.C. § 166(a), (d)(1)*; *Treas. Reg. § 1.166-6(a)*. Of course, ordinary loss treatment would not apply to unsatisfied amounts on debt issued by corporations that constitute "securities" under *I.R.C. section 165(g)(2)(C)*. See *I.R.C. §§ 166(e)* and *165(g)*.

(n75)Footnote 75. *Treas. Reg. § 1.1272-2(b)(3)*.

(n76)Footnote 76. *Treas. Reg. § 1.1272-2(b)(4)*.

(n77)Footnote 77. *Treas. Reg. § 1.1272-2(b)(5)*.

(n78)Footnote 78. Technically, the principal amount equals the sum of all amounts payable on the note after the purchase date, other than payments of qualified stated interest.

(n79)Footnote 79. *I.R.C. § 1272(c)(1)*; *Treas. Reg. § 1.1272-2(a), (b)(2)*.

(n80)Footnote 80. *I.R.C. § 171(c)*.

(n81)Footnote 81. *I.R.C. § 171(e), (b)(3)(A)*.

(n82)Footnote 82. *Treas. Reg. § 1.171-1(a)(1), (b)(2)*. The constant yield method of amortizing bond premium has been required even for debt instruments described in *I.R.C. section 1272(a)(6)(C)* under the clear reflection of income standard of *I.R.C. section 446*. See *Priv. Ltr. Rul. 200152028* (Sep. 28, 2001) (holder of mortgage-backed securities that amortized bond premium on a straight-line basis prior to acquisition of other mortgage-backed securities in an *I.R.C.*

section 381 transaction must, following the acquisition, use the constant yield method because the straight-line method does not clearly reflect income).

(n83)Footnote 83. *I.R.C. § 171(c)*.

(n84)Footnote 84. *I.R.C. § 1278(a)(1)(B)(i)*.

(n85)Footnote 85. *I.R.C. § 1278(a)(1)(D)(ii)*.

(n86)Footnote 86. *I.R.C. § 1278(a)(2)(C)*.

(n87)Footnote 87. A holder of a market discount note may elect to currently include market discount in income over the life of the market discount note. *I.R.C. § 1278(b)(1)*. Such an election applies to all debt instruments with market discount acquired by the electing holder on or after the first day of the first taxable year to which the election applies and may not be revoked without the consent of the IRS. *I.R.C. § 1278(b)(3)*.

(n88)Footnote 88. *I.R.C. § 1276(a)(1)*.

(n89)Footnote 89. *I.R.C. § 1276(b)(i) and (ii)*.

(n90)Footnote 90. *I.R.C. § 1276(b)(2)(C)*; *Rev. Proc. 92-67*, § 2.14.

(n91)Footnote 91. *I.R.C. § 1277(b)(2)*.

(n92)Footnote 92. *I.R.C. § 1272(a)(6)(C)(ii)*; *Treas. Reg. § 1.1272-1(c)(5)*.

(n93)Footnote 93. *Treas. Reg. § 1.1272-1(c)(6)*.

(n94)Footnote 94. If such an election is made with respect to a note with amortizable bond premium, the electing holder will be deemed to have elected to apply amortizable bond premium to reduce interest with respect to all debt instruments with amortizable bond premium (other than tax-exempt debt instruments) held by such electing holder as of the beginning of the taxable year in which the note with respect to which the election is made is acquired, and to all debt instruments thereafter acquired. The deemed election with respect to amortizable bond premium may not be revoked without the consent of the I.R.S. *Treas. Reg. § 1.1272-3(b)(2)(ii)(B)*.

(n95)Footnote 95. *Treas. Reg. § 1.1272-3(a)*.

(n96)Footnote 96. *Treas. Reg. § 1.1272-3(c)*.

(n97)Footnote 97. *Treas. Reg. § 1.1272-3(d), (e)*.

(n98)Footnote 98. *Treas. Reg. § 1.1272-3(b)(2)(ii)(B)*.

(n99)Footnote 99. *T.D. 8674, 1996-28 I.R.B. 7 (June 11, 1996)*; see also *FSA 1999-22-024, (June 4, 1999)* (company permitted to deduct OID on its contingent payments for patents or patent rights purchased before August 13, 1996, either when the payments became fixed, as permitted under the proposed regulations, or when the payments were made, as required by the final regulations).

(n100)Footnote 100. *Prop. Reg. § 1.1275-4(e) (1986)*, *51 Fed. Reg. 12,022 (April 8, 1986)*.

(n101)Footnote 101. See *Prop. Reg. § 1.1275-4(c) (1986)*; *Treas. Reg. § 1.1275-4(c)*.

(n102)Footnote 102. *Prop. Reg. § 1.1275-4(g)*, *56 Fed. Reg. 8,308 (Feb. 28, 1991)*.

(n103)Footnote 103. The Treasury regulations proposed in 1993 were never published in the Federal Register. Thus, the IRS could assert that the 1993 proposed regulations do not clearly constitute a reasonable method as defined in the preamble to the final regulations.

(n104)Footnote 104. *59 Fed. Reg. 62,884 (Dec. 16, 1994)* .

(n105)Footnote 105. *Treas. Reg. § 1.1275-4(a)(1)*. Note that the regulations would apply to debt modified by a liquidating bankruptcy plan to provide for distributions to creditors, the amount of which are contingent on the outcome of litigation pursued by the debtor's estate.

(n106)Footnote 106. *Treas. Reg. § 1.1275-4(a)(5)*.

(n107)Footnote 107. *Treas. Reg. § 1.1275-2(h)(2)*.

(n108)Footnote 108. *Treas. Reg. § 1.1275-2(h)(3)(i)*.

(n109)Footnote 109. *Treas. Reg. § 1.1275-4(b)(1)*.

(n110)Footnote 110. *Treas. Reg. § 1.1275-4(b)(2)*.

(n111)Footnote 111. *See T.D. 8674, 1996-28 I.R.B. 7 (June 11, 1996)* ; Notice of Proposed Rulemaking, Fed. Reg. 64,884 (Dec. 16, 1994).

(n112)Footnote 112. *Treas. Reg. § 1.1275-4(b)(3)(i), (4)(i)*.

(n113)Footnote 113. *Treas. Reg. § 1.1275-4(b)(3)(ii), (4)(ii)*.

(n114)Footnote 114. *Treas. Reg. § 1.1275-4(b)(3)(iii), (6)*.

(n115)Footnote 115. *Treas. Reg. § 1.1275-4(b)(3)(iv)*.

(n116)Footnote 116. *Treas. Reg. § 1.1275-4(b)(4)(i)*.

(n117)Footnote 117. *Treas. Reg. § 1.1275-4(b)(4)(ii)*.

(n118)Footnote 118. *Treas. Reg. § 1.1275-4(b)(4)(ii)(A)*.

(n119)Footnote 119. *Treas. Reg. § 1.1275-4(b)(4)(ii)(B)*.

(n120)Footnote 120. *Treas. Reg. § 1.1275-4(b)(4)(ii)(C)*.

(n121)Footnote 121. *Treas. Reg. § 1.1275-4(b)(4)(iii)*.

(n122)Footnote 122. *Treas. Reg. § 1.1275-4(b)(4)(ii)(B)*.

(n123)Footnote 123. *Treas. Reg. § 1.1275-4(b)(4)(ii)(B)*.

(n124)Footnote 124. *Treas. Reg. § 1.1275-4(b)(4)(ii)(C)*. If the debt instrument contains both market-based and non-market-based payments, adjustments are generally made first to the non-market-based payments because more objective information is available for market-based payments.

(n125)Footnote 125. *Treas. Reg. § 1.1275-4(b)(4)(ii)*.

(n126)Footnote 126. *Treas. Reg. § 1.1275-4(b)(6)*.

(n127)Footnote 127. *Treas. Reg. § 1.1275-4(b)(6)(i)*.

(n128)Footnote 128. *Treas. Reg. § 1.1275-4(b)(6)(i)*.

(n129)Footnote 129. *Treas. Reg. § 1.1275-4(b)(6)(ii)*.

(n130)Footnote 130. *See Treas. Reg. § 1.1275-4(b)(6)(iii)(A), (B)*.

(n131)Footnote 131. *Treas. Reg. § 1.1275-4(b)(6)(iii)(C)*.

(n132)Footnote 132. *Treas. Reg. § 1.1275-4(b)(6)(iii)(C)*.

(n133)Footnote 133. *Treas. Reg. § 1.1275-4(b)(6)(iii)(C)*.

(n134)Footnote 134. *Prop. Treas. Reg. § 1.1275-4(b)(6)(iii)(C)(2) (1994)*.

(n135)Footnote 135. *Treas. Reg. § 1.1275-4(c)(2)*.

(n136)Footnote 136. *Treas. Reg. § 1.1275-4(c)(3); T.D. 8674, 1996-28 I.R.B. 7 (June 11, 1996)*.

(n137)Footnote 137. *Treas. Reg. § 1.1275-4(c)(4)(i),(ii)*.

(n138)Footnote 138. *Treas. Reg. § 1.1275-4(c)(4)(iii)*.

(n139)Footnote 139. *See Treas. Reg. § 1.1274-2(g)*.

(n140)Footnote 140. *I.R.C. § 163(i)(1)*.

(n141)Footnote 141. *I.R.C. § 163(i)(2)*.

(n142)Footnote 142. *I.R.C. § 163(e)(5)(A)(ii)*.

(n143)Footnote 143. *I.R.C. § 163(e)(5)(A)(i)*.

(n144)Footnote 144. *I.R.C. § 163(e)(5)(C)(i)*.

(n145)Footnote 145. *I.R.C. § 163(e)(5)(B)*.

(n146)Footnote 146. *S. Rep. No. 101-56, at 54 (1989)*.

(n147)Footnote 147. *Id.*

(n148)Footnote 148. *Id.*

(n149)Footnote 149. *See H.R. Rep. No. 99-841, at II-238 (1986) (Conf. Rep.)*.

(n150)Footnote 150. *I.R.C. § 163(i)(3)(A) (emphasis added)*.

(n151)Footnote 151. Although the junior class may have a maturity date of less than five years, the imposition of the senior restriction may cause the term to exceed five years. A similar difficulty presents itself where a debt instrument with multiple classes is held by one person and is treated as a single issue under the section 1275 regulations, potentially subjecting the entire instrument to the HYDO rules.

(n152)Footnote 152. For a discussion of potential methods of avoiding this uncertainty and their effectiveness see Robert A. Rizzi, *Acquisition Indebtedness: Traps and Tricks*, 33 *J. Corp. Tax'n* 3 (May/June 2006).

(n153)Footnote 153. *Treas. Reg. § 1.701-2(f)*, Ex. 1.

(n154)Footnote 154. Such treatment would be consistent, for example, with the determination of "excludible COD income" and other income items at the partner level.

(n155)Footnote 155. *I.R.C. § 163(e)(5)(A)(ii)*.

(n156)Footnote 156. *I.R.C. § 163(e)(5)(A)(i)*.

(n157)Footnote 157. *I.R.C. § 163(e)(5)(B)*.

(n158)Footnote 158. See David C. Garlock, "Modifications of Debt Instruments and the High-Yield Discount Obligation Rules," 4 *J. Tax'n Fin. Prod.* No. 3 (Summer 2003) for a discussion of the more difficult issue of whether to retest a corporate debt instrument under the HYDO rules following a non-significant modification.

(n159)Footnote 159. *Rev. Proc. 2008-51, 2008-35 I.R.B. 562*.

(n160)Footnote 160. For purposes of this exception an exchange includes a deemed exchange pursuant to section 1001. *Rev. Proc. 2008-51, 2008-35 I.R.B. 562*.

(n161)Footnote 161. A debt instrument that is issued in exchange for a Pre-Committed Debt Instrument is excluded if (1) the debt instrument is issued within 15 months after the Pre-Committed Debt Instrument is issued, (2) the maturity date of the debt instrument is not more than one year later than the maturity date of the Pre-Committed Debt Instrument, and (3) the stated redemption price at maturity of the debt instrument is not greater than the stated redemption price at maturity of the Pre-Committed Debt Instrument. A debt instrument that is exchanged for such a debt instrument is also excluded if it satisfies the three requirements. *Rev. Proc. 2008-51, 2008-35 I.R.B. 562*.

(n162)Footnote 162. American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5 (2009); *I.R.C. § 163(e)(5)(F)*. After 2009, the Secretary of the Treasury has authority to apply the provision or raise the rate used to determine whether an instrument is subject to the HYDO rules if he or she determines the change is "appropriate in light of distressed conditions in the debt capital markets." *I.R.C. §§ 163(e)(5)(F)(iii) and 163(i)(1)*.

(n163)Footnote 163. Debt instruments that pay contingent interest described in section 871(h)(4) without regard to section 871(h)(4)(D) are excluded. Section 871(h)(4) generally addresses interest that depends on the profits, income, value, cash flow, or distributions of the issuer.

(n164)Footnote 164. *I.R.C. § 163(e)(5)(F)(i)*.

(n165)Footnote 165. *Treas. Reg. §§ 1.988-1(a)(1)(ii)-(2)(i); 2(b)(2)(ii)(B)*.

(n166)Footnote 166. *Treas. Reg. § 1.988-2(b)(2)(ii)(C)*.

(n167)Footnote 167. *Treas. Reg. § 1.988-2(b)(2)(ii)(C)*.

(n168)Footnote 168. *Treas. Reg. § 1.988-2(b)(3)*.

(n169)Footnote 169. *Treas. Reg. § 1.988-2(b)(2)(iii)(B)*.

(n170)Footnote 170. *Treas. Reg. § 1.988-2(b)(2)(iii)(B)*.

(n171)Footnote 171. *Treas. Reg. § 1.988-2(b)(2)(iii)(B)*.

(n172)Footnote 172. *Treas. Reg. § 1.988-2(b)(2)(ii)(B), (3)(i), (5)(i)*.

(n173)Footnote 173. *I.R.C. § 988(b)(1) and (2); Treas. Reg. § 1.988-2(b)(8).*

(n174)Footnote 174. *Treas. Reg. § 1.988-2(b)(2)(ii)(A).*

(n175)Footnote 175. *See Treas. Reg. § 1.988-2(b)(3) and (4).*

(n176)Footnote 176. *Treas. Reg. § 1.988-2(b)(10)(i).*

(n177)Footnote 177. *Treas. Reg. § 1.988-2(b)(10)(i), (ii) Ex. (B).*

(n178)Footnote 178. *Treas. Reg. § 1.988-2(b)(11)(i).*

(n179)Footnote 179. *Treas. Reg. § 1.988-2(b)(11)(i).*

(n180)Footnote 180. *I.R.S. Announ. 99-76, 1991-31 I.R.B. 223 .*

(n181)Footnote 181. *See Treas. Reg. § 1.1275-4.*

(n182)Footnote 182. *2004-40 I.R.B. 545, T.D. 9157 (Aug. 27, 2004) . See Section IV.H for a discussion of the contingent payment debt provisions.*

(n183)Footnote 183. *Treas. Reg. § 1.988-6(a)(1).* The nonfunctional currency CPDI rules do not apply to (i) an instrument if any payment made under such instrument is determined by reference to a hyperinflationary currency, or (ii) an obligation that is tax-exempt under section 103. *Treas. Reg. § 1.988-6(a)(2)(i), (f)(1).*

(n184)Footnote 184. *Treas. Reg. § 1.988-6(b)(3).*

(n185)Footnote 185. The election applies to the substitution of new debt for old debt if (1) either (a) debt instruments from a single new issue are substituted for debt instruments from two or more old issues, or (b) debt instruments issued in a qualified reopening (as defined in Treasury regulation section 1.1275-2) are substituted for debt instruments from one or more outstanding issues of debt; (2) the substitution does not result in a significant modification of the old debt and, therefore, is not a realization event; (3) the new debt and the old debt are publicly traded; (4) the old debt was issued at par, with premium, or with only a *de minimis* amount of OID; (5) the new debt is issued at par or with only a *de minimis* amount of OID or premium; (6) neither the new nor the old debt is a contingent payment debt instrument, a tax-exempt obligation, or a convertible debt instrument; (7) all payments on the old and new debt are denominated in or determined by reference to U.S. dollars, and the U.S. dollar is the functional currency of the issuer of the new debt; and (8) the issuer and one or more holders of the old debt each make the election. *Rev. Proc. 2001-21, 2001-9 I.R.B. 742 .*

(n186)Footnote 186. *See New York State Bar Association, Tax Section, Report on Definition of "Traded on an Established Market" Within the Meaning of Section 1273 (Aug. 12, 2004), available at <http://www.nysba.org/Content/ContentFolders20/TaxLawSection/TaxReports/rptl066> (questioning whether *Revenue Procedure 2001-21* provides relief where tax fungibility would be most beneficial, i.e., where additional bonds are issued under the same indenture, but at a discount exceeding a *de minimis* amount).*

(n187)Footnote 187. *Rev. Proc. 2001-21, 2001 -9 I.R.B. Section 3.02.*

(n188)Footnote 188. *TAM 9641001 (May 31, 1996) ; see also Denver Salt Lake Railway Co. v. Commissioner, 24 T.C. 709 (1955) , appeal dismissed, 234 F.2d 663 (10th Cir. 1956) (expenses accrued by target while polling its bondholders for their consents to a merger constituted reorganization expenses that must be capitalized); cf. Rev. Rul. 73-146, 1973-1 C.B. 61 (where target employees holding stock options consented to relinquish the options in order to effect a reorganization, consideration paid to option holders was deductible as compensation paid to employees); Priv. Ltr. Rul. 9540003 (June 30, 1995) (same).*

(n189)Footnote 189. The regulation states that cash payments from an issuer to a noteholder in a private transaction (other than payments for property or services provided by the lender such as commitment fees or loan processing costs) will reduce the issue price of the debt instrument, thus increasing the holder's capital gain (or decreasing the holder's capital loss) upon the simultaneous disposition of the debt instrument.

(n190)Footnote 190. *T.D. 8934, 2000-12 I.R.B. 904 (Mar. 19, 2001)* .

(n191)Footnote 191. *1999-47 I.R.B. 575, T.D. 8840 (Nov. 22, 1999)* . The temporary regulations applied to reopenings of Treasury securities that occurred on or after November 5, 1999, but before March 13, 2001, and the proposed regulations would have been effective for reopenings occurring 60 days or more after issuance as final regulations.

(n192)Footnote 192. *See Treas. Reg. § 1.1275-2(d)(2)(ii)(D)* (defining "qualified reopening" for a reopening of Treasury securities occurring prior to November 5, 1999).

(n193)Footnote 193. *1999-47 I.R.B. 575, T.D. 8840 (Nov. 22, 1999)* ; Temp. Treas. Reg. § 1.1275-2T(d).

(n194)Footnote 194. *Treas. Reg. § 1.1275-2(d)(2)(C)*.

(n195)Footnote 195. *Treas. Reg. § 1.1275-1(f)(2), (3)*.

(n196)Footnote 196. *Treas. Reg. § 1.1275-1(f)(1)(iii)*.

(n197)Footnote 197. *Treas. Reg. § 1.1275-2(k)(1)*.

(n198)Footnote 198. *Treas. Reg. § 1.1275-2(k)(2)(ii)*.

(n199)Footnote 199. The announcement date is the later of seven days before the date on which the price of the additional debt instruments is established or the date on which the issuer's intent to reopen a security is publicly announced through one or more media, including the standard electronic news services used by security broker-dealers (e.g., Reuters, Telerate, or Bloomberg). *Treas. Reg. § 1.1275-2(k)(2)(iv)*.

(n200)Footnote 200. *Treas. Reg. § 1.1275-2(k)(3)(ii)*.

(n201)Footnote 201. *Treas. Reg. § 1.1275-2(k)(3)(iii)*.

(n202)Footnote 202. *Treas. Reg. § 1.1275-2(k)(3)(iv)*.

(n203)Footnote 203. *Treas. Reg. § 1.163-7(e)(1)*.

(n204)Footnote 204. *Treas. Reg. § 1.163-7(e)(2)*.

(n205)Footnote 205. *Treas. Reg. § 1.163-7(e)(3)*.



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CHAPTER TX10 Tax-Free Reorganization of Debtor Corporations

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CHAPTER TX10 Tax-Free Reorganization of Debtor Corporations

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P TX10.01 Introduction

[1] One Corporation E Reorganization

A financially troubled debtor corporation frequently renegotiates or restructures the terms of its outstanding debt. The resulting "reshuffling" of its capital structure involves only the debtor corporation and its creditors and/or shareholders. If stock or securities are exchanged by stock or security holders for stock or securities of the same corporation, the exchange will qualify as a tax-free "E" reorganization (a recapitalization). The "E" recapitalization is the most common tax-free reorganization associated with a one company debt restructuring in or out of a title 11 case.

An "E" recapitalization that is tax-free to the exchanging stock or security holders has only two requirements: (1) there must be an exchange of "old" stock for "new" stock or "old" securities for "new" stock or securities of one corporation and (2) the exchange must have a business purpose. Because only one corporation is involved and the issuance by that corporation of its stock or securities is tax-free to the corporation, tax-free reorganization treatment is beneficial only to the exchanging stock or security holders. In that regard, section 1032 provides nonrecognition treatment on the issuance of the corporate issuer's stock whether or not the issuance qualifies as a section 368 reorganization.

[2] Two Corporation G Reorganization

A corporation in a title 11 or similar proceeding can arrange for an acquisition of its assets by an acquiring corporation in a tax-free "G" reorganization. The "G" reorganization was enacted as a part of the Bankruptcy Tax Act of 1980 in order to facilitate the reorganization of financially troubled corporations. n1 In so doing, Congress included the "G" as an additional category of tax-free corporate reorganizations under *I.R.C. section 368*. n2 For a transaction to qualify as a "G" reorganization, the transaction must comply with the many judicial and regulatory requirements associated with a "regular" tax-free reorganization. Many of these "regular" tax-free reorganization requirements are applied in a different manner to accommodate the unique circumstances faced by a debtor corporation in a title 11 case.

Despite the difficulties of conforming the regular tax-free reorganization requirements to a "G" reorganization, the "G" reorganization is a flexible vehicle. It is a hybrid provision, which takes its characteristics from the other asset reorganization sections listed in *I.R.C. section 368*. It is similar to an "A" reorganization (a state law merger), in that the only limitation on the nature of consideration given by the acquiring corporation is the "continuity of interest" doctrine. n3 However, like a "C" reorganization, the transaction does not need to meet state law merger requirements. The "G" reorganization contemplates an acquisition of "substantially all" the assets of the transferor corporation, but does not

require an exchange solely for voting stock as does a "C" reorganization. In fact, it is not even necessary to use voting stock in a qualifying "G" reorganization. n4 It is similar to a "D" reorganization except that it does not require that the former shareholders must be in "control" (as defined in *I.R.C. section 368(a)(2)(H)*) of the acquiring corporation immediately after the exchange. n4a It is different from an "E" recapitalization, because a "G" reorganization requires a transfer of assets by one corporation to another corporation. n5

There are some common misperceptions as well. The most common is that "G" reorganization qualification can be obtained only through an affirmative election by the debtor corporation. In fact, a "G" is not elective but definitional in nature--and presumably the I.R.S. is free to recharacterize a taxable two corporation asset acquisition as a tax-free "G" reorganization or vice versa. n6 Some may also believe that a "G" reorganization is limited to an acquisition of the assets of a debtor corporation in a title 11 or similar case by a nondebtor corporation. However, a "G" can be accomplished with the debtor corporation as the acquiring corporation, assuming the other statutory provisions are satisfied. n7

There are three principal tax advantages to structuring an acquisition as a "G" reorganization. First, it permits an acquiring corporation to acquire the assets of the target (usually the debtor corporation in a title 11 case) with a relatively small percentage (by "regular" tax reorganization standards) of equity consideration. Second, the acquiring corporation will take a carryover tax basis in the assets, which can be advantageous if the debtor corporation holds high-basis assets. Finally, a qualifying "G" reorganization will allow the acquiring corporation to succeed to the tax attributes of the debtor corporation, including its net operating loss carryovers. It must be cautioned that the second and third advantages may be practically eliminated, however, by the *I.R.C. section 382* limitations which apply to built-in (future) losses and net operating (past) losses. n8

FOOTNOTES:

(n1)Footnote 1. See Asofsky, *Reorganizing Corporations*, 47th N.Y.U. Tax Inst., ch. 40 (1989); Bergquist & Groff, *Reorganizing the Financially Troubled Corporation After the Bankruptcy Tax Act of 1980*, 36 *Tax. L. Rev.* 517 (1981); Eustice, *Cancellations of Indebtedness Redux: The Bankruptcy Tax Act of 1980 Proposals--Corporate Aspects*, 36 *Tax L. Rev.* 1(1980); Plumb, *The Bankruptcy Tax Act*, 33 U.S.C. Tax Inst. ch. 8 (1981).

(n2)Footnote 2. The legislative history provides that in order to facilitate the rehabilitation of debtor corporations, the "G" reorganization was "designed to eliminate many requirements which have effectively precluded financially troubled companies from utilizing the generally applicable tax-free reorganization provisions of present law." S. Rep. No. 1035, 96th Cong., 2d Sess. 35 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n3)Footnote 3. See *Priv. Ltr. Rul. 9121017 (Feb. 21, 1991)* (merger of multiple corporations into new corporation pursuant to a plan of reorganization treated as a "G" reorganization). See *P TX10.03[4][a] infra* for a discussion of the "continuity of interest" doctrine.

(n4)Footnote 4. However, a debtor corporation cannot issue nonvoting stock to creditors pursuant to a plan of reorganization under the Bankruptcy Code. 11 U.S.C. § 1123(a)(6). See 7 *Collier on Bankruptcy*, P 1123.01[5][f] (Matthew Bender 15th Edition Revised).

(n5)Footnote 4a. In contrast to a "G" reorganization, it may not be necessary for stock and / or securities of the acquiring corporation to be issued in a qualifying "D" reorganization. Temp. Reg. § 1.1368-2T(1), *T.D. 9303 (December 19, 2006)* .

(n6)Footnote 5. The conversion or exchange of a debt security into stock of another corporation, however, is fully taxable. See *Rev. Rul. 69-135, 1969-1 C.B. 198*.

(n7)Footnote 6. See ILM 200350016 (Aug. 28, 2003) (where the IRS concluded that a transaction was not a "G" reorganization); and *TAM 9841006 (June 25, 1998)* (providing a good example of the approach the IRS would take in attempting to characterize a purportedly taxable transaction as a tax-free reorganization under *I.R.C. § 368*).

(n8)Footnote 7. *I.R.C. § 368(a)(3)(B)(i)*. Definitionally, a "G" reorganization can involve an acquisition of the assets of the debtor corporation by the acquiring corporation or a subsidiary of the acquiring corporation, or by the debtor corporation or by a subsidiary of the debtor corporation. See *I.R.C. § 368(b)* (definition of a "party to the reorganization"). See generally *P TX10.03[5] infra*.

(n9)Footnote 8. See chapter TX11 *infra*.



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CHAPTER TX10 Tax-Free Reorganization of Debtor Corporations

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P TX10.02 One Corporation Recapitalization

[1] Introduction

Frequently, a financially troubled debtor corporation survives its financial difficulties by restructuring its capital structure, in particular its debt. It does so by renegotiating or restructuring the terms of its outstanding obligations, seeking new capital, exchanging equity for debt, or a combination thereof. This restructuring involves only the corporate debtor and its creditors and/or shareholders. Such a one corporation recapitalization, whether in or out of a title 11 case, can qualify as a tax-free "E" reorganization under *I.R.C. section 368*. The "E" recapitalization is the most common tax-free reorganization associated with a one company debt restructuring. However, because the corporation generally does not receive any property of another corporation in a recapitalization, tax-free "E" reorganization treatment is relevant only to the exchanging stock or security holders.

By comparison, a "G" reorganization is a specific category of corporate reorganization aimed to facilitate the acquisition of (or by) a corporation in a title 11 case. n1 By definition, a "G" reorganization requires the transfer by a corporation of "substantially all" of its assets to the acquiring corporation. Thus, a "G" reorganization requires two parties--an acquiring and an acquired corporation.

[2] Definition of a Recapitalization

Among the delineated categories of tax-free reorganizations, *I.R.C. section 368(a)(1)(E)* provides that a "reorganization" includes a "recapitalization." The definition of a recapitalization is left to examples provided in the Treasury regulations. n2 A recapitalization has been described as a "reshuffling of a capital structure within the framework of an existing corporation." n3 Under this definition, a recapitalization is limited to changes in capital stock or securities n4 of a single corporation. n5

The Treasury regulations describe a "recapitalization" qualifying as a tax-free reorganization as including the issuance of preferred stock in exchange for bonds, the issuance of preferred stock in exchange for outstanding common stock, the issuance of "new" common stock in exchange for outstanding preferred stock and an exchange of preferred stock with dividends in arrears for "other stock" of the corporation. n6 Further, exchanges of the same classes of stock (common for common and preferred for preferred) n7 and the exchange of old bonds for new bonds with the same principal amount will qualify. n8 Similarly, a recapitalization will include the issuance of preferred or common stock in exchange for long-term bonds qualifying as a tax security. n9 A recapitalization is not conditioned upon whether the exchange is

tax-free to the holder of the instrument exchanged. n10 However, a recapitalization will not be tax-free if the instrument exchanged pursuant to the plan does not qualify as stock or a tax security. n11

There are additional nonstatutory requirements generally imposed on all tax-free reorganizations that are applicable to a recapitalization. n12 Among these are that a recapitalization must only be undertaken with a legitimate business purpose. n13 The continuity of business enterprise requirement is inapplicable because a recapitalization involves only one corporation. n14 For the same reason, there is no shareholder continuity of interest requirement. n15

[3] Treatment of Issuing Corporation

Generally, the issuing corporation in a recapitalization only issues its own stock or securities and does not, as such, exchange "property" with respect to which gain or loss could otherwise be recognized. n16 To the extent that indebtedness of the corporation is reduced or eliminated through the issuance of stock or new debt, the corporation may realize discharge of indebtedness income. n17 Whether the discharge of indebtedness income is actually recognized as taxable income depends upon whether the corporation qualifies to exclude the discharge of indebtedness income under *I.R.C. section 108(a)*. n18 Clearly, a solvent corporation not in a title 11 case (or an insolvent corporation not in a title 11 case, to the extent made solvent) will recognize discharge of indebtedness income realized in the exchange. n19 Even if the issuing corporation's tax attributes remain intact, its attributes may be limited in the event of a change of stock ownership. n20 Original issue discount also can be created with respect to new debt instruments issued by the corporation. n21

[4] Treatment of Parties Receiving Stock or Securities

The income tax treatment of parties receiving consideration from the issuing corporation in a recapitalization will depend upon both the nature of the instrument exchanged and the consideration received in exchange therefor. Assuming the recapitalization qualifies as a tax-free reorganization under *I.R.C. section 368*, the analysis is the same as that for parties to a "G" reorganization. n22 The debtholder will not be entitled to nonrecognition treatment to the extent the holder receives a principal amount of securities in excess of the principal amount surrendered or to the extent any property received is attributable to accrued interest. n23

FOOTNOTES:

(n1)Footnote 1. *See P TX10.03 infra*.

(n2)Footnote 2. *Treas. Reg. § 1.368-2(e)*.

(n3)Footnote 3. *Helvering v. Southwest Consol. Corp.*, 315 U.S. 194, 202, 62 S. Ct. 546, 86 L. Ed. 789 (1942) ; *see also Commissioner v. Neustadt's Trust*, 131 F.2d 528 (2d Cir. 1942) . *See generally*, Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, P 12.27 (WGL 7th ed. 2000).

(n4)Footnote 4. For a definition of the term "securities," *see P TX7.03[1][a] supra*.

(n5)Footnote 5. The conversion or exchange of a debt security into stock of another corporation, however, is fully taxable. *See Rev. Rul. 69-135, 1969-1 C.B. 198* .

(n6)Footnote 6. *Treas. Reg. § 1.368-2(e)*. *See Rev. Rul. 86-25, 1986-1 C.B. 203* ; *Rev. Rul. 77-238, 1977-2 C.B. 115* ; *Priv. Ltr. Rul. 9205041 (Nov. 7, 1991)* (deemed exchange of Class B preferred stock for nonvoting common stock). Note that preferred stock issued for common may be treated as "section 306" stock. *See I.R.C. § 306(c)*; *Rev.*

Rul. 56-586, 1956-2 C.B. 214 .

(n7)Footnote 7. *Johnson v. Commissioner, 78 T.C. 564 (1982) ; Rev. Rul. 56-586, 1956-2 C.B. 214 ; Priv. Ltr. Rul. 9412007 (Dec. 7, 1993) (exchange of common stock for Series B ESOP common stock qualified as a recapitalization).*

An exchange of the same classes of stock may also qualify for nonrecognition unnder *I.R.C. § 1036. See Treas. Reg. § 1.1036-1(a).*

(n8)Footnote 8. *Commissioner v. Neustadt's Trust, 131 F.2d 528 (2d Cir. 1942) ; Rev. Rul. 58-546, 1958-2 C.B. 143 ; Tech. Adv. Mem. 8815 -003. See also Priv. Ltr. Ruls. 94-12-013 (Dec. 21, 1993) (exchange of old debentures for new debentures and common stock qualified as a recapitalization and was not a disposition under *I.R.C. § 453B (f)*); 92-35-052 (June 4, 1992) (exchange of proprietary interests in a mutual life insurance company qualified as a recapitalization).*

(n9)Footnote 9. *Treas. Reg. § 1.368-2(e)(1); Lorch v. Commissioner, 70 T.C. 674 (1978) , aff'd, 605 F.2d 657 (2d Cir. 1979) (exchange of debentures for preferred stock was a recapitalization); Davis v. Penfield, 205 F.2d 798 (5th Cir. 1953) (debentures for preferred stock); Hickok v. Commissioner, 32 T.C. 80 (1959) (debentures for common stock); Rev. Rul. 59-98, 1959-1 C.B. 76 (6-year mortgage bonds qualified as a security and exchange of bonds for stock qualified as a recapitalization).*

(n10)Footnote 10. *Microdot, Inc. v. United States, 728 F.2d 593 (2d Cir. 1984) .*

(n11)Footnote 11. *I.R.C. § 354(a)(1), (a)(2)(A). See P TX10.04[4] infra.*

(n12)Footnote 12. *See P TX10.03[4] infra.*

(n13)Footnote 13. *Commissioner v. Neustadt's Trust, 131 F.2d 528 (2d Cir. 1942) .*

(n14)Footnote 14. *Rev. Rul. 2003-19, 2003-7 I.R.B. 468 ; Treas. Reg. § 1.368-1(b).*

(n15)Footnote 15. *Microdot, Inc. v. United States, 728 F.2d 593 (2d Cir. 1984) ; Golden Nugget, Inc. v. Commissioner, 83 T.C. 28, 37 (1984) ; Hickok v. Commissioner, 32 T.C. 80 (1959) ; Treas. Reg. § 1.368-1(b)*

(n16)Footnote 16. *I.R.C. § 1032 (corporation does not recognize gain or loss on receipt of money or property in exchange for its stock); Treas. Reg. § 1.61-12(c)(1) (corporation realizes no gain or loss on issuance of bonds at face). Although the regulation refers to the face amount of the bond, the issue price of the debt instrument will be used to measure the amount of debt discharge income. *I.R.C. § 108(e)(10).**

(n17)Footnote 17. *I.R.C. § 108(a)(8).*

(n18)Footnote 18. For a discussion of the application of *I.R.C. § 108*, see P TX8 *supra*.

(n19)Footnote 19. *See Rev. Rul. 77-437, 1977-2 C.B. 28 (discharge income realized on a bond for bond exchange is not protected from income recognition by *I.R.C. § 1032*); Priv. Ltr. Rul. 9205041 (Nov. 7, 1991) ; see also General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, Staff of the Joint Committee on Taxation, 98th Cong. 2d Sess. 168(Dec. 31, 1984) ("Section 1032 does not prevent the recognition of ... income from the discharge of indebtedness" realized by a solvent corporation to the extent the adjusted issue price of the debt exceeds the value of stock given in exchange therefor).*

(n20)Footnote 20. In the event of a "change of ownership," a debtor corporation's built-in (future) as well as net operating (past) losses may be reduced or eliminated under *I.R.C. § 382. See chapter TX11 infra.*

(n21)Footnote 21. *I.R.C. § 108(e)(10)*. For a discussion of the original issue discount rules, *see* chapter TX9 *supra*. The AHYDO rules of *I.R.C. § 163(e)(5)* and *(i)* may apply to defer or deny a deduction for the original issue discount on the new debt instrument.

(n22)Footnote 22. *See P TX10.04[4] infra* and chapter TX7 *supra* .

(n23)Footnote 23. *I.R.C. §§ 354(a)(2)(A)* and *(B)*.



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CHAPTER TX10 Tax-Free Reorganization of Debtor Corporations

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P TX10.03 Requirements for Two Corporation G Reorganization

A "G" reorganization is defined in *I.R.C. section 368(a)(1)(G)* as (1) a transfer of assets, (2) by a corporation to another corporation if one (or both) of the corporations is in a title 11 or similar case, (3) followed by a distribution, in pursuance of the plan, of the consideration received in a transaction that qualifies under *I.R.C. section 354, 355 or 356*. As a tax-free reorganization, a "G" reorganization also requires compliance with various other regulatory and judicial requirements. Interestingly, a "G" reorganization is not elective and the IRS is presumably free to recharacterize a taxable acquisition of assets as a tax-free "G" reorganization. n1

[1] Transfer of Assets

[a] Transfer of "Substantially All" the Assets

The first requirement for a "G" reorganization is that there be a transfer by a corporation of all or part of its assets to another corporation. n2 A "transfer" includes an acquisition of the debtor corporation's assets by a pre-existing corporation n3 or the transfer of the debtor corporation's assets to a new corporation formed to effectuate the plan. n4 However, the mere transfer of stock of the debtor corporation to creditors in payment of claims will not qualify as a "G" reorganization. n5 A transfer of assets will qualify if *any party* to the reorganization is under the jurisdiction of the bankruptcy court. n6 Consequently, a "G" reorganization can take the form of (1) an acquisition of assets from the debtor corporation; (2) a divisive reorganization in which operating businesses of the debtor corporation are separated; or (3) an acquisition of assets *by* the debtor corporation. Thus, a debtor corporation subject to the jurisdiction of the bankruptcy court can acquire assets of a nondebtor corporation in exchange for its stock and securities in a qualifying "G" reorganization.

In addition to the specific "transfer" requirement of *I.R.C. Section 368(a)(1)(G)*, *I.R.C. section 354(b)* requires that there be an acquisition of "substantially all" of the assets of the transferor corporation. n7 A similar requirement is imposed to qualify as a "C" n8 or "D" n9 reorganization. To meet the "substantially all" requirement for advance ruling purposes for reorganizations other than a "G" reorganization, the IRS requires that at least 90 percent of the net assets and 70 percent of the gross assets must be acquired in the reorganization. n10

The "substantially all" requirement for advance ruling purposes appears to impose standards that may be difficult for a debtor corporation in a title 11 case to meet. For example, the typical debtor corporation may not even possess any "net assets," as the liabilities of the debtor corporation will exceed the fair market value of its assets. It could also be

expected that a debtor corporation would use in excess of 30 percent of its gross assets (or the proceeds of disposition of such assets) to pay claims of existing creditors. Congress intended that substantially all the requirements be interpreted liberally in view of the underlying purpose for the "G" reorganization provision of facilitating the reorganization of financially troubled companies. n11 As a result, the "substantially all" requirement should be satisfied even if the debtor corporation sells assets or business divisions to pay off certain classes of creditors or to otherwise rearrange its business affairs in order to obtain creditor approval of its chapter 11 plan of reorganization. n12

In private letter rulings, the IRS has adopted a more lenient position with respect to debtor corporations and the "substantially all" test. First, the IRS has ruled that an acquisition qualified as a "G" reorganization where it was represented that more than 50 percent of the value of the gross assets and more than 70 percent of the value of the operating assets were acquired. n13 For this purpose, "operating assets" were defined as all assets except cash, accounts receivable and investment assets. In testing the pool of operating assets, the IRS allowed the debtor to exclude certain assets which were removed from operations to be sold. n14

Second, and more importantly, only the assets held on the date that the debtor corporation determined that it could not continue as an independent going concern were taken into account by the IRS. Thus, under the IRS's ruling position, it appears that a financially troubled corporation may dispose of assets to pay operating costs and minimize losses while operating as a going concern without the fear of jeopardizing a subsequent "G" reorganization. As a practical matter, if it is apparent that the debtor corporation must sell assets to pay operating expenses or costs of the title 11 reorganization effort or simply wishes to dispose of unwanted assets, it is important that the corporation be operated as an independent going concern prior to a "G" reorganization transaction. Premature efforts to locate an acquiring corporation may prove fatal to a successful "G" reorganization if the debtor disposes of significant assets in the interim period; this is because all of the assets owned at the time of the premature efforts may be counted in determining whether or not "substantially all" of the assets were acquired.

[b] Divisive Reorganizations

A "G" reorganization may take the form of a divisive rather than an acquisitive reorganization. The divisive "G" reorganization is permitted by reason of the reference in *I.R.C. section 368(a)(1)(G)* to a distribution which occurs under *I.R.C. section 354, 355 or 356*. *I.R.C. section 355* permits a tax-free distribution by one corporation of solely stock or securities in a controlled corporation to its shareholders with respect to their stock or to security holders in exchange for their securities. n15 There are a number of requirements imposed by *I.R.C. section 355*. First, the distributing corporation must control the subsidiary whose stock or securities are being distributed immediately before the transaction. n16 *I.R.C. section 368(c)* defines "control" to mean at least 80 percent of total voting power and 80 percent of the total number of all other classes of nonvoting stock. Second, the affiliated group of which the distributing corporation and the controlled subsidiary are a part of must each conduct an active trade or business immediately after the distribution. n17 The active trade or business requirement will be satisfied if the business relied on was actively conducted for five years prior to the date of distribution or if a business with the requisite period of activity was acquired within the five year period prior to the distribution, it was acquired in a transaction in which any gain or loss was not recognized. n18 Third, the distributing corporation must either (1) distribute all of its stock and securities in the controlled subsidiary, or (2) distribute stock constituting "control" of the subsidiary and establish that the retention of the excess stock and/or securities is not a part of a tax avoidance plan. n19 In addition, the transaction must not be used principally as a device for the distribution of earnings and profits of the parent or subsidiary corporation or both. n20

A divisive "G" reorganization will only be possible when the business activities of the debtor corporation are such that they could be split into two active businesses (or the debtor owns a controlling interest in two or more operating subsidiary corporations) and such businesses (or stock interests) will be distributed pursuant to the plan of reorganization. While divisive "G" reorganizations are not used often in the bankruptcy context, there have been instances where divisive "G" reorganizations were used. n21

[2] Transfer Occurs in Title 11 or Similar Case

To qualify as a "G" reorganization, the transfer by a corporation of all or a part of its assets to another corporation must occur in a title 11 or similar case. The phrase "title 11 or similar case" includes a case under title 11 of the United States Code, and a receivership, foreclosure, or similar proceeding in a federal or state court. n22 This provision will be satisfied only if any party n23 to the reorganization is subject to the jurisdiction of a court *and* the transfer of assets occurs pursuant to a plan approved by such court. n24

Legislative history indicates that the definition of a receivership, foreclosure, or similar proceeding is intended to be the same as under prior law. Under prior law, n25 the phrase "receiverships, foreclosures or similar proceedings" included receiverships n26 and foreclosures n27 in which, in a transaction or series of transactions n28 pursuant to a plan approved by a court, n29 the insolvent corporation's interest n30 in all or a portion n31 of its assets was acquired by another corporation. Based on the prior case history, the acquisition of an insolvent corporation's assets through prejudgment proceedings such as attachment, sequestration or garnishment may qualify as a "G" reorganization if both the creditor's interest in the property and the plan of reorganization are approved or confirmed by a court.

Although out-of-court and foreign reorganizations are obviously excluded, chapter 11 reorganizations will qualify since the bankruptcy court will enter a formal order confirming the chapter 11 plan of reorganization. To ensure compliance, the chapter 11 plan of reorganization should contain an express statement that the transfer of the debtor's assets is in exchange for stock and other consideration of the acquiring corporation and that such transfer occurs pursuant to the plan. n32

[3] Distribution of Stock or Securities

The third statutory requirement is that stock or securities of the acquiring corporation must be distributed, pursuant to the plan, to a holder of stock or securities in the acquired corporation in a transaction which qualifies under *I.R.C. sections 354, 355 or 356*. In the typical chapter 11 reorganization case involving the acquisition of the debtor corporation's assets by an unrelated corporation, *I.R.C. sections 354 and 356* will have to apply (as opposed to *I.R.C. section 355* which deals with divisive reorganizations). *I.R.C. section 354* provides that holders of stock or securities in the debtor corporation will not recognize gain or loss if they exchange their stock or securities *solely* for stock or securities in the acquiring corporation. n33 If nonqualifying consideration ("boot"), such as cash or short-term notes, is transferred, *I.R.C. section 356* provides that, if *I.R.C. section 354* would apply to the transaction except for the receipt of "boot," the gain realized by the shareholders or security holders in the exchange will be recognized to the extent of the "boot" received. n34

Because there must be an exchange of stock or securities in order to qualify under *I.R.C. section 354*, a "G" reorganization requires a transfer by at least one holder of stock or a security of the acquired corporation's stock or securities. If a holder of securities in the acquired corporation actually receives stock or securities (or a shareholder actually receives stock) in the acquiring corporation pursuant to the plan of reorganization, the transaction should qualify as a "G" reorganization even if the value of the stock or securities received by such security holders (or stock received by shareholders) represents a small percentage of the value of the total equity consideration given in the transaction. n35 Thus, the threshold exchange requirement under *I.R.C. section 354* can be satisfied if at least one security holder receives stock or securities (or one shareholder receives stock) pursuant to the plan of reorganization. n36

Although compliance with *I.R.C. section 354* was intended to ensure that the transaction has all of the basic "trappings" of a tax-free reorganization, this requirement will present a difficult obstacle in qualifying many transactions as "G" reorganizations. A chapter 11 reorganization of a debtor corporation may involve only trade creditors and other short-term creditors; in such case, the chapter 11 reorganization may not qualify as a "G" reorganization. Except in large and complex cases, the acquired debtor corporation may not have any outstanding long-term debentures that qualify as

tax securities. Shareholders will generally not have any equity in the debtor corporation and may not be entitled to receive a distribution of stock or other property pursuant to the plan of reorganization. A typical reorganization plan providing for cancellation of the old shares and distribution of the acquiring corporation's stock among short-term creditors fails to satisfy the threshold *I.R.C. section 354* requirement of an exchange of "stock or securities," because the claims of these creditors do not constitute "securities" for federal income tax purposes. n37

As the above example illustrates, it appears that due to a technical flaw in the statute, a chapter 11 reorganization involving only short-term creditors cannot qualify as a tax-free "G." It is interesting to note that the 1980 Committee Reports do include short-term creditors for purposes of the continuity of interest requirement. n38 Nonetheless, until Congress remedies this problem, qualification under *I.R.C. section 354* requires a transfer of stock or securities to at least one shareholder or security holder. n39

One possible way to avoid this unintended result may be to convert the claims of creditors into stock of the acquired debtor corporation prior to the date that the "G" reorganization is consummated. n40 Thereafter, and pursuant to the plan, the creditor/shareholders exchange their stock in the debtor for stock and other consideration transferred by the acquiring corporation. Arguably, this conversion of creditors into shareholders merely formalizes the position of the creditors of a financially troubled entity as the true equity owners. This concept is based on principles first set out in *Helvering v. Alabama Asphaltic Limestone Co.* concerning the continuity of interest requirement. n41 In that case, the Supreme Court held that the continuity of interest requirement was met when, in an involuntary bankruptcy case, the creditors were issued stock in exchange for their debt. While the Court acknowledged that the old continuity of interest was clearly broken (since none of the former shareholders continued as owners of the "reorganized" corporation), it concluded that "[f]or practical purposes, however, it [the transfer] took place not later than the time when the creditors took steps to enforce their demands against their insolvent debtors. 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." n42

It should be noted, however, that even if the overall transaction qualifies as a tax-free "G" reorganization, short-term creditors who receive stock in exchange for their claims will recognize gain or loss. Recognition is required because the exchange fails to qualify for nonrecognition treatment under *I.R.C. section 354*. n43

One other consequence of the necessity of qualification under *I.R.C. section 354* is that the acquiring corporation's stock or securities received by the acquired debtor corporation and any other assets held by the corporation must be distributed pursuant to the plan of reorganization. This provision implicitly means that the acquired corporation (typically the debtor) must liquidate and dissolve as the final step in the reorganization. n44

[4] Other Tax-Free Reorganization Requirements

In addition to the statutory requirements, a "G" reorganization must meet additional nonstatutory requirements imposed on all tax-free corporate reorganizations. Principally, these include the "continuity of interest," "continuity of business enterprise," and "business purpose" requirements. As discussed below, these judicially developed concepts are not easily adapted to the unique title 11 environment and consequently add uncertainty to "G" reorganizations.

[a] Continuity of Interest

[i] Type of Consideration Given

Pursuant to the continuity of interest requirement, the former equity owners of the acquired corporation must not be "cashed out" but must maintain a proprietary interest in the acquiring or surviving corporation. That is, "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." n45 Although a "G" reorganization is similar to both a "C" and a "D" reorganization in that they each contemplate an

acquisition of substantially all of the assets of a corporation, one of the most important differences is the nature of consideration which can be given in the exchange. Like an "A" reorganization, the "G" reorganization provision does not specify the nature or extent of the equity consideration that must be received by the target shareholders, for the transaction to qualify as a tax-free reorganization. n46 Rather, the judicially created "continuity of interest" doctrine represents the only limitation on the character of consideration given in exchange for the assets of the acquired corporation. n47

Pursuant to the continuity of interest requirement, a substantial portion of the value of the proprietary interests in the transferor corporation must be preserved for a transaction to qualify as a reorganization under section 368 (the "Continuity of Interest Requirement"). n48 Temporary regulations published in 2007 effectively establish, through several examples, that the holders of proprietary interests in a transferor corporation must receive at least 40 percent of their total consideration in the form of stock to meet the Continuity of Interest Requirement. n49

In most reorganizations of bankrupt companies, the former shareholders of the company do not receive stock of the acquiring corporation. The courts have developed special rules in these circumstances, which treat the creditors of a failing company as the holders of its proprietary interests and therefore permit such reorganizations to satisfy the Continuity of Interest Requirement. In particular, based upon the case law and legislative history discussed below, for G Reorganization purposes, the most senior class of creditors to receive stock in the transaction, plus all interests equal and junior to them are generally treated as the owners of the proprietary interests of the corporation who must receive a substantial portion (*i.e.*, 40 percent) of their consideration in the form of stock. This view is generally reflected in final regulations issued by the Service and Treasury Department in December 2008 (the "Final Creditor Continuity of Interest Regulations"). n50

[A] Creditors Preserve Continuity of Interest

In *Helvering v. Alabama Asphaltic Limestone Co.*, the Supreme Court held, in a case involving a reorganization of a bankrupt corporation, that the old continuity of interest in the shareholders shifted to the creditors not later than the time when the creditors took steps to enforce their demands against the insolvent debtor (*i.e.*, the date of the institution of bankruptcy proceedings). n51 In *Atlas Oil & Refining Corp. v. Commissioner*, the Tax Court interpreted the determination of continuity of interest under *Alabama Asphaltic* to mean that only those creditors who actually received stock under the plan of reorganization can be considered to be equity owners at the time of the transfer. n52 Effectively, the court held that the most senior class of creditors to receive stock, and all junior classes of creditors who receive consideration, are considered the equity owners of a troubled corporation. n53

[B] Legislative History -- Bankruptcy Tax Act of 1980

As discussed above, the G Reorganization provisions were signed into law in the Bankruptcy Tax Act of 1980. n54 The legislative history to the Bankruptcy Tax Act of 1980 indicates Congressional intent that, in the case of a G Reorganization, "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." n55 In addition, this legislative history suggests that priority claims, such as administrative claims during the pendency of a bankruptcy proceeding, that are paid in cash may be excluded from the continuity of interest analysis due to the priority of such claims over other creditors. n56 Finally, the above-referenced legislative history further provides that "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 [U.S. federal] income tax purposes." n57 This standard for analyzing continuity of interest is similar to that espoused in *Alabama Asphaltic* and *Atlas Oil*.

[C] Final Creditor Continuity of Interest Regulations

The Final Creditor Continuity of Interest Regulations address the circumstances in which a creditor's claim against a target corporation will be treated as a proprietary interest in the target corporation for purposes of the Continuity of Interest Requirement. n58 The treatment accorded a creditor's interest in these final regulations is consistent with the preamble to the Proposed Net Value Regulations, which indicates that the rule is intended to implement the "relation back" approach of *Atlas Oil* and, in the case of G Reorganizations, the standards adopted in the legislative history to the Bankruptcy Tax Act of 1980. n59

In particular, the Final Creditor Continuity of Interest Regulations provide that a creditor's claim against a target corporation may be considered a proprietary interest for purposes of determining continuity of interest if the target is in a title 11 or similar case or is insolvent. n60 For purposes of this rule, a claim of the most senior class of creditors receiving a proprietary interest in the acquiring corporation in exchange for its claim, and every claim of equal and junior classes of creditors (in addition to claims of shareholders) is a proprietary interest in the target corporation. In such a case, if a class of creditor receives an equity interest in the acquiring corporation in exchange for part of its claim, the claims of that class of creditors are treated as representing, in part, a creditor claim against the corporation, and, in part, a proprietary interest in the corporation. It would appear that this provision applies to all creditors' claims, regardless of either the term of the debt or the period of time that the creditor has owned the debt. n61

If the most senior class of creditors receiving a proprietary interest receives both stock and other property, the determination of the portion of a senior claim that represents a proprietary interest in the target corporation is made by bifurcating such claim into the portion that is treated as a proprietary interest and the portion that is not. This bifurcation is accomplished by multiplying the fair market value of the creditor's claim by a fraction, the numerator of which is the fair market value of the stock in the acquiring corporation that is received in the aggregate in exchange for that class of claims, and the denominator of which is the sum of the money and the fair market value of all consideration (including the stock) received in exchange for such claims. n62 Furthermore, the entire amount of any junior creditor claims represent a proprietary interest in the target corporation, the value of which is represented by the fair market value of the claims (as measured by reference to the amount of money and the fair market value of other consideration received by such creditor). n63 Shares of the target corporation's stock for which consideration is received in the reorganization would also be considered proprietary interests for purposes of this test. n64

[ii] Post-Acquisition Continuity for Transactions After January 28, 1998

For transactions occurring after January 28, 1998, the requirement of post- reorganization continuity of interest was relaxed significantly. n65 Continuity of interest will be maintained if a substantial part of the value of the proprietary interests in the target corporation is preserved in the reorganization. n66 As discussed above, sufficient continuity exists if 40 percent of the consideration given is equity (IRS advance ruling guidelines). A significant change from prior law is that dispositions of stock of the issuing corporation received by target shareholders in the reorganization (and dispositions of target stock prior to the reorganization) to persons not related to the issuing corporation are ignored. n67

[b] Continuity of Business Enterprise

Continuation of the acquired corporation's business is not required by either the statute or the legislative history. It is, however, another judicial requirement imposed on all tax-free reorganizations, now reflected in the regulations. "Continuity of business enterprise" requires that the acquiring corporation must either (1) continue the acquired corporation's historic business, or (2) use a significant portion of the acquired corporation's historic business assets in a continuing business. n68 The Treasury Regulations indicate that this is a facts and circumstances test intended to ensure that the acquisition has the essential characteristics of a reorganization. n69 Although there is no specific relief from this provision, it appears that Congress implicitly intended that this rule be interpreted liberally in the case of a title 11 reorganization. As discussed above, n70 *I.R.C. section 354(b)(1)(A)* requires the transfer of "substantially all" of the assets of the acquired corporation. However, the 1980 Committee Reports specifically provide that a debtor corporation should be permitted to sell assets or divisions of its business in order to raise cash to pay certain creditors or to

otherwise rearrange its business operations in order to facilitate thereorganization, without failing the "substantially all" requirement. n71 Based on this authority, the "continuity of business enterprise" requirement should similarly be satisfied so long as a portion of the acquired debtor corporation's historic business or some of its assets are continued to be used in a business. n72

[c] Business Purpose

All tax-free reorganizations must be undertaken pursuant to a legitimate business purpose. The Treasury Regulations indicate that a reorganization which is part of a preconceived plan with no corporate purpose or which is a device for the avoidance of taxes, will not be respected as a tax-free reorganization. n73 As a practical matter, the "business purpose" doctrine should not be an issue in the typical title 11 reorganization. In the order confirming the debtor's reorganization plan, the Bankruptcy Code provides that the judge must find that the plan has been proposed in good faith. n74 Also, upon a proper motion of a governmental unit, the court may not confirm the plan if its principal purpose is the avoidance of taxes. n75

[d] Net Value

Treasury and the IRS issued proposed regulations on March 9, 2005 (the "Proposed Net Value Regulations"), taking a first step toward providing a comprehensive set of rules addressing the application of the nonrecognition provisions of subchapter C to transactions involving insolvent corporations. The Proposed Net Value Regulations address whether sections 332, 351, and 368 apply when there is no exchange of net value.

For purposes of section 368, the Proposed Net Value Regulations require that asset and stock reorganizations must also include an exchange of net value. n76 Although not specifically stated, this proposed requirement seemingly would apply to a G reorganization. Reorganizations described in *I.R.C. section 368(a)(1)(E)* or *(F)* would not be subject to this requirement. In a potential asset reorganization, the acquiring corporation is treated as surrendering net value if the fair market value (immediately prior to the transaction) of the assets transferred to the acquiring corporation exceeds the sum of the amount of liabilities assumed by the acquiring corporation and boot received by the target corporation. n77 The acquiring corporation is treated as receiving net value if the fair market value of its assets exceeds its liabilities immediately after the transaction. n78

In a potential stock reorganization under *I.R.C. section 368(a)(1)(B)* or *I.R.C. section 368(a)(1)(A)* (by reason of *I.R.C. section 368(a)(2)(E)*), the target corporation is treated as surrendering net value if the fair market value of its assets (immediately prior to the transaction) exceeds the sum of the liabilities of the target corporation (immediately prior to the transaction) and boot received by target shareholders in connection with the exchange. n79 Liabilities extinguished in the exchange are disregarded for this purpose, except to the extent such liabilities were owed to the corporation into which the target merges in an *A/(a)(2)(E)* reorganization. The target corporation is treated as receiving net value if the fair market value of the issuing corporation's assets exceed its liabilities immediately after the exchange. n80

For purposes of applying the net value provisions to potential subchapter C nonrecognition transactions, the Proposed Regulations take into account not only liabilities directly assumed in the transaction, but also liabilities assumed "in connection with" the transaction. Therefore, an acquiring corporation's assumption of a target corporation's liability (or a creditor's discharge of a target corporation's indebtedness) will affect the determination of whether there is a surrender of net value, and whether the assumption occurs before, during, or after the transaction. A similar rule applies for boot received in connection with the transaction.

The Proposed Regulations provide no guidance regarding the definition of "liability" for purposes of the net value requirement, nor do they provide guidance on determining the amount of a liability. The preamble indicates that the Treasury and the IRS intend that the term "liability" be interpreted for income tax purposes. The preamble also states that several approaches are being considered for determining the amount of a liability, including a determination of

adjusted issue price for debt instruments under the OID rules.

The Proposed Regulations are prospective, applying to transactions occurring after the regulations are finalized. n81 These rules, if finalized, will have a large impact on restructuring transactions involving bankrupt and insolvent corporations. Current law may continue to be relied upon until such date as the Proposed Regulations are finalized.

[5] Triangular and Drop-Down Reorganizations

One of the important consequences of including bankruptcy acquisitions as another category of tax-free reorganization is that there are additional provisions which permit flexibility in structuring the acquisition. For example, an acquiring corporation can transfer the acquired assets to a direct and indirect "controlled" subsidiary in a "drop-down" transaction. A qualifying "G" reorganization can also be structured as a forward triangular reorganization in which a subsidiary acquires the assets in exchange for stock of the corporation which is in control of the subsidiary (the "parent"). Finally, the transaction can be structured as a reverse triangular merger in which the acquired corporation is merged into a subsidiary of the controlling corporation. Each of these alternatives is discussed in more detail below.

[a] Drop-Down

An acquisition of substantially all of the assets of another corporation which qualifies as a "G" reorganization will not be disqualified if the assets are transferred to a direct and indirect "controlled" subsidiary. n82 This is commonly referred to as a "drop-down" reorganization. However, in the case of a drop-down "G" reorganization, the requirements of *I.R.C. section 354(b)(1)* must also be met. n83 As a result, (1) an acquiring corporation must acquire "substantially all" of the assets, and (2) the consideration received by the transferee corporation must be distributed pursuant to the plan. n84 These requirements will not impose any additional burden on the transaction, because, as discussed above, n85 a "G" reorganization requires that the stock or securities of the acquiring corporation must be distributed.

[b] Forward Triangular Merger

In a forward triangular merger, a subsidiary of the controlling parent corporation acquires the assets of the target corporation in exchange for stock of the parent. A forward subsidiary "G" reorganization is permitted if only stock of the controlling parent corporation is used. n86 Accordingly, a "G" reorganization can be structured either as a direct acquisition of assets by the acquiring corporation or, in the alternative, by the acquiring corporation's formation of a new subsidiary which then acquires the target corporation's assets solely in exchange for an amount of its parent corporation's stock sufficient to satisfy the continuity of interest requirements. n87

As a practical matter, a forward triangular merger is the optimal structure for an acquisition of a debtor corporation's assets in a "G" reorganization because the acquired assets will not have been owned by or passed through the parent corporation. Any creditors of the acquired debtor corporation whose claims may not have been discharged under the Bankruptcy Code would not have any basis on which to file a subsequent "matured" claim against the unrelated assets of the parent corporation. n88 Instead, such claims could only be filed against the assets of the acquiring subsidiary corporation. A forward triangular merger structure should also limit the assets which will be the subject of basis reduction for excluded discharge income under *I.R.C. sections 108(b)(2)(E)* and *1017* to only those assets acquired where a newly formed subsidiary is the acquiring company.

[c] Reverse Triangular Merger

A third alternative is also available. Outside of the bankruptcy context, a merger qualifies as a tax-free reorganization where stock of the controlling parent is used if (1) the surviving subsidiary holds substantially all of the properties owned by both the merged subsidiary and the target corporation, and (2) former shareholders of the surviving corporation receive voting stock equal to at least 80 percent of the value of the target. n89 This is commonly referred to as a reverse triangular merger because the target survives as the subsidiary of the acquiring parent corporation.

The second requirement of an exchange of 80 percent control by the shareholders of the target corporation would render this provision inapplicable to virtually every acquisition of a debtor corporation in bankruptcy. For this reason, there is special relief for acquired debtor corporations. n90 Specifically, the second requirement is met if (1) former shareholders of the surviving corporation do not receive any consideration for their stock, and (2) former creditors receive voting stock of the controlling parent corporation of a value equal to 80 percent or more of the fair market value of the debt of the debtor corporation. n91

Although the special rules applicable to debtor corporations are intended to facilitate the qualification of "G" reorganizations as reverse subsidiary "stock" acquisitions, n92 it is unlikely that many transactions will qualify. First, the target debtor corporation likely will be insolvent so that none of its shareholders receive any consideration in the transaction or any distribution pursuant to the plan of reorganization. Second, the Treasury Regulations governing reverse stock acquisitions require that 80 percent or more of the stock of the acquired target corporation must be surrendered in the transaction in exchange for voting stock of the controlling parent corporation. n93 It is unclear whether this prohibition against "creeping" acquisitions will prevent an acquiring corporation that owns more than 20 percent of the value of the outstanding claims of the debtor corporation from acquiring the assets in a reverse "G" transaction. Finally, the reverse stock acquisition rules increase the minimum value of voting stock of the acquiring parent corporation which must be given in the transaction from the continuity of interest limitation (which is, at most, 50 percent) to 80 percent of the value of the total debt. n94

[6] Reorganizations Qualifying Under Other Provisions

If a transaction qualifies as both a "G" reorganization and under any other reorganization category or as a complete liquidation n95 or as a tax-free incorporation n96 then, for purposes of Subchapter C (the subchapter governing the tax treatment of corporations), the transaction will only qualify as a "G" reorganization. n97 One interpretation of this exclusivity rule is that a failed "G" reorganization cannot alternatively qualify under one of the other corporate nonrecognition rules. There is some authority for this conclusion under similar Internal Revenue Code sections. n98 However, the 1980 Committee Reports provide that "[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 tax-free reorganizations. n99

For example, although a transfer of stock of the debtor corporation to creditors in exchange for their claims will not qualify as a "G" reorganization, the transaction may qualify as an "E" reorganization (a recapitalization). n100 Of course, an "E" recapitalization has its own set of requirements, principally that there must be an exchange of stock and/or securities (although it is not necessary that such exchange be tax-free to the exchanging shareholders or creditors) of a single corporation. n101 In the alternative, creditors may transfer their claims to a new corporation which then acquires the assets of the debtor corporation in exchange for the consolidated claims. Under this structure, the transfer of claims may fall outside the exception to nonrecognition for tax-free incorporations, n102 and gain is generally recognized on the incorporation to the extent of liabilities in excess of basis. n103 However, caution must be exercised (depending on whether taxable or tax-free results are intended), because this structure is, in form, a good "G" reorganization if the other requirements are satisfied (*e.g.*, substantially all the assets, complete distribution, continuity, etc.). n104 Ignoring possible "G" reorganization treatment under these circumstances is a substantial trap for the unwary.

FOOTNOTES:

(n1)Footnote 1. *See, e.g., Priv. Ltr. Rul. 9313020 (Dec. 30, 1990)* (transaction recharacterized as a "G" reorganization).

See also TAM 9841006 (June 25, 1998) (providing a good example of the approach the IRS would take in attempting to characterize a purportedly taxable transaction as a tax-free reorganization).

(n2)Footnote 2. A regular C corporation as well as an S corporation can be a party to a "G" reorganization. See I.R.C. § 1371(a)(1); Priv. Ltr. Rul. 96-29 -016; see Eustice, *Financially Distressed S Corporations*, 53 Tax Notes 97 (Oct. 7, 1991). However, the S election might be terminated as a result of the reorganization. See R. Blau, B. Lemons & T. Rohman, *S Corporations: Federal Taxation* § 13.49 (Callaghan, 1989).

(n3)Footnote 3. See Priv. Ltr. Ruls. 95-44-026 (Aug. 4, 1995) (transfer of substantially all assets of a mutual life insurance corporation to a new corporation); 94-28-014 (April 15, 1994) (parent corporation transfers assets to subsidiary); 94-09-037 (Dec. 7, 1993) (merger of debtor into largest creditor); 94-08-020 (Nov. 29, 1993) (merger of subsidiaries together followed by merger of parent corporation into the subsidiaries); 92-29-039 (April 23, 1992) (merger of parent corporation into first tier subsidiary qualified as a "G" reorganization); 92-26-064 (March 31, 1992) (merger of affiliated corporations qualified as a "G" reorganization); 92-17-040 (Jan. 28, 1992) (same).

(n4)Footnote 4. See Priv. Ltr. Rul. 9335029 (June 3, 1993) (transfer of assets by "old debtor" corporation to a new corporation, "new debtor").

(n5)Footnote 5. For a description of alternative characterizations of this exchange, see P TX10.03[6] *infra*.

(n6)Footnote 6. I.R.C. § 368(a)(3)(B)(i). Prior to its amendment in 1983, if a second corporation, not a title 11 debtor, transferred its assets to the debtor corporation in exchange for stock of the debtor, the transaction would not constitute a "G" reorganization. See Pub. L. No. 97-448, 97th Cong., 2d Sess., § 304(c) (1983); Asofsky, *Reorganizing Corporations*, 47th N.Y.U. Tax Inst., § 40.04[1][a] (1989).

(n7)Footnote 7. I.R.C. § 354(b)(1)(A).

(n8)Footnote 8. I.R.C. § 368(a)(1)(C). See also I.R.C. § 368(a)(2)(G)(i).

(n9)Footnote 9. As with a "G" reorganization, the "substantially all" requirement for a "D" is imposed by I.R.C. § 354(b)(1)(A).

(n10)Footnote 10. Rev. Proc. 77-37, § 3.01, 1977-2 C.B. 568, amplified by Rev. Proc. 86-42, 1986-2 C.B. 722 and Rev. Proc. 89-50, 1989-2 C.B. 631. The cases have generally focused on the operating assets of the business for purposes of the "substantially all" requirement. See, e.g., *Smothers v. United States*, 642 F.2d 894 (5th Cir. 1981); *American Mfg. Co., Inc. v. Commissioner*, 55 T.C. 204 (1970).

(n11)Footnote 11. S. Rep. No. 1035, 96th Cong., 2d Sess. 35-36 (1980), reprinted in Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised); see also H.R. Rep. No. 833, 96th Cong., 2d Sess. 31 (1980).

(n12)Footnote 12. S. Rep. No. 1035, 96th Cong., 2d Sess. 35-36 (1980), reprinted in Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised); see also H.R. Rep. No. 833, 96th Cong., 2d Sess. 31 (1980).

(n13)Footnote 13. See Priv. Ltr. Rul. 9313020 (Dec. 30, 1990); Priv. Ltr. Rul. 8726055 (March 31, 1987); Priv. Ltr. Rul. 8521083 (Feb. 27, 1985); Priv. Ltr. Rul. 8503064 (Oct. 24, 1984). See, e.g., Rev. Rul. 88-48, 1988-1 C.B. 117, where the IRS ruled that, in the context of a "C" reorganization, the "substantially all" requirement was met, although the transferor corporation sold 50 percent of its historic assets for cash to unrelated third parties prior to the qualifying stock for assets exchange. Rev. Rul. 88-48 may not be particularly helpful in the "G" reorganization context because the cash proceeds of the asset disposition were retained by the transferor company. In addition, the transferor corporation must satisfy the continuity of business enterprise requirement. Treas. Reg. § 1.368-1(c).

(n14)Footnote 14. See Priv. Ltr. Rul. 8503064 (Oct. 24, 1984).

(n15)Footnote 15. *I.R.C. § 355(a)(1)(A)*.

(n16)Footnote 16. *I.R.C. § 355(a)(1)(A)*.

(n17)Footnote 17. *I.R.C. § 355(a)(1)(C)* and *355(b)(3)*; *Treas. Reg. § 1.355-3* (Jan. 5, 1989).

(n18)Footnote 18. *I.R.C. § 355(b)*, (b)(2)(c); (b)(3) (the affiliated group that includes the distributor or controlled company is treated as a single entity).

(n19)Footnote 19. *I.R.C. § 355(a)(1)(D)*.

(n20)Footnote 20. *I.R.C. § 355(a)(1)(B)*; *Treas. Reg. § 1.355-2(d)* (Jan. 5, 1989). *Treas. Reg. § 1.355-2(b)* also provides that the transaction must be carried out for a corporate business purpose.

(n21)Footnote 21. See *PLR 200345049* (August 2, 2002) and *PLR 200403060* (September 30, 2003) .

(n22)Footnote 22. *I.R.C. § 368(a)(3)(A)*.

(n23)Footnote 23. The term "party to a reorganization" is defined in *I.R.C. § 368(b)*. See also *Treas. Reg. § 1.368-2(f)*.

(n24)Footnote 24. See *I.R.C. § 368(a)(3)(B)*. 11 U.S.C. § 1123, amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, specifies the contents of a chapter 11 plan. It should be noted that *Treas. Reg. § 1.368-3* provides that each of the corporate parties to a reorganization must adopt the plan of reorganization. See *P TX10.05[1] infra*.

(n25)Footnote 25. See, e.g., *I.R.C. § 371*; *Treas. Reg. § 1.371-1(a)(2)*; *I.R.C. § 371* and the regulations thereunder only applied to proceedings commenced before October 1, 1979; S. Rep. No. 1035, 96th Cong., 2d Sess. 39 (1980), reprinted in Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n26)Footnote 26. *Western Massachusetts Theatres, Inc. v. Commissioner*, 236 F.2d 186 (1st Cir. 1956) ; *San Antonio Transit Co. v. Commissioner*, 30 T.C. 1215 (1958) , acq., 1963-1 C.B. 4 ; *Goldstein Brothers, Inc. v. Commissioner*, 23 T.C. 1047 (1955) .

(n27)Footnote 27. *Pearson Hotel, Inc. v. United States*, 199 F. Supp. 33 (E.D. Ill. 1959) ; *Standard Coal, Inc. v. Commissioner*, 20 T.C. 208 (1953) .

(n28)Footnote 28. Compare *Pearson Hotel, Inc. v. United States*, 199 F. Supp. 33 (E.D. Ill. 1959) with *Northwestern Terra Cotta Corp. v. Commissioner*, 295 F.2d 522 (7th Cir. 1961) and *Harbor Building Trust v. Commissioner*, 16 T.C. 1321 (1951) .

(n29)Footnote 29. See, e.g., *Northwestern Terra Cotta Corp. v. Commissioner*, 295 F.2d 522 (7th Cir. 1961) (transfer not pursuant to court order). See also 11 U.S.C. § 1129, which provides the requirements for confirmation of a plan by the bankruptcy court.

(n30)Footnote 30. See *Harbor Building Trust v. Commissioner*, 16 T.C. 1321 (1951) (property not acquired from corporation because corporation's equity had been previously transferred upon foreclosure of subordinate loan).

(n31)Footnote 31. See, e.g., *Western Massachusetts Theatres, Inc., v. Commissioner*, 236 F.2d 186 (1st Cir. 1956) (transfer of 25 percent of total assets) and *San Antonio Transit Co. v. Commissioner*, 30 T.C. 1215 (1958) , acq., 1963-1 C.B. 4 (transfer of one building).

(n32)Footnote 32. See *Priv. Ltr. Rul. 9409037* (Dec. 7, 1993) , representation (g). For a discussion of the necessity of a "tax" plan of reorganization, see *P TX10.05[1] infra*.

(n33)Footnote 33. If a security holder receives securities with a principal amount in excess of the principal amount of the securities given up in the exchange (or if securities are received and none are given up), then such security holder will receive boot (and recognize gain) to the extent of such excess. *I.R.C. § 354(a)(2)(A)*. See *P TX10.04[4] infra*.

(n34)Footnote 34. *I.R.C. § 356(a)(1)*.

(n35)Footnote 35. *Priv. Ltr. Rul. 9122067 (March 6, 1991)* (under holding (15), a security holder did not recognize gain or loss on receipt of new company stock); *Priv. Ltr. Rul. 8909007 (Nov. 30, 1988)* (ruling conditioned on fact that debentures qualified as "securities" for purposes of *I.R.C. § 354*); *Priv. Ltr. Rul. 8836058 (June 16, 1988)* (no determination specified whether the creditors held "securities"); see also *Priv. Ltr. Rul. 8835057 (June 10, 1988)* (bank acquisition qualified as "G" reorganization despite failure of receipt of consideration by former shareholder), supplemented by *Priv. Ltr. Rul. 8842059 (July 28, 1988)*. If a former shareholder of the debtor corporation receives any consideration for his stock, the exception to the general rule of recognition to the extent that liabilities exceed the basis of assets transferred, contained in *I.R.C. § 357(c)(2)(C)*, will not apply.

(n36)Footnote 36. See *Priv. Ltr. Rul. 9428014* (represented that at least one parent corporation security holder will receive a subsidiary corporation security in actual or constructive exchange therefore); *Priv. Ltr. Rul. 9313020 (Dec. 30, 1990)* (represented that at least one security holder will receive a security in actual or constructive exchange therefor); *Priv. Ltr. Rul. 9226064 (March 31, 1992)* (represented that at least one person or entity which held a security would receive stock in actual or constructive exchange therefor); *Priv. Ltr. Rul. 8503064 (Oct. 24, 1984)* (represented that at least one security holder would receive preferred stock in exchange for a security).

(n37)Footnote 37. Although not defined in the Internal Revenue Code, a "security" is generally regarded as a debt instrument with a term in excess of ten years. See *Camp Wolters Enterprises, Inc. v. Commissioner*, 22 T.C. 737 (1954), *aff'd*, 230 F.2d 555 (5th Cir. 1954); *United States v. Hertwig*, 398 F.2d 452 (5th Cir. 1968); *Baker Commodities, Inc. v. Commissioner*, 48 T.C. 374 (1967), *aff'd*, 415 F.2d 519 (9th Cir. 1969); *Rev. Rul. 59-98, 1959-1 C.B. 76*. However, a debt instrument with a term of as little as five years may qualify. See *P TX7.03[1][a] supra*.

(n38)Footnote 38. See *P TX10.03[4] infra*.

(n39)Footnote 39. The 1980 Committee Reports caution that "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." S. Rep. No. 1035, 96th Cong., 2d Sess. 37 (1980), *reprinted in* Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n40)Footnote 40. *Rev. Rul. 59-222, 1959-1 C.B. 80*. For a discussion of this point, see Henderson & Goldring, *Failing and Failed Businesses*, PP 510, 602 (Aspen Publishers 2004 Ed.). Because this conversion necessarily results in an alteration of the character of the creditor's claims, it should be included as a part of the plan and, as such, formalized in the bankruptcy court's order confirming the plan. See 11 U.S.C. § 1129.

(n41)Footnote 41. *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 62 S. Ct. 540, 86 L. Ed. 775 (1942). See also *Kelm v. Minneapolis, Northfield & Southern R.R.*, 225 F.2d 909 (8th Cir. 1955); *Atlas Oil & Refining Corp. v. Commissioner*, 36 T.C. 675 (1961), *acq.*, 1962-2 C.B. 3; *Norman Scott, Inc. v. Commissioner*, 48 T.C. 598 (1967); *Treas. Reg. § 1.371-1(a)(4)*.

(n42)Footnote 42. *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 183, 62 S. Ct. 540, 543, 86 L. Ed. 775, 779 (1942). The Court further stated:

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 right 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.'

Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 184, 62 S. Ct. 540, 543, 86 L. Ed. 775, 779 (1942) . But see *Helvening v. Southwest Consolidated Corp.*, 315 U.S. 194 (S. Ct. 1942) (holding that creditors are not shareholders for purposes of the predecessor of section 354(a)(1)(D)).

(n43)Footnote 43. *Rev. Rul. 59-222, 1959-1 C.B. 80* ; *Priv. Ltr. Rul. 8933001 (Aug. 22, 1988)* ; *Priv. Ltr. Rul. 8852039 (Oct. 4, 1988)* . Alternatively, the transaction could be viewed as two separate reorganizations: an "E" recapitalization followed by a "G" reorganization. *See, e.g., Priv. Ltr. Rul. 8110139 (Dec. 12, 1980)* ("E" recapitalization deemed to occur before "F" reorganization).

(n44)Footnote 44. *See, e.g., Rev. Rul. 54-518, 1954-2 C.B. 142* , distinguished by *Rev. Rul. 60-50, 1960-1 C.B. 150* . A debtor corporation may be able to liquidate by converting to a limited liability company that is taxed as a partnership or other flow through entity for federal income tax purposes. In converting to a limited liability company, tax characterization as a partnership will depend on the number of owners of the entity and whether such interests are traded. *See I.R.C. § 7704*.

(n45)Footnote 45. S. Rep. No. 1035, 96th Cong., 2d Sess. 36 (1980), *reprinted in* Vol. E Collier on Bankruptcy App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n46)Footnote 46. In contrast, the statutory provision for a "C" reorganization provides the nature and extent of the equity consideration that must be received in the putative tax-free reorganization. Specifically, *I.R.C. § 368(a)(1)(C)* permits a tax-free acquisition of substantially all of the assets of another corporation in exchange solely for voting stock of the acquiring corporation. With respect to the "solely for voting stock" requirement, however, *I.R.C. § 368(a)(2)(B)* provides that up to 20 percent boot consideration may be given in the transaction. As a result, a "C" reorganization requires a significantly greater percentage of stock (which must also be voting stock) than a "G." With respect to the continuity of interest requirement in a "D" reorganization, *see Rev. Rul. 2004-83, 2004-32 I.R.B. 157* .

(n47)Footnote 47. The continuity of interest test does not apply to the acquiring corporation or its shareholders. *See Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders*, P 12.21[9] (WGL, 7th Ed. 2000). For a discussion of the continuity of interest doctrine, *see Faber, Continuity of Interest and Business Enterprise: Is it Time to Bury Some Sacred Cows?*, 34 *Tax Lawyer* 239 (1981).

(n48)Footnote 48. *Treas. Reg. § 1.368-1(e)*. *See also Pinellas Ice & Cold Storage Co. v. Commissioner*, 287 U.S. 462 (1933) and *LeTulle v. Scofield*, 308 U.S. 415 (1940) , two of the seminal cases that established the continuity of interest doctrine.

(n49)Footnote 49. *See Treas. Reg. § 1.368-1T(e)(2)(v)*, Examples 1, 2(ii), 5, and 6. *See also, T.D. 9225, 70 Fed. Reg. 54631, 54633* (September 16, 2005).

(n50)Footnote 50. *Treas. Reg. § 1.368-1(e)(6)*, *T.D. 9434 (December 11, 2008)* . The regulations treat the most senior level of claims to receive stock as representing, in part, a creditor claim against the corporation and, in part, a proprietary interest in the corporation. Such a rule mitigates the adverse effect on continuity of interest of senior creditors seeking payment primarily in non-stock consideration while still taking some payment in stock of the acquiring corporation. The Service intends this rule to be favorable to taxpayers.

(n51)Footnote 51. 315 U.S. 179, 183 (1942) .

(n52)Footnote 52. 36 T.C. 675 (1961) .

(n53)Footnote 53. The Service has adopted this view of the Continuity of Interest Requirement in private letter rulings. In *PLR 8503064 (October 24, 1984)* , "Target" transferred substantially all of its assets to "Acquiring" in exchange for Acquiring preferred stock and cash in an apparent exchange under *section 363 of the Bankruptcy Code*,

with a portion of the Acquiring preferred stock being issued to certain "Equity Creditors" of Target.[1] In its representation related to the Continuity of Interest Requirement, Target stated that Equity Creditors meant "all creditors of Target who are, or, but for the prior receipt of payment would be, members of any of those classes of creditors having a priority in bankruptcy (as set forth in the Bankruptcy Code) equal to or lower than that of the highest class of creditor to have at least one member receive Acquiring preferred stock."

(n54)Footnote 54. Pub. L. No. 96-589, 94 Stat. 3389 (1980).

(n55)Footnote 55. H.R. Rep. No. 96-833 at 32 (1980).

(n56)Footnote 56. S. Rep. No. 96-1035, 96th Cong., 2d Sess. 33, 37, fn. 7 (1980). Examples of such post-petition administrative expenses that are granted priority status under the Bankruptcy Code include wages, salaries, and commissions necessary to preserve the value of a debtor's bankruptcy estate; payment for the value of certain pre-petition goods received by a debtor in the ordinary course of its business; and compensation and reimbursement awarded to certain attorneys, accountants, appraisers, auctioneers, or other professional persons.

(n57)Footnote 57. S. Rep. No. 96-1035, 96th Cong., 2d Sess. 37 (1980).

(n58)Footnote 58. *Treas. Reg. § 1.368-1(e)(6)*. See also, *Temp. Reg. § 1.7874-2T(k)*, relying on *Alabama Asphaltic* to treat creditors as "stockholders" for purposes of Section 7874. *T.D. 9453 (June 9, 2009)*.

(n59)Footnote 59. 70 Fed. Reg. at 11907 (March 10, 2005). The Final Creditor Continuity of Interest Regulations were originally proposed in the same regulation package as the Proposed Net Value Regulations, which are described below.

(n60)Footnote 60. *Treas. Reg. § 1.368-1(e)(6)(i)*.

(n61)Footnote 61. As described above, however, in certain circumstances a loan in connection with a reorganization will not be treated as creating a debtor/creditor relationship. See *Rev. Rul. 72-343* discussed above, in the case of the DIP Facility.

(n62)Footnote 62. *Treas. Reg. § 1.368-1(e)(6)(ii)(A)*. The Final Creditor Continuity of Interest Regulations include two examples illustrating the application of these rules. See *Treas. Reg. § 1.368-1(e)(8)*, Example 10(i) and (ii).

(n63)Footnote 63. *Treas. Reg. § 1.368-1(e)(6)(ii)(B)*.

(n64)Footnote 64. *Treas. Reg. § 1.368-1(e)(6)(iv)*.

(n65)Footnote 65. *Treas. Reg. § 1.368-1(e)*, as amended by *T.D. 8760*, 63 Fed. Reg. 4174(Jan. 23, 1998).

(n66)Footnote 66. *Treas. Reg. § 1.368-1(e)(1)(I)*.

(n67)Footnote 67. *Treas. Reg. § 1.368-1(e)(1)(i)*.

(n68)Footnote 68. *Treas. Reg. § 1.368-1(d)*; *Treas. Reg. § 1.368-1(d)*, as amended by *T.D. 8760*, 63 Fed. Reg. 4174 (Jan. 23, 1998), amended, *Rev. Rul. 81-25*, 1981-1 C.B. 132. For a recent discussion of continuity of business enterprise, see *Berry Petroleum Co. v. Commissioner*, 104 T.C. 584, 635-37 (1995).

(n69)Footnote 69. *Treas. Reg. § 1-368-1(d)*. See, e.g., *Rev. Rul. 87-76*, 1987-2 C.B. 84.

(n70)Footnote 70. See *P TX10.03[1][a]* *supra*.

(n71)Footnote 71. S. Rep. No. 1035, 96th Cong., 2d Sess. 35-36 (1980), reprinted in Vol. E Collier on Bankruptcy,

App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised). The relaxation of the "substantially all" test is essential in the title 11 reorganization context because even the most successful reorganization cases usually involve the sale of significant, but perhaps unprofitable, operating assets prior to creditor and court approval of the plan. *See Priv. Ltr. Rul. 8521083 (Feb. 27, 1985)* and *Priv. Ltr. Rul. 8503064 (Oct. 24, 1984)* (assets sold prior to plan in order to permit corporation to operate as a going concern). *See P TX10.03[1][a] supra*.

(n72)Footnote 72. *See, e.g., Appeal of Laure v. Commissioner*, 653 F.2d 253 (6th Cir. 1981) (there was no preconceived plan to sell all of the acquired corporation's assets); *United States v. Adkins-Phelps, Inc.*, 400 F.2d 737 (8th Cir. 1968) (survivor corporation must carry on some business activity).

(n73)Footnote 73. *See Treas. Reg. § 1.368-1(c)*; *Gregory v. Helvering*, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596 (1935).

(n74)Footnote 74. 11 U.S.C. § 1129.

(n75)Footnote 75. 11 U.S.C. § 1129(d). *But see Treas. Reg. § 1.269-3(e)* (Dec. 31, 1991) (determination by a court under 11 U.S.C. § 1129(d) that the principal purpose of the plan is not avoidance of taxes is not controlling). As an aside, for a discussion of I.R.C. § 269, *see Princeton Aviation Corp. v. Commissioner*, 47 T.C.M. (CCH) 575 (1983).

(n76)Footnote 76. Prop. Reg § 1.368-1(b)(1) and § 368-1(f)(4).

(n77)Footnote 77. Prop. Reg § 1.368-1(f)(2)(i).

(n78)Footnote 78. Prop. Reg § 1.368-1(f)(2)(ii).

(n79)Footnote 79. Prop. Reg § 1.368-1(f)(3)(i).

(n80)Footnote 80. Prop. Reg § 1.368-1(f)(3)(ii).

(n81)Footnote 81. Prop. Reg § 1.368-1(f)(6).

(n82)Footnote 82. I.R.C. § 368(a)(2)(C). *Treas. Reg. § 1.368-2(k)*. *See Rev. Rul. 2002-85, 2002-2 C.B. 986*; *Rev. Rul. 72-576, 1972-2 C.B. 217*; *Priv. Ltr. Rul. 8909007* (Nov. 30, 1988). The controlling parent corporation will qualify as a "party to the reorganization." I.R.C. § 368(b).

(n83)Footnote 83. I.R.C. § 368(a)(2)(C). *See Rev. Rul. 72-576, 1972-2 C.B. 217*; *Priv. Ltr. Rul. 8909007* (Nov. 30, 1988). The controlling parent corporation will qualify as a "party to the reorganization." I.R.C. § 368(b).

(n84)Footnote 84. This necessarily means that a "drop-down" cannot be accomplished in a divisive acquisition.

(n85)Footnote 85. *See P TX10.03[3] supra*.

(n86)Footnote 86. I.R.C. § 368(a)(2)(D). *See, e.g., J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995); *Rev. Rul. 2001-46, 2001-2 C.B. 321*. The controlling parent corporation will qualify as a "party to the reorganization" under I.R.C. § 368(b). Accordingly, the debtor corporation can be the acquirer in a "G" reorganization could be completed when only the controlling parent corporation is in a title 11 case (and the controlled subsidiary is not in a title 11 case).

(n87)Footnote 87. The use of parent stock raised an important issue that affected the viability of a forward subsidiary "G" reorganization--whether the exchange of parent stock for the subsidiary's debt permitted the subsidiary to qualify for the stock for debt exception. For a discussion of whether the exchange of parent stock for the subsidiary's debt qualifies for the stock-for-debt exception, *see P TX8.03[5][d] supra*. The stock for debt exception has been repealed generally for stock transferred after December 31, 1994. *See Chapter TX8 supra*.

(n88)Footnote 88. *Section 1141 of the Bankruptcy Code* provides for a discharge of all the debtor corporation's preconfirmation debts. 11 U.S.C. § 1141(d)(1). "Debt" and "claim" are defined very broadly in title 11. *See* 11 U.S.C. § 101. *See also* 2 Collier on Bankruptcy, ch. 101 (Matthew Bender 15th Edition Revised). Nevertheless, a debtor corporation may have potential liability (e.g., toxic tort claims) which may be determined by the bankruptcy court not to have been within the scope of the § 1141 discharge. *See, e.g., In re UNR Indus., Inc.*, 29 B.R. 741 (N.D. Ill. 1983), *appeal dismissed*, 725 F.2d 1111, 9 C.B.C.2d 1169 (7th Cir. 1984). *But see In re Johns-Manville Corp.*, 9 C.B.C.2d 1199, 36 B.R. 743 (S.D.N.Y. 1984). In addition to possible claims of the reorganized debtor which were inchoate on the confirmation date but which later mature, the reorganized debtor may also have liability to creditors whose claims are not discharged because the creditors failed to receive notice of the bankruptcy case or of the reorganization plan. *See, e.g., Reliable Electric Co., Inc. v. Olson Constr. Co.*, 726 F.2d 620, 10 C.B.C.2d 759 (10th Cir. 1984) (creditor's claim not discharged because creditor did not receive adequate notice).

(n89)Footnote 89. *I.R.C. § 368(a)(2)(E)*.

(n90)Footnote 90. *I.R.C. § 368(a)(3)(E)*. While not entirely clear, the application of *I.R.C. § 368(a)(3)(E)* should be interpreted as providing another means of meeting the requirements of *I.R.C. § 368(a)(2)(E)*, but not an exclusive rule. Thus, a corporation in a title 11 case should be free to use either the "general rule" of section 368(a)(2)(E) or the more permissive provisions of section 368(a)(3)(E) as appropriate.

(n91)Footnote 91. *I.R.C. § 368(a)(3)(E)*. Priority claims paid in cash are excluded for this purpose. *See* S. Rep. No. 1035, 96th Cong. 2d Sess. 37 n.7 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised). For a discussion of whether the exchange of parent stock for the subsidiary's debt qualified for the stock for debt exception (which has been repealed as to most transactions completed after December 31, 1994), *see P TX8.03[5][d] supra*.

(n92)Footnote 92. Reverse subsidiary mergers are regarded, in substance, as an acquisition of stock. *See Rev. Rul. 74-565, 1974-2 C.B. 125*; *Rev. Rul. 67-448, 1967-2 C.B. 144*. Although direct stock acquisitions will not qualify as a "G," such a transaction could be structured as a reverse merger with essentially the same result.

(n93)Footnote 93. *Treas. Reg. § 1.368-2(j)(3)(i)*.

(n94)Footnote 94. *I.R.C. §§ 368(a)(2)(E) and 368(a)(3)(E)*.

(n95)Footnote 95. *I.R.C. § 332. See Priv. Ltr. Rul. 9122067 (March 6, 1991)*, holding (12).

(n96)Footnote 96. *I.R.C. § 351*.

(n97)Footnote 97. *I.R.C. § 368(a)(3)(C)*; *see, e.g., Priv. Ltr. Rul. 9217040* (merger of affiliated corporations in title 11 constituted a "G" reorganization); *Priv. Ltr. Rul. 9121017 (Feb. 21, 1991)* (same).

(n98)Footnote 98. *See Rev. Rul. 74-545, 1974-2 C.B. 122*.

(n99)Footnote 99. S. Rep. No. 1035, 96th Cong., 2d Sess. 31 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised); *Priv. Ltr. Rul. 8710027 (Dec. 8, 1986)* (in a merger, acquiring corporation failed to acquire "substantially all" of the assets and therefore transaction did not qualify as a "G" reorganization; however, provided state statutory merger requirements met, transaction qualified as an "A" reorganization).

(n100)Footnote 100. *I.R.C. § 368(a)(1)(E)*. *See P TX10.02 supra*.

(n101)Footnote 101. *See P TX10.02[2] supra*.

(n102)Footnote 102. *I.R.C. § 351(e)(2)*.

(n103)Footnote 103. *I.R.C. § 1001(a)*.

(n104)Footnote 104. *I.R.C. § 368(a)(3)(C)* provides that if a "G" reorganization overlaps with another reorganization or liquidation provision, the transaction will be treated as a "G" except for purposes of applying *I.R.C. § 357(c)(1)*.



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Collier on Bankruptcy Taxation

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CHAPTER TX10 Tax-Free Reorganization of Debtor Corporations

15-TX10 Collier on Bankruptcy Taxation P TX10.04

P TX10.04 Treatment of Parties to G Reorganization

Parties to a qualifying "G" reorganization are generally entitled to nonrecognition treatment. Gain will be recognized when "boot" is received by a shareholder or when a security holder exchanges an instrument with accrued but unpaid interest or receives securities with a face amount in excess of those exchanged. Short-term creditors who exchange a debt instrument that is not a tax security will recognize gain or loss on the exchange of their claims for stock or securities.

[1] Acquiring Corporation

[a] General

In a "G" reorganization, a corporation acquiring property in exchange for its stock (or stock of its parent) will not recognize any gain or loss. n1 In a taxable acquisition, no gain or loss would be recognized where stock of the parent corporation is used if the acquiring corporation satisfies all the conditions set forth in the regulations under *I.R.C. section 1032*. n2

[b] Basis of Assets Acquired

The tax basis of property acquired by a corporation "in connection with a reorganization" is the same as it was in the hands of the transferor increased by the amount of gain recognized by the transferor corporation. n3 As discussed below, n4 the transferor corporation will only recognize gain in limited circumstances. Accordingly, as a general rule, the acquiring corporation in a "G" reorganization will claim a carryover tax basis for the assets acquired. The holding period of the assets acquired includes the period during which the assets were held by the transferor corporation. n5

[2] Survival of Tax Attributes

[a] General Rule

The acquiring corporation succeeds to tax attributes of the transferor debtor corporation, if the transaction qualifies as a nondivisive "G" reorganization. n6 A "G" reorganization will be treated as a qualifying nondivisive reorganization only if "substantially all" of the transferor corporation's assets are acquired and the consideration received by the transferor corporation is distributed pursuant to the plan, as required under *I.R.C. section 354(b)(1)*. n7 As is the case with other

two-party tax-free acquisitive reorganizations, the acquiring corporation will succeed to an extensive list of tax attributes, including the net operating loss carryovers of the acquired corporation. n8

[b] Mechanics of Attribute Reduction

If a corporation realizes COD income in a tax year ended by a transaction described in *I.R.C. section 381* (in this case, the corporation is a party to a "G" reorganization), there is a prescribed order of attribute reduction required for Federal income tax purposes. First, the taxpayer's tax for the year must be determined. n9 Second, the COD income must be excluded and then applied to reduce the tax attributes remaining. n10 This means that any tax attributes to which the acquiring corporation succeeds and the basis of any property acquired must be reduced by the excluded COD income, to the extent provided in *I.R.C. section 108(b)(2)*. Thus, all tax attributes of the transferor (or distributor) corporation listed in *I.R.C. section 108(b)(2)*, after the determination of the tax for the year of the discharge, including the basis of property, must be reduced.

[c] Attribute Reduction for a Member of a Consolidated Group

There are special rules when the taxpayer realizing COD income is a C corporation that files a consolidated federal income tax return as a member of an affiliated group.

Generally, qualification for exclusion of COD income realized by a C corporation member is based on the status of the debtor corporation--whether the subject member is in a Title 11 case or insolvent. n11 Consistent with the separate entity rule, for purposes of computing insolvency under *I.R.C. section 108(a)(1)(B)*, only the assets and liabilities of the debtor corporation are considered.

If a member realizes excluded COD income, the regulations provide a consolidated approach to attribute reduction. All tax attributes available to the consolidated member will be reduced. The tax attributes of the debtor member are reduced first. n12 These attributes include (1) consolidated tax attributes attributable to the debtor corporation (such as consolidated net operating loss carryovers and carrybacks and tax credits); (2) attributes that arose in separate return limitation years; and (3) the basis of assets of the debtor member (subject to the limitation under *I.R.C. section 1017(b)(2)*, that basis is not reduced below the amount of remaining liabilities). The basis of subsidiary stock is not reduced below zero. n13 To the extent the basis of subsidiary stock is reduced, then the tax attributes of that subsidiary would be reduced in the same order as the subsidiary's parent company. To the extent the excluded COD income exceeds the debtor's tax attributes, the excluded COD income is applied to reduce the remaining consolidated tax attributes of the group. n14 The basis of assets of other members is not subject to reduction under this rule.

[3] Limitation on Net Operating Loss Carryovers

[a] General Rule

Although the acquiring corporation in a qualifying reorganization succeeds to tax attributes of the acquired corporation, *I.R.C. section 382* provides certain limitations on the postacquisition use of net operating loss carryovers ("NOLs"). n15 Prior to the amendment of *I.R.C. section 382* by the 1986 Act, an acquisition easily could be structured in order to preserve a substantial amount of the loss corporation's NOLs for future use by the acquiring corporation. Indeed, the survival of NOLs was one of the principal reasons for an acquisition of the loss corporation's assets in a "G" reorganization. However, after the Tax Reform Act of 1986, *I.R.C. section 382* imposes limitations on the availability of post-ownership change NOLs and the deductibility of so-called "built-in losses." n16

[b] Limited Exception for Shareholders and Historic Creditors

Congress enacted a limited exception to *I.R.C. section 382* which permits existing shareholders and/or historic creditors to "acquire" the debtor corporation in a stock for debt exchange without limitation on the post-ownership use of NOL's.

n17 Based on the statutory language, it is unclear whether existing shareholders and/or historic creditors could qualify an acquisition of a debtor corporation in a title 11 case both as a "G" reorganization and under the *I.R.C. section 382(l)(5)* exception. The completion of an acquisitive "G" reorganization of the debtor corporation in this context could involve either an acquisition by a pre-existing or a newly formed corporation that is not in bankruptcy. n18 In certain instances where the acquiring corporation is a pre-existing corporation it may be difficult to satisfy the requirement of *I.R.C. section 382(l)(5)* that the existing shareholders and/or historic creditors must own at least 50 percent of the stock of the "new" debtor corporation "as a result of being shareholders and creditors immediately before such [ownership] change." n19 The IRS has privately ruled that a transaction can qualify both as a "G" reorganization and as an exchange qualifying under the *I.R.C. section 382(l)(5)* exception. n20

[4] Parties Who Receive Stock or Securities

[a] Shareholders

Shareholders who exchange stock in the debtor corporation solely for stock in the acquiring corporation will not recognize any gain or loss. n21 If a shareholder receives stock and other nonqualifying property or money ("boot"), and if *I.R.C. section 354* or *355* would apply to the transaction, gain is recognized, but only to the extent of the "boot" received. n22 A shareholder is not entitled to claim a loss on the exchange. n23 Also, while unlikely, a shareholder can be subject to ordinary dividend treatment if such shareholder receives "boot" and the exchange has the "effect of the distribution of a dividend." n24

A shareholder who receives only securities in exchange for stock (*i.e.*, no securities are surrendered in the exchange) is subject to full recognition of gain or loss. n25 The policy for this apparent harsh result is that a shareholder receiving only securities has moved up in priority in the event of a corporate liquidation.

[b] Security Holders

Security holders who exchange "old" securities for "new" securities with a principal amount equal to or less than the principal amount of those exchanged (or who exchange their "old" securities for "new" stock) will be entitled to nonrecognition treatment. n26 However, security holders who receive securities with a principal amount (issue price) in excess of the principal amount of the securities surrendered (adjusted issue price) will recognize gain to the extent of the excess. n27

Security holders who exchange their old securities for new securities in a tax-free reorganization will recognize gain to the extent consideration is allocated to unpaid interest that has accrued since the taxpayer acquired the exchanged security. n28 Accrued interest will be recognized with respect to exchanged securities even if the security holder otherwise realizes a loss on the exchange. n29

With respect to the character of income, the statute does not provide that the gain recognized must be ordinary. It appears that since the accrued interest was realized in connection with an "exchange," a taxpayer may be able to argue for capital gain treatment under *Internal Revenue Code section 356(a)*. n30 On the other hand, the legislative history indicates that the security holder is "treated as receiving interest income on the exchange," thus strongly suggesting ordinary interest income treatment. n31

If securities with unpaid accrued interest are exchanged, the security holder must recognize loss if no interest is paid in the exchange. n32

[c] Short-Term Creditors

Creditors who do not hold debt instruments which qualify as "securities" for federal income tax consequences ("short-term creditors") will recognize gain or loss (depending, of course, on the amount of consideration received and

whether the tax basis in their debt has been increased by previously accrued income, if any) on the exchange of their debt for stock and/or securities in a transaction otherwise qualifying as a tax-free reorganization. n33 This result will obtain whether or not such creditors engage in a stock for debt exchange or whether their debt would otherwise be included for purposes of the special bankruptcy continuity of interest rules.

The recognition of gain or loss by short-term creditors should be carefully considered in any proposed "G" reorganization. Invariably, although most trade creditors use the accrual method of tax accounting, each creditor may have claimed a bad debt deduction for a differing percentage of its claim. Thus, a "G" reorganization that involves the receipt of stock or securities by a substantial short-term creditor group may not provide for meaningful deferral of tax recognition on the exchange.

[d] Recapture Potential In Stock Received By Creditors

Where a creditor receives stock of a debtor corporation (or stock of a parent or successor corporation to the debtor corporation) in satisfaction of the creditor's indebtedness, such stock is treated as *I.R.C. section 1245* property so that any gain recognized on a subsequent taxable disposition of such stock will be subject to *I.R.C. section 1245* ordinary income recapture to the extent of the deductions allowed to the creditor as bad debt deductions or ordinary loss on receipt of the stock. n34 The amount of potential *I.R.C. section 1245* recapture for bad debt deductions is reduced by any gain recognized by the creditor on receipt of the stock.

[5] Transferor Corporation

[a] Receipt of Property

Although it is possible to structure a "G" reorganization as an acquisition of assets *by* the debtor corporation, it is more likely that the transaction will involve an acquisition of assets *from* the debtor. Accordingly, the following discussion assumes the debtor corporation is the transferor of assets in the reorganization.

The acquired debtor corporation will not recognize gain or loss on the exchange of property *solely* in exchange for stock or securities of the acquiring corporation when such corporations are parties to the "G" reorganization. n35 The transferor debtor corporation will not recognize gain if it distributes the "boot" received in the exchange pursuant to the plan of reorganization. n36

If no former shareholder of the transferor corporation receives any consideration for such shareholder's stock, the fact that liabilities exceed the adjusted tax basis of assets transferred to the acquiring corporation in a "G" reorganization will not result in the recognition of gain. n37 Further, even where a former shareholder receives stock consideration in exchange for stock held in the transferor corporation, gain will not be recognized under section 357(c) to the extent liabilities exceed adjusted tax basis. n38

[b] Distribution of Property

Upon the receipt of solely stock and securities, the acquired debtor corporation is entitled to distribute stock and securities of the acquiring corporation without recognizing gain. n39 As stated above, a transfer of stock or securities received by the debtor corporation to its creditors "in connection with the reorganization" will be treated as a distribution pursuant to the plan of reorganization and therefore qualify for nonrecognition treatment. n40 As a result, creditors may receive stock or securities of the acquiring corporation without triggering the recognition of gain or loss to the debtor corporation.

Generally, a corporation which distributes appreciated property, other than "qualified property"(generally stock, stock rights or debt obligations of either the distributing corporation or another corporate party to the reorganization), will recognize gain "as if such property had been sold to the distributee at its fair market value." n41 This provision exists as

a part of the comprehensive repeal of the *General Utilities* n42 doctrine. In the context of a "G" reorganization, the acquired debtor corporation could recognize gain with respect to two types of property: (1) the debtor's distribution of nonqualified appreciated property (that it previously owned but did not transfer to the acquired corporation) to its creditors or shareholders; and (2) the debtor's distribution of "boot" property received in the exchange. However, in this second scenario, the tax basis of "boot" property received in the reorganization exchange (i.e., property other than stock or securities of a corporate party to the reorganization) will equal fair market value at the time of the transaction. n43 Thus, as a practical matter, the distributing debtor corporation will only recognize gain to the extent of the postacquisition appreciation, if any, of the "boot" property received. n44

Based on the above, if a debtor corporation transfers all of its appreciated property to the acquiring corporation and distributes any nonqualifying "boot" received pursuant to the plan of reorganization (which it must because of the "G" reorganization liquidation requirement), n45 it will be entitled to effective nonrecognition treatment (absent postacquisition appreciation of the "boot") provided that the value received in the distribution is equal to the fair market value of the property so distributed. n46

[c] Discharge of Indebtedness Income and Stock for Debt Exception

An important question to be considered in any "G" reorganization is the recognition of income as a result of the discharge of indebtedness. One of the longstanding principles of federal income taxation is that gross income includes income from the discharge of indebtedness. n47 Therefore, when a debtor corporation distributes property to its creditors in satisfaction of their claims, and such property has a value less than the face amount of such claims, the transaction should be treated as a discharge of indebtedness transaction. n48 However, a corporation will not recognize such income if the discharge occurs in a title 11 case. n49 There is a "cost" for avoiding the recognition of such income: the amount excluded will be applied to reduce the tax attributes of the debtor corporation, in a prescribed order beginning with the reduction of net operating loss carryovers n50 (unless the debtor affirmatively elects to first reduce the basis of depreciable assets). n51

FOOTNOTES:

(n1)Footnote 1. *I.R.C. § 1032(a); Treas. Reg. § 1.1032-2; Rev. Rul. 73-427, 1973-2 C.B. 301 ; Rev. Rul. 57-278, 1957-1 C.B. 124 .*

(n2)Footnote 2. *I.R.C. § 1032(a). Treas. Reg. § 1.1032-2(a); Treas. Reg. § 1.1032-3.*

(n3)Footnote 3. *I.R.C. § 362(b).*

(n4)Footnote 4. *See P TX10.04[5] infra.*

(n5)Footnote 5. *I.R.C. § 1223(2).*

(n6)Footnote 6. *I.R.C. § 381(a)(2). See Priv. Ltr. Rul. 8712026 (Dec. 19, 1986) .*

(n7)Footnote 7. *I.R.C. § 381(a) (last sentence).*

(n8)Footnote 8. *I.R.C. § 381(a), (c).*

(n9)Footnote 9. *I.R.C. § 108(b)(4)(A); Treas. Reg. § 1.108-7(b).*

(n10)Footnote 10. *Treas. Reg. § 1.108-7(c).*

(n11)Footnote 11. *Treas. Reg. § 1.1502-28(a)*.

(n12)Footnote 12. *Treas. Reg. § 1.1502-28(a)(2)*.

(n13)Footnote 13. *Treas. Reg. § 1.1502-28(a)(2)*.

(n14)Footnote 14. *Treas. Reg. § 1.1502-28(a)(4)*.

(n15)Footnote 15. For other limitations see *I.R.C. § 269*; *Treas. Reg. § 1.269-3*; *11 U.S.C. § 1129(d)* (bankruptcy court can deny confirmation of the plan of reorganization if the "principal purpose" of the plan is tax avoidance).

(n16)Footnote 16. For a detailed discussion, see chapter TX11 *infra*.

(n17)Footnote 17. *I.R.C. § 382(l)(5)*; *Treas. Reg. § 1.382-9*. Loss corporations acquired pursuant to "G" reorganizations will generally, therefore, be subject to the *I.R.C. § 382* limitations. See *Priv. Ltr. Rul. 8909007 (Nov. 30, 1988)*. For a detailed discussion, see P TX11.04 *infra*.

(n18)Footnote 18. Alternatively, it might be possible for a nominee to form a shell corporation ("Newco") and then, pursuant to the chapter 11 plan of reorganization, Newco would acquire "substantially all" of the assets of the debtor and issue Newco stock and/or securities directly to the creditors in exchange for their claims against the debtor corporation.

(n19)Footnote 19. *I.R.C. § 382(l)(5)(ii)*; *Treas. Reg. § 1.382-9(d)*.

(n20)Footnote 20. See *Priv. Ltr. Rul. 8836058 (June 16, 1988)*.

(n21)Footnote 21. *I.R.C. § 354(a)(1)*. Former shareholders who do not receive a distribution will be entitled to a deductible loss under *I.R.C. § 165*.

(n22)Footnote 22. *I.R.C. §§ 354(a)(3), 356(a)(1)*; *Treas. Reg. § 1.356-1(a)*. The shareholder's basis of the stock received will generally be the same as the basis in the stock transferred, decreased by any boot received and increased by any gain recognized. *I.R.C. § 358(a)*.

(n23)Footnote 23. *I.R.C. § 356(c)*; *Treas. Reg. § 1.356-1(a)(2)*.

(n24)Footnote 24. *I.R.C. § 356(a)(2)*; *Treas. Reg. § 1.356-1(b)*; *Commissioner v. Clark, 489 U.S. 726, 109 S. Ct. 1455, 103 L. Ed. 2d 753 (1989)* (effect tested by examining the exchange as a whole); *Rev. Rul. 93-61, 1993-2 C.B. 118 (Clark applied to exchange of stock for note and stock)*.

(n25)Footnote 25. *I.R.C. § 354(a)(2)(A)*. See *Treas. Reg. § 1.354-1(d)*, Example 3.

(n26)Footnote 26. *I.R.C. § 354(a)(1)*. See *Priv. Ltr. Rul. 9335029 (June 4, 1993)*; *Priv. Ltr. Rul. 8909007 (Nov. 30, 1988)*; *Priv. Ltr. Rul. 8521083 (Feb. 27, 1985)*; see also *Rev. Rul. 77-437, 1977-2 C.B. 28*. See P TX7.03[1][a] *supra*.

(n27)Footnote 27. *I.R.C. §§ 354(a)(2)(A), 356(d)(2)(B)*. See *I.R.C. § 108(e)(10)*.

(n28)Footnote 28. *I.R.C. §§ 354(a)(2)(B), 355(a)(3)(C)*.

(n29)Footnote 29. *I.R.C. §§ 354(a)(2)(B), 355(a)(3)(C)*. See S. Rep. No. 1035, 96th Cong., 2d Sess. 37-38 (1980), reprinted in Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii)(Matthew Bender 15th Edition Revised). See P TX7.06 *supra*. This result does not make sense where an accrual basis holder has previously included the interest in income, but it seems clear that *I.R.C. § 354(a)(2)(B)* even applies to original issue discount. But see *Tech. Adv. Mem. 9538007*

(June 13, 1995) (holders of OID debt must accrue OID regardless of the financial condition of the issuer. *I.R.C.* § 354(a)(2)(B) exception does not apply to OID; thus, holders were not entitled to recognize loss on exchange of debt for stock in a G reorganization).

(n30)Footnote 30. *See, e.g., Middleton v. Commissioner*, 77 T.C. 310 (1981) , *aff'd*, 693 F.2d 124 (11th Cir. 1982) ; *Freeland v. Commissioner*, 74 T.C. 970 (1980) .

(n31)Footnote 31. S. Rep. No. 1035, 96th Cong., 2d Sess. 38 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n32)Footnote 32. S. Rep. No. 1035, 96th Cong., 2d Sess. 38 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised).

(n33)Footnote 33. *Rev. Rul.* 59-222, 1959-1 C.B. 80 ; S. Rep. No. 1035, 96th Cong., 2d Sess. 37 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Edition Revised). *See Priv. Ltr. Rul.* 8909007 (Nov. 11, 1988) . *See, e.g., Rev. Rul.* 73-233, 1973-1 C.B. 179 ; *Priv. Ltr. Rul.* 9333048 (May 28, 1993) . The character and amount of the gain may also be affected by the application of the tax benefit rule. *See Hillsboro Nat'l Bank v. Commissioner*, 460 U.S. 370, 103 S. Ct. 1134, 75 L. Ed. 2d 130 (1983) ; *I.R.C.* § 111; *see also Allan v. Commissioner*, 86 T.C. 655 (1986) , *aff'd*, 856 F.2d 1169 (8th Cir. 1988) (taxes and interest added to principal of debt were not subject to recharacterization under the tax benefit rule). for a detailed discussion *see P TX6.03[5][d] supra*. If the basis exceeds the value of property received, the creditor is generally entitled to a bad debt deduction under *I.R.C.* § 166. *Treas. Reg.* § 1.166-1(d)(2)(ii).

(n34)Footnote 34. *I.R.C.* § 108(e)(7).

(n35)Footnote 35. *I.R.C.* § 361(a).

(n36)Footnote 36. *I.R.C.* § 361(b)(1)(A).

(n37)Footnote 37. *I.R.C.* § 357(c)(2)(B).

(n38)Footnote 38. *Rev. Rul.* 2007-8 ; 2007-1 C.B. 469 .

(n39)Footnote 39. *I.R.C.* §§ 361(b)(1)(A), 361(c)(1).

(n40)Footnote 40. *I.R.C.* § 361(b)(3).

(n41)Footnote 41. *I.R.C.* § 361(c)(2)(A).

(n42)Footnote 42. *See, e.g., H.R. Conf. Rep.* No. 841, 99th Cong, 2d Sess. II-200 (1986); *General Utilities & Operating Co. v. Helvering*, 296 U.S. 200, 56 S. Ct. 185, 80 L. Ed. 154 (1936) . Prior to 1986, a corporation generally did not recognize any gain or loss on a distribution of its assets to its shareholders in complete liquidation. These special corporate nonrecognition rules were known as the *General Utilities* doctrine.

(n43)Footnote 43. S. Rep. No. 445, 100th Cong., 2d Sess. 392 (1988).

(n44)Footnote 44. S. Rep. No. 445, 100th Cong., 2d Sess. 392 (1988). *See Priv. Ltr. Rul.* 9335029(June 3, 1993) (neither acquiring nor acquired debtor corporation recognized gain or loss in "G" reorganization).

(n45)Footnote 45. *See P TX10.03[3] supra*.

(n46)Footnote 46. *See, e.g., Treas. Reg.* § 1.1032-1(d); *United States v. Davis*, 370 U.S. 65, 82 S. Ct. 1190, 8 L. Ed. 2d 335 , *reh'g denied*, 371 U.S. 854, 83 S. Ct. 14, 9 L. Ed. 2d 92 (1962) ; *Philadelphia Park Amusement Co. v.*

Commissioner, 126 F. Supp. 184 (1954) (value of property given in a transaction is presumed equal to the value of property received in exchange therefor); *Rev. Rul. 73-233, 1973-1 C.B. 179*.

(n47)Footnote 47. *I.R.C. § 61(a)(12)*; *United States v. Kirby Lumber Co.*, 284 U.S. 1, 52 S. Ct. 4, 76 L. Ed. 131 (1931); *see also Priv. Ltr. Rul. 8120014 (Jan.29, 1981)* (discharge occurs in year all events occurred which established the unconditional cancellation). For a discussion of the timing of recognition of discharge income, *see P TX6.02[7][c] supra*.

(n48)Footnote 48. *See S. Rep. No. 445, 100th Cong. 2d Sess. 392, n.104 (1988)* ("these amendments are not intended to affect the treatment of any income from the discharge of indebtedness arising in connection with a corporate reorganization").

(n49)Footnote 49. *I.R.C. § 108(a)(1)*.

(n50)Footnote 50. *I.R.C. § 108(b)*.

(n51)Footnote 51. *See I.R.C. § 108(b)(5)*. For a detailed discussion, *see P TX6.03 supra*.

Historically, discharge of indebtedness income was not realized if a debtor corporation transferred stock in satisfaction of claims held by its creditors. *Motor Mart Trust v. Commissioner*, 4 T.C. 931 (1945), *aff'd*, 156 F.2d 122 (1st Cir. 1946); *Commissioner v. Capento Securities Corp.*, 140 F.2d 382 (1st Cir. 1944); *Tower Bldg. Corp. v. Commissioner*, 6 T.C. 125 (1946); *see also Rev. Rul 83-98, 1983-2 C.B. 40*. *See P TX8.02 supra*. The Stock for Debt exception was repealed prospectively by the Omnibus Budget Reconciliation Act of 1993 (Pub. L. No.103-66) for stock transferred after December 31, 1994, unless the issuing corporation is in a title 11 or similar case filed on or before December 31, 1993. Thus for stock for debt exchanges after 1994, the debtor corporation will realize discharge of indebtedness income to the extent the value of stock is less than the adjusted issue price of the indebtedness satisfied. As discussed above, a corporate debtor in a title 11 case will not be taxable on the income, but its tax attributes (beginning with its net operating loss carryovers) will be subject to reduction. *See Treas. Reg. § 1.108-7*.



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CHAPTER TX10 Tax-Free Reorganization of Debtor Corporations

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P TX10.05 Plan of Reorganization and Reporting Requirements

For federal income tax purposes, a tax-free reorganization must be effectuated pursuant to a plan of reorganization. n1 A plan of reorganization must be adopted by each of the corporate parties to the reorganization. n2 The Treasury regulations provide that the adoption of the plan must be shown by the acts of the duly constituted officers and appear on the official records of the corporation. n3 As a practical matter, a chapter 11 plan of reorganization should qualify as a "tax" plan of reorganization provided it is adopted by both the acquired and acquiring corporations (that is, both the debtor and nondebtor corporations, as the case may be). Each corporate party must file a statement of all pertinent facts with its federal income tax return for its taxable year within which the reorganization occurred n4 and must keep permanent records of the transaction. n5 Similar requirements are imposed on holders who receive stock, securities or other property. n6

FOOTNOTES:

(n1)Footnote 1. *Treas. Reg. § 1.368-2(g)*. See *J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995) ("plan of reorganization" interpreted broadly).

(n2)Footnote 2. *Treas. Reg. § 1.368-3(a)*.

(n3)Footnote 3. *Treas. Reg. § 1.368-3(a)*.

(n4)Footnote 4. *Treas. Reg. § 1.368-3(a)*.

(n5)Footnote 5. *Treas. Reg. § 1.368-3(c)*. The reorganization should not be invalidated by the failure to comply with the reporting requirements. *Wilson v. Commissioner*, 20 T.C.M. (CCH) 676 (1961) .

(n6)Footnote 6. *Treas. Reg. § 1.368-3(b)*.



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CHAPTER TX11 Preservation and Use of Net Operating Losses and Other Corporate Tax Attributes

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CHAPTER TX11 Preservation and Use of Net Operating Losses and Other Corporate Tax Attributes

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P TX11.01 Introduction

Preservation of favorable tax attributes, typically net operating losses ("NOLs") of a corporation (a "loss corporation"), is frequently critical to corporate transactions. This chapter emphasizes the preservation of tax attributes of loss corporations, including debtors reorganizing under title 11 of the United States Code (the "Bankruptcy Code"). Whether an internal reorganization of a loss corporation or an acquisition of or by loss corporations is involved, certain statutory rules and judicial limitations apply to restrict the amount, survival, carryover, and use of the loss corporation's tax attributes.

Among a loss corporation's most important tax attributes are its NOLs. An NOL generally results when deductions exceed income for a taxable year. n1 Under I.R.C. section 172(b), an NOL can generally be carried back two years and carried forward twenty years. n2 Certain exceptions and special rules apply to particular NOLs. n3 For example, the Job Creation and Workers Assistance Act of 2002 lengthens the carryback period from two to five years for NOLs incurred in taxable years ending in 2001 and 2002. n4 The American Recovery and Reinvestment Act of 2009 provides that certain "eligible small businesses" (defined by applying the gross receipts test of I.R.C. Section 448(c) substituting \$15,000,000 for \$5,000,000 each place it appears in that test) can elect to extend the carryback period for NOLs incurred in any taxable year ending in 2008 or, if elected by the taxpayer, NOLs for any taxable year beginning in 2008, from two years to any whole number of years elected by the taxpayer that is more than two years and less than six years. n5

FOOTNOTES:

(n1)Footnote 1. I.R.C. § 172(c). The purpose of the NOL deduction is to remedy the potential unfairness caused by computing taxable income on an annual accounting period. See I.R.C. § 441(a) (providing that taxable income is computed on the basis of the taxpayer's taxable year); *Libson Shops, Inc. v. Koehler*, 353 U.S. 382, 386 (1957) ("[The net operating loss rules] were enacted to ameliorate the unduly drastic consequences of taxing income strictly on an annual basis. They were designed to permit a taxpayer to set off its lean years against its lush years, and to strike something like an average taxable income computed over a period longer than one year.").

(n2)Footnote 2. I.R.C. § 172(b)(1)(A). For taxable years beginning before Aug. 6, 1997, NOLs can be carried back three years and carried forward fifteen years.

(n3)Footnote 3. *See* I.R.C. § 172(b)(1).

(n4)Footnote 4. I.R.C. § 172(b)(1)(H), as originally enacted by the Job Creation and Workers Assistance Act of 2002, Pub. L. No. 107-147, § 102(a). *See* Revenue Procedure 2002-40, 2002-23 I.R.B. 1096 (May 22, 2002) regarding certain procedural aspect of the five-year carrback period and the revocation of prior elections under I.R.C. Section 172(b)(3) to forgo the carryback period for losses arising in 2001 or 2002. *See* P TX 11.08[3][b] *infra* regarding the application of I.R.C. § 172(b)(1)(H), as enacted by the Job Creation and Workers Assistance Act of 2002, to consolidated groups.

(n5)Footnote 5. I.R.C. § 172(b)(1)(H)(iv), as amended by the American Recovery and Reinvestment Act of 2009, Pub. L. No. 111-5, § 1211(a). Any election to extend the carryback period, once made, is irrevocable. I.R.C. § 172(b)(1)(H)(iii). *See* Revenue Procedure 2009-19, 2009-14 I.R.B. 747 (March 16, 2009) regarding certain procedural aspects of I.R.C. § 172(b)(1)(H), as amended by the American Recovery and Reinvestment Act of 2009.



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CHAPTER TX11 Preservation and Use of Net Operating Losses and Other Corporate Tax Attributes

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P TX11.02 Statutory and Judicial Limitations on Tax Attributes

[1] Statutory Limitations

The principal general statutory limitations of the Internal Revenue Code are *I.R.C. section 108* respecting income from discharge of indebtedness; *I.R.C. section 269*, respecting acquisitions made to evade or avoid income tax; *I.R.C. section 382*, respecting limitation on net operating loss carryforwards and certain built-in losses following an ownership change; *I.R.C. section 383*, respecting special limitations on certain excess credits, etc., which essentially compliments and operates similarly to *I.R.C. section 382*; and *I.R.C. section 384*, respecting limitation on use of preacquisition losses to offset built-in gains. The implications of discharges of indebtedness under *I.R.C. section 108* are discussed below in chapter 13. The other sections of the Internal Revenue Code are discussed in this chapter.

[2] Judicial Limitations

In addition to the statutory provisions referred to above, it is well to keep in mind certain general judicial limitations that can affect the use of tax attributes. These judicially developed rules include the *Libson Shops* doctrine and business purpose, step transaction and form-over-substance principles. n1

[3] Consolidated Return Considerations

Many acquisitions and bankruptcy reorganizations will also involve affiliated corporations filing consolidated federal income tax returns ("Consolidated Groups"). In the simple case, the acquisition group will wish to have the acquiring company and the loss corporation file consolidated returns in order to offset future profits against the loss corporation's NOLs. The important Consolidated Return issues, which are discussed below, n2 include separate return limitation year ("SRLY") rules, n3 built-in-deductions, the consolidated return change of ownership ("CRCO") limitation, n4 the implementation of the rules of *I.R.C. sections 382-384* in the Consolidated Return context, n5 the disallowance of losses on the disposition of subsidiary stock in the Consolidated Return context n6 and reverse acquisitions. n7

[4] Alternative Minimum Tax Limitations

The alternative minimum tax ("AMT") applies much more readily to corporations since the Tax Reform Act of 1986. It will certainly apply to corporations with large NOLs relative to regular taxable income. The rules of *I.R.C. sections 55* and *56* affect the amount of existing NOLs under the AMT and the amount that may be used in a taxable year.

FOOTNOTES:

(n1)Footnote 1. *See P TX11.07 infra.*

(n2)Footnote 2. *See P TX11.08 infra.*

(n3)Footnote 3. *See P TX11.08[4]-[7] infra.*

(n4)Footnote 4. *See P TX11.08[8] infra.*

(n5)Footnote 5. *See P TX11.08[9]-[10] infra.*

(n6)Footnote 6. *See P TX11.08[11] infra.*

(n7)Footnote 7. *See P TX11.08[12] infra.*



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P TX11.03 Acquisitions Made to Evade Tax

[1] I.R.C. section 269 in General

Any acquisition of a loss corporation can raise a concern under *I.R.C. section 269*, especially where the price paid is disproportionate to the value of the loss corporation's assets other than its tax attributes. *I.R.C. section 269* disallows deductions, credits and losses available to a taxpayer as a result of acquisitions with a dominant tax avoidance purpose. *I.R.C. section 269* disallows the benefits of tax attributes when the principal purpose of acquiring control of a corporation or the transferred basis property of another non-commonly controlled corporation is the avoidance or evasion of tax by securing a tax benefit which would not otherwise be enjoyed. Control is defined to mean at least 50% of the voting power or value of all classes of stock. While *I.R.C. section 269* appears to proscribe acquisitions of loss corporations by individuals and profitable corporations, in a case antedating *I.R.C. section 384*,ⁿ¹ the Tax Court ruled that purchase of a profitable subsidiary by a loss corporation could potentially be subject to *I.R.C. section 269*.ⁿ² The Claims Court has held that despite the initial acquisition of 25% of a corporation by a creditor for valid business reasons, the subsequent acquisition of control to use expiring tax benefits was subject to *I.R.C. section 269(a)(1)*.ⁿ³ In a recent case, the taxpayer prevailed when a bankruptcy court found no tax avoidance motive. It held that section 269 did not prevent a debtor from deducting an acquired corporation's net operating losses.ⁿ⁴ The allowance of post-acquisition losses, whether realized built-in losses or continued operating losses of the business, is subject to a split in authority.ⁿ⁵ The Conference Committee Report for the Tax Reform Act of 1986ⁿ⁶ specifically states that the revisions to *I.R.C. section 382* do not alter the continuing application of *I.R.C. section 269*.ⁿ⁷ As recently as in March of 2004, the Service pledged to continue to scrutinize abusive transactions that are designed to generate foreign tax credits and to challenge the claimed tax consequences of such transactions under the existing general principals of law, including *I.R.C. section 269*.^{n7a}

Regulations also provide that a determination by a court, pursuant to *section 1129(d) of the Bankruptcy Code*, that the principal purpose of a plan of reorganization is not the avoidance of taxes is not controlling for purposes of *I.R.C. section 269*.ⁿ⁸

[2] Relationship of I.R.C. section 269 to I.R.C. section 338 Acquisitions

Prior to the enactment of *I.R.C. section 338* it was generally not possible to acquire a corporation and immediately liquidate it under *I.R.C. section 332*. Any such liquidation pursuant to a plan adopted within two years of acquisition would trigger purchase of assets treatment under former *I.R.C. section 334(b)(2)* and eliminate the subsidiary's tax

attributes. *I.R.C. section 269(b)* was adopted to close the loophole perceived to have been created by the enactment of *I.R.C. section 338*. If (i) an *I.R.C. section 338* qualified stock purchase is made, (ii) no election is made under *I.R.C. section 338* with respect to such purchase (presumably a carryover basis election is disregarded), (iii) the subsidiary is liquidated pursuant to a plan adopted not more than two years after the acquisition date, and (iv) the principal purpose of the liquidation is a prohibited *I.R.C. section 269* purpose by the acquiring corporation, the Commissioner can disallow the benefits of the tax attributes.

Treasury Regulation section 1.269-7 permits the imposition of the disallowance rules of *I.R.C. section 269* even though *I.R.C. sections 382* and *383* limit or reduce the utilization of a loss or credit. The regulation does provide, however, that the fact that *I.R.C. sections 382* or *383* limit the use of losses or deductions should be taken into account in the determination of whether the taxpayer had the proscribed *I.R.C. section 269* purpose. n8a *Treasury Regulation section 1.269-3(d)* imposes the disallowance rules of *I.R.C. section 269* in certain circumstances when the special rules of *I.R.C. section 382(l)(5)*, respecting certain changes of stock ownership in title 11 or similar cases, apply. n9

FOOTNOTES:

(n1)Footnote 1. See P TX11.06 *infra*.

(n2)Footnote 2. *Briarcliff Candy Corp. v. Commissioner*, 54 T.C.M. (CCH) 667 (1987) .

(n3)Footnote 3. *Jupiter Corp. v. United States*, 1983-1 U.S.T.C. P 9168 (Cl. Ct. 1983). See also *Inductotherm Industries, Inc. v. Commissioner*, 48 T.C.M. 167 (1984) , *aff'd*, 770 F.2d 1071 (3d Cir. 1985) .

(n4)Footnote 4. *Plains Petroleum Co. v. Commissioner*, 78 T.C.M. (CCH) 130 (1999) . See also *In the Matter of Federated Department Stores, Inc.*, 135 B.R. 962 (Bankr. S.D. Ohio 1992) , *aff'd on other grounds sub nom. United States v. Federated Department Stores, Inc. (In re Federated Department Stores Inc., Debtor)*, 170 B.R. 331 (S.D. Ohio 1994) ; *U.S. Shelter v. United States*, 87-2 U.S.T.C. P 9588 (Cl. Ct. 1987).

(n5)Footnote 5. In *Inductotherm Industries, Inc. v. Commissioner*, 48 T.C.M. (CCH) 167 (1984) , *aff'd*, 770 F.2d 1071 (3d Cir. 1985) , post-acquisition losses were permitted to be used. The court followed *Herculite Protective Fabrics Corp. v. Commissioner*, 387 F.2d 475 (3d Cir. 1968) . But see, e.g., *United States v. Hall Paving Co.*, 471 F.2d 261 (5th Cir. 1973) (*I.R.C. Section 269* prohibits use of post-acquisition losses in a consolidated return); *R.P. Collins v. United States*, 303 F.2d 142 (1st Cir. 1962) ; *Luke v. Commissioner*, 351 F.2d 568 (7 Cir. 1965). In *G.C.M. 33840*, the Service stated that it disagrees with the per curium opinion in *Herculite Protective Fabrics Corporation*, to the extent that the opinion may be construed to mean that post-acquisition losses are, as a matter of law, outside the reach of *I.R.C. Section 269*. See 1968 GCM LEXIS 266 (1968) .

(n6)Footnote 6. H.R. Rep. No. 841, 99th Cong., 2d Sess. (1986). Hereinafter referred to as "Conference Committee Report."

(n7)Footnote 7. Conference Committee Report at II-194. See also P TX11.04[6] *infra*.

(n8)Footnote 7a. 2004-11 I.R.B. 606 (March 15, 2004) ; see also 2002-41 I.R.B. 690, Notice 2002-65 (Oct. 15, 2002) , in which the IRS stated that it will use § 269 to disallow a taxpayer's loss deductions by asserting that the acquisition of control of an S corporation had the principal purpose of avoiding federal income tax.

(n9)Footnote 8. *Treas. Reg. § 1.269-3(e)*. See also *In re Hartman Material Handling Sys., Inc.*, 92-2 U.S.T.C. P 50,325 (Bankr. S.D.N.Y. 1992) (court lacked jurisdiction to determine collateral estoppel effects of a decision under § 1129(d) of the Bankruptcy Code and a decision regarding *I.R.C. § 269*, but disapproved of *Treas. Reg. § 1.269-3(e)*).

(n10)Footnote 8a. *Priv. Let. Rul. 2002-04-002 (Jan. 25, 2002)* (the IRS took the position in the private letter ruling

that nonrecognition of gain on the transfer of stock pursuant to *I.R.C. Sections 368 and 351* has the effect of diminishing tax liability and thus is an "allowance" within the meaning of *I.R.C. Section 269*). *But see Cherry v. U.S.*, 264 F. Supp. 969 (C.D. Cal. 1967) and *Bijou Park Properties, Inc. v. Commissioner*, 47 T.C. 207 (1966) (courts refused to extend *I.R.C. Section 269* to disallow nonrecognition treatment otherwise granted by other *I.R.C. Sections*, such as *I.R.C. Sections 336 and 453(d)*); and in *Modern Home Life & Casualty Co. v. Commissioner*, 54 T.C. 839 (1970) (the Tax Court declined to deny the benefits of an S corporation election because such denial would thwart "the intent of Congress to allow shareholders of electing small business corporations to 'be taxed directly on the corporations earnings' and to report corporate income (whether or not distributed) as their own for tax purposes.") More recently, in the *Private Letter Ruling 2005-10-035*, the Service concluded that it should not assert *I.R.C. Section 269(a)(1)* to deny taxpayer the benefits obtained from the formation of a foreign company that was subsequently determined to have failed to qualify for tax-exempt status because Congress intended to grant the benefits sought (the benefit of exemption from tax under *I.R.C. Section 501(a)*).

(n11)Footnote 9. *See P TX11.04[6] infra.*



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CHAPTER TX11 Preservation and Use of Net Operating Losses and Other Corporate Tax Attributes

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P TX11.04 Limitations on NOLs Following an Ownership Change

[1] Predecessors to I.R.C. section 382

Unhappiness with old *I.R.C. section 382* before its amendment ("old section 382") resulted (as a matter of hindsight) in a modest revision in 1976 of *I.R.C. section 382*. This revised version of *I.R.C. section 382* attempted to provide a more coherent policy approach to survival of NOLs, but general dissatisfaction with the provision led to the periodic deferral of the effective date of this revision of *I.R.C. section 382*. The Tax Reform Act of 1986 substantially revised *I.R.C. section 382*, generally applicable to periods after December 31, 1986, but with a stock ownership look-back provision to May 6, 1986.

[2] I.R.C. section 382 in General

In general, *I.R.C. section 382* adopts the approach that following a substantial change in ownership of the loss corporation, n1 the annual *earnings* against which NOLs can be applied should be limited. The earnings limitation is designed to approximate (on a conservative basis) the extent to which the loss corporation would have been able to avail itself of its own NOLs without a significant infusion of new capital. Thus, in general upon a substantial change of ownership, accumulating to more than fifty percentage points within a three-year period, the value of the loss corporation is determined and an objective rate of earnings is imputed on that value. The rate (published monthly in the Internal Revenue Bulletin) is the average yield for long-term U.S. obligations, adjusted to the rate the bonds would have if tax exempt. The amount of the loss corporation's income that may be offset by its NOLs each year is referred to as the *I.R.C. section 382* limitation. n2

To the extent the corporation's earnings in fact are less than the *I.R.C. section 382* limitation, the difference can be carried forward until offset by actual earnings or the NOLs expire. The *I.R.C. section 382* limitation is zero n3 if the corporation fails to satisfy continuity of business enterprise tests. n4 The test is generally the same as the continuity of business enterprise rule that is applicable to tax free reorganizations. n4a

Example 1:

L corporation, a calendar year taxpayer, has a \$10,000,000 NOL expiring in 2003. On January 1, 2002, individual X buys all of the stock of L for \$1,000,000, the value of L. The long-term tax exempt bond rate on that date is 6.39%. During 2002, L earns \$500,000. Under *I.R.C. section 382* L can only use \$63,900 (\$1,000,000 of value x 6.39%, long term rate) of the NOL carryforward to offset its income each

year.

Example 2:

Use the same facts as Example 1, except assume that L earns only \$35,000 in 2002. Then L can offset the full \$35,000 in 2002 and \$92,800 (\$28,900 + \$63,900) of NOLs will be available to offset income of L in 2003. At the end of 2003 the unused NOLs expire independently of the operation of the *I.R.C. section 382* limitation.

In addition to this relatively straight-forward provision, *I.R.C. section 382* employs its own particular jargon and contains numerous technical provisions designed to deal with particular circumstances and tax avoidance. "Ownership change," n5 "owner shift" n6 and "equity structure shift" n7 are three important new buzz words adopted by the Tax Reform Act of 1986. An "ownership change" (imposing the limitations of *I.R.C. section 382* on NOLs) occurs if there has been a more than fifty percentage point increase in stock ownership immediately following an "owner shift" involving a "5-percent shareholder" n8 or an "equity structure shift" within the "testing period," n9 which is generally three years. Increases in stock ownership are measured from the lowest amount held by the relevant shareholders during the testing period. n10

There is an exception to the three-year "testing period" when there has been an ownership change during the three-year lookback period. If there has been a recent ownership change under section 382, the testing period for determining whether a second ownership change has occurred does not begin before the first day following the "change date" for such earlier change. n10a The "change date" is the date of the "owner shift" or the reorganization, whichever is later. n10b In a recent private letter ruling, the Service concluded that the date of confirmation of a bankruptcy reorganization plan rather than the effective date of the plan was the change date. n10c In the ruling, the bankruptcy court confirmed the taxpayer's plan of reorganization which entailed the issuance of new taxpayer common stock to creditors of the taxpayer in satisfaction of their claims, and cancellation of the existing common stock of the taxpayer. The distribution of new common stock and cancellation of the existing stock did not occur until a later date, the date on which the plan became effective. The taxpayer also sold voting preferred stock on the effective date. The taxpayer sought the ruling to avoid the application of section 382(l)(5)(D), n10d which would cause the taxpayer to lose all of its NOL carryforwards. The ruling is surprisingly silent on whether the effectiveness of the taxpayer's plan was subject to any conditions precedent. If so, traditionally, the effective date of the plan would be the date on which the beneficial ownership of stock would shift and thus would be the "change date". The ruling also implicitly holds that the issuance of the preferred stock on the effective date is not treated as part of the stock deemed issued on the confirmation date. This conclusion is potentially relevant both for purposes of the initial qualification under section 382(l)(5) as well as the timing of a second ownership change. n10e It is unclear why the Service reached these conclusions. Would it matter whether the preferred stock sale was provided for in the plan, as opposed to not being included in the plan? If so, does it make the timing issue effectively elective if the taxpayer can decide whether or not to include the stock sale in the plan (of course, the taxpayer may not have the luxury of a choice)?

The definition of stock adopted for *I.R.C. section 1504* purposes is intended to be used for purposes of *I.R.C. section 382*. n11 In general this means that nonvoting, nonconvertible, limited and preferred stock without an unreasonable redemption or liquidation premium will not be treated as stock. n11a The Treasury is authorized by *I.R.C. section 1504(a)(5)* to issue regulations which could significantly modify these principles. As discussed below, certain convertible preferred stock has been treated as non-stock plus an option. n12 Non-convertible debt that does not offer the lender an opportunity for significant participation in the growth of the debtor is not treated as outstanding stock, despite the debtor's argument that the lender would not be repaid unless such growth occurred. n13 The Regulations under *I.R.C. section 382* also provide that non-voting preferred stock which becomes entitled to vote merely because of dividend arrearages does not thereby become voting stock for purposes of *I.R.C. section 382*. n14 This is a benefit that may avoid an ownership change when the loss corporation falls on hard times and cannot pay dividends. It also means that one can meet the requirements of a voting security for bankruptcy law purposes without causing an ownership change.

The Temporary Regulations also evidence a concern that certain instruments may be created to nominally meet the "stock" definitions (or not as stock) in order to avoid an ownership change. Under certain enumerated objective conditions susceptible of characterization as evidencing a tax avoidance motive, such instruments are to be treated as the opposite of what was intended by the loss corporation, provided the result is to cause an ownership change. n15 Caution should be exercised in fashioning an instrument that has a participation interest in the growth of the loss corporation disproportionate to its share of the equity of the company and the instrument's usual character. n16 Caution is also indicated in evaluating whether preferred stock is non-stock when the value of the preferred is substantially below its redemption value or its liquidation price. Such equity may in fact be found to be stock under *I.R.C. section 1504(a)(4)* because (i) it will participate in corporate growth to a significant extent in order for its value to reach the redemption or liquidation value or (ii) it may be found to have an unreasonable redemption or liquidation premium by analogy to the section 305 Regulations. n17

There is no guidance as to when the attributes of preferred that is non-stock at the time it is issued should be tested when later events cause the preferred to have a different value than it had at the time of its issuance. *I.R.C. section 382(l)(3)(C)* recognizes that changes in proportionate ownership can occur by reason of fluctuations in the relative fair market values of different classes of stock. When the changes in proportionate ownership are "solely" attributable to changes in value, the fluctuations are ignored unless otherwise provided in regulations. n17a It is unclear that this provision would control the classification of preferred as stock or non-stock, even though the effect of classifying the preferred as stock under such circumstances may be a large proportionate shift of ownership among the classes of stock. On the one hand, it would appear that so long as the original owner holds preferred stock with original terms that was non-stock at the time of its issuance, the preferred should not be recharacterized. On the other hand, preferred stock periodically issued as dividends paid-in-kind ("PIK") in lieu of cash dividends may be particularly susceptible to such stock treatment for the reasons stated in the prior paragraph even though the original PIK instrument had a value (issue price) approximating its liquidation or redemption value and was properly characterized as non-stock. Only if the PIK stock and the PIK dividends are analyzed as a single instrument, that is non-stock at the time of issuance, is this problem avoided. n18

A loss corporation must file an information statement with its tax return providing detailed information from which the IRS can determine whether an ownership change has occurred, the loss corporation's 5-percent shareholders on each testing date (described below) and the extent to which the loss corporation is vulnerable to such an ownership change. n19 The information statement is required for each year in which a testing date occurs. Thus, stock issuances and grants of options treated as exercised under the regulations, and transfers of stock or options to or by 5-percent shareholders can necessitate the filing of the statement and if they do so, require a detailed description on a quarter by quarter basis. n20

I.R.C. section 269, SRLY and CRCO rules continue to govern notwithstanding the adoption of *I.R.C. section 382*. n21

[3] Determination of the Testing Period

While the testing period is generally three years for determining whether the cumulative owner shifts of a loss corporation constitute an ownership change, there are certain exceptions. Following an ownership change a new three-year testing period begins for measuring changes in stock ownership by 5-percent shareholders. n22 Moreover, since *I.R.C. section 382* is intended to proscribe only trafficking in the stock of loss corporations, there is a special rule shortening the testing period when the corporation has no losses in the earlier periods. In such cases, the testing period does not begin earlier than the first day of the first taxable year from which there is a tax loss or credit carryforward to a year following a change of ownership or the year of the transaction being tested. n23 Except as provided in regulations, this shortened test period rule does not apply to a loss corporation with a net built-in loss. n24 Literally, this means that even though the built-in losses are created in the tax year prior to the transaction being tested and owner shifts in the first tax year of the normal three year testing period would be ignored had such built-in losses been realized net

operating loss carryforwards, the special rule does not apply. The Temporary Regulations ameliorate this result in situations where the loss corporation can establish the tax year in which the net unrealized built-in loss first accrued.
n25

[4] Definition of Owner Shift

Under old section 382 there were differences in treatment of stock sales and most tax reorganizations defined in *I.R.C. section 368(a)*. n26 This difference in treatment of stock sales and tax reorganizations could result in very different treatment of transactions depending on the form of the deal. Unlike old section 382, after a transition rule period, it is intended that under *I.R.C. section 382*, there be no essential difference between the consequences of stock purchases and tax reorganizations. The Temporary Regulations make this explicit by defining all stock issuances, including issuances pursuant to tax reorganizations, as "owner shifts." n27 Further, unlike old section 382, there is no ten-largest-shareholder-control group concept. Under the prior rules this group concept permitted transfers of stock between the persons that made up this control group without triggering the limitations of old section 382. The elimination of this control group concept means that under *I.R.C. section 382* transfers of stock between any 5-percent shareholders are owner shifts that can be counted so as to cause an ownership change if the fifty percentage point test is exceeded during the testing period.

An owner shift is a change in the stock ownership of a corporation that affects the percentage of stock held by a 5-percent shareholder before or after such change. n27a The date of each such change is also a "testing date" on which the loss corporation is required to determine whether the fifty percentage point threshold for an ownership change has been exceeded. n28 With certain important exceptions, all shareholders holding less than 5% of the stock are aggregated and treated as a single 5-percent shareholder. Transactions between the members of this less-than-5-percent-shareholder ("LFPS") group and between members of different LFPS groups are not owner shifts and are not taken into account. n29 Determining stock ownership and testing dates is relatively straightforward when all of the stock of a loss corporation is owned by individuals. It is significantly more complicated to determine whether an ownership change has occurred on any testing date when there are successively higher tiers of stock ownership by entities other than individuals. n30

Stock held by a corporation is attributed to its shareholders and generally those shareholders are aggregated. When a tax reorganization involving two or more corporations occurs, the acquiring and acquired corporations' shareholders are each segregated as separate LFPS groups. n31 Under the current Temporary Regulations, LFPSs existing before and after transactions covered by *I.R.C. section 1032* (e.g., recapitalizations and stock offerings) or redemption-type transactions are also segregated as separate LFPS groups. n32 In general, these shareholder groups are treated as 5-percent shareholders even though the group may in fact not own in the aggregate 5% of the loss corporation's stock. n33 As discussed below, this rule is modified under certain circumstances under the new regulations. Small issuances during a year that result in multiple LFPS groups can be aggregated. n34 It may not be in the best interest of the loss corporation to do so since the aggregation will delay the time at which the stock acquired by such LFPS shareholder groups falls outside the three year testing period.

Example 3:

L, a calendar year loss corporation owned by the public since June 30, 1996, exchanges stock for trade debt pursuant to its title11 plan of reorganization on July 1, 2002. The large number of trade creditors (none of whom individually owns as much as 5% of the L stock) then own 51% of the L stock. This exchange is covered by *I.R.C. section 1032*. The Temporary Regulations currently require the segregation of the trade creditors into a LFPS group distinct from the old shareholders constituting a LFPS group. Since the new trade creditor LFPS group has increased its stock ownership from zero to fifty-one percentage points, this transaction results in an ownership change.

Example 4:

L, a calendar year loss corporation owned by the public since August 31, 1996, sells 51% of its stock in a public offering on September 1, 2002 and thereafter no one owns more than 5% of L. The new shareholders who acquire the stock under the Temporary Regulations will be segregated in a separate LFPS group whose interest has increased by fifty-one percentage points. An ownership change has occurred.

Example 5:

L, a calendar year loss corporation owned by the public, redeems 60% of its stock with a cash tender on September 1, 2002. The remaining public shareholders will be treated as a LFPS group, separate from the shareholders who had their stock redeemed. The remaining public LFPS will have increased its ownership from 40% to 100%. An ownership change has occurred.

[a] Equity Structure Shift

An equity structure shift includes any tax reorganization other than a divisive (*i.e.*, one in which less than substantially all of the assets of the reorganizing corporation are being transferred) reorganization. n35 An ownership change occurs if the interest in the loss corporation of the 5-percent shareholders (identified at each testing date) has increased by more than fifty percentage points. Moreover, any increase in stock ownership of the loss corporation during the preceding three-year testing period by such 5-percent shareholders will be counted and can result in an ownership change. Thus a series of transactions--whether owner shifts or equity structure shifts--can result in an ownership change. As indicated above, for all practical purposes, there is no distinction between these two types of transactions.

Example 6:

On January 1, 2002, I (an individual) purchases 40% of L, a loss corporation. On July 1, 2002, L is merged into P, which is wholly-owned by I, in a tax-free "G" reorganization, an owner shift followed by an equity structure shift and an owner shift. The shareholders of L receive 60% of the stock of P. There is an ownership change on July 1, 2002 because of I's purchase and the merger. The percentage increase of I is 64% (24% on account of the L stock and 40% on account of the P stock). n36

[b] Attribution, Aggregation and Segregation Rules

In determining whether an owner shift has occurred, it is important to identify the ultimate human beings that own the stock of the loss corporation. n37 Intervening juridical entities are largely ignored as a result of the "look through" approach of *I.R.C. section 382* and the Temporary Regulations reflected in modified *I.R.C. section 318* constructive ownership rules and the aggregation and segregation rules of the regulations referred to above.

For purposes of ascertaining stock ownership, the constructive ownership attribution rules of *I.R.C. section 318* are applied with certain exceptions. n38 Thus related parties will have their stock aggregated in determining the extent of any owner shift. The normal family attribution rules do not apply and an individual and the members of his or her family described in the family attribution rules of *I.R.C. section 318(a)(1)* are treated as one person for purposes of *I.R.C. section 382*. n39 One corollary of these rules is that transfers of stock between related parties may not count as an owner shift. Another important exception to the normal *I.R.C. section 318(a)* constructive ownership rules is that the attribution "from" entities rule of *I.R.C. section 318(a)(2)* is applied without regard to the 50% limitation applicable to corporations and, except as provided in regulations (of which there are none as yet), stock that is attributed to another under these rules is no longer treated as owned by the entity from which it is attributed. n40 The Temporary Regulations for administrative convenience modify these operating rules to cut off attribution of stock to and from successively higher tiers of ownership under certain limited conditions. n41 The attribution "to" entities rule of *I.R.C. section 318(a)(3)* is applicable only to the extent provided in regulations and there are no such regulations. n42

The Temporary Regulations "segregate" and "aggregate" individual shareholders into different shareholder groups for purposes of determining owner shifts. n43 As noted above, all the LFPSs of a loss corporation at the beginning of a testing period are aggregated into one group treated as a 5-percent shareholder, whether or not such persons in fact own 5% or more of the corporation's stock. n44 Thus trading among such persons cannot cause an ownership change even if in fact the identity of each individual changes. n45 The shareholders of different juridical entities who, by attribution, would own less than 5% of the stock of the loss corporation are aggregated for purposes of measuring owner shifts in order to achieve the same results that one would expect from looking only at the entities involved. n46 For instance, if large public company PC purchases all of the stock of L, a small publicly-held loss corporation, neither of which in fact has any shareholder who owns 5% of its stock, there will be an ownership change with respect to L. This is because the aggregation rules will treat all of the public shareholders of PC, the purchaser of L, as a LFPS group. n47

To prevent the abuse of the five percent threshold, the regulations provide "a group of persons who have a formal or informal understanding among themselves to make a coordinated acquisition of stock" will be treated as a single entity for purposes of section 382. n47a In a private letter ruling, n47b the Service considered circumstances when a family of partnerships constituting a hedge fund should not be treated as an "entity" within the meaning of Treas. Reg. section 1.382-3(a)(1) and thus each partnership should be tested separately for purposes of determining 5-percent shareholder status. On the facts of the letter ruling, the three partnerships had the same investment objectives and in virtually every case the manager of the partnerships decided to invest each partnership's assets in the same stock or security. Moreover, the manager invested the same percentage of each partnership's total assets in that stock or security, but the manager did not invest based on the percentage of an issuer's stock or security to be acquired by one or more of the partnerships. In the letter ruling, each partnership represented that it (i) has not indicated to its investors that the partnerships would acquire equity interests in any issuer for the purpose of the partnerships' accumulating ownership of any particular or minimum percentage of the equity interests of any issuer, and (ii) did not acquire any issuer stock for the purpose of changing or influencing the control of the issuer. The Service concluded that the partnerships do not constitute a group of persons acting in concert to acquire issuer's stock, and therefore are not aggregated as a single entity for purposes of section 382.

Various transactions can cause the segregation of LFPSs into separate public groups, each treated as a 5-percent shareholder. n48 If the loss corporation engages in a non-divisive tax reorganization constituting an equity structure shift or, subject to the new segregation rules discussed below, an issuance of stock governed by *I.R.C. section 1032*, then the new shareholders of the loss corporation will be treated as a separate public group. n49 If the loss corporation redeems stock from a public group, the public group is treated as if it were two public groups, one owning the shares that were redeemed and one owning the shares that were not redeemed. n50 This results in the public group deemed to own the unredeemed shares increasing its percentage ownership of the corporation. These segregation rules are generally applicable to testing dates after September 3, 1987. n51

These segregation rules do not apply, however, to the extent that the loss corporation has actual knowledge that the assumptions contained in such rules are not true. n52 Thus, for example, in a self-tender redemption, a loss corporation can show that all of its public shareholders redeemed a proportionate amount of their shares and the segregation rule applying to redemptions would not apply. The information statement required to be filed by the loss corporation with its tax return n53 requires the disclosure of the extent to which the loss corporation is relying on these presumptions.

In a 1998 Field Service Advice the IRS took a position that, although Temp. Treas. Reg. section 1.382-2T(k)(6) reserves the issue of how *I.R.C. Section 382* applies to indirect ownership changes of a U.S. loss corporation as a result of changes of ownership in an indirect foreign shareholder, the rules of Temp. Treas. Reg. section 1.382-2T nevertheless apply. n53a

On October 4, 1993, final regulations were adopted which liberalize the segregation rules as applied to small issuances and new stock offerings for cash to the public by a loss corporation. n54 It should be kept in mind that the new rules do not wholly exempt such issuances from the taint of stock owner shifts for purposes of determining when a fifty

percentage point change of ownership has occurred. Instead, such rules exempt the stock issuances from only the segregation rules. They will still be taken into account in determining the percentage shifts in stock ownership. The benefit is that by combining such issuances with the stock already held by existing LFPS groups, the dilution achieved by grouping the new issuances with the stock already owned by those groups will reduce the amount of tainted stock ownership.

The regulations except from the segregation rules small issuances of stock during a year up to the "small issuance limitation." The small issuance limitation for each taxable year, at the loss corporation's election, is (i) 10% of the total value of the loss corporation's stock at the *beginning* of the year (less *I.R.C. section 1504(a)(4)* preferred stock) or (ii) on a class-by-class basis, 10% of a class at the *beginning* of the year. n55 When more than one class of stock is issued in the relevant transaction, determination of the limitation must be by value. n56

To the extent that an issuance, when added to previous issuances, exceeds the small issuance limitation, it is not exempt. If any issuance during the year by itself exceeds the small issuance limitation, then none of it is exempt; however, it does not count in disqualifying future small issuances. Thus, the result in Example 4 would not be changed as a result of the small issuance exemption.

The effect of the small issuance exemption is to permit widely-held loss companies, especially startup companies, to issue stock over time without increasing by the same amount the amount of tainted stock counted against them for purposes of determining whether there has been an ownership change. While the existing LFPS groups will increase their ownership of the loss corporation's stock, because of the dilution inherent in the issuance of stock under the small issuance exemption, the net amount of the increase in tainted stock ownership will be less than under the prior segregation rules.

Example 6a:

L, a calendar year loss corporation owned by the public since August 31, 1996, sells 10% of its then outstanding stock for cash in a public offering on each of September 1, 1999, 2000, and 2001 and after each offering no one owns more than 5% of L. Under the final regulations, the new shareholders will *not* be segregated into three separate LFPS groups whose interests have increased by 24.8 percentage points in the aggregate ($7.5 + 8.3 + 9.0 = 24.8$). Thus, unlike under the prior Temporary Regulations, L could sell an additional 49 percentage points of its stock to 5-percent shareholders without triggering an ownership change.

The operation of the dilutive effect of the existing LFPS groups in light of the small issuance exemption is shown in the following example. For purposes of this example, assume that the initial number of shares owned by a shareholder is also the percentage of shares owned by such person. The Old Residual is an old and cold, LFPS group and the Old Shareholder is also old and cold. The New Shareholder acquired her shares within the relevant testing period and her shares are thus tainted. Since there are initially 100 shares outstanding, initially the number of shares owned also equals each shareholder's percentage of total share ownership. First, consider the effect of an issuance of 10% of the stock of the loss corporation prior to the finalization of the small issuance exemption regulations. The necessity of segregating the purchasers of the new issue into a separate LFPS group causes an ownership change.

Example 6b:

Shareholder	Shares 1/92	Owned 1/93	Percent Total	Points of In- crease
Old Residual	40	40	36.36%	--
Old Shareholder	14	14	12.73%	--
New Shareholder	46	46	41.82%	41.82

New LFPS Group	--	10	9.09%	9.09
TOTAL	100	110	100.00%	50.91

Now consider the same transaction under the small issuance exemption. The fact that none of the shares issued in the small issuance exemption must be segregated in a new LFPS group permits the shares issued to be attributed to the old residual LFPS group where the existing percentage of ownership by that group dilutes the full effect of the new issuance.

Example 6c:

Shareholder	Shares 1/92	Owned 1/93	Percent Total	Points of In- crease
Old Residual	40	50	45.45%	5.45
Old Shareholder	14	14	12.73%	--
New Shareholder	46	46	41.82%	41.82
TOTAL	100	110	100.00%	47.27

The regulations also now contain a cash issuance exemption that changes the presumption about overlapping stock ownership when a loss corporation with one or more LFPS groups issues stock for cash. The IRS determined the presumption of the Temporary Regulations that existing small shareholders do not purchase subsequent issues of stock of a loss corporation is unrealistic and too restrictive. Under the cash issuance exemption, the lesser of (i) 50% of the current percentage of stock owned by LFPS groups multiplied by the amount of stock issued for cash, or (ii) the stock issued for cash less the amount acquired by 5-percent shareholders is treated as being acquired by LFPS groups existing before the issuance. n57 The cash issuance exemption does not apply to stock exempted from the segregation rules under the small issuance exemption. n58

The stock issued is deemed to be acquired proportionately by each existing LFPS group. To the extent the loss corporation can show greater overlapping ownership of the newly issued stock for purposes of the exemptions it may do so. However, when distributed options are exercised, the loss corporation must show that the stock actually was acquired by members of preexisting LFPS groups. n59

Example 6d:

L, a calendar year loss corporation owned by the public since August 31, 1996, sells 51% of its stock for cash in a public offering on September 1, 2002, and thereafter no one owns more than 5% of L. The new shareholders will be segregated in a separate LFPS group whose interest has increased by 25.5 percentage points. Unlike the result in Example 4, an ownership change has not occurred.

The operation of the dilutive effect of the existing LFPS groups in light of the cash issuance exemption is shown in the following example using the same fact pattern used above to illustrate the small issuance exemption. For purposes of this example, the initial number of shares owned is the same as the initial percentage of shares owned. The Old Residual is an old and cold LFPS group and the Old Shareholder is also old and cold. The New Shareholder acquired her shares during the current year. First, consider the effect of an issuance of 10% of the stock of the loss corporation prior to the finalization of the cash issuance exemption. The necessity of segregating the purchasers of the new issue into a separate LFPS group causes an ownership change just as it did in Example 6b.

Example 6e:

Shareholder	<i>Shares</i> 1/92	<i>Owned</i> 1/93	Percent Total	Points of In-crease
Old Residual	40	40	36.36%	--
Old Shareholder	14	14	12.73%	--
New Shareholder	46	46	41.82%	41.82
New LFPS Group	--	10	9.09%	9.09
TOTAL	100	110	100.00%	50.91

Now consider the same transaction under the cash issuance exemption. Since the loss corporation has already issued more than 10% of its stock during the year, the small issuance exemption is not available. The fact that part of the new share issuance for cash equal to 50% of the proportion of the pre-issuance outstanding stock owned by the existing LFPS groups (*i.e.*, $50 \times .40 \times 10 = 2$) need not be segregated in a new LFPS group permits the new shares attributed to the Old Residual LFPS group partially to dilute the full effect of the cash issuance. In this case, an ownership change is avoided.

Example 6f:

Shareholder	<i>Shares</i> 1/92	<i>Owned</i> 1/93	Percent Total	Points of In-crease
Old Residual	40	42	38.18%	--
Old Shareholder	14	14	12.73%	--
New Shareholder	46	46	41.82%	41.82
New LFPS Group	--	8	7.27%	7.27
TOTAL	100	110	100.00%	49.09

The new segregation exemptions do not apply to issuances in equity structure shifts (generally tax free reorganizations) other than a small issuance pursuant to an "E" Reorganization. n60 Related transactions or tax avoidance transactions must be aggregated for purposes of applying the exemptions. n61

The regulations do not make clear when the shares owned by existing segregated public groups, which are treated as receiving shares under the new exemptions, are no longer taken into account in determining an ownership change. Under the regulations, the shares owned by a segregated public group resulting from a segregation event are only counted for purposes of determining an ownership change during testing periods which include the segregation event. n62 The regulations do not, however, discuss what would happen if one of the segregated groups experiences an owner shift after the segregation event occurs. A literal reading of the regulations would say that regardless of when that later shift occurred, the taint from such owner shift would disappear three years after the initial segregation event. This issue is only a practical problem with respect to the small issuance exemption, since there is no percentage increase in ownership of segregated public groups in situations involving the cash issuance exemption because of the effects of dilution.

The exemptions to the segregation rules are effective as to issuances of stock after November 3, 1992. However, the loss corporation may irrevocably elect with the first tax return filed after 60 days after October 4, 1993, to apply the rules retroactively. n63 This election is available even though the loss corporation had experienced an ownership change

under the existing Temporary Regulations. In addition, it applies even though the year of the ownership change was a closed year under the statute of limitations, provided appropriate adjustments were made to account for the closed years.

A detailed examination of the operation of the segregation and aggregation rules is beyond the scope of this chapter, but as can be seen by the above examples they are detailed and complicated in their application. n64

With few exceptions, prior to the finalization of the new regulations relating to the deemed exercise of options proposed amendments discussed below, options and similar rights, including redemption and put rights, were considered to be exercised (on an option by option basis) if the effect was to cause an ownership change to occur. n65 Generally, no consideration was given to contingencies or conditions affecting the exercise of an option. n66 Thus it made no difference whether the option was presently exercisable, "out of the money," or subject to a condition outside the control of the option holder. n67 The segregation rules provide that options deemed exercised by LFPSs result in a separate public group. n68

The old Temporary Regulations had certain limited exceptions to the deemed exercise rule. n69 One significant exception was that if an option was outstanding both before and after an ownership change under *I.R.C. section 382*, then the option would be ignored for purposes of the option deemed-exercised rule as long as it continued to be owned or treated as owned by the same 5-percent shareholder. n70 Furthermore, the actual exercise of any option outstanding before and after an ownership change, whether or not deemed exercised so as to cause an ownership change, was disregarded as long as the option was exercised by the same 5-percent shareholder or person who would have been a 5-percent shareholder had the option been exercised. n71

The original option rule was the greatest deterrent to planning ways to avoid an ownership change. It was also a trap for the unwary.

Example 7:

On January 1, 1992, I, an individual, purchases 49% of the common stock of L, a loss corporation from B, an individual. I receives an option from B to purchase the remaining 51% of L at any time after January 1, 1995. An ownership change has occurred (even though the option is not exercisable within the same testing period as the stock purchase).

Example 8:

Same facts as Example 7, except that the remaining common stock held by B is recapitalized into voting preferred stock that is stock under *I.R.C. section 1504(a)(4)*. The preferred stock is redeemable by L after January 1, 1995. An ownership change has occurred because the redemption feature of the preferred is treated as an option for the corporation to redeem its stock. It could also result in income items, such as discharge of indebtedness income upon the compromise of indebtedness, being subject to the *I.R.C. section 382* limitation if under the option deemed-exercise rule the ownership change occurs in advance of the closing of the stock-for-debt exchange.

The creation of an option with respect to a plan of reorganization under the Bankruptcy Code, however, should not cause the abovementioned problems. *Treasury Regulation section 1.382-9(o)* provides that an option created as a result of a plan of reorganization under the Bankruptcy Code shall not be deemed to be exercised prior to the effective date of the plan.

On March 17, 1994, final regulations were adopted that generally reverse the pervasive presumption of the Temporary Regulations in most circumstances concerning the deemed exercise of options for purposes of determining whether an ownership change has occurred. n72 The final regulations define an option as any contingent purchase, warrant, convertible debt, put, stock subject to risk of forfeiture, contract to acquire stock, or similar interest. n73 Thus, a merger agreement between a loss corporation and another corporation, a stock purchase agreement and an out-of-court debt

restructuring (which includes a stock issuance) are all options that can cause an ownership change, subject to rules discussed below, to take place in advance of the closing or effective date. n74 The IRS has ruled that in these contexts an option arises when as a "legal and practical matter" the parties are bound to go forward. n75 Convertible stock is treated as an option only if the terms of the conversion feature permit or require the tender of consideration other than the stock being converted. n76

Under the final regulations, an option is not deemed exercised for purposes of causing an ownership change unless it satisfies one of three tests: (i) an ownership test; (ii) a control test; or (iii) an income test. n77 These tests are performed only on the date the option is issued or transferred, and, if the option satisfies a test, it will be deemed exercised on that date and on each succeeding testing date until an ownership change occurs. n78

An option satisfies the ownership test if the principal purpose of the issuance, transfer or structuring of the option is to avoid or ameliorate the impact of an ownership change of the loss corporation by providing the option holder with a substantial portion of the attributes of ownership of all or part of the stock covered by the option prior to its exercise or transfer. n79

An option satisfies the control test if (i) a principal purpose of the issuance, transfer or structuring of the option is to avoid, or ameliorate the impact of an ownership change of the loss corporation, and (ii) the holder of the option and any related persons have, in the aggregate, a direct and indirect ownership interest in the loss corporation of more than fifty percent. n80 For purposes of this test, ownership includes the deemed exercise of all options held by the holder or related persons, including the option in question, plus any intended increases in such persons' ownership interest as if such intended increases had already occurred. n81 Persons are "related" to the holder if they bear a relationship to the holder set forth in *I.R.C. sections 267(b) or 707(b)* or if they have a formal or informal understanding among themselves to make a coordinated acquisition of stock. n82 Indirect ownership is determined by the constructive ownership rules of the Temporary Regulations, except that entities may be treated as owning stock and the old option attribution rules do not apply. n83

An option satisfies the income test if a principal purpose of the issuance, transfer or structuring of the option (alone or in combination with other arrangements) is to avoid or ameliorate the impact of an ownership change of the loss corporation by facilitating the creation of income (including accelerating income or deferring deductions) or value (including unrealized built-in gains) prior to the exercise or transfer of the option. n84

An option is tested under each of the three tests based on all relevant facts and circumstances. n85 The following factors are relevant (without any particular weight) n86 in applying all three tests: (i) business purposes for the issuance, transfer or structure of the option; (ii) the likelihood of exercise of the option (taking into account, for example, contingencies to exercise); (iii) transactions related to the issuance or transfer of the option; and (iv) the consequences of treating the option as exercised. n87 Notwithstanding any of the other rules, an option will not be treated as exercised if a principal purpose of its issuance, transfer or structuring is to avoid an ownership change if deemed exercised. n88

Four additional factors apply with respect to the ownership test. They are relevant in determining whether the option holder benefits from additional attributes of stock ownership. The factors are: (i) the relationship between the exercise price of the option and the value of the underlying stock at the time of issuance or transfer; (ii) whether the option provides its holder or a related person with the right to participate in the management of the loss corporation or with other rights that ordinarily would be afforded to owners of the underlying stock (*e.g.*, voting rights); (iii) the existence of a reciprocal option (*e.g.*, a call option held by the prospective purchaser and a corresponding put option held by the prospective seller); and (iv) the ability of the holder of an option with a fixed exercise price to share in future appreciation of the underlying stock. n89 The regulations state that the last factor would not be sufficient by itself to cause an option to satisfy the ownership test. n90 On the other hand, the regulations also state that the fact that a holder of an option does not bear the risk of loss with respect to the underlying stock does not preclude the option from satisfying the ownership test. n91

Two additional factors apply with respect to the control test. Those factors are (i) the economic interests in the loss corporation of the option holder or related persons, and (ii) the influence of those persons over the management of the loss corporation. n92 Either factor may be present in the option itself, a related arrangement or through rights in stock. n93 The application of these factors with respect to the control test is not entirely clear. They may be intended to relate to the determination of indirect control.

Two additional factors apply with respect to the income test. Those factors are (i) whether the loss corporation engages in income acceleration transactions (or deduction deferrals), and (ii) whether the option holder or a related person purchases stock from, or makes a capital contribution or loan to, the loss corporation that can reasonably be expected to avoid or ameliorate the impact of an ownership change. n94 Stock purchases, capital contributions or loans made to enable the loss corporation to continue basic business operations are generally not taken into account in applying the income test. n95

The regulations list five safe harbors (apart from providing for additional exceptions to be published in the Internal Revenue Bulletin) from the ownership, control and income tests. It is specifically stated that failure of an option to fall within a safe harbor does not affect the determination of whether the option satisfies one of the tests. n96 The first safe harbor is for stock purchase agreements or similar arrangements, the terms of which are commercially reasonable, which are subject only to reasonable closing conditions and which close within one year of the date entered into. n97 This safe harbor does not apply with respect to the income test. n98

The second safe harbor covers an option that is part of a security arrangement (including stock held in escrow or under a pledge) in a typical lending transaction (including a purchase money loan), if the arrangement is subject to customary commercial conditions. n99

The third safe harbor applies to customary employee stock options (including those given to directors and independent contractors) given in connection with the performance of services for the corporation or a related person (and that is not excessive by reference to the services performed). n100 In addition, the option must be nontransferable within the meaning of *Section 1.83-3(d) of the Treasury Regulations* and must not have a readily ascertainable fair market value as defined in *Section 1.83-7(b) of the Treasury Regulations* on the date the option is issued. n101

The fourth safe harbor is for an option entered into between stockholders of a corporation (or a stockholder and the corporation) with respect to stock of either stockholder, that is exercisable only upon the death, disability or mental incompetency of the stockholder. n102 This safe harbor also applies in the case of an option (on the part of a shareholder or the corporation) to acquire stock acquired in connection with the performance of services for the corporation or a related person (and that is not excessive by reference to the services performed) upon the retirement of the person who performed the services. n103

The fifth safe harbor covers a bona fide right of first refusal with customary terms, entered into between stockholders of a corporation (or between the corporation and a stockholder). n104

Certain transfers of options are exempted from a determination of whether such options satisfy one of the tests. First, transfers between persons who are not 5-percent shareholders and would not be 5-percent shareholders if all options held by them were deemed exercised are exempted. n105 Second, transfers between separate public groups are exempted. n106 Third, transfers arising from the circumstances described in *I.R.C. section 382(l)(3)(B)*, such as by reason of death, gift, divorce, separation, etc., are exempted. n107

If an entity is formed or availed of for the principal purpose of facilitating an indirect transfer of an option by issuing or transferring interests in the entity, the issuance or transfer of an interest in the entity will be treated as a transfer of the option for purposes of applying the ownership, control and income tests. n108 Appropriate adjustments must be made

with respect to put options to take into account the fact that a put provides its holder with the right to transfer, rather than acquire, the stock. n109

Once an option is deemed exercised and results in an ownership change, the actual exercise of that option by the person who owned the option immediately after the ownership change will not be taken into account in determining if another ownership change occurs. n110 In addition, the option will not be deemed exercised on any subsequent testing date after the change date unless and until it is transferred in a transfer that itself would satisfy one of the three tests. n111 It should be noted that the foregoing rules do not apply to options that were not deemed exercised. Thus, the actual issuance of stock pursuant to an option that was not deemed exercised will result in an owner shift, even if the option existed prior to a previous ownership change.

If an option that is deemed exercised under the new option rules and causes an ownership change is actually exercised within three years of the change date, an alternative look-back rule permits the taxpayer to treat the option as having been actually exercised on the change date such that the underlying stock will be deemed to be outstanding for purposes of determining whether ownership changes occur after that change date. n112 Any transfer of such option in the interim will be treated as a transfer of the underlying stock. n113

The final regulations provide that the new option rules apply to any testing date on or after November 5, 1992. n114 There are special effective date rules with respect to the control test n115 and convertible preferred stock. n116 The regulations also provide for an election to extend the application of the old option rules in the Temporary Regulations for particular periods. n117 If an option existed immediately before and after an ownership change to which the option rules under the Temporary Regulations applied, the option will not be deemed exercised on any subsequent testing date unless and until it is transferred in a transfer that satisfies one of the ownership, control or income tests. n118

Example 8a:

On July 1, 2003, I, an individual, purchases 49% of the common stock of L, a loss corporation from B, an individual. L issues options exercisable for 10% of its stock to its employees pursuant to bona fide employment arrangements. Unlike under the old Temporary Regulations, the employee options are not deemed exercised and an ownership change has not occurred. When *exercised*, these options should not cause an ownership change to the extent they qualify for the small issuance exemption and there is only one LFPS group. The result could change if there is more than one group.

Example 8b:

Same facts as in Example 8a, except that the 10% stock option is issued to a new investor, A. The option is not exercisable for three years. I enters into a voting arrangement with A in which A can effectively vote 20% of I's shares (*i.e.*, almost 10% of L's stock). It is likely that the stock option satisfies the ownership test and will therefore be deemed exercised to cause an ownership change on the date of issuance.

Example 8c:

Same facts as in Example 8a, except that the 10% stock option is issued to I. If there is no valid business reason for issuing the option, as opposed to the underlying stock, the options will likely satisfy the control test and will therefore be deemed exercised to cause an ownership change on the date of issuance.

Example 8d:

Same facts as in Example 8b, except that the option is not exercisable for one year and A has no voting arrangements or other management arrangements with anyone. Assume that L has net unrealized built-in losses, n119 but also has Asset 1 with unrealized built-in gain. n120 L plans to sell Asset 1 by the end of the year. It is likely that the stock option satisfies the income test and will therefore be deemed exercised to cause an ownership change on the date of issuance.

It should be noted that one result of the change in the presumption under the new option rules is to eliminate the rule that "cleanses" options which exist both before and after an ownership change. Under the new option rules, a nonabusive option that exists both before and after an ownership change may result in an owner shift when it is actually exercised. This would not have occurred under the former Temporary Regulations, even if the deemed exercise of the options was not necessary to cause the ownership change which cleansed them.

[c] Special Issues Respecting Owner Shifts

For taxable years beginning after December 31, 1987, treatment of a loss corporation's stock as worthless by a person that owned at least 50% of such stock during the testing period will result in the shareholder being deemed to have acquired the worthless stock on the first day of the next taxable year and not to have owned such stock prior to such date. n121 In *Official Committee of Unsecured Creditors v. PSS Steamship Co. (In re Prudential Lines, Inc.)*, n122 the Court of Appeals for the Second Circuit affirmed a bankruptcy court holding that a NOL is property of the bankruptcy estate and, therefore, the taking of a worthless stock deduction by the sole shareholder would interfere with such property in violation of the automatic stay of *section 362 of the Bankruptcy Code*. n122a The treatment of stock held in a disputed claims reserve might impact the determination of whether and when an ownership change occurs. For instance, if the loss company's common stock held in a disputed claims reserve is not treated as issued and outstanding pending resolution of the claims, the calculations of stock issued to 5-percent shareholders could change. n123

Likewise, purchases and sales of stock by 5-percent shareholders during the pendency of a case under the Bankruptcy Code may cause an ownership change of a debtor corporation even though the stock has very little value relative to the interest of creditors. In such cases it might be prudent to consider a request to the bankruptcy court that it issue an order restricting transfers of the loss corporation's stock by or to 5-percent shareholders during the pendency of the case. As discussed in the next paragraph, such orders may only be partially effective in preventing owner shifts. Such action was approved in at least two bankruptcy cases. n124

If stock is issued to creditors in a case under the Bankruptcy Code and either there is no ownership change or the exception in *I.R.C. section 382(l)(5)* applies, n125 the loss company may still be at risk of an ownership change if 5-percent shareholders sell to others or persons accumulate stock of the loss corporation so as to become 5-percent shareholders. The determination of feasibility of the plan of reorganization of the reorganized company may be dependent on the availability of the NOLs in order to meet the plan projections. In order to forestall future owner shifts that could have an adverse impact on the reorganized company, some debtors as a part of the plan have adopted amendments to the reorganized company's charter documents that void any acquisition of its stock that will result in the transferee becoming a 5-percent shareholder or increasing the percentage ownership of a 5-percent shareholder.

These charter restrictions, even if respected by the IRS n126 as they should be, n126a can only go so far in protecting the reorganized company. First, there is some doubt whether they can reach acquisitions of higher tier entities that indirectly own the loss company stock by attribution under the constructive ownership rules discussed above. Second, while trading among the members of the LFPS group is ignored, a sale of stock by a 5-percent shareholder "into the market" to small shareholders in the LFPS group will cause that group's percentage of ownership to increase. The adverse consequences of such an increase can only be avoided by an absolute prohibition on sales by 5-percent shareholders during the relevant testing period. This is unlikely to be palatable to major creditors.

Special rules are also provided by *I.R.C. section 382* for treating stock acquired by reason of death, gift, divorce, or separation, and employee stock ownership plans. n127 OBRA 1989 n128 deleted the special owner shift exception in former *I.R.C. section 382(l)(3)(C)* for stock acquired by certain employee ownership plans. n128a. The Service finalized temporary Regulations making it clear that, if a qualified trust (trust described in section 401(a)) distributes an ownership interest in an entity, then for testing dates on or after the date of the distribution, the distributed ownership interest will be treated as having been acquired by the distributee on the date and in the manner acquired by the trust. Therefore, the distributions do not cause there to be a new testing date. n128b

[5] Value of the Loss Corporation

The value of the loss corporation against which the *I.R.C. section 382* limitation for any year is calculated is generally the fair market value of the stock of the loss corporation immediately before the ownership change. n129 The price paid may not be conclusive. n129a For instance, premium paid for control probably should be eliminated since the objective is to value the whole loss corporation. n130 The equity respecting the value of the loss corporation includes stock (including preferred stock not treated as "stock" under *I.R.C. section 1504(a)(4)*), and should include the option value of warrants or options issued by the corporation, and of the conversion feature of debt and other equity interests. n131 However, the deemed exercise price of options with respect to unissued stock does not increase the value of the loss corporation. n131a

The value of the loss corporation is reduced for capital contributions made to avoid or increase the *I.R.C. section 382* limitation. n132 Contributions made to the loss corporation within the prior two years are "irrebuttably" presumed to be bad, except as provided in regulations. n133 According to Notice 2008-78, Treasury intends to issue regulations that "turn off" this two-year presumption and replace it with a facts and circumstances determination. n134 Notice 2008-78 also sets out four anticipated safe harbors. n135

The first safe harbor applies to capital contributions by a person who is neither a controlling shareholder (determined immediately before the capital contribution) nor a related party (within the meaning of *I.R.C. Section 267(b)*, as determined immediately after the capital contribution), where no more than 20 percent of the total value of the loss corporation's outstanding stock is issued in connection with the contribution, there was no "agreement, understanding, arrangement, or substantial negotiations" at the time of the contribution regarding a transaction that would result in an ownership change, and the ownership change occurs more than six months after the contribution. n135a

The second safe harbor applies to capital contributions made by a related party (within the meaning of *I.R.C. Section 267(b)*, as determined immediately after the capital contribution), where no more than 10 percent of the total value of the loss corporation's stock is issued in connection with the contribution, or to capital contributions made by a person other than a related party, and in either case there was no "agreement, understanding, arrangement, or substantial negotiations" at the time of the contribution regarding a transaction that would result in an ownership change, and the ownership change occurs more than one year after the contribution.

The third safe harbor applies to capital contributions in exchange for stock issued in connection with the performance of services, or stock acquired by a retirement plan, under the terms and conditions in *Section 1.355-7(d)(8)* or (9) of the Treasury Regulations, respectively.

The fourth safe harbor applies to capital contribution received on the formation of a loss corporation (not accompanied by the incorporation of assets with a net unrealized built in loss) or received before the first year from which there is a carryforward of a net operating loss, capital loss, excess credit, or excess foreign taxes (or in which a net unrealized built-in loss arose). n135b

Notice 2008-78 also clarifies that appropriate adjustment must be made to ensure that any reduction in value caused by a capital contribution that violates the anti-stuffing rule does not result in a duplicate reduction for nonbusiness assets under *I.R.C. Section 382(l)(4)*. The IRS has indicated that regulations pursuant Notice 2008-78 may provide retroactive relief. n135c

The value of the loss corporation (other than certain investment entities) is also reduced if at least one-third of the loss corporation's assets consist of nonbusiness assets. n136 Indebtedness is allocated between business and nonbusiness assets on the basis of the ratio of the fair market value of nonbusiness assets to total assets. n137 The parent is deemed to own a *pro rata* share of the assets of its 50% or more owned subsidiaries (by voting power and value) for purposes of this rule. n138 In *Berry Petroleum Co.*, n139 the Tax Court held that the sale of a business asset by the loss corporation

pursuant to a planned transaction entered into by the acquiror of the loss corporation prior to the acquisition created non-business assets for purposes of *I.R.C. section 382(l)(4)*. n140 The court held that the sale proceeds of the business assets had to be included for purposes of calculating whether the one-third of assets threshold was met, but would be excluded for purposes of determining the amount of reduction in value of the loss corporation. n141

In the case of an ownership change associated with a stock redemption, the value is determined after the redemption transaction. n142 Under TAMRA, n143 certain contractions including leveraged buy-out transactions are treated as redemptions. n144

If the loss corporation fails to carry on the historic business enterprise for two years following the ownership change, the *I.R.C. section 382* limitation will be zero (except for built-in gains described in *P 11.04[7] infra*). n145 The continuity of business enterprise rules developed with respect to tax reorganizations are to be followed. n145a

In the case of an ownership change of the typical debtor in a case under the Bankruptcy Code, the value of the stock of the loss corporation is likely to be very little. Thus, following the ownership change, the loss corporation would have little or no *I.R.C. section 382* limitation available to it to permit the use of its NOLs in the periods following the ownership change. Recognizing the severity of this result, post transaction value of the loss corporation was originally used for purposes of calculating the *I.R.C. section 382* limitation in the case of a "G" Reorganization under *I.R.C. section 368(a)(1)(G)*. n146 or a title 11 stock-for-debt exchange to which the new bankruptcy special exception is not applicable (either through a failure to meet its requirements or by election). n147 This is referred to as the "(l)(6) valuation." The statutory language seemed to permit the determination of the value of the loss corporation by taking into account new money contributed to the loss corporation by a plan proponent. TAMRA changed the rule to use the pre-ownership change value of the loss corporation, adjusted to reflect any increase in value resulting from the cancellation of creditors' claims. n148 This would preclude taking into account increases in value of the loss corporation by reason of contributions or funding of the plan by creditors, shareholders or third parties. n149

On March 17, 1994, final regulations were issued under *I.R.C. section 382(l)(6)* for determining the value of a bankrupt loss corporation in circumstances in which an ownership change occurs, but *I.R.C. section 382(l)(5)* does not apply. n150 The regulations also contain guidance on the manner of electing not to apply *I.R.C. section 382(l)(5)*. n151 The rules provide that the "(l)(6) valuation" will be the lesser of the value of the stock of the loss corporation immediately after the ownership change or the value of the loss corporation's pre-change assets. n152

The value of the stock includes stock described in *I.R.C. section 1504(a)(4)* and stock that was not treated as stock for purposes of determining whether an ownership change occurred. n153 It does not include ownership interests that are treated as stock pursuant to section 1.382-2T(f)(18)(iii) of the regulations (presumably other than stock described in *I.R.C. section 1504(a)(4)*). n154 The rules discussed above for reducing value for certain non-business assets apply here as well. n155 With an important exception discussed below, the rule discussed above for reducing value by capital contributions made to avoid or increase the *I.R.C. section 382* limitation does not apply here. n156 However, the value is reduced by the value of stock that is issued with a principal purpose of increasing the *I.R.C. section 382* limitation, but without subjecting the investment to the "entrepreneurial risks of corporate business operations." n157 The regulations also limit the value of stock issued in connection with the ownership change to the cash and the value of property (including indebtedness of the issuer) received in consideration for its issuance. n158

The value of the loss corporation's pre-change assets is the gross value of its assets immediately before the ownership change. n159 Such value is reduced by the amount of capital contributions made to avoid or increase the limitation and the value of nonbusiness assets, as discussed above. n160 The rules discussed above for reducing value for redemptions and corporate contractions do not apply to reduce the asset value. n161

Given the alternative valuations under the regulations, a debtor being reorganized that will continue to have outstanding indebtedness appears to be able to increase its (l)(6) valuation. To the extent that the post-change value of the stock is

depressed by the retained liabilities, the (l)(6) valuation can be increased by the sale of stock to investors for cash or property with a value up to the amount of the indebtedness retained. This is the point when the two alternative valuation tests will generally be equalized and the *I.R.C. section 382* limitation will, therefore, be maximized. This can be demonstrated by the following illustration which shows that the (l)(6) valuation can be increased.

Example 8e:

Assume that the only reorganization event is the retention of \$40 of liabilities and issuance of stock of the reorganized company to the remaining creditors in satisfaction of their indebtedness. The (l)(6) valuation would be computed as follows:

PRE-CHANGE VALUE OF GROSS ASSETS	\$100
RETAINED LIABILITIES	(40)
POST-CHANGE VALUE OF STOCK (Net Worth)	\$ 60

In this situation, the (l)(6) value can be increased by selling stock for \$40 at the time of the chapter 11 reorganization so that the reorganized company's post-effective date simplified balance sheet looks like this:

PRE-CHANGE VALUE OF GROSS ASSETS	\$100
POST-CHANGE CASH	40
RETAINED LIABILITIES	(40)
POST-CHANGE VALUE OF STOCK (Net Worth)	\$100

By issuing additional stock for new cash as part of the reorganization, the amount of NOLs that can be used following the ownership change is increased. This makes the value of the new investment to the reorganized company greater than simply the new investor's proportionate share of the fair market value of the reorganized company's net assets. Timing the new investment to take place at the effective date as part of the plan of reorganization is especially important if the reorganized company is in any case likely to need to raise additional funds for future operations.

[6] Special Title 11 Exception to Ownership Changes

I.R.C. section 382 has a special exception to the *I.R.C. section 382* limitation rules for tax reorganizations or stock-for-debt exchanges that are part of a title 11 or similar case. n162 The special bankruptcy exception of *I.R.C. section 382(l)(5)* requires that the creditors and shareholders own at least 50% of the participating stock of the reorganized corporation or its successor (or the stock of a corporation controlling the new loss corporation if also in bankruptcy). TAMRA requires that such 50% stock ownership result from such persons previously being creditors or shareholders. Thus it is doubtful that new issuances of stock to existing shareholders and creditors for new value will permit such persons to qualify under the special bankruptcy exception because such new issuance of stock will be treated as in exchange for new value, as opposed to being in exchange for existing creditor or equity positions. n163 In another modification to tighten this provision, options are deemed exercised under regulations if such deemed exercise would cause existing shareholders and qualified creditors to own less than 50% of the stock of the reorganized corporation. n164 Only debt of creditors who held their debt for eighteen months before the filing or whose debt arose in the ordinary course of business may be counted. When the debtor has public debt outstanding, trading in that debt during the pendency of the title 11 case could preclude qualification of the debtor for the *I.R.C. section 382(l)(5)* exception. Likewise, a failed prepetition restructuring of the loss corporation's old debt may preclude the creditors

holding the restructured debt from qualifying, even though they are the same persons who held the old debt that was restructured.

On March 17, 1994, final regulations were adopted to address some of the issues and problems that had been identified with *I.R.C. section 382(l)(5)*. To meet the concerns of practitioners respecting the holders of debt that qualified as pre-existing creditors for purposes of satisfying the rule, the regulations define a qualified creditor, define ordinary course indebtedness and adopt generally similar administrative convenience standards respecting trading by small holders of "widely-held indebtedness" as are applicable to stock. n165 Unlike the stock rules, however, the regulations respecting widely-held indebtedness held the debtor to its actual knowledge respecting beneficial ownership of the debt. The final regulations include a *de minimis* rule that allows the loss corporation to treat the owner of indebtedness immediately before the ownership change as having always owned the debt unless immediately after the ownership change the holder is a 5-percent shareholder or an entity through which a 5-percent shareholder owns an interest in the loss corporation. An exception is made to this liberal *de minimis* rule if it is made evident to the debtor as a result of the holder's participation in the plan of reorganization process that the holder had not held the debt for the necessary period. n166 The regulations also include tacking rules for the holding of debt, including an exception for debt exchanged for new debt in a prior workout that might constitute an exchange under *I.R.C. section 1001*. n167

When a debtor avails itself of the special bankruptcy exception, accrued interest deductions for the three tax years ending prior to the year of the ownership change, plus the year of the change, on debt exchanged for stock are eliminated from NOLs. n168 This is a very significant toll charge to debtors with significant amounts of interest-bearing indebtedness that is to be compromised pursuant to the chapter 11 plan of reorganization. n169

It appears that in general the special rule is likely to be attractive to a debtor when the debtor has very little interest-bearing debt that is satisfied by the issuance of stock as part of the reorganization. That is to say, the trade creditors and others without interest bearing debt receive the bulk of the stock issued in the chapter 11 reorganization. In this situation, the interest write-down of the debtor's NOLs is minimized.

If a second ownership change occurs within two years after the ownership change subject to the special bankruptcy exception, then the *I.R.C. section 382* limitation will be zero following the second ownership change. n170

Because the special bankruptcy exception may produce tax results that are worse than the *I.R.C. section 382* limitation applied to the value of the loss corporation as a result of the bankruptcy reorganization, a loss corporation may elect out of the special exception. n171 If the debtor elects out of the rule, *I.R.C. section 382(l)(6)* provides a benefit to reorganized debtors not available to corporations experiencing an ownership change outside of a title 11 or similar case. As discussed in the preceding section, this provision permits the reorganized company to use the pre-ownership change value of the loss corporation, adjusted to reflect any increase in value resulting from any surrender or cancellation of creditors' claims.

Even if *I.R.C. section 382(l)(5)* preserves the use of NOLs and other tax attributes, *Treasury Regulation section 1.269-3(d)* will eliminate the use of such NOLs and tax attributes "unless the corporation carries on more than an insignificant amount of an active trade or business during and subsequent to the title 11 or similar case." This is a facts and circumstances test and may include as relevant the amount of historic business assets that continue to be used or the number of employees who continue to work for the business. n171a A showing of sufficient continuity can overcome the fact of a temporary cessation of all trade or business activity.

[7] Application of the I.R.C. section 382 Limitation

There is a special rule for the "post-change year" n172 that includes the "change date." n173 Essentially, it splits the year of the ownership change into two parts. n174 In the first part of the year, NOLs can be used to offset, without limitation, a *pro rata* share of income of the year. In the second part of the year, there is a *pro rata I.R.C. section 382*

limitation on the use of NOLs. n175 In the absence of a closing of the year on the change date, income is prorated over the entire year of the ownership change. n176 This can have significant tax impact depending on whether the ownership change takes place late in the year and the loss corporation has large discharge of indebtedness or other income that otherwise would be allocated to the pre-change period and thus not be subject to the section 382 limitation. Similarly, if a loss is generated in the change year, the post-change share of the loss is not subject to the *I.R.C. section 382* limitation. Under the provisions of *Notice 87-79*, the IRS routinely has granted permission for loss corporations to "close their books" on the change date, in lieu of the *pro rata* allocation of income. n177 The IRS has also ruled that the 90 percent alternative minimum tax limitation of *I.R.C. section 56(d)(1)(A)* must be applied separately from the *I.R.C. section 382* limitation in the change year. n178

On June 22, 1994, final regulations were adopted which permit a loss corporation that experiences an ownership change to allocate net operating loss or taxable income and net capital loss or gain (i) by ratably allocating an equal portion to each day in the change year or (ii) if it so elects, based on the interim closing of the books method as of the change date. n179 If the closing of the books method is elected, the amounts allocated to either the pre- or post-change period cannot exceed the net operating loss or taxable income and net capital loss or gain for the change year under operating rules provided in the regulations. n180

Net operating loss or taxable income is determined without regard to gains or losses on the sale or exchange of capital assets. Net operating loss or taxable income or modified net capital gain income are determined without regard to the *I.R.C. section 382* limitation and do not include any income, gain, loss or deduction to which *I.R.C. section 382(h)(5)(A)*, relating to increases in the limitation for realized built-in gains, applies, or any income or gain on assets transferred to the loss corporation for the purpose of ameliorating the effect of the limitation. Modified net capital gain allocated to each period is offset by capital losses to which *I.R.C. section 382(h)(5)(A)* (treating them as pre-change losses) applies and capital loss carryovers subject to the limitation. Net operating losses allocated to each period are reduced by the remaining capital gain allocated to such period and then by any remaining capital gain in the other period. n181

The irrevocable election must be made by the loss corporation on the information statement required by Temporary Treasury Regulation section 1.382-2T(a)(2)(ii) on or before the due date of the return (including extensions) for the year of the change. n182 The election for a consolidated group or a loss subgroup is made by the common parent for every member of the group. n183 Each member of a controlled group must make the election for the election to be valid. n184 In *Private Letter Ruling 200549007 (August 5, 2005)*, the IRS confirmed that a closing-of-the-books election under *Treasury Regulation section 1.382-6(b)* for an ownership change does not contain any special rules under *Treasury Regulation section 1.382-6* with respect to the allocation of extraordinary items. n184a

This provision is effective for ownership changes occurring on or after June 22, 1994, the date of the final regulations. n185

[a] Built-in Losses

In addition to NOL carryforwards, the "pre-change loss" includes any losses (both ordinary and capital) allocated to the pre-change period during the change year and built-in losses and deductions (including depreciation, amortization, and depletion representing "net unrealized built-in losses") recognized during the five years beginning on the change date. n185a When realized, these built-in losses are subject to the same limitations as losses realized before the change date and represented by NOLs at the change date. n186 The corporation's "net unrealized built-in loss" is the excess of basis over value of assets plus any tax deduction items and less any income items "attributable to" a pre-change period (*e.g.*, *I.R.C. section 481* adjustments) which have not yet been utilized for tax purposes. n187 There is a *de minimis* threshold exception where the net unrealized built-in loss does not exceed the lesser of fifteen percent of the value of assets, excluding cash and unappreciated cash equivalents, or \$10 million, changed in 1989 by OBRA from a twenty-five percent threshold. n188

It should be noted that the built-in loss concept does not reach the situation where the built-in loss asset appreciates after the measuring date and is then sold. This appreciation can be the result of market forces or improvements that close the gap between the specific asset's value and its tax basis at the time of the ownership change. For instance, built-in loss real estate held for development could produce a loss subject to the *I.R.C. section 382* limitation if sold following an ownership change since such built-in loss cannot shelter gain on other assets. If the same asset is first developed and then sold, the real estate development gross profit margin on the sale of such asset can be sheltered by its own built-in loss tax basis.

[b] Built-in Gains

Likewise, there is a similar "net unrealized built-in gain" (excess of value over basis and income attributable to a pre-change period, subject to the fifteen percent of value or \$10 million limitation) concept that permits an addition to the allowable NOL limitation to the extent that such built-in gains are recognized during the five-year period beginning on the change date. n189 This can be a very significant benefit to the loss corporation suffering an ownership change. Consider for instance a loss corporation with substantial appreciated assets but a very small equity value because of the amount of indebtedness on its books. Such a corporation will have a small annual *I.R.C. section 382* limitation. Nevertheless its NOLs may be valuable even after an ownership change if the loss corporation has net unrealized built-in gain and will sell its appreciated assets within five years to pay down indebtedness. n189a

[c] Built-in Gain/Loss Formula

A practical formula for determining a corporation's net unrealized built-in gains or losses is as follows:

$$\frac{\text{FMV} - \text{AB} + (\text{BII} - \text{BID})}{\text{FMV}^*}$$

"FMV" equals the fair market value of the loss corporation's assets. "AB" equals the adjusted tax basis of the loss corporation's assets. "BII" means the amount of the loss corporation's built-in income items. "BID" means the amount of the loss corporation's built-in deduction items. "FMV*" equals the fair market value of the loss corporation's assets plus certain built-in gains.

[d] Guidance Regarding Identification of Built-in Items

On October 6, 2003, the IRS issued *Notice 2003-65* n189b to provide guidance regarding the identification of built-in items. The notice sets forth two safe harbors under section 382(h) on which taxpayers can rely until temporary or final regulations are issued. n189c

The first approach is based upon the regulations under *I.R.C. section 1374* (the "Section 1374 Approach"). The second approach is based upon *I.R.C. section 338* ("Section 338 Approach"). Both approaches begin with the calculation of net unrealized built-in gain ("NUBIG") or net unrealized built-in loss ("NUBIL"). Under the Notice, NUBIG or NUBIL 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 that assumed all of loss corporation's liabilities immediately before the ownership change. n189d The hypothetical amount realized is adjusted as follows (1) decreased by the sum of any deductible liabilities and by aggregate adjusted asset basis and (2) increased by any RBIL that would not be allowed due to prior ownership changes and (3) increased or decreased by the amount of section 481 adjustments that would have to be taken into account on a hypothetical sale.

Under the section 1374 Approach, a taxpayer uses the tax accrual method of accounting to identify income or deduction items as recognized built-in gain ("RBIG") or recognized built-in loss ("RBIL") "attributable to periods before the

change date." In addition, items of depreciation, amortization, or depletion are treated as RBIL, unless the taxpayer can establish that such items are not attributable to the excess of an asset's basis over its fair market value on the change date. The taxpayer may establish this by any reasonable method. The Notice provides that one reasonable method is the method described below under the section 338 Approach. Cancellation of indebtedness income or a bad debt deduction that arises from a debt owed by or to a loss corporation is treated as RBIG or RBIL, respectively, if such item is properly taken into account during the first twelve months of the recognition period. If the cancellation of indebtedness is excluded from income during the first twelve months, then any reduction in the basis of the loss corporation's assets resulting from such cancellation is treated as occurring prior to the change in ownership and thus effects calculations of RBIL and RBIG with respect to such assets if and when they are sold or exchanged; but not the calculation of NUBIG and NUBIL (since it is understood that such amount has already been taken into account).

Under the section 338 Approach, a taxpayer identifies items of RBIL and RBIG by comparing actual items to those that would have resulted if an *I.R.C. section 338* election (subject to specified modifications) had been made with respect to a hypothetical purchase of stock on the change date. Thus, under the section 338 Approach, RBIG and RBIL may arise even if assets are not disposed of during the recognition period. With respect to wasting assets, this approach treats as RBIG the amount of any excess cost recovery deduction that would have been allowed as a result of such *I.R.C. section 338* election. Any shortfall is treated as RBIL. Any contingent liabilities recognized during the recognition period are treated as RBIL only to the extent of the estimated amount of such liability on the ownership change date. Finally, cancellation of indebtedness income that is included in gross income and attributable to any pre-change debt of the loss corporation is RBIG in an amount not exceeding the excess of the adjusted issue price of the discharged debt over the fair market value of the debt on the change date. If the loss corporation recognized cancellation of indebtedness income that is excluded from gross income, any corresponding reduction of tax basis is treated as having occurred before the ownership change for purposes of determining whether a recognized gain or loss is RBIG or RBIL, but only to the extent of the adjusted issue price of the discharged debt over the fair market value of the debt on the ownership change date. n189e

Example 8f:

Company has (i) an amortizable intangible asset with a FMV of \$400, basis of \$100 and a remaining 5 years of amortization, (ii) long-term debt with FMV of \$80 and adjusted issue price of \$100 and (iii) a contingent liability valued at \$40. In Year 1, the long-term debt is cancelled for \$70, resulting in \$30 of COD. In Year 2, the asset is sold for \$400 and the contingent liability is settled for \$50. On these facts, the Company has a NUBIG equal to \$260 (asset's FMV (\$400)--asset's basis (\$100)--amount of contingent liability (\$40)). Under Notice 2003-65, RBIG is calculated as follows: Under the section 1374 Approach, in Year 1, the COD of \$30 is RBIG if it is included in income and \$20 of amortization deduction is permitted. In Year 2, if the asset is sold for \$400, the gain is \$320 and \$300 of such gain is RBIG, but limited to the remaining NUBIG of \$230 (original \$260 - \$30 of Year 1 RBIG). In Year 2, the deduction for the \$50 settlement of the contingent liability is also permitted.

Under the section 338 Approach, in Year 1, only \$20 of the \$30 COD is RBIG if the COD is included in income (RBIG is equal to the difference between FMV of debt and its adjusted issue price) and \$7 of amortization is RBIG (because if a section 338 election had been made, the amortization would be \$27 (\$400/15) instead of \$20). In Year 2, if the asset is sold for \$400, the gain is \$320. The gain would have been \$27 if a section 338 election had been made on the change date (\$400 FMV--\$373 new basis). Therefore, the RBIG would be \$293 (difference between gain of \$320 and hypothetical section 338 election gain of \$27), but limited to the remaining NUBIG of \$233 (original \$260 -\$20 of COD RBIG and -\$7 amortization RBIG).

[8] Modifications Arising from Government Bailouts in 2008-2009

[a] Fannie Mae and Freddie Mac Bailout

According to Notice 2008-76, the Treasury intends to issue regulations under which Fannie Mae and Freddie Mac will cease to have testing dates as of September 7, 2008, the date on which the Treasury acquired preferred stock and warrants from both Fannie Mae and Freddie Mac. n190 Therefore, they will not be affected by I.R.C. section 382, until further guidance is provided. n191

[b] United States Holding More Than 50 Percent of Corporation's Stock

According to Notice 2008-84, the Treasury intends to issue regulations providing that a date will not be treated as a "testing date" for a corporation under I.R.C. section 382, when the day ends with the United States (which includes any agency thereof) holding more than a 50 percent interest in that corporation. n192 A "more than 50 percent interest" is stock with more than 50 percent of the total value of shares of all classes (excluding stock described in I.R.C. Section 1504(a)(4)), or more than 50 percent of the total combined voting power of all classes of voting stock, or an option to acquire such stock. The regulations will apply for taxable years ending on or after September 23, 2008, unless and until official guidance provides for different treatment.

[c] Bank Built-In Losses Under I.R.C. section 382(h)

On September 30, 2008, the IRS issued Notice 2008-83, which provided that banks that undergo an ownership change under I.R.C. Section 382, may treat all deductions with respect to losses on loans or bad debts, including deductions for a reasonable addition to a reserve for bad debts, as occurring after the ownership change. n193 Notice 2008-83 did not affect a bank's net unrealized built-in gain or loss, however. The notice was effective for all tax years that were open while the notice was in effect.

This notice was highly controversial. Some commentators argued that the IRS did not have authority to issue Notice 2008-83, and were concerned that the notice resulted from Treasury officials having a conflict-of-interest with respect to Wells Fargo's acquisition of Wachovia. The controversy ended when the American Recovery and Reinvestment Act of 2009 (the "Recovery Act") terminated the effect of Notice 2008-83 for ownership changes occurring on or after February 17, 2009. n194

The Recovery Act also provides that Notice 2008-83 is inconsistent with congressional intent regarding I.R.C. section 382(m), which generally authorizes the Treasury to issue regulations to carry out the purposes of that section. n195 Congress also found that the Treasury's legal authority for issuing Notice 2008-83 is doubtful, and that I.R.C. section 382(m) does not authorize the Treasury to provide exceptions to I.R.C. section 382 that are limited to certain industries or classes of taxpayers. n196 This last finding arguably affects Notice 2008-76, which applies only to Fannie Mae and Freddie Mac, and which was issued pursuant to I.R.C. section 382(m).

When the Recovery Act was enacted, financial statements were generally required to be based on the "fair value" of assets, which was the price such assets were selling for in the market. n197 On April 2, 2009, the Financial Accounting Standards Board determined that when a market for an asset is inactive, its fair value should be an estimate of what the market price would be, if the market were active. n198 Corporations are allowed to follow this guidance for reporting periods ending after March 15, 2009. n199 As this new approach allows corporations to exercise substantial discretion in their financial reports, it is possible that for banks, these adjustments will effectively provide the same tax benefit as provided by Notice 2008-83, despite the Recovery Act's repeal of that notice.

[d] Certain TARP Programs

On October 3, 2008, the Emergency Economic Stabilization Act of 2008 ("EESA") established the Troubled Assets Relief Program ("TARP"), under which the Treasury has developed various programs to stabilize financial institutions. As of April 30, 2009, the IRS has issued three notices regarding the tax consequences for entities issuing instruments to

the Treasury through certain TARP programs: Notice 2008-100, Notice 2009-14, and Notice 2009-38. n200 The latter two supersede and generally augment the preceding TARP notice. The table below specifies the type of instruments subject to each notice.

	Notice 2008-100 (Oct. 14, 2008)	Notice 2009-14 (Jan. 30, 2009)	Notice 2009-38 (Apr. 13, 2009)
Instruments issued to Treasury pursuant to the following TARP programs			
Capital Purchase Program ("CPP"):			
for any issuer, when stock or warrants is- sued	X		
for public issuers		X	X
for private issuers (not S corps.)		X	X
for S corp. issuers		X	X
Targeted Investment Program		X	X
Automotive Industry Financing Program		X	X
Asset Guarantee Program			X
Systemically Significant Failing Institutions Program			X
Capital Assistance Program when issuer is public			X
Instruments issued to Treasury but not pursuant to TARP program			
"Covered Instruments:" instruments acquired by Treasury in exchange for an instrument issued pursuant to a TARP program listed above, or in exchange for a Covered Instrument			X

In general, Notice 2009-38 (or a superseding TARP notice, once issued) will apply to an instrument whose issuance is subject to that notice. An earlier notice will apply, however, when both (a) it provides contrary guidance regarding such instrument, and (b) the earlier notice had not been superseded when such instrument was issued, or when a binding contract regarding such issuance was entered into. As Notice 2009-38 generally augments the prior TARP notices, the following discussion will address that notice. n201

Instruments subject to Notice 2009-38 generally will be treated as they are denominated. For example, an instrument denominated as debt will be treated as debt, not stock. There are, however, five exceptions. First, Covered Instruments (defined in the table, above) will be characterized under general principles of tax law, and will not be subject to the exceptions that follow. n202 Second, instruments issued to the Treasury pursuant to the Capital Assistance Program for public issuers, excluding those denominated as warrants, will be characterized under general principles of federal tax law, and will not be subject to the exceptions that follow. n203 Third, all preferred stock will be treated as stock described in I.R.C. section 1504(a)(4). Fourth, warrants to acquire stock that are issued by private corporations pursuant to the CPP (defined in the table, above), will be treated as an ownership interest in the underlying stock, which will be treated as stock described in I.R.C. section 1504(a)(4). Fifth, warrants to acquire indebtedness, issued by S corporations pursuant to the CPP, will be treated as the underlying indebtedness.

For purposes of I.R.C. section 382, common stock subject to Notice 2009-38 will not be treated as increasing the Treasury's ownership of the issuing corporation over its lowest percentage owned on any earlier date. Such stock will be treated as outstanding for purposes of computing the percentage of stock held by other 5 percent shareholders, except with respect to testing dates occurring after a redemption of the Treasury's common stock (in which case such redeemed stock will be treated as never having been outstanding).

For instruments subject to Notice 2009-38, amounts received by an issuer will be treated as received in exchange for the instruments. When such amounts constitute a capital contribution by the Treasury, I.R.C. Section 382(l)(1) will not apply to such capital contributions. Instead, those amounts will be included in the value of the corporation for purposes of determining a Section 382 limitation that results from an ownership change, regardless of when the capital contribution was made.

[e] I.R.C. section 382(n)

I.R.C. section 382(n) was enacted as part of the Recovery Act. n204 It provides that the I.R.C. Section 382 limitation does not apply to an ownership change (i) occurring under a restructuring plan required under a loan agreement or a commitment for a line of credit entered into with the United States under the EESA, and (ii) intended to result in a rationalization of the costs, capitalization, and capacity with regard to the manufacturing workforce of, and suppliers to, the loss corporation and its subsidiaries. n205 A subsequent ownership change is not subject to this exception unless it also meets these requirements. n206 An ownership change that otherwise meets the requirements for this exception will remain subject to the I.R.C. Section 382 limitation if, immediately after such ownership change, any person (other than a voluntary employees' beneficiary association within the meaning of I.R.C. Section 501(c)(9)) owns stock of the corporation possessing 50 percent or more of the total combined voting power of all classes of stock entitled to vote or of the total value of the stock of such corporation. For purposes of applying the 50-percent test, persons related under I.R.C. Section 267(b) or 707(b) or who are "acting in concert" are treated as a single person. n207

FOOTNOTES:

(n1)Footnote 1. *I.R.C. § 382(k)(1); Treas. Reg. § 1.382-2(a)(1).*

(n2)Footnote 2. *I.R.C. § 382(a), (b).*

(n3)Footnote 3. Except for built-in gains described in *P TX11.04[7] infra* .

(n4)Footnote 4. *I.R.C. § 382(c); Treas. Reg. § 1.368-1(d). See also In the Matter of Federated Department Stores, Inc., 135 B.R. 962 (Bankr. S.D. Ohio 1992) (court found sufficient carryover of business to permit use of NOLs under I.R.C. § 382(c)), aff'd sub nom. United States v. Federated Department Stores, Inc. (In re Federated Department Stores, Inc.), 170 B.R. 331 (S.D. Ohio 1994); Berry Petroleum Co. v. Commissioner, 104 T.C. 584 (1995), aff'd w/o published opinion, 142 F.3d 442 (9th Cir. 1998) (court found sufficient continuation of business to satisfy I.R.C. § 382(c), even though the taxpayer disposed of its most valuable business property immediately after the ownership change); Samson Investment Co. v. Commissioner, 76 T.C.M. (CCH) 158 (1998) (court found sufficient continuation of business activity due to economic downturn prior to ownership change because loss corporation remained ready, willing and able to operate).*

(n5)Footnote 4a. *Internal Revenue Service FSA 200140049 -049, 2001 FSA Lexis 123 (July 6, 2001) (citing S. Rep. No. 99-313 at 234 (1986)); Chief Couns. Adv. Mem., CA 200444002 -002, 2004 IRS CCA Lexis 33 (October 29, 2004).*

(n6)Footnote 5. *I.R.C. § 382(g); Temp. Treas. Reg. § 1.382-2T(a)(1).*

(n7)Footnote 6. *I.R.C. § 382(g)(2)*; Temp. Treas. Reg. § 1.382-2T(e)(1).

(n8)Footnote 7. *I.R.C. § 382(g)(3)*; Temp. Treas. Reg. § 1.382-2T(e)(2).

(n9)Footnote 8. *I.R.C. § 382(k)(7)*; Temp. Treas. Reg. § 1.382-2T(g)(1).

(n10)Footnote 9. *I.R.C. § 382(i)*; Temp. Treas. Reg. § 1.382-2T(d)(1).

(n11)Footnote 10. *See I.R.C. § 382(g)(1)(B)*.

(n12)Footnote 10a. Section 382(i)(2).

(n13)Footnote 10b. Temp. Treas. Reg. § 1.382-2T(f)(19).

(n14)Footnote 10c. *Priv. Ltr. Rul. 2007-20-012 (May 18, 2007)*.

(n15)Footnote 10d. *See P TX11.04[6] infra*.

(n16)Footnote 10e. *See P TX11.04[6] infra*.

(n17)Footnote 11. *Treas. Reg. § 1.382-2(a)(3)*. *See P TX11.08[2] infra*.

(n18)Footnote 11a. *See P TX 11.04[8][d] infra* regarding the treatment of certain preferred stock acquired by the United States.

(N19)Footnote 12. *See P TX11.04[4][b] infra*. *See also* Internal Revenue Service F.S.A. 2000-10-003 (August 20, 1999) for a discussion of the treatment of convertible pure preferred stock under the temporary and final regulations.

(n20)Footnote 13. *Priv. Ltr. Rul. 199910009 (Dec. 2, 1998)*.

(n21)Footnote 14. *Treas. Reg. § 1.382-2(a)(3)*.

(n22)Footnote 15. Temp. Treas. Reg. § 1.382-2T(f)(18)(ii).

(n23)Footnote 16. *See Priv. Ltr. Rul. 9441036 (July 14, 1994)* (new debt issued in restructuring of insolvent loss corporation not "stock").

(n24)Footnote 17. *See Treas. Reg. § 1.305-5(b)*.

(n25)Footnote 17a. *I.R.C. Section 382(l)(3)(C)* recognizes that, except as provided in regulations, no changes in proportionate ownership can occur solely by reason of fluctuations in the relative fair market values of different classes of stock. No regulations have been issued on this point to date. *Treas. Reg. § 1.382-2T(l)* entitled "Changes in percentage ownership which are attributable to fluctuations in value" is "reserved." *Priv. Ltr. Rul. 200511008 (Dec. 6, 2004)*, *Priv. Ltr. Rul. 2005-20-011 (Feb. 18, 2005)* and *Priv. Ltr. Rul. 200511008 (March 18, 2005)* which imply, however, that fluctuations in relative value of different classes of stock should be taken into account in determining whether a shift in ownership occurred upon issuance by the taxpayer of additional stock. Since the word "solely" in the statute provides much leeway for owner shifts that may have other factors beyond market fluctuations, it is not beyond the pale for the Service to rule on such issues absent regulations.

(n26)Footnote 18. For a discussion of PIK Preferred Stock, *see Phillips, Is PIK Preferred "Plain Vanilla"?* 45 *Tax Law*. 69 (1991).

(n27)Footnote 19. Temp. Treas. Reg. § 1.382-2T(a)(2)(ii).

(n28)Footnote 20. See Temp. Treas. Reg. § 1.382-2T(a)(2)(i).

(n29)Footnote 21. Conference Committee Report at II-194. See also *Treas. Reg. § 1.269-3(d)*. But see *P TX11.08[8] infra*.

(n30)Footnote 22. *I.R.C. § 382(i)(2)*.

(n31)Footnote 23. Temp. Treas. Reg. § 1.382-2T(d)(3) (note special rule for built-in losses).

(n32)Footnote 24. *I.R.C. § 382(i)(3)*.

(n33)Footnote 25. Temp. Treas. Reg. § 1.382-2T(d)(3)(ii).

(n34)Footnote 26. Tax-free reorganization as defined in *I.R.C. § 368* must be distinguished from reorganization under the Bankruptcy Code. The phrase "tax reorganization," as used herein, refers to such reorganization under *I.R.C. § 368* as opposed to a reorganization under the Bankruptcy Code.

(n35)Footnote 27. Temp. Treas. Reg. §§ 1.382-2T(e)(1)(i) and 1.382-2T(e)(2)(iii).

(n36)Footnote 27a. See *P TX 11.04[8][d] infra* regarding the treatment of stock for certain corporations whose stock is acquired by the United States.

(n37)Footnote 28. For dates on or after November 5, 1992, see *Treas. Reg. § 1.382-2(a)(4)*. For dates prior to November 5, 1992, see Temp. Treas. Reg. § 1.382-2T(a)(2)(i). A testing date also includes certain transactions involving options. See *P TX11.04[4][b] infra*. See *P TX 11.04[8][a]* and *[b]* regarding testing dates for certain corporations whose stock is acquired by the United States.

(n38)Footnote 29. Temp. Treas. Reg. § 1.382-2T(e)(1)(ii).

(n39)Footnote 30. Only one who has attempted a real life analysis of a public loss corporation and studied the complicated example charts set forth in the Temporary Regulations at Temp. Treas. Reg. § 1.382-2T(g)(4) can truly appreciate the significance of the discussion in the text.

(n40)Footnote 31. *I.R.C. § 382(g)(4)(B)(i)*; Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(B)(1).

(n41)Footnote 32. Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(B)(1)(ii) and (C).

(n42)Footnote 33. Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(A).

(n43)Footnote 34. Temp. Treas. Reg. § 1.382-2T(j)(2)(iv)(A).

(n44)Footnote 35. Some practitioners consider transactions similar to that described in Example 3 as a recapitalization tax reorganization, and thus an equity structure shift, despite the fact that the recipients are trade creditors and not tax security holders. But see *Priv. Ltr. Rul. 7912066 (Dec. 20, 1978)*, supplementing *Priv. Ltr. Rul. 7828062 (Apr. 14, 1978)*.

(n45)Footnote 36. See Conference Committee Report at II-179, Example 11.

(n46)Footnote 37. See, e.g., *Priv. Ltr. Rul. 2000-24-047 (March 21, 2000)* (a distribution from limited partnership to its partners in proportion to their partnership interests was not owner shift); *Priv. Ltr. Rul. 96-52-019 (Sept. 30, 1996)* (holding that ESOP plan participants treated as owners of corporation's stock for purposes of section 382); *Priv. Ltr. Rul. 96-19-051 (February 8, 1996)* (transfers of stock from qualified settlement fund to original trust beneficiaries not an owner shift); *Priv. Ltr. Rul. 95-33-024 (May 19, 1995)* (person with economic ownership consisting of) right to

dividends and sale proceeds, and not investment advisor with power to vote and dispose of stock, is owner for purposes of *I.R.C. § 382*; *Priv. Ltr. Rul. 95-10-007* (Dec. 6, 1994) (distributions from ESOPs to participants were not owner shifts).

(n47)Footnote 38. *I.R.C. § 382(l)(3)(A)*; Temp. Treas. Reg. § 1.382-2T(h). See *Priv. Ltr. Rul. 9439013* (Jun. 30, 1994).

(n48)Footnote 39. *I.R.C. § 382(l)(3)(A)(i)*. See *Priv. Ltr. Rul. 9517049* (Feb. 1, 1995) (nonstandard stock transfer and restriction agreement among family members). See also *Priv. Ltr. Rul. 199918051* (May 7, 1999) (family attribution rules applied to result in smallest owner shift); *Priv. Ltr. Rul. 200245006* (July 25, 2002) (no family attribution among two brothers because they were not the children of any living "individual", as both of their parents died prior to, and did not own company stock during, the testing period set forth in *I.R.C. Section 382(i)*). The U.S. Tax Court has recently clarified in *Garber Industries Holding Co., Inc.*, 124 T.C. 1 (Jan. 25, 2005), *aff'd*, 435 F.3d 555 (5th Cir. 2006), that the family aggregation rule of *I.R.C. Section 382(l)(3)(A)(i)* applies solely from the perspective of individuals who are shareholders (as determined under the attribution rules of *I.R.C. Section 382(l)(3)(A)*) of the loss corporation. Thus, sibling shareholders are not aggregated under *I.R.C. Section 382(l)(3)(A)(i)* if none of their parents or grandparents is a shareholder of the loss corporation.

(n49)Footnote 40. *I.R.C. § 382(l)(3)(A)(ii)(II)*. See, e.g., *Priv. Ltr. Rul. 200024047* (March 21, 2000) (attribution from RIC to its shareholders and attribution from limited partnership to its partners).

(n50)Footnote 41. Temp. Treas. Reg. § 1.382-2T(j)(1)(iv).

(n51)Footnote 42. *I.R.C. § 382(l)(3)(A)(iii)*.

(n52)Footnote 43. Temp. Treas. Reg. § 1.382-2T(j). For an illustration of the operation of the segregation rules in the context of options prior to the adoption of the new option rules discussed below, see 1990-1 C.B. 93, *Rev. Rul. 90-15*. The regulations also contain various presumptions on which the taxpayer may rely in determining stock ownership. See, e.g., *Priv. Ltr. Rul. 9533024* (May 19, 1995) (loss corporation may rely on Securities and Exchange Commission Schedules 13D and 13G unless it has contrary actual knowledge). But see *Priv. Ltr. Rul. 9725039* (Mar. 26, 1997) (holding that investment advisors who had "reporting ownership" through right to acquire, vote and dispose of stock were not 5-percent shareholders for *I.R.C. § 382* purposes despite their inclusion on SEC filings because they did not have right to economic benefits of stock).

(n53)Footnote 44. It is important to keep in mind that the concept of the 5-percent shareholder is an artificial creation of *I.R.C. § 382* and such persons, or less than 5-percent shareholder groups treated as such, need not in fact own 5% of the corporation's stock. Thus, subject to changes caused by the small issuance exemption, if a total of 2% of a corporation's stock is issued to ten persons in a cash sale by the corporation, each such person is treated definitionally as a 5-percent shareholder, unless the issuer elects to aggregate all of such less than 5-percent shareholders into one 5-percent shareholder group. Temp. Treas. Reg. § 1.382-2T(j)(2)(iv)(A).

(n54)Footnote 45. Temp. Treas. Reg. § 1.382-2T(e)(1)(ii).

(n55)Footnote 46. Temp. Treas. Reg. § 1.382-2T(j)(1)(iv).

(n56)Footnote 47. See Examples 3, 4 & 5 in P 11.04[4] *supra*.

(n57)Footnote 47a. Treas. Reg. § 1.382-3(a)(1)(i).

(n58)Footnote 47b. *Priv. Ltr. Rul. 2006-05-003* (Oct. 28, 2005)

(n59)Footnote 48. Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(A).

(n60)Footnote 49. Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(B).

(n61)Footnote 50. Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(C). *See Priv. Ltr. Rul. 9113032 (Jan. 3, 1991)* .

(n62)Footnote 51. Temp. Treas. Reg. § 1.382-2T(m)(4)(i) & (iii).

(n63)Footnote 52. Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(A).

(n64)Footnote 53. *See P TX11.04[2] supra*.

(n65)Footnote 53a. *1998 FSA LEXIS 204 (Jan. 14, 1998)* .

(n66)Footnote 54. *Treas. Reg. § 1.382-3*.

(n67)Footnote 55. *Treas. Reg. § 1.382-3(j)(2)*.

(n68)Footnote 56. *Treas. Reg. § 1.382-3(j)(2)(iii)(A)*.

(n69)Footnote 57. *Treas. Reg. § 1.382-3(j)(3)*. *See, e.g., Priv. Ltr. Rul. 96-52-019 (Sept. 30, 1996)* and *Priv. Ltr. Rul. 95-08-030 (Nov. 29, 1994)* (conversion of convertible debt issued for cash ineligible for exemption); *Priv. Ltr. Rul. 200024047 (Mar. 27, 2000)* (the cash exercise of warrants distributed with respect to stock has been held to be the acquisition of stock solely for cash).

(n70)Footnote 58. *Treas. Reg. § 1.382-3(j)(3)(iii)*.

(n71)Footnote 59. *Treas. Reg. § 1.382-3(j)(5)* and *(10)*.

(n72)Footnote 60. *Treas. Reg. § 1.382-3(j)(6)*.

(n73)Footnote 61. *Treas. Reg. § 1.382-3(j)(8)*.

(n74)Footnote 62. Temp. Treas. Reg. § 1.382-2T(j)(2)(B).

(n75)Footnote 63. *Treas. Reg. § 1.382-3(j)(14)(iii)*. *See Priv. Ltr. Rul. 9508030 (Nov. 29, 1994)* . *See also Priv. Ltr. Rul. 9648041 (August 30, 1996)* (I.R.C. Section 9100 relief).

(n76)Footnote 64. For a more detailed treatment of the segregation and aggregation rules prior to the two new exemptions, *see Silverman & Keyes, Section 382 as Amended by the Tax Reform Act of 1986, in 4 Tax Strategies for Corporate Acquisitions, Disposition, Financings, Joint Ventures, Reorganizations and Restructurings 1991, at 58 (PLI 1991)*.

(n77)Footnote 65. Temp. Treas. Reg. § 1.382-2T(h)(4). *See Conference Committee Report at II-182-3*.

(n78)Footnote 66. Temp. Treas. Reg. § 1.382-2T(h)(4)(iii).

(n79)Footnote 67. Temp. Treas. Reg. § 1.382-2T(h)(4)(iii).

(n80)Footnote 68. Temp. Treas. Reg. § 1.382-2T(j)(2)(iii)(D). The rule provides that such segregation is to be taken into account in determining whether an option is deemed to be exercised.

(n81)Footnote 69. Temp. Treas. Reg. § 1.382-2T(h)(4)(ix).

(n82)Footnote 70. Temp. Treas. Reg. § 1.382-2T(h)(4)(x)(F).

(n83)Footnote 71. Temp. Treas. Reg. § 1.382-2T(h)(4)(vi)(A).

(n84)Footnote 72. *Treas. Reg. § 1.382-4(d)*. See also *Priv. Ltr. Rul. 200024047 (June 16, 2000)* .

(n85)Footnote 73. *Treas. Reg. § 1.382-4(d)(9)*.

(n86)Footnote 74. See, e.g., *Priv. Ltr. Ruls. 92-25-032 (Mar. 24, 1992)* (creation of an option in an out of court debt restructuring) and *91-37-041 (June 18, 1991)* (creation of an option on the confirmation date of a plan of reorganization under the Bankruptcy Code).

(n87)Footnote 75. See, e.g., *Priv. Ltr. Rul. 92-11-028 (Dec. 13, 1991)*; *Priv. Ltr. Rul. 2000-24-047 (March 21, 2000)*.

(n88)Footnote 76. *Treas. Reg. § 1.382-4(d)(9)(ii)*.

(n89)Footnote 77. *Treas. Reg. § 1.382-4(d)(2)*. See P TX 11.04[8][d] *infra* regarding the treatment of options issued to the United States by certain corporations.

(n90)Footnote 78. *Treas. Reg. § 1.382-4(d)(2)*.

(n91)Footnote 79. *Treas. Reg. § 1.382-4(d)(3)*.

(n92)Footnote 80. *Treas. Reg. § 1.382-4(d)(4)(i)*. See, e.g., *Priv. Ltr. Rul. 9515037 (Jan. 17, 1995)* .

(n93)Footnote 81. *Treas. Reg. § 1.382-4(d)(4)(i)(B)*.

(n94)Footnote 82. *Treas. Reg. § 1.382-4(d)(4)(ii)(A)(2)*.

(n95)Footnote 83. *Treas. Reg. § 1.382-4(d)(4)(ii)(B)*.

(n96)Footnote 84. *Treas. Reg. § 1.382-4(d)(5)*.

(n97)Footnote 85. *Treas. Reg. § 1.382-4(d)(6)(i)*.

(n98)Footnote 86. In fact, the regulations specifically provide that the presence or absence of any factor does not create a presumption. *Treas. Reg. § 1.382-4(d)(6)(i)*.

(n99)Footnote 87. *Treas. Reg. § 1.382-4(d)(6)(i)*.

(n100)Footnote 88. *Treas. Reg. § 1.382-4(d)(6)(i)*.

(n101)Footnote 89. *Treas. Reg. § 1.382-4(d)(6)(ii)*.

(n102)Footnote 90. *Treas. Reg. § 1.382-4(d)(6)(ii)*.

(n103)Footnote 91. *Treas. Reg. § 1.382-4(d)(6)(ii)*.

(n104)Footnote 92. *Treas. Reg. § 1.382-4(d)(6)(iii)*.

(n105)Footnote 93. *Treas. Reg. § 1.382-4(d)(6)(iii)*.

(n106)Footnote 94. *Treas. Reg. § 1.382-4(d)(6)(iv)*.

(n107)Footnote 95. *Treas. Reg. § 1.382-4(d)(6)(iv)*.

(n108)Footnote 96. *Treas. Reg. § 1.382-4(d)(7)*.

(n109)Footnote 97. *Treas. Reg. § 1.382-4(d)(7)(i)*.

(n110)Footnote 98. *Treas. Reg. § 1.382-4(d)(7)(i)*.

(n111)Footnote 99. *Treas. Reg. § 1.382-4(d)(7)(ii)*.

(n112)Footnote 100. *Treas. Reg. § 1.382-4(d)(7)(iii)*.

(n113)Footnote 101. *Treas. Reg. § 1.382-4(d)(7)(iii)(A) & (B)*.

(n114)Footnote 102. *Treas. Reg. § 1.382-4(d)(7)(iv)*.

(n115)Footnote 103. *Treas. Reg. § 1.382-4(d)(7)(iv)*.

(n116)Footnote 104. *Treas. Reg. § 1.382-4(d)(7)(v)*. But see, *Priv. Ltr. Rul. 9517049 (Feb. 1, 1995)* (non-customary stock transfer and restriction agreement among family members does not cause an ownership change; IRS does not address deemed exercise rule on account of the agreement).

(n117)Footnote 105. *Treas. Reg. § 1.382-4(d)(11)(i)*.

(n118)Footnote 106. *Treas. Reg. § 1.382-4(d)(11)(ii)*.

(n119)Footnote 107. *Treas. Reg. § 1.382-4(d)(11)(iii)*.

(n120)Footnote 108. *Treas. Reg. § 1.382-4(d)(8)(ii)*.

(n121)Footnote 109. *Treas. Reg. § 1.382-4(d)(8)(iv)*.

(n122)Footnote 110. *Treas. Reg. § 1.382-4(d)(10)(i)(B)*.

(n123)Footnote 111. *Treas. Reg. § 1.382-4(d)(10)(i)(A)*.

(n124)Footnote 112. *Treas. Reg. § 1.382-4(d)(10)(ii)*. See 1998 FSA Lexis 212 (Jan. 28, 1998) (an option has to be in existence before the "change date" in order for the look-back rules provided in *Treas. Reg. § 1.382-4(d)(10)(ii)* to apply).

(n125)Footnote 113. *Treas. Reg. § 1.382-4(d)(10)(ii)*.

(n126)Footnote 114. *Treas. Reg. § 1.382-4(h)(2)(i)*.

(n127)Footnote 115. *Treas. Reg. § 1.382-4(h)(2)(ii)*.

(n128)Footnote 116. *Treas. Reg. § 1.382-4(h)(2)(iii)*.

(n129)Footnote 117. *Treas. Reg. § 1.382-4(h)(2)(vi)*; see IRS FSA 200010003 (Aug. 20, 1999) (application of old option rules at election of taxpayer to convertible pure preferred stock).

(n130)Footnote 118. *Treas. Reg. § 1.382-4(h)(2)(v)*. See *Priv. Ltr. Rul. 9527027*.

(n131)Footnote 119. See P TX11.04[7][a] *infra*.

(n132)Footnote 120. See P TX11.04[7][b] *infra*.

(n133)Footnote 121. *I.R.C. § 382(g)(4)(D)*. In light of the attribution rules, *see P TX11.04[4][b] supra*, members of a family or other related shareholders may be a 50% shareholder for these purposes. The taking of a worthless stock loss by any of such persons might invoke this rule.

(n134)Footnote 122. *Committee of Unsecured Creditors v. PSS Steamship Co. (In re Prudential Lines, Inc.)*, 928 F.2d 565, 24 C.B.C.2d 1503 (2d Cir.), *cert. denied*, 502 U.S. 821, 112 S. Ct. 82, 116 L. Ed. 2d 55 (1991) .

(n135)Footnote 122a. *But see In re White Metal Rolling and Stamping Corp.*, 222 B.R. 417 (Bankr. S.D.N.Y. 1998) (holding that worthless stock deduction is allowed if debtor cannot show ability to utilize NOL).

(n136)Footnote 123. *See P TX14.04[3][a] supra. Compare Priv. Ltr. Rul. 9516025 (Jan. 18, 1995) .*

(n137)Footnote 124. *See In re Southeast Banking Corp.*, No. 91-14561-BKC-PGH, 1994 Bankr. Lexis 2389 (Bankr. S.D. Fla. July 24, 1994) (enjoining sales by persons owning 5% of the debtor's stock); *In re Phar-Mor, Inc.*, 152 B.R. 924 (Bankr. N.D. Ohio 1993) .

(n138)Footnote 125. *See P TX11.04[6] infra.*

(n139)Footnote 126. *See Priv. Ltr. Rul. 2000-24-047 (June 16, 2000)*, *Priv. Ltr. Rul. 94-22-048 (June 3, 1994)*, supplementing *Priv. Ltr. Rul. 94-05-011 (Nov. 3, 1993)*; *Priv. Ltr. Rul. 93-51-011 (Sept. 23, 1992)*; *Priv. Ltr. Rul. 89-49-040 (Sept. 11, 1989)*.

(n140)Footnote 126a. *See Jean Morris, Imposition of Transfer Limitations on Claims and Equity Interests During Corporate Debtor's Chapter 11 Case to Preserve the Debtor's Net Operating Loss Carryforward: Examining the Emerging Trend*, American Bankruptcy Law Journal, 77 Am. Bankr. L.J. 285, Summer 2003 (argues that the issuance of orders restraining trading in the debtor's equity and debt securities by large holders of such instruments as a routine matter by the bankruptcy courts is based on questionable legal analysis and potentially has wide ranging effects on the public debt and equity markets and the chapter 11 process).

(n141)Footnote 127. *I.R.C. § 382(l)(3)(B)*. Conference Committee Report at II-183.

(n142)Footnote 128. Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239 (1989).

(n143)Footnote 128a. The IRS has held in Private Letter Rulings that ESOP plan participants are treated as the owners of the corporation's stock for purposes of Section 382 and that distributions of the corporation's stock from an ESOP to plan participants do not constitute owner shifts or equity structure shifts. *See, e.g., Priv. Ltr. Rul. 9652019 (Sept. 30, 1996) .*

(n144)Footnote 128b. Treas. Reg. § 1.382-10.

(n145)Footnote 129. *I.R.C. § 382(e)(1)*. A special rule under section 382(e)(3) provides that in determining the value of any loss corporation that is a foreign corporation, only "items treated as connected with the conduct of a trade or business in the United States" are considered, except as otherwise provided in regulations. There are no regulations interpreting this provision. *See CCA 200238025 (Sept. 20, 2002) .*

(n146)Footnote 129a. *Amerada Hess Corporation v. Commissioner*, 517 F.2d 75, 82 (3d Cir. 1975) (where the stock price on the valuation date is so markedly out of line with its price on said exchange throughout the year straddling the critical date as to be aberrational, indices other than market price may be preferable to measure value of the corporation). *Compare T.A.M. 200513027* (Released April 1, 2005) (the IRS rejected taxpayer's argument that because "market was too slow in comprehending the information it had in its possession" about the company, the taxpayer should be permitted to depart from the market capitalization approach for purposes of § 382, concluding that where public market exists for stock, the market should be considered to have assimilated all available information

concerning the company.)

(n147)Footnote 130. The IRS concluded that "adjustments to the market price may be made to reflect certain unusual conditions in the market or to reflect discounts or premiums (e.g., blockage, control, etc.) that are warranted by the circumstances," *citing* H.R. Rep. Conf. Rep. No. 99-841, at II-187 (1986). *See T.A.M. 200513027* (Released April 1, 2005). *Cf. Treas. Reg. § 1.382-2(a)(3)(i)*.

(n148)Footnote 131. Temp. Treas. Reg. § 1.382-2T(f)(18)(iv).

(n149)Footnote 131a. Temp. Treas. Reg. § 1.382-2T(h)(4)(vii)(C).

(n150)Footnote 132. *I.R.C. § 382(l)(1)(A)*. *See* P TX 11.04[8][d] *infra* regarding the treatment of certain capital contributions by the United States.

(n151)Footnote 133. *I.R.C. § 382(l)(1)(B)*; 1996 FSA Lexis 541 (March 18, 1996) (the IRS noted that a capitalization of intercompany notes payable should be tested under *I.R.C. Section 382(l)(1)(B)* to determine whether it is a disqualified capital contribution); I.R.S. FSA 1999-10-009 (Dec. 2, 1998) (applying *I.R.C. Section 382(l)(1)* to exclude from the valuation of the loss corporation the value of debt that was deemed to have been converted into stock within two years of the ownership change). *But see Priv. Ltr. Rul. 2008-14-004* (April 4, 2008) (declining to apply *I.R.C. Section 382(l)(1)* to exclude the value of debt converted into equity). Note, however, that the result in *Priv. Ltr. Rul. 2008-14-004* may be explained by the exception for capital contributions to meet certain minimum capitalization requirements as well as the fact that an unrelated shareholder stood to benefit from the contribution. *See infra* note 135b.

(n152)Footnote 134. Notice 2008-78, 2008-41 I.R.B. 851 (Oct. 14, 2008).

(n153)Footnote 135. Notice 2008-78 references terms and definitions used in Section 1.355-7 of the Treasury Regulations and provides that they have the same meaning, but substituting, in each instance "contribution" for "distribution," "loss corporation" for "Distributing and/or Controlled," and "ownership change" for "acquisition."

(n154)Footnote 135a. The definition of "agreement, understanding, arrangement, or substantial negotiations" is set out in Section 1.355-7(h)(1) of the Treasury Regulations.

(n155)Footnote 135b. This safe harbor implements two of the three exceptions to *I.R.C. Section 382(l)(1)* contained in the legislative history--the exceptions for initial capital contributions on formation and capital contributions made before the first NOL year--but omits the exception for "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)." Conference Report to the Tax Reform Act of 1986, H.R. Conf. Rep. No. 99-841, at II-189 (1986). This exception has been the subject of several private letter rulings and other IRS guidance, which generally except capital contributions from *I.R.C. Section 382(l)(1)* to the extent the contributed funds are used for operating expenses arising "proximate in time" to the time the contributions were made or to meet certain capitalization requirements. *See, e.g.,* Tech. Adv. Memo. 93-32-004 (April 30, 1993), *Priv. Ltr. Rul. 95-08-035* (Nov. 30, 1994), *Priv. Ltr. Rul. 95-41-019* (Jul. 10, 1995), *Priv. Ltr. Rul. 96-30-038* (May 1, 1996), *Priv. Ltr. Rul. 97-06-014* (Nov. 13, 1996), *Priv. Ltr. Rul. 98-35-027* (May 29, 1998), and *Priv. Ltr. Rul. 2007-30-003* (Jul. 27, 2007).

(n156)Footnote 135c. *See* Drew Douglas, "Forthcoming IRS Rules on Notice 2008-78 May Allow Retroactive Relief, Official Says," 07 DTR G-5 (Jan. 13, 2009) (discussing comments made by Mark Jennings, chief of Branch I in the Office of Associate Chief Counsel (Corporate)).

(n157)Footnote 136. *I.R.C. § 382(l)(4)*. *See, e.g., Priv. Ltr. Rul. 9630038* (May 1, 1996) ; I.R.S. FSA 2001-40-049 , 2001 FSA Lexis 123 (July 6, 2001) (the IRS' analysis of whether cash raised in an IPO is a "non-business" asset of the consolidated group.).

(n158)Footnote 137. *I.R.C. § 382(l)(4)(D)*.

(n159)Footnote 138. *I.R.C. § 382(l)(4)(E)*.

(n160)Footnote 139. *Berry Petroleum Co. v. Commissioner*, 104 T.C. 584 (1995) , *aff'd*, 142 F.3d 442 (9th Cir. 1998) .

(n161)Footnote 140. *Berry Petroleum Co. v. Commissioner*, 104 T.C. 584 (1995), *aff'd* 142 F.3d 442 (9th Cir. 1998).

(n162)Footnote 141. *Berry Petroleum Co. v. Commissioner*, 104 T.C. 584 (1995) , *aff'd*, 142 F.3d 442 (9th Cir. 1998) .

(n163)Footnote 142. *I.R.C. § 382(e)(2)*.

(n164)Footnote 143. Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647 (1988).

(n165)Footnote 144. *I.R.C. § 382(e)(2)*. See IRS FSA 200140049 (Oct. 5, 2001) (discusses application and legislative history of *I.R.C. Section 382(e)(2)*). In *Berry Petroleum Co. v. Commissioner*, 104 T.C. 584 (1995) , *aff'd*, 142 F.3d 442 (9th Cir. 1998) , the Tax Court held that advances from an acquired loss corporation to its new parent that were subsequently (within 6 months) cancelled constituted a corporate contraction. The court found that the advances were made necessary as a result of the cash acquisition of the loss corporation. In *I.R.S. FSA 200140049* , the IRS treated a distribution of funds by the target corporation to an acquiror shortly after such acquisition as an equivalent of a "bootstrap" acquisition and thus as a "corporate contraction" within the meaning of § 382(c). 2001 FSA Lexis 123 (July 6, 2001) . In *Priv. Ltr. Rul. 200406027* (Oct. 10, 2003) , the IRS concluded that in determining the value of a target under § 382(e)(1) and *Treasury Regulation § 1.1502-93(b)*, none of (i) the acquisition of target stock (including the squeeze-out merger), (ii) the funding of the acquisition of target stock, (iii) the consolidated treasury management and cash sweep program and the payment of royalties or (iv) the pre-merger operational consolidations constitutes a "redemption or other corporation contraction" occurring in connection with the acquisition within the meaning of section 382(e)(2).

(n166)Footnote 145. *I.R.C. § 382(c)*; *Treas. Reg. § 1.368-1(d)*. See also In the Matter of Federated Department Stores Inc., 92-1 U.S.T.C. (CCH) P 50,091 (Bankr. S.D. Ohio 1992) (court found sufficient carryover of business to permit use of NOLs under *I.R.C. § 382(c)*), *aff'd sub nom.* United States v. Federated Department Stores, Inc. (*In re* Federated Department Stores, Inc.), 94-2 U.S.T.C. (CCH) P 50,418 (S.D. Ohio 1994); *Berry Petroleum Co. v. Commissioner*, 104 T.C. 584 (1995) , *aff'd*, 142 F.3d 442 (9th Cir. 1998) (court found sufficient continuation of business to satisfy section 382(c), even though the taxpayer disposed of its most valuable business property immediately after the ownership change); *Priv. Ltr. Rul. 9438018* (Jun. 27, 1994) (no *I.R.C. § 382* limitation since loss corporation ceased to do business shortly after change date); *Samson Investment Co. v. Commissioner*, 76 T.C.M. (CCH) 158 (1998) (court found sufficient continuation of business activity due to economic downturn prior to ownership change because loss corporation remained ready, willing and able to operate).

(n167)Footnote 145a. 2004 IRS CCA LEXIS 33 ; CCA 200444002 (July 22, 2004) . Under *Treas. Reg. § 1.368-1(d)*, business continuity is satisfied if the acquiring corporation continues the target corporation's historic business or uses a significant portion of the target's historic assets in a business.

(n168)Footnote 146. See chapter TX10 *supra*.

(n169)Footnote 147. See P TX11.04[6] *infra*.

(n170)Footnote 148. *I.R.C. § 382(l)(6)*.

(n171)Footnote 149. *I.R.C. § 382(l)(6)*.

(n172)Footnote 150. *Treas. Reg. § 1.382-9(j), (k) and (l)*.

(n173)Footnote 151. *Treas. Reg. § 1.382-9(i)*.

(n174)Footnote 152. *Treas. Reg. § 1.382-9(j)*.

(n175)Footnote 153. *Treas. Reg. § 1.382-9(k)(1)(i)*.

(n176)Footnote 154. *Treas. Reg. § 1.382-9(k)(1)(ii)*.

(n177)Footnote 155. *Treas. Reg. § 1.382-9(k)(5)*.

(n178)Footnote 156. *Treas. Reg. § 1.382-9(k)(4)*.

(n179)Footnote 157. *Treas. Reg. § 1.382-9(k)(6)*.

(n180)Footnote 158. *Treas. Reg. § 1.382-9(k)(7)*. It is not clear how indebtedness of the issuer is to be valued for this purpose. Such value could be market value, adjusted issue price or face amount.

(n181)Footnote 159. *Treas. Reg. § 1.382-9(l)(1)*.

(n182)Footnote 160. *Treas. Reg. § 1.382-9(l)(4) & (5)*.

(n183)Footnote 161. *Treas. Reg. § 1.382-9(l)(2)*.

(n184)Footnote 162. "Title 11 or similar case" is defined in *I.R.C. § 368(a)(3)(A)*. In addition to a case under the Bankruptcy Code, it includes a "receivership, foreclosure or similar proceeding in a Federal or State Court." *I.R.C. § 368(a)(3)(D)* expands the definition by treating the agency as a court in any receivership, foreclosure or similar proceeding before a Federal or State agency involving certain financial institutions.

(n185)Footnote 163. *See Treas. Reg. § 1.382-9(d)*.

(n186)Footnote 164. *Treas. Reg. § 1.382-9(e)*.

(n187)Footnote 165. *Treas. Reg. § 1.382-9(d)*. Temp. *Treas. Reg. § 1.382-2T(e)(1)(ii)*. *See Priv. Ltr. Rul. 9733019 (May 22, 1997)* (trust treated as qualified settlement fund under *I.R.C. Section 468B* will be a qualified creditor).

(n188)Footnote 166. *Treas. Reg. § 1.382-9(d)(3)*.

(n189)Footnote 167. *Treas. Reg. § 1.382-9(d)(5)*. *See Priv. Ltr. Rul. 200243034 (July 26, 2002)* (a transfer from a decedent will be considered a qualified transfer).

(n190)Footnote 168. *I.R.C. § 382(l)(5)(B)*. *See Internal Revenue Service F.S.A. 2000-06-004 (June 28, 1999)* (concluded that the amount of interest paid or accrued by taxpayer during the period on or before the change date of the taxable year in which the ownership change occurred should be taken into account in computing the tax attribute reduction prescribed by *I.R.C. Section 382(l)(5)(B)*, regardless of whether taxpayer incurred any NOL during that period).

(n191)Footnote 169. In addition to the interest write-down, NOLs and other tax attributes must be reduced by 50% of the amounts not treated as discharge of indebtedness because of the stock-for-debt exception (except for amounts already counted as a result of the interest write-down rule), if the stock for debt exception happens to apply. *See P TX8.03[2][b] supra*. The stock for debt exception was repealed by the Omnibus Budget Reconciliation Act of 1993

(Pub. No. 103-66). The repeal of this exception took place in two stages; the repeal was effective in chapter 11 cases commenced after 1993 and exchanges effected after 1994. *I.R.C. Section 382(l)(5)(C)* was changed along with the repeal of the stock for debt exception, but its prior version applies to situations in which the stock for debt exception still applies.

(n192)Footnote 170. *I.R.C. § 382(l)(5)(D)*.

(n193)Footnote 171. *I.R.C. § 382(l)(5)(H)*.

(n194)Footnote 171a. *See* Chief Couns. Adv. 2004-44-002, (July 22, 2004) ("The trade or business does not have to be the historic trade or business.").

(n195)Footnote 172. *I.R.C. § 382(d)(2)*.

(n196)Footnote 173. *I.R.C. § 382(j)*.

(n197)Footnote 174. *I.R.C. § 382(b)(3)*.

(n198)Footnote 175. *I.R.C. § 382(b)(3)*; 1987-2 C.B. 387, Notice 87-79 .

(n199)Footnote 176. *I.R.C. § 382(b)(3)(A)*.

(n200)Footnote 177. *I.R.S. Notice 87-79, 1987-2 C.B. 387 . See, e.g., Priv. Ltr. Rul. 2001-25-056 (March 14, 2001), Priv. Ltr. Rul. 96-17-030 (Jan. 26, 1996), Priv. Ltr. Rul. 90-30-023 (Apr. 27, 1990) and Priv. Ltr. Rul. 88-22-074 (Mar. 8, 1988).*

(n201)Footnote 178. *See, e.g., Priv. Ltr. Rul. 97-34-030 (May 22, 1997) and Priv. Ltr. Rul. 95-15-037 (Jan. 17, 1995).*

(n202)Footnote 179. *Treas. Reg. § 1.382-6*.

(n203)Footnote 180. *Treas. Reg. § 1.382-6(c)*.

(n204)Footnote 181. *Treas. Reg. § 1.382-6(c)(2)(ii)*.

(n205)Footnote 182. *Treas. Reg. § 1.382-6(b)(2)*. Under *I.R.C. § 301.9100-1(c)*, however, the Commissioner has discretion to grant a reasonable extension of time to make such an election, and such extensions have often been granted. *See, e.g., Priv. Ltr. Rul. 200306023 (Oct. 31, 2002) .*

(n206)Footnote 183. *Treas. Reg. § 1.382-6(b)(3)(i)*.

(n207)Footnote 184. *Treas. Reg. § 1.382-6(b)(3)(ii)*.

(n208)Footnote 184a. *See 1994-2 C.B. 43, 44, T.D. 8546 .*

(n209)Footnote 185. *Treas. Reg. § 1.382-6(h)*.

(n210)Footnote 185a. *See* P TX 11.04[8][c] *infra* regarding the treatment of certain built-in losses for banks prior to February 17, 2009.

(n211)Footnote 186. *I.R.C. § 382(h)(1)(B), (2)(B)*.

(n212)Footnote 187. *I.R.C. § 382(h)(3)(A) and 382(h)(6)*.

(n213)Footnote 188. *I.R.C. § 382(h)(3)(B)*.

(n214)Footnote 189. *I.R.C. § 382(h)(1)(A)*. 1990-1 C.B. 336, Notice 90-27, states that regulations will provide for the extension of the five-year recognition period, and an increase in the *I.R.C. § 382* limitation to account for payments received after the five years on account of built-in gain assets sold on the installment method.

(n215)Footnote 189a. *But see T.A.M. 200217009*, 2001 PLR LEXIS 2088 (Dec. 4, 2001) (post-change income attributable to pre-change patient base, which had zero basis because the loss corporation had expensed costs to create the patient base is not recognized built-in gain income) and *T.A.M. 199942003*, 1999 PLR LEXIS 1119 (July 6, 1999) (prepayments for services, properly taken into account for federal income tax purposes during the recognition period, are too tenuously connected to the pre-change period to be treated as built-in gains). Effective June 14, 2007, the Service issued Temp. Treas. Reg. § 1.382-7T(b) to clarify that prepaid income is not recognized built-in gain. The term "pre-paid income" is defined as any amount received prior to the change date that is attributable to performance occurring on or after the change date, such as income received prior to the change date that is deferred under Section 455, § 1.451-5 or Rev. Proc. 2004-34.

(n216)Footnote 189b. 2003-2 C.B. 747.

(n217)Footnote 189c. Prior to February 17, 2009, certain built-in losses of banks are subject to special treatment. See P TX 11.04[8][c] *infra*.

(n218)Footnote 189d. The authors understand that it is the intention of the IRS to treat all liabilities as consideration in this hypothetical sale, even if the total of such liabilities exceeds the fair market value of the assets.

(n219)Footnote 189e. See *Priv. Ltr. Rul. 2006-24-001* (June 16, 2006).

(n220)Footnote 190. See Notice 2008-76, 2008-39 I.R.B. 768 (Sept. 29, 2008).

(n221)Footnote 191. See P TX 11.04[8][c] *infra* regarding the Treasury's authority for issuing Notice 2008-76.

(n222)Footnote 192. See Notice 2008-84, 2008-41 I.R.B. 855 (Oct. 14, 2008).

(n223)Footnote 193. See Notice 2008-83, 2008-42 I.R.B. 905 (Oct. 20, 2008).

(n224)Footnote 194. See Recovery Act § 1261(b)(1). Certain ownership changes, however, are grandfathered if, prior to February 17, 2009, the corporation entered into a binding contract, or made a public announcement of an agreement, and the ownership change occurs pursuant to such contract or announcement. See § 1261(b)(2).

(n225)Footnote 195. See Recovery Act of 2009 § 1261(a)(2).

(n226)Footnote 196. See Recovery Act of 2009 § 1261(a)(1), (3).

(n227)Footnote 197. See FASB Statement 157.

(n228)Footnote 198. See <http://www.fasb.org/action/sbd040209pf.html> (accessed Apr. 13, 2009).

(n229)Footnote 199. See FASB FSP FAS 157-4 P 21.

(n230)Footnote 200. See Notice 2008-100 (issued Oct. 14, 2008), 2008-44 I.R.B. 1081 (Nov. 3, 2008); Notice 2009-14 (issued Jan. 30, 2009), 2009-7 I.R.B. 516 (Feb. 17, 2009); Notice 2009-38 (issued April 13, 2009), 2009-18 I.R.B. 901 (May 4, 2009).

(n231)Footnote 201. On April 7, 2009, the Treasury released CPP term sheets for an issuer when it or its

subsidiary is a mutual organization. Notice 2009-38 will likely be superseded by guidance that specifically applies to such issuers. If superseding guidance conflicts with Notice 2008-100, and is released after an issuer with a mutual top-tier parent issues stock or warrants pursuant to the CPP, or enters into a binding contract regarding such an issuance, then Notice 2008-100 will apply. See Notice 2008-100 § IV.

(n232)Footnote 202. Accordingly, Temporary Treasury Regulation § 1.382-2T(f)(18) should not apply to Covered Instruments.

(n233)Footnote 203. Accordingly, Temporary Treasury Regulation § 1.382-2T(f)(18) should not apply to such instruments.

(n234)Footnote 204. Recovery Act § 1262(a).

(n235)Footnote 205. I.R.C. § 382(n)(1). As a practical matter, given these requirements, I.R.C. § 382(n) may only apply to General Motors.

(n236)Footnote 206. I.R.C. § 382(n)(2).

(n237)Footnote 207. I.R.C. § 382(n)(3).



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Collier on Bankruptcy Taxation

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CHAPTER TX11 Preservation and Use of Net Operating Losses and Other Corporate Tax Attributes

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P TX11.05 I.R.C. section 383--Special Limitations on Certain Excess Credits, Etc.

I.R.C. section 383, as revised by the Tax Reform Act of 1986 ("*I.R.C. section 383*"), is supposed to follow the general principles and limitations of *I.R.C. section 382*. The actual application of the *I.R.C. section 382* principles to various credit carryovers (i.e., general business credit and alternative minimum tax credit), capital loss carryovers, and excess foreign taxes is provided for in Treasury Regulations. n1

The *I.R.C. section 383* rules generally provide that the various pre-change credits can be used to offset taxable income (via offsetting tax liability) to the extent that NOL and capital loss carryovers used in any particular year are less than the *I.R.C. section 382* limitation. They also provide ordering rules for the use of losses and credits and procedures for calculating any remaining section 382/383 limitation to be carried forward. *Treasury Regulation section 1.383-2* has been reserved for "Limitations on certain capital losses and excess credits in computing alternative minimum tax."

FOOTNOTES:

(n1)Footnote 1. *Treas. Reg. § 1.383-1*.



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CHAPTER TX11 Preservation and Use of Net Operating Losses and Other Corporate Tax Attributes

15-TX11 Collier on Bankruptcy Taxation P TX11.06

P TX11.06 I.R.C. section 384--Limitation on Use of Pre-Acquisition Losses to Offset Built-in Gains

I.R.C. section 384 was added by the Revenue Reconciliation Act of 1987. Its stated purpose was to prevent a corporation or Consolidated Group with NOLs that acquires assets, or the stock of a company with assets, that have significant unrealized appreciation from using its NOLs against the recognition of gain on those assets within five years of the acquisition. TAMRA made significant amendments to *I.R.C. section 384*. The most important change is that *I.R.C. section 384* will apply if either the acquiring or the acquired corporation has significantly appreciated assets. n1

I.R.C. section 384, as amended, provides that if (i) a corporation that has a net unrealized built-in gain acquires or is acquired by another corporation n2 after December 15, 1987, or (ii) the assets of a corporation are acquired by another corporation after December 15, 1987, in an "A", "C" or "D" type tax reorganization and either corporation has a net unrealized built-in gain, the "pre-acquisition loss" of any corporation (other than the built-in gain corporation) cannot offset the "recognized built-in gain" of the built-in gain corporation during the five-year "recognition period." n3

Example 10:

S, a member of the L and S calendar year Consolidated Group, buys all of the stock of T, a corporation that has a net unrealized built-in gain, from individual A on January 1, 2002. On December 31, 2002, T sells an asset, recognizing \$100 of gain of which \$80 is built-in gain. Since T became a member of the L, S and T Consolidated Group on January 1, 2002, L's losses incurred prior to 2002 (and any post-acquisition recognized built-in losses) cannot be used to offset the \$80 of T's recognized built-in gain. However, L's pre-2002 losses and built-in losses can be used to offset the \$20 of non-built-in gain recognized by T, and L's losses incurred in 2002 (other than built-in losses) should be available to offset the \$80 of built-in gain.

Example 11:

Same facts as in Example 10, except that T merges into S and S sells the asset on December 31, 2002. The tax consequences are the same.

Recognized built-in gain means any gain recognized on the disposition of any asset during the recognition period unless it is shown that the asset was not held by the acquired corporation on the acquisition date or such gain exceeds the excess of the fair market value of the asset over its basis on the acquisition date. n4 It also includes certain income items attributed to the pre-acquisition period but recognized under our tax regime in the post-acquisition recognition period. n5 The House Report of the 1987 OBRA gives as an example of this type of income, the income from a "burnt-out"

leasing subsidiary. n6

I.R.C. section 384 is clearly designed to capture the situation where economic accrued income in the form of value over tax basis is acquired directly or indirectly by a loss corporation to offset NOLs or their economic equivalent. The timing of the realization of this type of income is largely in the control of the entity with the built-in gain; the income can be realized by sale of the built-in gain asset. If such income is recognized (as contrasted with realized) n7 within the five-year recognition period, it is subject to the limitations of the section; if recognized outside the recognition period, it is not. The provision was not intended to reach normal operating profits inherent in a profitable business. The problem is that often a stream of income is inherent in the built-in gain assets. This can be illustrated by reference to a highly appreciated patent. The realization of the built-in gain by sale of the patent is clearly within *I.R.C. section 384*; the collection of annual royalties and the manufacture and sale of patented items apparently are not. Existing inventory of the acquired company presents a more troubling case. While apparently not the primary target of *I.R.C. section 384*, the gross profit inherent in existing inventory of the acquired corporation appears to be subject to the limitations of the section. n8

A "pre-acquisition loss" is a NOL carryforward to the acquisition year, the *pro rata* portion of a NOL in the acquisition year allocable to the portion of the year prior to the acquisition and a recognized built-in loss of a corporation having a net unrealized built-in loss on the acquisition date. n9 Other terms used in *I.R.C. section 384* have the same meaning as identical terms used in *I.R.C. section 382*. n10 The legislative history confirms that the threshold rule for net unrealized built-in gain is also applicable to *I.R.C. section 384*. n11

I.R.C. sections 384 and *382* both have parallel built-in gain and loss provisions. The difference is that each section has a presumption that works to the disadvantage of the taxpayer. Under *I.R.C. section 382*, post-ownership change realized losses are presumed to be the result of built-in losses so as to subject them to the *I.R.C. section 382* limitation, while realized gains are not presumed to be built-in gains that increase the limitation, unless in each case the taxpayer demonstrates otherwise. *I.R.C. section 384* presumes that gains are built-in gains unless the taxpayer demonstrates otherwise. n12 The result is that the taxpayer may be required to perform an analysis of the value and tax basis of the assets and built-in income and loss items of both the loss corporation and the profitable corporation to prevent being whipsawed by the disadvantageous presumptions in the statutes.

I.R.C. section 384 does not apply if the acquired and acquiring corporations were members of the same controlled group, as defined in *I.R.C. section 1563(a)* (except that "more than 50 percent" is substituted for all occurrences in the text of "at least 80 percent" and the ownership tests must be met for both voting power and value), at all times during the five-year period ending on the acquisition date. n13

Example 12:

L, a loss corporation, is owned entirely by individual A. L has owned 60% of the stock of corporation T (with assets having net unrealized built-in gain) since 1980. In 2000, L buys 21% of T's stock from other shareholders, creating an affiliated group. L will be able to use any and all of its losses to offset T's recognition of built-in gain.

Example 13:

If the facts were the same as those of Example 12, except that A owned the 60% interest in T since 1980 and contributed that stock to L, the same result occurs. This was not the case prior to the amendments made by TAMRA.

FOOTNOTES:

(n1)Footnote 1. *I.R.C. § 384(a)(2)*.

(n2)Footnote 2. Internal Revenue Service F.S.A. 2001-25-007 (March 9, 2001) (concluding that because neither Section 384 nor Section 1504(a)(2) provides constructive ownership rules for determining "control," " the corporation has not acquired "control" " under Section 384).

(n3)Footnote 3. *I.R.C. § 384(a)*.

(n4)Footnote 4. *I.R.C. § 384(c)(1)(A)*.

(n5)Footnote 5. *I.R.C. § 384(c)(1)(B)*.

(n6)Footnote 6. H. Rep. No. 100-391, 100th Cong., 1st Sess. 1094 (1987).

(n7)Footnote 7. *I.R.S. Notice 90-27, 1990-1 C.B. 336* , states that regulations will be issued providing that a gain from an installment sale will be recognized built-in gain for purposes of *I.R.C. §§ 382, 384 and 1374* whether the gain is recognized during the 5-year recognition period or thereafter. This rule would apply whether the installment sale occurs before or after the beginning of the recognition period (but not after the end of the recognition period). This rule will cost the taxpayer under *I.R.C. § 384*, but help the taxpayer under *I.R.C. § 382* (because the recognized gain will (generally) cause an increase in the Section 382 limitation for the taxable year of payment).

(n8)Footnote 8. See McGeehan, *Section 384 Limitations on the Use of Losses to Offset Built-In Gains*, 42 Major Tax Planning 5-21 (1990). This article is a good resource for a more detailed discussion of *I.R.C. § 384*. Note that under *I.R.C. § 382*, this result is advantageous in its creation of built-in gain. See *P TX11.04[7][b] supra*.

(n9)Footnote 9. *I.R.C. § 384(c)(3)*.

(n10)Footnote 10. *I.R.C. § 384(c)(4)*.

(n11)Footnote 11. See *P 11.04[6] supra*.

(n12)Footnote 12. *I.R.C. § 384(c)(1)(A)*.

(n13)Footnote 13. *I.R.C. § 384(b)*.



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CHAPTER TX11 Preservation and Use of Net Operating Losses and Other Corporate Tax Attributes

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P TX11.07 Judicial Limitations on Preserving NOLS

[1] *Libson Shops* Doctrine

In *Libson Shops v. Koehler*,ⁿ¹ the Supreme Court adopted a test of business continuity in limiting the carryover of NOLs following the merger of seventeen corporations. In effect, the Court prohibited the income from the profitable businesses from offsetting the losses generated by the NOL companies. In the Ninth Circuit, *Libson Shops*, which was decided under the Internal Revenue Code of 1939, did not apply to transactions governed by specific provisions of the 1954 Code.ⁿ² The IRS took the position that *Libson Shops* may have continuing vitality where there has been a shift in the benefits of a NOL carryover.ⁿ³ In *National Tea Co. v. Commissioner*,ⁿ⁴ the Tax Court held in a case involving an "F" Reorganization, prior to the 1982 amendment to *I.R.C. section 368(a)(1)(F)* limiting "F" Reorganization treatment to a single corporation, that *Libson Shops* governs those situations not specifically covered by the 1954 Code. *I.R.C. section 382* resulted in the demise of *Libson Shops* for situations governed by the new law.ⁿ⁵

[2] Other Judicial Limitations

Any planning must take account of the judicially imposed principles of business purpose,ⁿ⁶ step transactions,ⁿ⁷ and form over substance.ⁿ⁸ Keep in mind the overriding principle: "if it's too good to be true, it probably isn't."

FOOTNOTES:

(n1)Footnote 1. *Libson Shops v. Koehler*, 353 U.S. 382, 77 S. Ct. 990, 1 L. Ed. 2d 924 (1957) .

(n2)Footnote 2. *Maxwell Hardware Co. v. Commissioner*, 343 F.2d 713 (9th Cir. 1965) .

(n3)Footnote 3. I.R.S. Tech. Info. Rel. 773 Stand. Fed. Tax Rep. (CCH) P 6,751 (Oct. 13, 1965), *modifying* 1963-1 C.B. 46, Rev. Rul. 63-40 .

(n4)Footnote 4. *National Tea Co. v. Commissioner*, 83 T.C. 8 (1984) , *aff'd* 793 F.2d 864 (7th Cir, 1986)

(n5)Footnote 5. Conference Committee Report at II-194.

(n6)Footnote 6. *See, e.g., Gregory v. Helvering*, 293 U.S. 465, 55 S. Ct. 266, 79 L. Ed. 596 (1936) .

(n7)Footnote 7. *See, e.g., Warner v. Commissioner*, 26 B.T.A. 1225 (1932) (acq.).

(n8)Footnote 8. *See, e.g., Weinert's Estate v. Commissioner*, 294 F.2d 750, 15 O.&G.R. 125 (5th Cir. 1961) .



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CHAPTER TX11 Preservation and Use of Net Operating Losses and Other Corporate Tax Attributes

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P TX11.08 Consolidated Return Considerations

[1] Consolidated Return Regulations

The ability to offset one corporation's income with another corporation's loss is a major advantage of filing consolidated federal tax returns. Buying or selling a member of a Consolidated Group n1--whether a single corporation, a chain of corporations or the whole group--necessarily involves the intricacies of the Consolidated Return Regulations. n2 As noted above, attempted use of the consolidated return rules to avoid tax absent a business purpose can be struck down by the courts. n3

The Consolidated Return Regulations have recently been the subject of several amendments that have a significant impact on the planning for the use of NOLs and other tax attributes in a consolidated return context. n4 A discussion of these amendments are beyond the scope of this chapter, but they generally involve investment adjustments and earnings and profits adjustments. n5 Particular attention should be paid to the effect of changes to the circular basis rules and the rules for triggering excess loss accounts. n6

[2] Tests for Affiliation of Consolidated Group Corporations

The Tax Reform Act of 1984 amendments to *I.R.C. section 1504* materially changed the test for affiliation of corporations for consolidated tax return filing purposes. The amendments were designed to eliminate consolidated return games played by making equity interests disproportionate to voting power and creating mechanisms that resulted in "springing" affiliation or disaffiliation of a corporation, depending on tax attributes of the member and the group.

Affiliation now requires ownership of *both* eighty percent of the total voting power and eighty percent of the total value of stock. n7 On May 24, 2004, the Service issued *Notice 2004-37* announcing the circumstances under which a consolidated group that owns stock of an includible corporation will be treated as satisfying the value requirement of *I.R.C. section 1504(a)(2)(B)* for certain purposes. The notice also announced the intention of the Service and the Treasury to propose regulations pursuant to *I.R.C. section 1504(a)(5)(C)* n7a providing that the value requirement will be treated as satisfied if the affiliated group, in reliance on a good faith determination of value, treated such requirement as satisfied. In addition, pursuant to *I.R.C. section 1504(a)(5)(D)*, n7b the proposed regulations will disregard an inadvertent ceasing to satisfy the value requirement by reason of changes in relative values of different classes of stock.

The definition of stock has been broadened. However, the term "stock" does not include any stock that (i) is not entitled

to vote; (ii) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent; (iii) has redemption and liquidation rights that do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium); and (iv) is not convertible into another class of stock. n8

Any corporation that was included in a consolidated return after 1984 and becomes disaffiliated cannot be included in a consolidated return with the same group for five years without the Commissioner's consent. n9 Treasury is given broad authority to prescribe regulations respecting affiliation, including regulations that treat warrants, obligations convertible into stock, and other similar interests as stock, and stock as not stock; treat options to acquire or sell stock as having been exercised; permit reliance on a good faith determination of value; disregard changes in relative values of different classes of stock; ignore transfers of stock within the group and disregard changes in voting power to the extent such changes are disproportionate to related changes in value. n10 Regulations were adopted on December 28, 1992, respecting warrants, options, convertible obligations and similar interests. n11

[3] Limitations on Intercompany Use of Tax Attributes

[a] Introduction

The income combining advantages of consolidated returns are limited by a series of rules (Separate Return Limitation Year ("SRLY"), Built-in Deductions, and Reverse Acquisitions) basically designed to restrict the benefit of offsetting income and loss to the same corporations of the Consolidated Group (and indirectly the ultimate owners thereof) that sustained the losses. n11a The impact of these limitation rules is generally avoided by combining the income-producing businesses and the loss businesses in a single corporate entity. Such combination can itself produce new problems. These problems involve the limitation of *I.R.C. section 269(b)* when a plan of liquidation is adopted within two years after an *I.R.C. section 338* qualified stock purchase, n12 and the limitation of *I.R.C. section 384* on use of pre-acquisition losses to offset built-in gains. n13 There are also Consolidated Return section 382 rules. n14

[b] Consolidated NOL Deduction

The consolidated NOL deduction of the Consolidated Group is the aggregate of the individual members' net operating loss carryovers and carrybacks to the year. n15 In general, the consolidated NOL deduction is limited to NOLs of the same members and their predecessors that originally sustained the NOL. n16

Each member of the Consolidated Group is allocated a pro rata share of the Consolidated NOL ("CNOL") for the year. The percentage assigned to each member of the Consolidated Group now must be reallocated when either: (1) the member has excluded cancellation of indebtedness income that reduces its allocable NOL and (2) the member carries back its share of the CNOL to a separate return limitation year. n16a Thus, under the new rule, a member has a new percentage of the CNOL for each year generated equal to the unabsorbed CNOL from such year attributable to such member on the first day of the following taxable year over the total unabsorbed CNOL from such year as of the same date. The reallocation of percentage of CNOLs means that before a member departs the Consolidated Group, the common parent must take account of prior changes in such member's percentage allocation to determine how much of the current CNOL will be "apportioned" to such departing member as discussed in more detail immediately below.

When a corporation ceases to be a member of the selling Consolidated Group because it is sold outside the group, part of the unused CNOL is "apportioned" to the departing member. n17 Under the loss disallowance rules, discussed below, the common parent may still, under certain circumstances, reattribute losses of the subsidiary to itself. n18 The amount to be apportioned is determined as of the end of the year of the Common Parent. n19 Thus, post-sale events affecting the income of the remaining members of the selling Consolidated Group will affect the departing member. As a result, the purchaser of a loss corporation may find that the expected NOL of the loss corporation is eliminated or substantially reduced by unanticipated income of the other members of the selling group during the year of sale.

Example 14:

Income and consolidated NOLs of P and S for the consolidated calendar years 1998 through 2000, assuming a sale of S on June 30, 2000, are as follows:

		Consolidated		Separate	
		12/98	12/99	12/00	12/00
Income	P:	[3,000)	(\$10,000)	\$8,000	X
(loss):					
	S:	-0-	(5,000)	1,000	\$4,000
Total:		(3,000)	(15,000)	9,000	X

P sells its subsidiary, S, on June 30, 2000. In its 2000 consolidated return for the year ending December 31, 2000, P will use all \$3,000 of its 1998 NOL carryovers, \$4,000 [10/15 x (\$9,000-\$3,000)] of its 1999 NOL carryovers, and \$2,000 [5/15 x (\$9,000-\$3,000)] of the NOL carryovers of S that would otherwise be available for S in its post-disposition years starting with the short year ending December 31, 2000. It would not matter that P earned the entire \$8,000 in 2000 after S left the group.

Under *Treas. Reg. section 1.1502-11(b)*, gain on the sale of a subsidiary cannot be offset against the subsidiary's remaining NOL. This prevents circular basis adjustments which would absorb significant additional CNOLs. However, this rule does not work when more than one subsidiary is sold in the same year. Any unused NOL of a disposed of subsidiary would be apportioned to it for use in its separate return years. n20 Under "loss disallowance rules," a loss on the sale of a subsidiary generally is not deductible. n21

Special rules apply to the carryback of the post-acquisition losses of the acquired corporation. If a consolidated NOL may be carried under *I.R.C. section 172(b)* to a separate return of any member, such as the acquired corporation, then the NOL is apportioned to the member (or its successor in a *I.R.C. section 381(a)* transaction) and the loss is not part of the consolidated NOL carryback to the equivalent consolidated return year. n22 The Common Parent may elect under *I.R.C. section 172(b)(3)(C)* to relinquish the entire carryback period for the group. n22a The election may not be "split" between members of the group, except for carrybacks of members that move from one consolidated group to another (but the waiver applies to all members that left the former group and joined the electing group in related transactions) and insolvent financial institutions. n23 It has been held that the irrevocable election to relinquish a NOL carryback is nonetheless voidable by a bankruptcy trustee when the other requirements of fraudulent transfer are met under the *Bankruptcy Code section 548*. n24

The enactment of *I.R.C. section 172(b)(1)(H)* as part of the Job Creation and Workers Assistance Act of 2002, n24a and the taxpayers' ability to revoke prior elections under *section 172(b)(3)*, as well as to make certain other filings in order to take advantage of the 5-year carryback period, prompted the IRS and Treasury to introduce Temporary and Proposed Regulations to allow a consolidated group to waive the entire carryback period or the extended carryback period for the portion of 2001 and 2002 losses attributable to acquired members, for pre-acquisition years. n24b In this regard, the Treasury added Temporary Regulation *section 1.1502-21T(b)(3)(ii)(C)*, which sets forth two elections. n24c

Pursuant to the first election, an acquiring group may waive the 5-year carryback period for the portion of 2001 and 2002 losses attributable to a member acquired from another group after June 25, 1999, for which the member was a member of another group. While this election effectively permits a waiver of the entire 5-year carryback period (to the extent that it is prior to the acquisition with respect to a consolidated NOL arising in a particular taxable year), it is only available where none of such losses have previously been carried back to a taxable year in which the acquired member was previously a member.

Pursuant to the second election, an acquiring group may waive the pre-acquisition carryback period for the portion of 2001 and 2002 losses attributable to a member acquired from another group, to the extent that the Job Creation and

Worker Assistance Act of 2002 increased the carryback period for such losses. This second election effectively permits a waiver of the third, fourth and fifth carryback years, where such years are prior to the acquisition. The waiver is available even where 2001 or 2002 losses have been carried back to the first or second carryback years of the acquired member that are pre-acquisition years. This second election, however, is only available with respect to consolidated NOLs arising in a particular taxable year where none of those losses have been carried back to a taxable year that is prior to the second taxable year preceding the taxable year of the loss of a group of which the acquired member was previously a member.

When a member creates a subsidiary that thereafter sustains a NOL, for consolidated return years beginning before January 1, 1997, the loss may be carried back to a separate return year of the new subsidiary's immediate parent (and not the Common Parent) if the subsidiary was not in existence in the prior year to which the loss is carried. n25 For consolidated return years beginning on or after January 1, 1997, such an NOL will be carried back to a consolidated return, even if the member that created the subsidiary was not a member of the consolidated group in such carryback year. n26 If the consolidated group did not file a consolidated return in such carryback year, the NOL can be carried back to the separate return of the common parent, but only if the common parent was not a member of another affiliated group in the year of the carryback or any subsequent year in the carryback period. n27

[c] Application of section 108 to Members of a Consolidated Group

On September 4, 2003, the Treasury published a notice of proposed rulemaking and temporary regulations under *I.R.C. section 1502* adding Temporary Treasury Regulation section 1.1502-28T to provide guidance regarding the determination of the attributes that are available for reduction when a member of a consolidated group realizes discharge of indebtedness income that is excluded from gross income ("Excluded COD") and the method for reducing those attributes effective for discharges of indebtedness that occur after August 29, 2003. n27a On March 15, 2004, the Treasury issued proposed guidance in the form of Proposed *Treasury Regulation section 1.1502-11(c)* regarding the timing of stock basis adjustments, the calculation of stock gain or loss and the reduction of attributes when a member disposes of stock of a subsidiary during a year in which a member of the Consolidated Group realizes Excluded COD. n27b

Temporary Treasury regulation section 1.1502-28T(a)(1) provides that the determination of the qualification for the insolvency (and presumably the bankruptcy) exception under *I.R.C. section 108(a)* looks only to the debtor member. It adopts a hybrid approach to attribute reduction in a Consolidated Group. When a member has Excluded COD, the Temporary Regulation requires the reduction of all attributes that are available to the debtor member, including the consolidated tax attributes attributable to other members of the Consolidated Group and, in certain circumstances, the basis of assets of other members of the Consolidated Group. The tax attributes of the Consolidated Group are reduced in the following order: (1) tax attributes attributable to the debtor member pursuant to the principles of Temporary Treasury Regulation section 1.1502-21T(b)(2)(iv) and tax attributes attributable to the debtor that arose in a separate return year for which the debtor is a member of a separate return limitation year subgroup are reduced; n28 (2) attributes of subsidiaries of the debtor member are reduced to the extent of any basis reduction in such subsidiary's stock (referred to herein as the "Look Through" rule); n28a and (3) remaining consolidated tax attributes of the Consolidated Group on a pro rata basis (by year of generation). n28b Temporary Treasury Regulation section 1.1502-28T was amended in December of 2003 to clarify that, under the third step, the tax attributes attributable to other members that arose in a separate return year or in a separate return limitation year if no separate return limitation year limitation applies (e.g., if the "overlap rule" applies) to the use of such attributes are also subject to reduction. n28c

The reduction of separate member tax attributes includes the debtor's deferred deductions under *Treasury Regulations section 1.1502-13* which are treated as basis. Basis reduction stops at zero, even for subsidiary stock. The "liability floor" for basis reduction applicable under *I.R.C. section 1017(b)(2)* applies on a separate member basis. n28d Finally, the election under *I.R.C. section 108(b)(5)* to first reduce depreciable basis is made separately for each member. n28e

If the basis of stock of a member is reduced under *I.R.C. section 108(b)(2)(E)* (not as a result of an *I.R.C. section 108(b)(5)* election), such lower-tier member is deemed to have realized Excluded COD ("deemed Excluded COD") itself in an amount equal to the amount of such basis reduction pursuant to the Look Through rule. n28f Unlike the case of actual Excluded COD, reduction of tax attributes as a result of such deemed Excluded COD may only reduce the tax attributes attributable to such lower-tier member. n28g Temporary Treasury regulation section 1.1502-32T(b)(3)(ii)(C) was also amended to clarify that if a lower-tier member is deemed to have realized Excluded COD, the reduction of the tax attribute is not treated as a noncapital, nondeductible expense of such lower-tier subsidiary for purposes of the basis adjustment rules of *Treasury Regulation section 1.1502-32*. Likewise, the deemed Excluded COD does not result in a positive basis adjustment. Once a subsidiary's attributes are fully reduced under the Look Through rule, no further reduction (even as to consolidated attributes) is required with respect to the deemed Excluded COD (other than with respect to the reduction of basis of stock of its subsidiaries, to which the Look Through rule is applied as well). Where multiple members of the group have Excluded COD, the separate company attribute reduction and Look Through rules are to be applied starting with the higher tier member. This will generally maximize the amount of tax attributes reduced in the Consolidated Group.

The Look Through rule had the potential effect of multiplying and spreading the *I.R.C. section 1245* taint throughout the Consolidated Group because *I.R.C. section 1017(d)* treats property with reduced basis as *I.R.C. section 1245* property and *I.R.C. section 1245(a)(1)* requires recognition of ordinary income on a disposition of *I.R.C. section 1245* property to extent of *I.R.C. section 108(b)* basis reduction. Thus *I.R.C. section 1245* recapture would have applied to both the reduction in basis of a subsidiary's stock and to the corresponding reduction in basis of assets of such subsidiary. To avoid multiple *I.R.C. section 1245* recapture, the IRS limited recapture with respect to stock basis reduction to any excess of stock basis reduction over such subsidiary's inside attribute reduction. n28h

Consolidated attributes allocated to other members are only reduced after the Look Through rule reduction is complete. Any unabsorbed deemed Excluded COD under the Look Through rule does not reduce consolidated attributes of other members. Any reduction in a consolidated attribute proportionally reduces each member's attributable portion thereof. n28i Note that these rules do not change the ordering rules of *I.R.C. section 108(b)*. Thus, CNOLs are reduced first in the current year and then to earliest year going forward. The proportional reduction should apply to the carryforward year from which only a portion of the CNOL from that year is reduced.

Temporary Treasury Regulation section 1.1502-28T contains special rules that should be consulted if in a single taxable year multiple members of the Consolidated Group realize Excluded COD. For example, if in a single taxable year multiple members realize Excluded COD income, reduction of attributes begins at the highest level debtor and the Look-Through rules apply to the Excluded COD income of such member and then the same procedure is performed with each other lower level debtor prior to the application of the rule requiring reduction of consolidated attributes attributable to other members. Proposed Treasury Regulations adopt an approach that limits stock basis adjustments in certain cases in which a disposition (actual or deemed under section 1.1502-19(c)(1)(iii)(B)) of subsidiary stock occurs during a year in which one or more members realize Excluded COD. Proposed *Treasury Regulation section 1.1502-11(c)* establishes a nine-step process for determining stock basis adjustments with respect to members leaving the group when the group has Excluded COD.

Step One: *Treasury Regulation section 1.1502-11(b)* is applied first to determine the extent to which deductions and losses of the departing member ("DM") may offset income and gain.

Step Two: *Treasury Regulation section 1.1502-32* is tentatively applied to adjust DM's stock basis to reflect the amount of unlimited deductions and losses calculated in Step One. Tentative adjustment of DM's stock basis is made without taking into account the reduction of attributes in respect of Excluded COD.

Step Three: In a case in which the disposition of stock did not result from excluded COD income not being fully applied to reduce attributes, gain or loss from the disposition of DM's stock is computed using the basis of DM's stock

determined in Step Two.

Step Four: Tentative income (or loss) for the year of disposition is computed. In a case in which the disposition of stock did not result from Excluded COD income not being fully applied to reduce attributes, gain or loss on disposition of DM's stock is taken into account.

Step Five: Excluded COD income is tentatively applied to reduce attributes that remained after the tentative computation of taxable income made in Step Four.

Step Six: *Treasury Regulation section 1.1502-32* is applied to adjust the basis of DM's stock to reflect the absorption of attributes in step four and the reduction of attributes in Step Five.

Step Seven: Gain or loss on disposition of DM's stock is calculated using the basis in DM's stock as calculated in Step Six. Any excess loss account in DM's stock is now calculated and taken into account, regardless of the cause of disposition.

Step Eight: The taxable income (or loss) for the year of the disposition is computed by taking into account any gain (loss) calculated in Step Seven and any limitation on the use of DM's deductions and losses to offset income computed pursuant to the first step.

Step Nine: Excluded COD income is actually applied to reduce attributes remaining after the actual computations of taxable income (or loss) in Step Eight. The Proposed Treasury regulations provide that the aggregate amount of the Excluded COD that is applied to reduce attributes attributable to members other than the debtor member in step nine shall not exceed the aggregate amount of Excluded COD that was tentatively applied to reduce the same attributes in Step Five. Also, the aggregate amount of the Excluded COD that is applied to reduce attributes (other than credits) attributable to the debtor member in Step Nine shall not exceed the aggregate amount of the Excluded COD that was tentatively applied to reduce attributes (other than credits) in Step Six. If the reduction of attributes attributable to a debtor member is prevented as a result of the above described limitation, the Excluded COD is applied to reduce the remaining attributes of members other than the debtor member on a pro rata basis pursuant to Treasury Regulation section 1.1502-28T(a)(4).

On March 22, 2005, the Treasury, after consideration of all the comments on the Temporary and Proposed Treasury Regulations discussed in the paragraphs above, adopted the Proposed Treasury Regulations and removed the affected provisions in the corresponding Temporary Treasury Regulations. n28j These regulations are generally effective March 21, 2005. The Treasury, however, provided that a portion of *Treasury Regulations section 1.1502-28* may be applied by the taxpayer at its election to discharges of indebtedness that occur on or before March 21, 2005, and after August 29, 2003. Furthermore, rules addressing potential duplication of ordinary income recapture under *I.R.C. section 1245* may be applied at the election of the taxpayer to discharges of indebtedness that occur on or before August 29, 2003, in cases in which *I.R.C. section 1017(b)(3)(D)* was applied.

The more significant revisions are discussed below:

Apportionment of Net Operating Losses: Temporary Treasury Regulation section 1.1502-21T required a recomputation of the percentage of a consolidated net operating loss attributable to a member when a portion of the loss is carried back to a separate return year or is reduced in respect of Excluded COD, or when a member departs. The final regulations clarify the timing of the recomputation in these cases: the percentage of the CNOL attributable to each member is recomputed as of the first day of the following consolidated return year.

Timing of Asset Basis Reduction: *Treasury Regulation section 1.1502-28(b)(3)(i)* was added to clarify that basis of property is subject to reduction pursuant to the rules of *I.R.C. sections 108* and *1017* and section 1.1502-28 after the

determination of tax for the year during which the member realizes excluded COD income (and any prior years) and coincident with the reduction of other attributes pursuant to *I.R.C. section 108* and *Treasury Regulations section 1.1502-28*. However, only the basis of property held as of the beginning of the taxable year following the taxable year during which the Excluded COD is realized is available for reduction.

Application of Look-Through Rule: *Treasury Regulation section 1.1502-28(a)(3)(ii)* clarified that the Look Through rule will apply to reduce the attributes of the lower tier member if the basis of stock of a corporation (the lower tier member) that is owned by another corporation (the higher tier member) is reduced and both of such corporations are members of the same consolidated group (i) on the last day of the higher tier member's taxable year that includes the date on which the Excluded COD is realized or (ii) the first day of the higher tier member's taxable year that follows the taxable year that includes the date on which the Excluded COD is realized.

Attributes Available for Reduction on Departure of Debtor Member: *Treasury Regulation section 1.1502-28(b)(8)* clarifies that in cases in which the member that realizes the excluded COD income leaves the group or the assets of the member are acquired by a corporation that is not a member of the group in a transaction to which *I.R.C. section 381(a)* applies on or prior to the last day of the consolidated return year during which the Excluded COD is realized, the tax attributes that remain after the determination of the tax imposed on the group that belong to members of the group are still available for reduction. Thus, disposing of the member with Excluded COD does not protect other members' tax attributes.

Intragroup Reorganizations and Group Structure Changes: *Treasury Regulation section 1.1502-28(b)(9)* was introduced to clarify that if the taxable year of a member during which such member realizes Excluded COD ends prior to the last day of the consolidated return year and, on the first day of the taxable year of such member that follows the taxable year during which such member realizes Excluded COD, such member has a successor member, the successor member is treated as if it had realized the Excluded COD. The rule was introduced to address the difficulty of tracing attributes and property of the debtor member once the debtor member has been acquired by another member and recognizes that the direction of a transaction to which section 381(a) applies in a group may not be meaningful.

Application of Next Day Rule: Generally, under the "next day rule" of *Treasury Regulation section 1.1502-76(b)(1)(ii)(B)*, any transaction that occurs on the day the member ceases to be affiliated with the group that is properly allocable to the portion of the subsidiary's day after the event terminating affiliation must be treated as occurring at the beginning of the following day. *Treasury Regulations section 1.1502-28(b)(10)* was added to clarify that the next day rule cannot be applied to treat Excluded COD as realized at the beginning of the day following the day on which it is realized.

Timing of Investment Adjustments: Under *Treasury Regulation section 1.1502-32(b)(1)(ii)* was clarified to provide that in cases in which a subsidiary ceases to be a member of the group on or prior to the end of the consolidated return year during which a member realizes Excluded COD, basis adjustments resulting from the realization of Excluded COD and from the reduction of attributes in respect thereof are made immediately after the determination of tax for the group for the consolidated return year during which the Excluded COD is realized (and any prior years) and are effective immediately before the beginning of the day following the day the member departs from the group. Thus, the new group will not suffer any stock basis adjustments as a result of realization of Excluded COD.

Elimination of Circular Stock Basis on Disposition of Member Stock: *Treasury Regulation section 1.1502-11(c)(2)(iv)* and *(viii)* are revised so that in Step 4 and Step 8 described above, the tentative tax and tax imposed by chapter 1 of the Code, respectively, is computed, rather than tentative and actual taxable income (or loss), respectively. The change was implemented because a computation of the limitation on attribute reduction based on the tax attributes remaining after a tentative computation of taxable income (or loss) does not account for the use of credits in the computation of the group's tax liability for the taxable year of the discharge.

Note that, like *Treasury Regulation section 1.1502-11(b)*, *Treasury Regulation section 1.1502-11(c)* still does not solve the circularity problem, if more than one member leaves the group and generates gain with respect to its stock during the taxable year.

In an Office of Chief Counsel Memorandum, the Service concluded that section 108 and the consolidated return regulations require members of a consolidated group with excluded COD to reduce NOLs and alternative minimum tax credits on a single entity basis and to reduce asset basis on a separate entity basis for periods prior to the adoption of Treas. Reg. section 1.1502-28T. n28k

[d] Consolidated Group Tax Years and Taxes

The tax year of the sold corporation closes on the date of its sale. It must adopt the tax year of its new Consolidated Group. Note that short taxable years resulting from acquisitions and dispositions of corporations may adversely affect the length of the carryover period of the tax attribute. The benefits of the "thirty day" rule have been eliminated, effective for corporations joining or leaving a Consolidated Group after December 31, 1994. n29 This rule permitted the Common Parent to include from the first day of the new member's year a corporation that joins during the first thirty days of its year or to exclude from the Consolidated Group a subsidiary that was a member of the acquiring group for less than thirty days. n30 The period for which a member is so excluded from the group must be accounted for by a separate return covering the excluded period.

Every member of a Consolidated Group must be concerned with the quality of the consolidated NOLs of the group which are used to offset income of the group. Since each member of a Consolidated Group is severally liable for all the taxes of its consolidated return group for the periods it was a member of the group, each departing member has an interest in the quality of the tax returns filed by the group. n31 The Tax Court held in 1947 that, although members of the Consolidated Group are severally liable to the government for the full amount of deficiency and interest, as between themselves, such members are obligated "under principles of general law to pay only its [each member's] fair share of the common burden." The Tax Court proceeded to state that the right of contribution arises as a matter of "general law" whenever one pays on a common obligation in excess of the proper share as between himself and others similarly liable. n31a

It is important to remember that if a subsidiary member of the Consolidated Group converts or merges into a single member limited liability company that is a disregarded entity for U.S. federal income tax purposes, pursuant to state tax transfer liability laws such disregarded entity continues to carry its predecessor's *Treasury Regulation section 1.1502-6(a)* tax liability.

The Common Parent of the selling group is agent for the group. n32 The Common Parent remains the agent of the group for periods in which it was the Common Parent, even if it is no longer the Common Parent for current periods. n33 However, this is not the case if the former Common Parent is no longer a member of the Consolidated Group. n34 The Common Parent agent's actions will bind the former subsidiary. The former Common Parent of a sold subsidiary will receive any refunds from carrybacks by its former subsidiary. n35 When possible, purchasers should contract for the treatment of carrybacks and audit adjustments.

Special problems can occur when some members of an affiliated group are in cases under the Bankruptcy Code and other members are not. Interest on tax deficiencies may be assessed against the unfilled members, while not being permitted as claims against the members in title 11 cases. n36

Common parent in bankruptcy. The Tax Court held in *J & S Carborator Co. v. Commissioner* n37 that members not in a title 11 case are not entitled to file a Tax Court petition when the common parent is in a title 11 case. While a debtor is in bankruptcy, its right to petition the Tax Court is preserved under *I.R.C. section 6213(f)(1)* for the period during which the debtor is prohibited by reason of such case from filing a petition in the Tax Court and for 60 days thereafter.

Similarly, the IRS is precluded from making an assessment against the debtor common parent pursuant to *I.R.C. section 6213(a)* prior to the expiration of the period available to the debtor to file a Tax Court petition. The IRS is protected as the running of the statute of limitation on assessment is suspended under *I.R.C. sections 6503(h)* and *6503(a)(1)* for the same period. Further, *I.R.C. section 6503(a)(2)* provides that if a notice of deficiency is mailed to a corporation, the suspension of the period of limitations provided in *I.R.C. section 6503(a)(1)* shall apply to corporations with which such corporation made a consolidated income tax return for the taxable year. Based on *I.R.C. section 6503(a)(2)*, the IRS concluded that the period of limitations for assessment against the subsidiaries with which the debtor common parent filed a consolidated return is suspended if the period of limitation against the common parent is suspended under section 6503(a)(1). n38 The IRS further noted that the suspension of the running of the statute of limitations against nondebtor subsidiaries "is consistent with the principle that the nondebtor subsidiaries cannot petition the Tax Court" (i.e., see holding in the above cited J & S Carburetor case).

Subsidiary is in bankruptcy. Unlike the case in which the common parent is in bankruptcy, the law is unclear when only a subsidiary member of the Consolidated Group is in bankruptcy. A debtor subsidiary may attempt to prevent the common parent from filing a petition with the Tax Court on the grounds that such filing violates the automatic stay under *Bankruptcy Code section 362(d)*. The debtor subsidiary could argue, based on *Treasury Regulation sections 1.1502-2, -6 and -11*, that the determination of tax liability against the common parent would be equivalent to the determination of the tax liability against the debtor subsidiary. There is no authority that would allow the common parent to split itself off from its debtor subsidiary and file a petition with the Tax Court only with respect to the tax deficiencies arising out of activities of non-debtor members of the Consolidated Group. n39 If the common parent's petition with the Tax Court is rejected, such common parent should argue that *I.R.C. section 6213(f)* should be interpreted to suspend the 90 day filing period not just for the "debtor" but also for each entity that joins the filing of the consolidated return with the debtor. Such broader interpretation of *I.R.C. section 6213(f)* is consistent with *I.R.C. section 6503(f)(2)* which suspends the statute of limitations for the IRS to assert the deficiency against all companies that joined the filing of the consolidated return with the debtor. The Bankruptcy Court recently considered the following facts. A parent corporation filed consolidated federal income tax returns for three tax years, for itself and affiliated corporations, including the debtor. n39a Subsequently, the debtor became a subsidiary of a different corporation and, together with that corporation, commenced Chapter 11 proceedings. The debtor sought tax refunds for the years that its former parent corporation filed consolidated returns. The Bankruptcy Court dismissed former-subsubsidiary debtor's tax refund claim against the Service holding that a former subsidiary member of a consolidated group is not a proper party to seek the refund or credit where a consolidated tax return was filed by the parent corporation. The Bankruptcy Court held that pursuant to *Treasury Regulation section 1.1502-77(a)* the former parent corporation was the only agent authorized to act in matters relating to the tax liability for the consolidated return years and that to hold otherwise would require the court to determine tax liability of non-debtors. The Bankruptcy Court recognized, however, that it has jurisdiction over issues relating to whether or not potential tax refunds constitute property of the bankruptcy estate of the former-subsubsidiary and that its ruling dismissing the action against the Service did not bar action against the former parent corporation such as to require the parent to protect debtor's interests, if such was determined to be necessary. It remains to be seen what actions the court might require a former parent corporation to undertake to protect former-subsubsidiaries' rights to a portion of the consolidated group's tax refund.

The former common parent of a sold subsidiary will receive any refunds from carrybacks by its former subsidiary, unless in the case of a "quickie refund" the former subsidiary was not a member of the Consolidated Group in the carryback year and thus was permitted to make an application under section 6411 for a tentative carryback adjustment of the taxes in its own name. n39b Where possible, purchasers should contract for the treatment of carrybacks and audit adjustments. n39c In a Chief Counsel Advice Memorandum, the Service recently concluded that section 6621(d) does not allow for the netting of interest between an overpayment of a consolidated group's income tax for one taxable year and an underpayment of a member's income tax for a prior taxable year because the consolidated group and the member are not "the same taxpayer" for purposes of both the overpayment and the underpayment and that section 6621(d) does not allow for the netting of interest between an overpayment of a consolidated group's income tax and an underpayment of a member's employment or excise tax because the consolidated group and the member are not "the same taxpayer"

for purposes of both the overpayment and the underpayment. n39d The Service reasoned that since the return is that of the group, the overpayment, and interest on overpayment, is also the group's, not that of any single member or subgroup of members.

[4] Old SRLY (Separate Return Limitation Year) Rules

A Separate Return Limitation Year ("SRLY") is, generally speaking, a year of a member (or predecessor) other than the Common Parent, during which it filed a separate return, or joined in the filing of a consolidated return with *another* group. n40

Example 15:

P is the Common Parent of a calendar year group consisting of P and S. S purchases all of the stock of T on June 30, 1992. T owns all of the stock of U. The years of T and U end on June 30, and preceding years are each SRLYs.

The application of the SRLY concept had been changed pursuant to Temporary Regulations, effective for taxable years beginning on or after January 1, 1997 and electively for prior years as well.

In *Notice 98-38*, n41 the Service, in response to complaints that the SRLY rules are too complex, proposed changing the rules to apply the section 382 concept to determine the SRLY limitation and to make the section 382 and SRLY limitations identical. In light of significant negative commentary, the proposal was dropped and Final Regulations, substantially similar to the Temporary Regulations (but with certain significant modifications) were published in June 1999. The remainder of this subsection describes the SRLY rules prior to the Temporary and Final Regulations.

The purchase of the Common Parent of a Consolidated Group or a chain of corporations will fragment the NOLs of those corporations. In accordance with *Treasury Regulation section 1.1502-79*, the consolidated NOLs of the target group are apportioned among the various corporations that were members of the target group. In the new acquiring group, the NOL of each target corporation is separately subject to its own SRLY limitations. n42 Thus, in the preceding example, the NOLs of T and U would each be subject to SRLY limitations and insofar as the new Consolidated Group is concerned it is irrelevant that T and U were previously part of the same Consolidated Group.

The separate return years of the Common Parent are not SRLYs, the so-called Lonely Parent rule. If the loss corporation Lonely Parent acquires a profitable target corporation, it may offset the subsequent consolidated profits by its own prior NOL. This result is of course subject to the limitations of *I.R.C. section 384* respecting built-in gains. *I.R.C. section 269* has not historically been applied to the situation of a loss corporation acquiring a profitable subsidiary. The Final Regulations make it clear, subject to the application of an anti-avoidance rule, that the Lonely Parent rule applies to built-in losses. n43

Proposed Treasury Regulations which would also have treated as SRLY NOLs, for carryback purposes, certain post-acquisition losses sustained by a member of a Consolidated Group that acquired the majority of its assets from a non-member in an *I.R.C. section 381(a)* carryover basis transaction were withdrawn. n44 These rules are now incorporated by a change in the definition of SRLY. n45 This prevents the Consolidated Group from carrying the losses generated by the target company's business back to prior consolidated return years of the group.

In effect, a NOL of an acquired corporation sustained in a SRLY and carried to the consolidated taxable year of the acquiring group is allowable as part of the consolidated NOL deduction only to the extent of the SRLY member's income. n46

Example 16:

The consolidated net income for 1992 of the P and S calendar year group is \$16,000 without regard to

the consolidated NOL deduction. Without S's income and deductions such consolidated income is \$9,000. The maximum usable carryover of S from its SRLYs for 1992 is \$7,000.

The SRLY limitations are constraints on the use of the consolidated return process to obtain benefits not otherwise available to corporations filing on a separate return basis. Thus the SRLY limitations can be avoided by liquidating or merging the loss member into a profitable member so that there will be a carryover of the NOL under *I.R.C. section 381(a)*. The profitable member may offset its predecessor's NOL against its own income. n47 The effect of *I.R.C. section 269(b)* upon the liquidation of a recently acquired subsidiary into its parent must be considered. n48 This provision was adopted to meet a perceived abuse not possible under former *I.R.C. section 334(b)(2)*, the predecessor of *I.R.C. section 338*. n49

The applicability of the usual separate return consequences of *I.R.C. section 381* to the consolidated return successor corporation in an *I.R.C. section 381* transaction also must be considered.

In addition to NOLs, the SRLY limitations apply to other tax attributes: investment credit carryovers, n50 foreign tax credit carryovers, n51 and capital loss carryovers. n52 Limitations similar to the SRLY limitations also apply to built-in losses and deductions. n53

[5] Final SRLY (Separate Return Limitation Year) Rules

The Final SRLY Consolidated Return Regulations filed in June 1999 make significant changes in the application of the SRLY concept to Consolidated Groups. First, in many circumstances in which a section 382 limitation applies to losses of a member or members of a Consolidated Group, a separate SRLY limitation will not apply. Second, fragmentation of the NOLs among the members of the former group is eliminated under certain circumstances. n54 This is a significant beneficial change. Third, the SRLY limitation contains a cumulative concept applicable to both NOLs and contribution to consolidated income. n55 Fourth, the built-in loss rules are coordinated for purposes of *I.R.C. section 382* and SRLY. n56 Fifth, the subsidiary "offspring rule" is significantly altered. n57 While references herein are to NOLs, substantially similar rules apply to capital losses and *I.R.C. section 1231* losses. n58

The Final Regulations introduced the "overlap rule." Generally, this eliminates the applicability of the SRLY rules to losses (other than recognized built-in losses, which are covered by their own overlap rule, see below) of a member to which a section 382 limitation applies with respect to an ownership change that occurred (or occurs) within six months of the member joining the Consolidated Group. n59 Literally, this rule would not seem to apply to members that have qualified for (and not elected out of) treatment under section 382(l)(5). Special operating rules apply when the ownership change does not occur on the same date that the member(s) enter the Consolidated Group, which may affect the taxable years for which the SRLY rules do not apply. n60 The overlap rule only applies to a SRLY subgroup (as contrasted to separate application to its members) if it has the exact same members as a loss subgroup for section 382 purposes. n61 It is unclear whether the overlap rule applies to separate members of a SRLY subgroup which are members of a "non-matching" loss subgroup to which a subgroup section 382 limitation applies.

The Temporary Regulations introduced (and the Final Regulations retained) the subgroup concept and thus generally eliminate the fragmentation of NOLs among the members of the former Consolidated Group when that group ceases to exist or previously affiliated members leave the old group at the same time. n62 Fragmentation is retained for certain built-in losses, unless the subgroup members have been continuously affiliated in the old group for at least sixty months prior to joining the current consolidated group and until the year the built-in loss is recognized. n63

Example 17:

P is the Common Parent of a calendar year group consisting of P and S. S purchases all of the stock of T on July 31, 1999. T owns all of the stock of U. Under the regulations the years of T and U ended on July 31, and preceding years are each SRLYs and any NOLs of T and U would have been fragmented under

the prior regulations. Under the Final (and Temporary) Regulations, provided they remain continuously affiliated, T and U constitute a SRLY subgroup. The NOLs of the subgroup from the old T Consolidated Group are aggregated and the income of both T and U is taken into account in determining the SRLY limitation of the subgroup.

Fragmentation is also retained as an anti-avoidance consequence. n64

The members of the old group can also form a loss group for Consolidated *I.R.C. section 382* purposes provided they are continuously affiliated with each other in the new group under *I.R.C. section 1504(a)(1)* (including having their own subgroup common parent). n65 Thus if previously affiliated acquired corporations simultaneously become brother-sister corporations in the new group with a new sub-parent, they do not constitute a Consolidated *I.R.C. section 382* loss subgroup (unless an election is made) even though the former group members may constitute a SRLY subgroup with respect to a particular SRLY loss. n66 The subgroup definition is different with respect to built-in losses that are treated as SRLY losses.

The prior regulations generally limited the use of SRLY NOLs to the amount of the current year's consolidated income attributable to the SRLY member determined under a "with" and "without" calculation. The proposed regulations calculate the SRLY limitation on the basis of both the *cumulative* contribution of the SRLY loss member (or members if a SRLY loss subgroup is involved) to consolidated taxable income and the aggregate of the NOLs of the member (or members) that have been included in the consolidated NOL deduction of the group. If the aggregate contribution to consolidated taxable income exceeds the aggregate inclusion of the member's NOLs in consolidated NOL, then the SRLY NOLs can be used in the year to the extent of the lesser of excess contribution to income or the group's consolidated taxable income for the year. n67

The rules for carryovers and carrybacks of tax attributes are restated in the Final Regulations but generally follow the prior regulations. n68 Tax free transactions described in *I.R.C. section 381* between members will not result in a short year for the non-surviving member for purposes of the carryover rules. n69 The election to relinquish the carryback period with respect to a consolidated NOL must be made with respect to the entire Consolidated Group. n70 There are, however, exceptions for carrybacks of members that move from one consolidated group to another (but the waiver applies to all members that left the former group) and insolvent financial institutions. n71 The Final Regulations also expand the definitions of predecessors and successors to include *I.R.C. section 381(a)* transactions or transferred basis property transactions if there is a material built-in loss. n72 The purpose of these rules is to prevent the inappropriate use of tax attributes to circumvent SRLY limitations.

The "offspring rule" of the prior regulations n73 is changed. n74 The losses of a continuously affiliated newly organized member are included in the consolidated NOLs of the group for years before the member's existence. If there were no prior consolidated return years, then the loss can be carried to the Common Parent's separate return year, but only if the Common Parent was not a member of a different Consolidated Group or an affiliated group filing separate returns. The Common Parent must truly be a "lonely parent" in such carryback years.

A NOL that is attributable to a SRLY need not be separately tracked for purposes of *I.R.C. section 382* if the member or the loss subgroup has an ownership change within six months before, on, or after joining the new group. n75 In addition, in the absence of an ownership change, separate tracking of a SRLY NOL for purposes of *I.R.C. section 382* ceases at the end of the fifth consecutive period after the member or loss subgroup joins the new Consolidated Group. n76 Nevertheless, the SRLY taint is *not* eliminated for purposes of determining how much of the SRLY NOLs or built-in losses may be absorbed by the new group under *Treasury Regulation sections 1.1502-21(c)* or -15 in the post change years.

The Final SRLY rules generally apply to all taxable years for which the due date of the return (without extensions) is after June 25, 1999. Various special effective date rules can be found in *Treasury Regulations section 1.1502-21(h)*.

Except for certain subsections identified herein, the Temporary SRLY rules by their terms apply to deductions and losses that may be used in taxable years beginning on or after January 1, 1997 and for which the due date of the return (without extensions) is on or before June 25, 1999. n77 The prior rules, as amended, apply to taxable years beginning prior to such time. n77a However, the consolidated group may elect to have the Temporary Regulations apply to all consolidated return years ending on or after January 29, 1991, under certain conditions. n78

On May 24, 2005, the Treasury issued a notice of proposed rulemaking regarding dual consolidated losses under *I.R.C. section 1503(d)*. n78a *I.R.C. section 1503(d)* generally provides that a dual consolidated loss of a dual resident corporation cannot reduce the taxable income of any other member of the affiliated group unless, to the extent provided in regulations, such loss does not offset the income of any foreign corporation. The proposed regulations address various dual consolidated loss issues, including exceptions to the general prohibition against using a dual consolidated loss to reduce the taxable income of any other member of the affiliated group. A detailed analysis of these proposed rules are beyond the scope of this chapter, but the reader should keep in mind that the Treasury proposed to treat a dual consolidated loss as a loss incurred by the dual resident corporation or separate unit in a separate return limitation year and shall be subject to all of the limitations of *Treasury Regulations section 1.1502-21(c)* discussed above, with certain modifications.

[6] Old Built-in Deduction Rules

A built-in deduction in general is a deduction of a corporation recognized in a consolidated return year, but which is economically accrued in a SRLY. n79 The concept is similar to the built-in loss rules of *I.R.C. section 382*. n80 The built-in deduction limitations of the prior Consolidated Return Regulations did not disallow the deduction to the loss member in calculating its taxable income, but limited its use against consolidated income. n81

Example 18:

At the time T is acquired in December 1991 from I, an individual, by S of the unrelated P and S calendar year group, T owns one *I.R.C. section 1231* asset with a fair market value of \$10 and a basis of \$100. The \$90 represents the potential for the built-in deduction. If the asset were sold for \$10, the \$90 *I.R.C. section 1231* loss would be a built-in deduction. To the extent not offset by T's income, it is subject to SRLY limitations. The depreciation deductions attributable to the \$90 difference are treated as built-in deductions and subject to SRLY limitations if not offset by T's income. For purposes of *I.R.C. section 382*, T is a loss corporation, the purchase also is an ownership change and the built-in deduction may also be part of a net unrealized built-in loss.

Under the prior Consolidated Return Regulations the consequences of built-in deduction characterization could be avoided if (i) the assets were acquired by the group ten years before the taxable year of recognition, or (ii) the aggregate adjusted basis of all the assets (other than cash, marketable securities and goodwill) immediately prior to their acquisition by the group did not exceed their fair market value by more than fifteen percent. n82

The built-in deduction limitations did not disallow the deduction to the loss member in calculating its taxable income. Thus, as with the general SRLY limitation, the built-in deduction limitation may be avoided by liquidating the loss member under *I.R.C. section 332* into a profitable member (carefully avoiding adverse consequences of *I.R.C. sections 338* and *269(b)*). A merger into a profitable member in an *I.R.C. section 381* transaction could also avoid the limitation.

[7] Final SRLY Built-in Loss Rules

Treasury Regulation section 1.1502-15 essentially adopts the *I.R.C. section 382* definitions of built-in losses, including the new threshold rules. n83 Losses characterized as built-in losses are treated as hypothetical net operating losses or capital losses arising in the year of recognition and such year is treated as a SRLY.

The overlap rule for built-in losses is very similar to the overlap rule for NOL's. n84 The built-in loss overlap rule does not require that the size of the built-in loss be the same at the time of the ownership change and of joining the Consolidated Group. n85 Anti-avoidance rules (although not so entitled) apply for contributions of built-in loss assets to corporations between the time of an ownership change and joining a Consolidated Group (or vice versa). n86 The overlap rule specifically does not apply to assets acquired after the occurrence of both the SRLY and section 382 events. n87

Losses disallowed or deferred under the Consolidated Return intercompany transaction rules generally are not treated as recognized until allowed under such rules. n88 Built-in losses are determined on a corporation by corporation basis unless a corporation is at the time it is acquired treated as a member of a subgroup. Corporations are treated as members of a subgroup for built-in loss purposes if they have been continuously affiliated with each other for the 60-month period immediately before they become members of the consolidated group in which the built-in loss is recognized. n89 Corporations that are members of a subgroup compute their net unrealized built-in losses by looking at the aggregate of the unrealized built-in gains and losses of the subgroup members. For purposes of the overlap rule, members of one Consolidated Group that have built-in losses subject to the overlap rule will be treated as having been affiliated for 60 months with the Common Parent of that group and any members affiliated with the Common Parent at the time those members become members of another Consolidated Group. n90

If a corporation or subgroup has a built-in loss that exceeds the threshold requirement, the *entire* unrealized loss is treated as a built-in loss for purposes of the *Treasury Regulation section 1.1502-15* rules to the extent such loss is recognized during the five-year recognition period.

These rules have similar effective dates to the regular SRLY rules. n91

[8] Prior Consolidated I.R.C. section 382 Rules

The Consolidated Return Regulations had their own *I.R.C. section 382* limitations on survival of NOLs. n92 They had not been modified to account for the Tax Reform Act of 1986 adoption of *I.R.C. section 382*, but have been replaced by the Temporary Consolidated Return *I.R.C. section 382* rules. n93

Under the prior rules, if at the end of any year there had been an old section 382(a) change of ownership in the Common Parent, then the carryovers of any subsidiary that had not continued to carry on substantially the same trade or business would be disallowed. n94 Note that this rule was more lenient than were the normal ownership change rules under old section 382(a) because it was possible to have a change of ownership at the subsidiary level and not at the Common Parent level.

An interesting issue arises as to how taxpayers should apply *I.R.C. section 382* in the consolidated return context in years prior to the effective date of the Temporary Consolidated *I.R.C. section 382* rules. n95 The Temporary Regulations assume that the principles of *I.R.C. section 382* apply in the consolidated return context despite the absence of an amendment to the Consolidated Return Regulations. n96 While the Temporary Regulations are effective for testing dates occurring on or after January 1, 1997, they provide that a taxpayer may consistently apply rules that do not materially differ from the proposals, a reasonable application of the rules of *I.R.C. section 382* and the regulations thereunder applied to each member on a separate entity basis (and avoiding duplication of benefits), or a method approved by the Commissioner on application. n97

[9] The Consolidated Return I.R.C. section 382 Regulations

On June 26, 1996, the IRS filed three sets of Temporary (and final in some instances) Regulations. One set involved various consolidated return issues, including a repeal of the Consolidated Return Change of Ownership rule and a major overhaul of the SRLY rules. n98 A second set involved the application of *I.R.C. section 382* in the controlled group

context, which will be discussed briefly below. n99 A third set dealt with the application of *I.R.C. section 382* in the consolidated return context. n100 On June 25, 1999, the IRS issued Final Regulations making some important changes, but retaining many features of the Temporary Regulations. The third set of Final Regulations (*Treas. Reg. sections 1.1502-90 through 1.1502-99*) will be the main focus of the remainder of this chapter.

The Final Regulations still generally take a single entity approach with respect to an affiliated group filing a consolidated return for purposes of *I.R.C. section 382*. Therefore, in general, ownership changes are determined and the *I.R.C. section 382* limitation is applied on a Consolidated Group-wide basis. n101

[a] Loss Groups and Subgroups

The single entity approach is applied to "loss groups" and "loss subgroups." A "loss group" is defined as a Consolidated Group that (i) is entitled to use a NOL carryover that did not arise and is not treated as arising in a SRLY; (ii) has a consolidated NOL ("CNOL") for the taxable year in which a testing date of the common parent occurs; or (iii) has a net unrealized built-in loss. n102

A "loss subgroup" is defined as two or more corporations that become members of a Consolidated Group if (i) they were affiliated with each other in another group (whether or not such group was a consolidated group); (ii) bear a relationship to each other described in *I.R.C. section 1504(a)(1)* (i.e., they have a common parent among themselves) immediately after they become members of the Consolidated Group (or are deemed to bear that relationship as a result of an election to treat them as such); and (iii) either (a) at least one of the members carries over a NOL that did not arise and is not treated as arising in a SRLY with respect to the former group, or (b) the members have been continuously affiliated for the five consecutive years prior to joining the Consolidated Group and they have a net unrealized built-in loss. n103

The IRS has reconsidered the need to have a loss subgroup common parent. The Common Parent of a Consolidated Group that acquires members at the same time that were affiliated with each other immediately before joining the Group can elect to treat such new members for purposes of the loss subgroup rules as if they met the section 1504(a)(1) requirement. The "cost" of making such an election is that all members joining the Consolidated Group from the affiliated group must be part of the loss subgroup and each member will be treated as the common parent of the subgroup, thus requiring each such member to be separately tracked for ownership change purposes of the loss subgroup. This latter rule does not apply with respect to an ownership change of a loss subgroup member upon leaving the Consolidated Group. It should be noted that the rules also permit a reconfiguration of the members of the former Consolidated Group that are being transferred to the new Consolidated Group such that they can meet the requirement stated in the immediately preceding paragraph. n104

An anti-abuse rule will ignore a loss subgroup if any of its members were formed, acquired or availed of with a principal purpose of avoiding the application of or increasing the *I.R.C. section 382* limitation. n105 The rearrangement of members discussed above would not, by itself, trigger this anti-abuse provision. n106

[b] Determining an Ownership Change for a Loss Group or Loss Subgroup

In general, a loss group or a loss subgroup has an ownership change when the Common Parent of the loss group or loss subgroup, respectively, has an ownership change. For this purpose, the CNOLs described above n107 are treated as losses of the Common Parent of the loss group and loss subgroup, respectively; and only those losses are taken into account for determining when the testing period begins. n108 This method will hereinafter be referred to as the "Parent Change Method."

Example 21:

A (an individual) has always owned all of the stock of L. L and B (an individual) have always owned

80% and 20%, respectively, of the stock of L1. L and L1 file a consolidated return and have a CNOL carryforward from 1996 to 1997. On August 15, 1997, A sells 51% of his L stock to C.

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The L Group has experienced an ownership change. This is the case even though L1 would not have experienced an ownership change if viewed separately.

Example 22:

Same facts as Example 21, except that A sells only 49% of his L stock to C and on the same day in a wholly unrelated transaction B sells her 20% interest in L1 to D. Here, the L Group does not experience an ownership change even though L1 would have experienced an ownership change if viewed separately. See Example 26 below for the treatment of the Consolidated Group if the purchases by C and D were pursuant to a plan or arrangement.

Example 23:

A owns all of the stock of corporation M. M owns 35% and B owns 65% of the stock of L, which owns all of the stock of L1. The L Group has a CNOL arising in 1996. On May 19, 1997, B sells 45% of the stock of L to M. M, L and L1 thereafter file consolidated returns. The M Group has a CNOL arising in 1997. On June 9, 1998, A sells 70% of the M stock to C.

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When L and L1 join the M Group, they constitute a loss subgroup that has not yet experienced an ownership change. Their losses, however, are tracked separately within the subgroup. When A sells 70% of the M stock to C, both the M Group and the L loss subgroup experience an ownership change. The CNOLs of the M Group (including those apportioned to L and L1 for the period after their affiliation with M) will have a separate *I.R.C. section 382* limitation from the NOLs of the L loss subgroup (with respect to the losses generated prior to joining the M group).

Example 24:

Same facts as in Example 23, except that A only sells 30% of the M stock to C. Here, only the L loss subgroup experiences an ownership change. Thus, only the NOLs of L and L1 generated prior to joining the M group are subject to the *I.R.C. section 382* limitation. Neither the CNOLs apportioned to M or to L or L1 for the 1996 or 1997 consolidated return years are subject to an *I.R.C. section 382* limitation.

Special conforming rules are provided for successor parent corporations of groups and loss subgroups. If a parent of a loss subgroup has not been the loss subgroup parent for at least three years as of a testing date, "appropriate adjustments must be made to take into account owner shifts of members of the loss subgroup so that the structure of the loss subgroup does not have the effect of avoiding an ownership change under section 382." n109 The Regulations do not specify how such appropriate adjustments are to be made.

There are special supplemental rules for determining whether a loss group or loss subgroup has had an ownership change to prevent abuses of the Parent Change Method. These rules will be referred to as the "Supplemental Change Method." The Supplemental Change Method applies in addition to, and not instead of, the Parent Change Method. n110 Thus, the Supplemental Change Method can only be used to cause an ownership change, not prevent one resulting under the Parent Change Method.

The Supplemental Change Method applies to a loss group or loss subgroup if, during a testing period, any 5-percent shareholder of the Common Parent or loss subgroup parent increases its percentage ownership interest in both the

respective parent and a subsidiary of the respective group (other than by a direct or indirect acquisition of the respective parent). n111 The Supplemental Change Method provides that the loss group or loss subgroup parent is treated as though it had issued the same value of its own stock as that of the stock of the subsidiary acquired (or deemed acquired). n112 A similar principle applies in the case of a redemption. n113 This provision concerning redemptions is somewhat ambiguous in that it does not explain how the values are to be calculated. In valuing the stock of the appropriate parent, the value of all outstanding subsidiary stock not held by members of the respective loss group or subgroup (or at least the value of any subsidiary stock subject to the Supplemental Change Method) should be added back to the value of the parent. Otherwise, the resulting percentage increase in the parent will be too high.

Example 25:

A owns all the stock of L with a value of \$55. L has a NOL carryforward to 1997. On July 16, 1997, L transfers all of its assets and liabilities to a newly created subsidiary, S, in exchange for all the S stock. L and S thereafter file consolidated returns. On November 23, 1997, B contributes \$45 of cash to L in exchange for a 45% ownership interest in L and contributes \$13.75 of cash to S for a 20% ownership interest in S.

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Since B is a 5-percent shareholder of L, the Supplemental Change Method must be applied to his acquisition of the S stock. The Proposed Regulations would treat B as acquiring an additional \$13.75 worth of L stock. But they do not tell us how B is deemed to acquire such stock. Does B get the stock by a deemed contribution of \$13.75 to L? In that case, B would be deemed to own 51.65% (\$48.75 + \$113.75), resulting in an ownership change for the L loss group. This appears to be the correct approach since B should be treated as if all of his capital contribution was made to L.

If B had only acquired 10% of S with a \$6.11 capital contribution, L should only have an owner shift of 48.17% (\$51.11 + \$106.11) under the Supplemental Change Method. This gives the same result as if B had contributed \$51.11 directly to L.

Special operating rules provide that a 5-percent shareholder of a loss group or loss subgroup parent is treated as increasing its percentage ownership interest in a parent or subsidiary if pursuant to a plan or arrangement under which such 5 percent shareholder increases the percentage ownership in the Common Parent, any person or persons increases its percentage ownership interest in the stock of a subsidiary. n114 It is also provided that solely for purposes of the Supplemental Change Method, the rules of *I.R.C. section 382(l)(3)*, Temp. Treas. Reg. section 1.382-2T(h) and *Treas. Reg. section 1.382-4(d)* (relating to constructive ownership) apply with respect to the stock of the subsidiary as if it were stock of a loss corporation. n115 The Regulations give an example where a public offering of a subsidiary's stock was part of a plan that included a sale of 49% of the parent stock to an individual. The public offering would be covered by the Supplemental Change Method. n116

There is also a backstop anti-abuse rule in case the Supplemental Change Method can be avoided. n117 This can occur if a subsidiary with losses is part of a group with relatively more valuable members. This method only applies when the Supplemental Change Method does not result in an ownership change, but the subsidiary would have an ownership change if treated as a separate corporation. It will be referred to as the "Subsidiary Change Method."

The Subsidiary Change Method applies if (i) the deemed exercise, pursuant to *Treas. Reg. section 1.382-4(d)*, of an option or options (other than options with respect to the stock of the Common Parent) would result in the acquisition of more than 20% of the stock of a subsidiary or (ii) one or more 5-percent shareholders, acting pursuant to a plan or arrangement to avoid an ownership change of a subsidiary, increases their percentage ownership interest in the subsidiary by more than 50 percentage points during the testing period of the subsidiary through actual or deemed acquisition of ownership interests in the subsidiary and in higher-tier members with respect to the subsidiary. n118

Example 26:

L owns all the stock of L1, which owns all the stock of L2, which owns all the stock of L3, which owns all the stock of L4. The L group has a CNOL carryforward to 1998, a significant part of which is attributable to L4. L has assets other than its L1 stock worth \$900. L1, L2 and L3 have no assets other than their subsidiary stock. L4 has assets worth \$100. Pursuant to a plan to avoid an ownership change of L4, A, B, C and D buy 20% of the stock of L1, L2, L3 and L4, respectively, during 1998.

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The acquisitions by A, B, C and D pursuant to the plan have increased their respective percentage ownership interests in L4 by 10.24, 12.80, 16 and 20%, resulting in a total owner shift of 59.04%. Thus, under the Subsidiary Change Method, L4 has experienced an ownership change.

If a subsidiary experiences an ownership change as a result of the Subsidiary Change Method, the *I.R.C. section 382* limitation applies to such subsidiary as if the subsidiary were not a member of a group filing a consolidated return and as if its pre-change losses included its allocable part of any CNOLs that are not carried back and absorbed in a prior taxable year and any of its NOLs arising in a SRLY. n119

A member or loss subgroup that joins a group can cease separately to track its owner shifts on the earlier of the time the member or loss subgroup experiences an ownership change within six months before, on, or after becoming a member of the group or five consecutive years after becoming a member of the group. n120 This means that if a member or loss subgroup experiences an ownership change upon becoming a member (or members) of the group, separate tracking of that member's or subgroup's owner shifts is not necessary. This does not mean, however, that the member's or subgroup's SRLY losses or built-in losses at the time of the ownership change are not subject to the limitation resulting from that ownership change.

[c] Special Information Statement

The Common Parent of a Consolidated Group with members that are loss corporations must file an information statement for the group due to any owner shift, equity structure shift, or other transactions resulting in shifts in ownership. n121 The statement must include the following: (i) information regarding owner shifts with respect to common parent stock or subsidiary stock which must be taken into account under the Supplemental Change Method; (ii) information regarding ownership changes of subsidiaries under the Subsidiary Change Method; and (iii) information regarding ownership changes of loss subgroups and separate loss members (while separate tracking is in force). The loss subgroup parent or the separate loss member is, however, still required to maintain records necessary to determine if the loss subgroup or separate loss member has an ownership change (while separate tracking is in force), even though owner shifts need not be reported. n122

[d] Consolidated (or Subgroup) I.R.C. section 382 Limitation

Following an ownership change under either the Parent Change Method or the Supplemental Change Method, the consolidated *I.R.C. section 382* limitation (or the subgroup *I.R.C. section 382* limitation) for any post-change year is an amount equal to the value, immediately before the ownership change, of the loss group (or loss subgroup) multiplied by the long-term tax-exempt rate. n123 The value of a loss group or subgroup is the aggregate value of the stock of each member, other than stock owned directly or indirectly by another member. n124

Example 27:

L, L1 and L2 compose a Consolidated Group. L, the Common Parent, has outstanding stock worth \$100. L1 has outstanding common stock worth \$40, owned 90% by L and 10% by A. A also owns all of L1's outstanding preferred stock described in *I.R.C. section 1504(a)(4)*, worth \$30. L2 has outstanding

common stock owned 50 percent by each of L and L1.

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The value of the L group for purposes of computing the consolidated *I.R.C. section 382* limitation is \$134. This is determined by adding to the \$100 value of the L stock, 10 percent of the value of the L1 common stock held by A (\$4) and the value of the section 1504(a)(4) stock of L1 held by A (\$30).

A member is considered to indirectly own stock of another member through a nonmember only if the member has a 5% or greater ownership interest in the nonmember. n125

Example 28:

L and L1 compose a consolidated group. L owns 80% of L1's stock; M owns the remaining 20%. L owns 79% of M's stock; the public owns the remaining 21%. L's stock has a value of \$100 and L1's stock has a value of \$100.

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The value of the L group includes only the value of L's stock plus the portion of the L1 stock owned by M that is not indirectly owned by L since L owns more than 5% of M. Thus, the value of the L group is \$104.20 (\$100 + 21% of \$20).

The value of a loss group or subgroup is reduced under the general rules for reducing value under *I.R.C. section 382*. n126 However, redemptions and corporate contractions that do not effect a transfer of value outside of the loss group (or subgroup) are disregarded, contributions between members of a loss group (or subgroup) are ignored and the substantial non-business asset test is applied on a loss group (or subgroup) basis, not member by member. The value of a loss group or subgroup is also adjusted to prevent any duplication of the value of the stock of a member. n127

[e] Built-in Gains and Losses

Net unrealized built-in gain or loss of a loss group or subgroup is determined by aggregating the separately computed (taking into account built-in income and deduction items) net unrealized built-in gains or losses of each member that is included for this purpose. n128 The threshold requirement under *I.R.C. section 382(h)(3)(B)* applies to the group or subgroup in the aggregate and not on a member-by-member basis. For built-in loss purposes, members compose a loss subgroup if they have been continuously affiliated for 5 years prior to joining the Consolidated Group, bear (or are deemed to bear) a section 1504(a)(1) relationship to each other through a loss subgroup Common Parent and have a net unrealized built-in loss in the aggregate. n129 The 5 year affiliation requirement is deemed to be satisfied for members of an affiliated group that would otherwise constitute a loss subgroup if separate tracking does not apply due to an ownership change upon joining a Consolidated Group. n130 All members of a Consolidated Group are included in determining whether a loss group has a net unrealized built-in gain. n131 Members included in determining whether a loss subgroup has a net unrealized built-in loss are the Common Parent and all members of the loss group affiliated with the Common parent for the 5 consecutive years preceding the determination date, any other member that has a net unrealized built-in loss on the determination date and is not a new loss member or a member of a loss subgroup, any new loss member that has a net unrealized built-in gain on the determination date and the members of a loss subgroup if the subgroup has a net unrealized built-in gain on the determination date. n132 Members included in determining whether a loss subgroup has a net unrealized built-in gain are all members of the loss subgroup on the determination date. n133 Members included in determining whether a loss subgroup has a net unrealized built-in loss are all members that had been continuously affiliated with each other for 5 years (or are deemed to be affiliated for 5 years) before they became members of the group and bear (or are deemed to bear) a section 1504(a)(1) relationship to each other through a loss subgroup parent. n134

Net unrealized built-in gain or loss with respect to stock (or an intercompany obligation) of members included in the loss group or subgroup for this purpose are not taken into account in determining the consolidated or subgroup net unrealized built-in gain or loss. n135 The net unrealized built-in gain or loss with respect to stock (or an intercompany obligation) of members excluded from the loss group or subgroup for this purpose are taken into account.

Amounts deferred under *I.R.C. section 267* or under *Treasury Regulation section 1.1502-13*, other than amounts deferred with respect to stock (or intercompany obligations) of a member that is included in the loss group or subgroup for this purpose, are to be taken into account as built-in items. n136

An anti-abuse rule prevents a member, group or subgroup from taking into account assets acquired with the principal purpose of affecting the amount of net unrealized built-in gain or loss. n137 Moreover, a member's separately computed net unrealized built-in gain or loss is required to be adjusted to the extent necessary to prevent any duplication of unrealized built-in gain or loss attributable to the member's indirect ownership interest in another member through a non-member if the member has a five percent or greater ownership interest in the non-member. n138 The Regulations give no further guidance as to how to implement this requirement.

Example 29:

L owns all of the stock of L1 and L2 with respective bases of \$70 and \$50 and respective values of \$30 and \$25. L owns one other asset with a value of \$25 and a basis of \$40. L1 has assets with an aggregate value of \$30 and an aggregate basis of \$15. L2 has assets with an aggregate value of \$50 (it also has \$25 of debt) and an aggregate basis of \$20.

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The Consolidated Group has an aggregate asset value of \$105 and an aggregate asset basis of \$75. Therefore the group has a net unrealized built-in gain of \$30, which exceeds the threshold of \$15.75 (15% of \$105). This is the case even though on a separate company basis L would have a substantial built-in loss.

The Final Regulations have reserved the general rules regarding the recognition of built-in gains and losses. n139 Gain or loss recognized on the disposition of stock of another member is taken into account (unless disallowed under the loss disallowance rules n140 or otherwise) in determining recognized built-in gain or loss, even though such built-in gain or loss was not taken into account in determining net unrealized built-in gain or loss. Gain or loss recognized by a member with respect to an intercompany obligation is treated as recognized gain or loss only to the extent the transaction gives rise to aggregate income or loss within the Consolidated Group. n141 Thus, it appears that a loss group or subgroup must keep track of the built-in gain or loss on stock (or intercompany obligations) of members for purposes of this provision.

Deferred gain or loss under the intercompany transaction and similar provisions is treated as recognized built-in gain or loss only to the extent it is restored during the recognition period. n142 Exchanged basis (also known as substituted basis) property, in whole or in part, is to be treated, with certain undisclosed "appropriate adjustments," as if it were the asset for which it was exchanged, for purposes of built-in gain or loss recognition. n143

[f] Continuity of Business Requirement

A loss group or loss subgroup is treated as a single entity for purposes of determining whether the continuity of business enterprise requirement of *I.R.C. section 382(c)(1)* is satisfied. n144 An example in the Temporary Regulations indicates that when three members of a loss group each have separate lines of business of equal value, *only one* of those businesses must be continued for the requisite two-year period in order to satisfy the continuity of business enterprise requirement. n145

[g] Members Leaving a Consolidated Group

When a member leaves a Consolidated Group or loss subgroup that has already experienced an ownership change, a decision must be made as to the apportionment of any preexisting consolidated or subgroup *I.R.C. section 382* limitation. *Treasury Regulation section 1.1502-95(c)* provides that the Common Parent (not the subgroup parent) may elect to apportion any amount of the consolidated or subgroup *I.R.C. section 382* limitation to the departing member. The Regulations divide the *I.R.C. section 382* limitation into two elements: (i) the "value element" consisting only of the amount of the annual limitation based upon the value multiplied by the long-term tax-exempt rate as provided in *I.R.C. section 382(b)(1)*, and (ii) the "adjustment element" consisting of any *I.R.C. section 382* limitation carried over from prior years pursuant to *I.R.C. section 382(b)(2)*.ⁿ¹⁴⁶ The Regulations permit the Common Parent to allocate any portion of either or both of such elements to the departing subsidiary or subgroup. It is important to note that the import of such an allocation election is that departing members receive no allocable portion of the consolidated *I.R.C. section 382* limitation without such an allocation election, even though portions of the consolidated NOL may be apportioned to the departing members by operation of *Treasury Regulation section 1.1502-21(b)*. Similarly, the Common Parent may elect to apportion any part of the remaining unrealized built-in gain of the Consolidated Group.

A loss group (or subgroup) is required to allocate to a departing member a portion of the remaining balance of the loss group's (or subgroup's) net unrealized built-in loss. The portion allocated is a fraction, the numerator of which is the amount of built-in loss, as determined on the original ownership change date, in the assets held by the departing member immediately after leaving the loss group (or subgroup). The denominator is the numerator plus the amount of built-in loss, as determined on the original ownership change date, in the assets held by the loss group or subgroup immediately after the close of the taxable year in which the member ceased to be a member.

If the departing member or subgroup experiences an ownership change when it leaves the group, the *I.R.C. section 382* limitation that applies, if more restrictive than the amount of the consolidated *I.R.C. section 382* limitation allocated to such departing member or subgroup, will override the allocated consolidated *I.R.C. section 382* limitation.ⁿ¹⁴⁷ Thus, in determining how much of the consolidated *I.R.C. section 382* limitation to allocate to departing members, the Common Parent should take into consideration any additional *I.R.C. section 382* limitation that may apply to the departing members.

Treasury Regulation section 1.1502-96(d)(4) provides that if a Common Parent elects to reattribute losses to itself pursuant to *Treasury Regulation section 1.1502-20(g)* (see P TX 11.08[11][b] *infra*), it may also elect to reattribute to itself all or part of any separate section 382 limitation of the departing member.

[10] Loss Disallowance Rules

Treasury Regulation sections 1.1502-20 and *1.337(d)-2* generally disallow the deduction of any loss recognized upon the "disposition" of the stock of a member of the Consolidated Group (the "loss disallowance rules") after February 1, 1991. *Treasury Regulation sections 1.337(d)-1* and *-2* provide transitional rules for stock dispositions not covered by the general rule.

It was initially contemplated that the new temporary regulations would implement *I.R.S. Notice 87-14*.ⁿ¹⁴⁸ The notice purportedly was supposed to prevent the use of the "son of mirrors" device for avoiding the legislative repeal of the *General Utilities* doctrine in the 1986 Code. The son of mirrors device utilized the investment adjustment rules of the Consolidated Return Regulations to avoid a double tax on assets having built-in gains in corporate solution.ⁿ¹⁴⁹

Example 30 :

Corporation T has one asset with a basis of zero and a fair market value of \$100. If corporation P buys the stock of T for \$100, P could sell the asset without paying tax on the gain if T filed a consolidated tax return with P. When T sold the asset for \$100, \$100 of gain would be recognized and P would increase

its basis in the stock of T under the investment adjustment rules. n150 P would then own stock in T with a basis of \$200 and a fair market value of \$100. Prior to the loss disallowance rules, P could sell the stock of T for \$100, recognize a loss of \$100 and offset the \$100 of gain on the sale of T's asset. Thus, P would not pay a tax on the recognition of the built-in gain in T's asset. This is the basis of the son of mirrors device.

[a] Transition Tracing Rule

Notice 87-14 implied that some sort of tracing rule would be implemented in regulations to prevent the loss on the sale of the T stock in Example 32 from being recognized if the loss resulted from an investment adjustment caused by the recognition of built-in gain. This is effectively what has been provided in the transition rule of *Treasury Regulation sections 1.337(d)-1* and *-2*. They provide that the general loss disallowance rule does not apply to the extent that the taxpayer can prove that the loss did not arise from the recognition of a built-in gain of a T asset, if T was acquired after January 6, 1987, and the loss was recognized before November 19, 1990, or on or after that date if *Treasury Regulation section 1.1502-20* does not apply to the disposition.

The general loss disallowance rule does permit the Common Parent to elect to reattribute to itself the (non-SRLY) losses of the subsidiary whose stock was disposed of to the extent of the loss disallowed on the disposition. n151 This rule does not apply to the extent the subsidiary is insolvent or any intermediate subsidiary is insolvent. n152

The original loss disallowance rule of Temporary Treasury Regulation section 1.1502-20T, which was filed on March 9, 1990 (and later withdrawn), did not provide any exceptions for situations where the purchasing corporation may suffer an otherwise unrecognizable (for tax purposes) real economic loss. In the preamble to the loss disallowance rules, example 6 illustrates the problem. It postulates facts similar to Example 32 above, except that the asset value declines to zero before it is sold. Thus, corporation P has a real economic loss of \$100, but no way to recognize it for tax purposes. n153

It is important to note that certain problems created by the loss disallowance rules, with respect to dispositions of subsidiaries, can be avoided by making an election pursuant to *I.R.C. section 338(h)(10)*. Pursuant to *I.R.C. section 332*, this election, which must be made by both the buyer and seller, results in the treatment of the subsidiary as if it had sold its assets and then liquidated into its immediate parent. n154 Such treatment results in any losses recognized on the deemed asset sale being included in the seller's consolidated return, and any unused NOLs of the subsidiary being transferred to its immediate parent. n155

[b] General Loss Disallowance Rule

In September 1991, the Service adopted final regulations dealing with the loss disallowance rules, *Treas. Reg. section 1.1502-20*, which was essentially the same as the prior loss disallowance rule, except that it placed a ceiling on the amount of loss disallowed. The final regulation is essentially the same as the proposed regulation. The ceiling is equal to the sum of "extraordinary gain dispositions," "positive investment adjustments" and "duplicated loss."

Extraordinary gain dispositions are defined as actual or deemed dispositions of specified assets after November 18, 1990, resulting in a gain. A discharge of indebtedness is also an extraordinary gain disposition. Positive investment adjustments include all earnings and profits other than those attributable to extraordinary gain dispositions. Distributions are not permitted to offset positive adjustments for this purpose. Duplicated loss is defined as the excess of (i) the sum of asset bases (including the assets of lower tier subsidiaries on a "look through" basis), losses (including losses of lower tier subsidiaries) carried over to the subsidiary's first taxable year following disposition and any deferred deductions (including those of lower tier subsidiaries) over (ii) the sum of the value of the subsidiary's stock, any liabilities of the subsidiary and any other relevant items. However, in 2001, the United States Court of Appeals for the Federal Circuit held that the duplicated loss factor of *Treas. Reg. section 1.1502-20* is not a proper exercise of the

Treasury Secretary's regulatory authority under *Section 1502 of the Internal Revenue Code*. n156

The IRS, as stated in *I.R.S. Notice 2002-11*, n157 has decided that "the interests of sound tax administration will not be served by continuing to litigate the validity of the loss duplication factor of section 1.1502-20;" moreover, "because of the interrelationship in the operation of all of the loss disallowance factors," the IRS and Treasury have decided that new regulations governing loss disallowance on sales of stock of a member of a Consolidated Group should be implemented. The IRS also stated in *IRS Notice 2002-18* n158 that, because the Treasury Regulations do not disallow a stock loss that reflects NOLs or built-in asset losses of a subsidiary member, it intends 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.

However, Congress periodically proposes legislation that would uphold Treasury's consolidated return regulatory authority to treat corporations filing consolidated returns differently from corporations filing separate returns, and to overrule the *Rite Aid* decision to the extent that it suggests that the Secretary is required to identify a problem created by the filing of a consolidated return in order to issue regulations that change the application of a Code provision. n159 The American Job Creation Act of 2004 (P.L. 108-257) reaffirmed the tax administration's power to make legislative regulations for corporations filing consolidated returns. Section 844 of the new law provides that, in exercising its authority to issue consolidated return regulations, Treasury may issue regulations that treat corporations filing consolidated returns differently from corporations filing separate returns. The *Rite Aid* case consequently is limited to its facts. Section 844 of the new law does not prevent or invalidate the various approaches Treasury has announced it will apply to address "duplicated losses." n159a

On March 12, 2002, the Treasury issued Temporary Treasury Regulations, n160 that set forth rules governing a Consolidated Group's allowable loss, or basis reduction, on a disposition or deconsolidation of subsidiary stock. n161

For dispositions and deconsolidations of subsidiary stock on or after March 7, 2002, unless the disposition or deconsolidation was effected pursuant to a binding written contract entered into before such date and was in continuous effect until the disposition or deconsolidation, Temporary Treasury Regulation section 1.337(d)-2T, and not section 1.1502-20, governs the amount of loss allowable on such sales or the amount of basis reduction required on such deconsolidations, of subsidiary stock. Temporary Treasury Regulation section 1.337(d)-2T restates the current section 1.337(d)-2, with certain modifications. As currently in effect, *Treasury Regulation section 1.337(d)-2* permits recognition of a loss only where a Consolidated Group disposes of its entire equity interest in a member of the Consolidated Group to persons not related to any member of the Consolidated Group within the meaning of section 267(b) or section 707(b)(1). Temporary Treasury Regulation section 1.337(d)-2T eliminates those restrictions.

On May 31, 2002, the Treasury and the IRS issued another set of Temporary Regulations to clarify and amend those issued on March 7, 2002. n162 The Treasury and the I.R.S. added Temporary Treasury Regulation section 1.337(d)-2T(a)(4) to provide a rule similar to the rule contained in *Treasury Regulation section 1.1502-20(a)(4)*, allowing the netting of gain and loss on certain dispositions of stock. Further, the Treasury and the IRS added a new Temporary Treasury Regulation section 1.337(d)-2T(b)(4) to allow netting for purposes of the basis reduction rules on deconsolidations of subsidiary stock.

For dispositions and deconsolidations of subsidiary stock before March 7, 2002, and dispositions and deconsolidations of subsidiary stock on or after March 7, 2002 that were effected pursuant to a binding written contract entered into before such date in continuous effect until the disposition or deconsolidation, Temporary Treasury Regulation section 1.1502-20T(i) was added. Under that new regulation, Consolidated Groups are permitted to calculate allowable loss on the sale of subsidiary stock by applying *Treasury Regulation section 1.1502-20* in its entirety or, in lieu thereof, electing to apply one of two alternative regimes. In the first, the Consolidated Group may elect to apply the provisions of *Treasury Regulation section 1.1502-20* without regard to the duplicated loss factor of the loss disallowance formula,

i.e., calculating disallowed loss by taking into account only extraordinary gain dispositions and positive investment adjustment amounts. Alternatively, the Consolidated Group may elect to apply the provisions of Temporary Treasury Regulation section 1.337(d)-2T, as further amended by the Treasury and the I.R.S. on May 31, 2002. Such election may be made with the original return for the taxable year that includes the later of March 7, 2002 or the date of the disposition or deconsolidation of the stock of the subsidiary. If the date of the disposition or deconsolidation of the stock of the subsidiary is after March 7, 2002, the statement of the election may be filed with or as part of a timely filed (including any extensions) original return for the taxable year that includes such date. In effect, the second alternative allows a taxpayer to treat the disposition or deconsolidation that occurred in 2001 as if they occurred pursuant to the binding written contract entered into before March 7, 2002. Finally, the Treasury and the IRS clarified that a taxpayer does not have to file a "statement of allowed loss," as described in Treasury Regulations sections 1.337(d)-2T(c)(3) or 1.1502-20(c)(3), in order to perfect an election pursuant to Treasury Regulation section 1.1502-20T(i).

An election described in *Treasury Regulation section 1.1502-20(g)* to reattribute losses (see last paragraph of *P TX11.08[10] supra*) will be respected only if the requirements of *Treasury Regulation section 1.1502-20(g)*, including the requirement that the election be filed with the Consolidated Group's income tax return for the year of the disposition, have been or are satisfied. The Temporary Treasury Regulations do not extend the time for filing an election under section 1.1502-20(g). If a Consolidated Group made an election described in *Treasury Regulation section 1.1502-20(g)* and chooses to determine its allowable loss by applying one of the alternative regimes pursuant to Temporary Treasury Regulation section 1.1502-20T(i), the amount of loss treated as reattributed may be reduced. If the Consolidated Group elects to determine its allowable loss by applying the provisions of *Treasury Regulation section 1.1502-20* without regard to the duplicated loss factor of the loss disallowance formula, the amount of loss treated as reattributed is equal to the amount of loss originally reattributed, reduced by the amount that exceeds the greater of (1) the loss disallowance amount determined by taking into account only extraordinary gain dispositions and positive investment adjustments (and not the duplicated loss factor of the loss disallowance formula), and (2) the amount of reattributed losses that the common parent of the selling group absorbed in closed years. If the Consolidated Group elects to determine its allowable loss by applying Temporary Treasury Regulation section 1.337(d)-2T, the amount of loss treated as reattributed is the greater of (1) zero, and (2) the amount of reattributed losses that the common parent of the selling group absorbed in closed years. For this purpose, a taxable year is a closed year to the extent the assessment of a deficiency is prevented by any law or rule of law as of the date the election.

To the extent that an election under Temporary Treasury Regulation section 1.1502-20T(i) results in a reduction in the amount of losses treated as reattributed, such excess losses will be treated as available for use by the subsidiary or any other group of which the subsidiary is a member, subject to any applicable limitations (e.g., section 382). In order to permit the subsidiary's use of such losses, Temporary Treasury Regulation section 1.1502-20T(i) allows the common parent of the Consolidated Group that disposed of the stock to make certain adjustments to the amount of such a limitation apportioned under *Treasury Regulation sections 1.1502-95* or *1.1502-96* (see *P TX11.08[10][g] supra*). Temporary Treasury Regulation section 1.1502-20T(i) requires the common parent of the selling group to notify the subsidiary of the recomputed reattribution amount and any adjustment to the apportionment of a section 382 limitation made in connection with the election to apply one of the alternative regimes. In addition, if the acquirer was a member of a Consolidated Group at the time of the acquisition, the common parent of the selling group must provide such notification to the common parent of the acquirer at the time of the acquisition. The rules set forth in Temporary Treasury Regulation section 1.1502-20T(i) also confirm that any losses treated as reattributed to the common parent of the selling group will not be available to offset income of the subsidiary or any other group of which such subsidiary is a member.

Temporary Treasury Regulation section 1.1502-32T(b)(4)(v) was added to provide that, if, in a closed year, the subsidiary's loss carryovers are increased by reason of an election to apply one of the alternative regimes and such loss carryovers expire, or would have been properly used to offset income, the purchasing group will be deemed to have made an election to treat all of such expired loss carryovers as expiring for all Federal income tax purposes immediately before the subsidiary became a member of the purchasing group. Accordingly, no basis reduction under *Treasury*

Regulation section 1.1502-32 will result from the expiration of, or failure to use, such losses.

Temporary Treasury Regulation section 1.1502-32T(b)(4)(v) further provides that, if, in a closed year, the subsidiary's loss carryovers are increased by reason of a Temporary Treasury Regulation section 1.1502-20T(i) election and such loss carryovers have not expired, and would not have been properly used to offset income, the purchasing group may make an election under *Treasury Regulation section 1.1502-32(b)(4)* to treat all or a portion of such loss carryovers as expiring for all Federal income tax purposes immediately before the subsidiary became a member of the purchasing group. The election must be filed with the purchasing group's return for the taxable year in which the subsidiary receives the notification of the recomputed reattributed loss amount. On the other hand, the Temporary Treasury Regulations issued on May 31, 2002 stated that, if, in a closed year, all or some portion of a previously disallowed loss would have been properly absorbed or expired as a result of the application of Temporary Treasury Regulation section 1.1502-20T(i), the basis in the stock of the disposing member may be increased. This adjustment would be for purposes of calculation the group's or the shareholder-member's Federal income tax liability for all open years.

Finally, the Temporary Treasury Regulations issued on May 31, 2002 indicated that, to the extent that absorption of a closed year's excess loss would have affected the tax treatment of another item (such as another loss that was absorbed in such year) that has an effect in an open year, the election described in Temporary Treasury Regulation section 1.1502-20T(i) will affect the treatment of such other item. On October 23, 2002, the Treasury issued a notice of proposed rulemaking to implement the principle set forth in *Notice 2002-18* that a consolidated group should not obtain more than one tax benefit from a single economic loss. The proposed rules set forth a basis redetermination rule, a loss suspension rule and a basis reduction rule. n163

The basis redetermination rule requires the redetermination and reallocation of the basis of subsidiary member stock held by members of the group immediately before a disposition or deconsolidation of a share of subsidiary member stock when the basis of such stock exceeds its value. The stated purpose of the rule is to prevent the group from obtaining the recognition of a current loss on a particular share of subsidiary member stock. The rule applies differently when the subsidiary remains a member of the group as opposed to when the subsidiary does not remain a member of the group. If the subsidiary remains a member of the group, then the group's aggregate basis in all shares of the subsidiary member is allocated first to the shares of the subsidiary preferred stock (up to value of such preferred stock) and then to the common stock in proportion to its value, in each case to shares held by members of the group. n164

If the subsidiary does not remain a member of the group, the amount subject to reallocation (the "Reallocable Basis Amount") is equal to the lesser of (1) the loss inherent in the stock disposed of or deconsolidated, and (2) the subsidiary member's items of deduction and loss that were taken into account in computing the adjustment to the basis of any share of stock of the subsidiary member (other than disposed shares) during the time such subsidiary member was a member of the group. The basis in the shares of subsidiary member stock that were disposed of or deconsolidated shall be reduced by the Reallocable Basis Amount. Then to the extent of the Reallocable Basis Amount, first the basis of all the preferred shares of stock of the subsidiary member that continue to be held by the members are increased to their value immediately before the disposition or deconsolidation and then the bases of all common shares are increased in the manner that to the greatest extent possible causes the ratio of the basis to the value of each common share to be the same. n165

The loss suspension rule (applied after application of the basis redetermination rule and only if the subsidiary member continues to be a member of the group immediately after the disposition of its stock) provides that the selling member's stock loss is suspended to the extent of the "duplicated loss" with respect to such stock. n166 The amount of duplicated loss is the excess of (1) the sum of the aggregate basis of the subsidiary member's assets, losses carried forward to its first taxable year after the disposition, and deductions that have been recognized but deferred under another provision, over (2) the sum of the value of the stock of the subsidiary member and the subsidiary member's liabilities that have been taken into account for tax purposes. The suspended loss is reduced (and thus is forever disallowed) as the subsidiary member's duplicated deductions and losses are taken into account in determining the group's consolidated

taxable income (or loss). Furthermore, unless the taxpayer can establish otherwise, the proposed regulations contain a presumption that all deductions and losses are attributable first to the duplicated loss that gave rise to a suspended stock loss. n167 The remaining suspended loss is allowed when the subsidiary member leaves the group or when the group is allowed a worthless stock deduction with respect to all of the subsidiary member stock owned by members. n168

The basis reduction rule provides that if a member disposes of subsidiary member stock and on the following day the subsidiary is not a member of the group and does not have a separate return year (*i.e.*, the subsidiary member is liquidated), then the basis of the subsidiary member stock is reduced to the extent of the CNOL and net capital loss carryforwards attributable to such subsidiary member (that would otherwise be of use to the remaining members of the group), as though they were absorbed immediately prior to the disposition. n169

The proposed rules were to apply to transactions that occur on or after March 7, 2002, but only if such transactions occur during a taxable year the original return for which is due after the date these regulations are published as temporary or final in the Federal Register. n170

On March 14, 2003, the Treasury issued temporary regulations, effective generally March 14, 2003, on suspension of losses on certain stock dispositions (the temporary regulations are substantially similar to the proposed regulations issued in October of 2002). n171 The temporary regulations expanded application of the basis redetermination rule introduced in the proposed regulations by requiring its application regardless of whether deconsolidation occurs as a result of a transfer of a loss share or of a gain share or issuance of additional stock. In addition, the temporary regulations require members to take into account all losses and all prior negative basis adjustments to members' shares of the subsidiary stock (not just losses and adjustments attributable to disposed shares of stock). n172

The temporary regulations refined the proposed regulations to make sure that the loss disallowance rule does not disallow a tax loss with respect to an economic loss. For example, a taxpayer will be permitted to treat a suspended stock loss as restored to the extent that a prior reduction in the suspended stock loss would result in the permanent disallowance of an economic loss. The temporary regulations also changed the application of the basis reduction rule by providing that all losses treated as attributable to the subsidiary member whose stock is either deconsolidated or treated as worthless under *I.R.C. section 165* shall be treated as expired, but not as absorbed by the group of which the subsidiary member was previously a member. Because the loss is treated as not absorbed by the group, a tax loss for the economic loss on an investment in the subsidiary member is permitted. n173

Since provisions of the temporary regulations changed the application of the proposed rules (which treated losses as expired but absorbed), the temporary regulations include a special election for determinations of worthlessness and dispositions that occurred on or after March 7, 2002 and before March 14, 2003. Pursuant to the election the common parent of the group would make an irrevocable election under principles of *Treasury Regulation section 1.1502-21* to reattribute to itself all or a portion of the losses attributable to the subsidiary member which would allow such common parent to treat such reattributed losses as absorbed immediately prior to the allowance of any loss or inclusion of any income or gain with respect to the determination of worthlessness or the disposition and the common parent would be treated as succeeding to the subsidiary's losses in a transaction described in *I.R.C. section 381*. n174

Finally, the temporary regulations include anti-abuse rules that provide that the basis redetermination and loss suspension rules will not apply if a transaction is structured with a view to, and has the effect of, deferring or avoiding the recognition of gain on a disposition of stock. n175

On March 18, 2004, the Treasury issued final and temporary regulations, effective March 18, 2004, clarifying certain aspects of the deductibility of losses recognized on dispositions of subsidiary stock by members of a consolidated group and the consequences of treating subsidiary stock as worthless. n176 The Treasury addressed concerns of taxpayers that *I.R.C. section 1.1502-80(c)* may prevent a Consolidated Group from claiming a worthless stock deduction with respect to subsidiary stock if the subsidiary ceases to be a member of the Consolidated Group before it satisfies the

requirements of *Treasury Regulations section 1.1502-19(c)(1)(iii)*. Temporary regulations clarify that the *I.R.C. section 165* deferral terminates immediately prior to the time that the subsidiary ceases to be a member of a Consolidated Group. The Treasury noted that it is considering whether *Treasury Regulations section 1.1502-80(c)* is still necessary given that 1.1502-20 no longer governs the allowance of loss on sales of subsidiary stock.

The Treasury amended Temporary Treasury Regulations section 1.1502-35T(f) to provide that the subsidiary's apportioned part of the CNOL is treated as expired (on the first day of the taxable year following the year of worthlessness) if a member claims a worthless stock deduction ("claiming member") with respect to the subsidiary's stock and, during the next taxable year, the subsidiary is a member of a group that includes any corporation that was a member of the group that includes the claiming member. Thus, the apportioned CNOL is disallowed only if the subsidiary with respect to which the worthless stock deduction is claimed has no separate return limitation year or is part of a SRLY subgroup following the year in which the worthless stock deduction is claimed. In addition, the expiration of the CNOL is not treated as a non-capital, non-deductible expense for purposes of the investment adjustment provisions.

The Treasury also amended Treasury Regulations section 1.337(d)-2T(c)(2) to clarify that recognized built-in gain is considered net of directly related expenses (including certain federal income taxes due as a result of disposition of an asset). The correction was made because the expenses attributable to the recognition of built-in gain already reduce the basis of the subsidiary's stock and thus should be taken into account in computation of the amount of stock loss that is attributable to the recognition of built-in gain.

On September 15, 2004, the IRS and Treasury published *Notice 2004-58*, n177 setting forth a new approach for determining the extent to which a stock loss is allowable and determines the adjustment in stock basis upon deconsolidation. It is known as the "basis disconformity approach." Under this approach, loss is disallowed on a disposition of subsidiary stock and basis is reduced on a deconsolidation of a subsidiary in an amount equal to the least of the "gain amount," the "disconformity amount," and the "positive investment adjustment amount." The gain amount is the sum of all gains (net of directly related expenses) recognized on asset dispositions of the subsidiary that are allocable to the shares in question while the subsidiary is a member of the group. The disconformity amount is the excess, if any, of the basis in the shares in question over such shares' proportionate interest in the subsidiary's "net asset basis." Net asset basis is the excess of (a) the sum of the subsidiary's money, basis in assets (other than stock of consolidated subsidiaries), loss carryforwards that would be carried to a separate return year of the subsidiary under the principles of *Treasury Regulation section 1.1502-21*, and deduction that have been recognized but deferred, over (b) the subsidiary's liabilities that have been taken into account for tax purposes. The positive investment adjustment amount is the excess, if any, of the sum of the positive investment adjustments made to the shares in question over the sum of the negative investment adjustments, excluding adjustments for distributions. Contemporaneously with the issuance of *Notice 2004-58*, the Treasury published temporary and proposed regulation extending the time for making an election under Temporary Treasury Regulations section 1.1502-20T(i) (discussed above on page TX11-98) and permitting taxpayers to amend or revoke prior elections made under the same regulations.

On March 22, 2005, the Treasury issued final and temporary regulations under *I.R.C. sections 337(d)* and *1502* to be effective April 5, 2005. In the preamble to the regulations, the Treasury and the Service stated that they are continuing to study comments received on the Temporary Treasury Regulations section 1.337(d)-2T and the *Notice 2004-58*. Meanwhile, the Treasury announced that taxpayers should continue to determine whether certain losses recognized on sales of subsidiary stock are disallowed and whether the basis of subsidiary stock must be reduced immediately before a consolidation of the stock under rules of Temporary Treasury Regulation section 1.337(d)-2T adopted as final 1.337(d)-2 without substantive change. Further, the Treasury stated that it will accept the "basis disconformity method" (announced in the *Notice 2004-58*) as a method for determining whether a subsidiary stock loss is disallowed and subsidiary stock basis is reduced under the final Treasury Regulations. Furthermore, the Treasury will continue to allow taxpayers to make the election to apply *Treasury Regulation section 1.1502-20* without regard to the duplicated loss factor of the "loss disallowance" rule or the rule of 1.337(d)-2. To that effect, rules of Temporary Treasury Regulation

section 1.1502-20T are adopted as final *Treasury Regulation section 1.1502-20* as well as the correlative rules of Temporary Treasury Regulation section 1.1502-32T are adopted as final *Treasury Regulation section 1.1502-32*, in each case, without substantive change.

On March 14, 2006, Treasury and the IRS issued a final rule and notice of removal of temporary regulations, T.D. 9254, 2006-13 I.R.P. 662. In the notice, the IRS stated that until the Treasury issues regulations which would address both the circumvention of General Utilities repeal and the inappropriate duplication of loss in a single integrated regulation, the circumvention of General Utilities repeal will continue to be addressed by *Treasury Regulation section 1.337(d)-2* and the duplication of loss will continue to be addressed by the rules of Treasury Regulation section 1.1502-35T. Accordingly, the Treasury decision adopted the rules of Treasury Regulation section 1.1502-35T (as in effect on February 1, 2006 and discussed in *P TX11.08[9]* above) as final *Treasury Regulation section 1.1502-35*. The final Treasury Regulations did not change the rules of the temporary Treasury Regulations substantively. They modified certain examples in the temporary Treasury Regulations to reflect the enactment of *I.R.C. section 362(e)(2)*. This Treasury decision also adopted, without substantive change, the related provisions in Treasury Regulation sections 1.1502-21T and 1.1502-32T as final regulations.

It should be additionally noted that the investment adjustment rules and related provisions had been significantly modified under final Treasury regulations issued August 12, 1994, effective for determinations and transactions in tax years beginning on or after January 1, 1995.

On January 24, 2007, the IRS proposed new treasury regulations to address the circumvention of General Utilities repeal and the duplication of loss by a consolidated group with respect to a loss on subsidiary stock. n177a The IRS proposed to repeal Treas. Reg. sections 1.337(d)-1, 1.337(d)-2 and 1.1502-35, which together with Notice 2004-58, currently determine the extent to which loss on subsidiary stock is disallowed. The proposed regulations consist of three principal rules: a basis redetermination rule, a basis reduction rule and an attribute reduction rule, which rules generally apply in the order listed. The integrated set of rules in Prop. Treas. Reg. section 1.1502-36 proposes to address all three categories of loss: noneconomic "son or mirrors" losses, "duplicated" losses and losses on individual shares due to -32 noneconomic allocations of built-in items. The proposed rules will be effective when published as final regulations.

If a member "transfers" a share of subsidiary stock and such share is a loss share, the Basis Redetermination Rule moves both positive and negative adjustments to eliminate loss on preferred shares and then eliminate basis disparity on all shares. The rule first removes positive investment adjustments from the bases of transferred loss shares (up to the amount of loss) n177b and then, to the extent of any remaining loss on the transferred shares, negative investment adjustments are removed from shares that are not transferred loss shares and applied to reduce the loss on the transferred loss shares n177c and, finally, the positive investment adjustments removed in the first step are allocated first to members' preferred shares to eliminate any built-in gain and then among common shares, including transferred loss shares. n177d The adjustments are made only to shares that were held by members in the year investment adjustments were originally taken into account n177e and the investment adjustments cannot be reallocated to the extent the resulting basis has previously been taken into account. n177f Basis does not need to be reallocated if redetermination would not have an effect on basis n177g or when the group disposes of all shares in a subsidiary in one or more fully taxable transactions during a taxable year. n177h For purposes of the -36 regulations, "transfer" means (i) a member ceases to own a subsidiary share and, but for -36, would recognize gain or loss, including as a result of an intercompany transaction, (ii) the member and the subsidiary cease to belong to the same consolidated group, (iii) a subsidiary share is acquired by a non-member, or (iv) a subsidiary share is worthless. n177i

The Basis Reduction Rule provides that if, after Basis Redetermination, any member's transferred share is a loss share, the basis of such share is reduced (immediately before the transfer) by an amount equal to the lesser of the share's "disconformity amount" and its "net positive adjustment." n177j A share's disconformity amount is the excess of the member's basis in the subsidiary share over its allocable portion of the subsidiary's net inside attributes amount (i.e., loss carryovers, deferred deductions, cash and asset basis, reduced by liabilities), determined immediately before the

transfer. n177k A share's net positive adjustment is computed as the greater of zero and the sum of all investment adjustments, excluding distributions, reflected in the basis of the share. n177l There are special rules applicable if the subsidiary holds stock of a lower-tier subsidiary that is not transferred in the transaction. n177m

If a transferred share remains a loss share after application of the rules discussed above in (a) and (b), the Attribute Reduction Rule reduces the subsidiary's tax attributes by the "attribute reduction amount" ("ARA") n177n which is equal to the lesser of the "net stock loss" and the subsidiary's "aggregate inside loss." n177o Net stock loss means the aggregate basis of all transferred subsidiary shares over the aggregate value of such shares. n177p Aggregate inside loss is the entire amount by which the subsidiary's net inside attribute amount exceeds the value of all outstanding subsidiary shares. n177q The subsidiary's attributes are reduced in the following order: NOLs, capital loss carryforwards, deferred deductions, publicly traded loss property, basis in assets (including, stock in subsidiaries) other than cash, cash equivalents and publicly traded property. n177r The ARA is applied proportionally to attributes in a category, except for loss carryovers, in which case the ARA is applied to reduce losses carried from the earliest year and then from each successive year. n177s If the ARA exceeds the total amount of available attributes, the excess is suspended to the extent of any contingent liabilities n177t and reduces the deduction or basis that results when those liabilities are taken into account, and any remaining ARA has no further effect. n177u

Finally, the -36 rules include anti-avoidance provisions which target acts with a view to avoid the purposes of -36, or to apply -36 to avoid the purposes of any other rule of law. n177v In such case, appropriate adjustments will be made to carry out the purposes of -36 or such other rule of law. As this most recent release was going to print, Treasury and IRS issued sweeping final regulations under sections 358, 362(e)(2) and 1502 to be effective September 17, 2008, TD 9424. The preamble explains that although the proposed -36 rules issued in January 2007 were favorably received, concerns were expressed about their complexity and the anticipated difficulty in their implementation, especially those rules relating to transfers of stock of subsidiaries that hold stock in other subsidiaries. The final regulations generally adopt the proposed regulations and attempt to simplify these rules where possible.

[11] Reverse Acquisitions

In general, a reverse acquisition is a Consolidated Return Regulation concept involving an acquisition of the stock of a corporation in which the shareholders of the acquired corporation own after the acquisition more than fifty percent of the fair market value of the stock of the nominal acquiring corporation and a consolidated return is filed for the first year ending after the acquisition. n178 The reverse acquisition rules prevent the taxpayers from selecting the continuing Consolidated Group by structuring the form of the acquisition.

If a reverse acquisition occurs, the acquired corporation is treated as the dominant corporation and the Consolidated Group of which it is a member is treated as the continuing group. The usual Consolidated Return Regulation consequences of the termination of a group affect the acquiring group. The years of the acquiring corporation and its group ending on or before the date of acquisition become SRLY's. All of the NOLs of the members of the acquiring group are fragmented among its various members. Accrued, but unrealized, losses may become built-in deductions. Each new corporate acquisition is tested separately provided there is not a step transaction. n179

Technically, a downstream merger of the Common Parent into a member of its group is not a reverse acquisition. Nevertheless, the group is considered to remain in existence with the corporation acquiring the Common Parent's assets succeeding to the role of Common Parent. n180 The former Common Parent in an *I.R.C. section 381(a)* transaction does not close its year and is treated as the acquiring corporation, while the nominal acquiring subsidiary corporation is treated as the transferor corporation for purposes of *I.R.C. section 381*.

The creation of a holding company structure is also technically not a reverse acquisition, but is treated like a merger of the Common Parent into one of its subsidiaries so the Consolidated Group is treated as continuing in existence. n181

Example 31:

P, an operating company with NOLs is the Common Parent of the P and S group. On July 1, 1992, P forms a subsidiary T and T forms subsidiary U. U is merged into P in a reverse triangular merger (*I.R.C. section 368(a)(2)(E)*) as a result of which all of the outstanding P stock is converted into T stock.

T becomes the new Common Parent and the old P group is considered to remain in existence with the effect that the NOL of P remains a consolidated NOL. Nevertheless, the NOLs of P are attributable to P, now a first tier subsidiary. If the stock of P is subsequently sold by T, the new Common Parent, the NOLs would leave the group with P under *Treasury Regulation section 1.1502-79*. Compare the result if P, avoiding a "D" Reorganization, were to form a holding company structure by dropping down the assets of the loss business to a new subsidiary V. If the stock of V is subsequently sold, the NOL attributable to P should still remain with the group (because section 351 is not one of the listed transactions for purposes of the section 381 carryover of attributes rules).

FOOTNOTES:

(n1)Footnote 1. *Treas. Reg. § 1.1502-1(h)*.

(n2)Footnote 2. *See* Goldman, *Joining or Leaving an Affiliated Group Which Files a Consolidated Return: A Checklist for the Agreement*, 36 *Tax L. Rev.* 197 (1981); Hyman & Hoffman, *Consolidated Returns: Summary of Tax Considerations in Acquisitions of Common Parent or Subsidiary Member of Affiliated Group*, 33 *Tax Law.* 383 (1980).

(n3)Footnote 3. *See J.D. & A.B. Spreckels Co. v. Commissioner*, 41 *B.T.A.* 370 (1940) . *See also Canaveral Int'l Corp. v. Commissioner*, 61 *T.C.* 520 (1974) , *acq.*, 1974-2 *C.B.* 1 (*I.R.C. § 269* used to prevent benefits of stock purchase and consolidation); *see also TAM 8837003 (May 21, 1988)* (concluding that a newly acquired subsidiary cannot be deemed to be affiliated with the group because the acquisition of such corporation was transitory and for the ultimate purpose of acquiring its assets).

(n4)Footnote 4. *Treas. Reg. § 1.1502-32; Treas. Reg. § 1.1502-33.*

(n5)Footnote 5. *Treas. Reg. § 1.1502-11(b)*.

(n6)Footnote 6. *Treas. Reg. § 1.1502-19.*

(n7)Footnote 7. *I.R.C. § 1504(a)(2)*. *See Alumax Inc. v. Comm'r*, 165 *F.3d* 822 (11th Cir. 1999) (restrictions on directors, even in only limited circumstances, prevent satisfaction of 80% voting control test); *Tech. Adv. Mem. 9452002 (Aug. 26, 1994)* . *Cf. Priv. Ltr. Rul. 9714002 (Dec. 6, 1996)* (parent owning 74 percent of voting power of subsidiary did not meet 80 percent test despite power to elect 80 percent of subsidiary directors through noncumulative voting).

(n8)Footnote 7a. *I.R.C. § 1504(a)(5)(C)* directs the Secretary to prescribe regulations that provide that the value requirement will be treated as met if the affiliated group, in reliance on a good faith determination of value, treated it as met (the good faith exception).

(n9)Footnote 7b. *I.R.C. § 1504(a)(5)(D)* directs the Secretary to prescribe regulations that disregard an inadvertent ceasing to meet the value requirement by reason of changes in relative values of different classes of stock (the inadvertence exception).

The notice further announced that until temporary or final regulations implementing *I.R.C. Section 1504(a)(5)(C)* and *(D)* are promulgated, or until the notice is revised, the Service will not challenge a consolidated group's position on a consolidated return that the stock ownership of an includible corporation satisfies the value requirement for purposes of

applying any "value provision" if the consolidated group (including a consolidated group that arises or continues to exist by reason of the relief provided in the notice) satisfies certain requirements. The requirements of the notice would be satisfied if the consolidated group made a good faith determination that the value requirement was satisfied. The requirements would also be satisfied if (a) the consolidated group's ownership of stock of the corporation does not satisfy the value requirement as a result of a change in the relative values of different classes of stock and such change is not attributable to the occurrence of a certain designated events described in section 3.04 of the notice (e.g., issuance of stock to a person that is not a member of the consolidated group), and (b) immediately before such change in relative values, the consolidated group's ownership of stock of the corporation satisfied the value requirement.

(n10)Footnote 8. *I.R.C. § 1504(a)(4)*.

(n11)Footnote 9. *I.R.C. § 1504(a)(3)*. See 2002-1 C.B. 959, *Rev. Proc. 2002-32 (May 20, 2002)* (grants certain taxpayers an automatic waiver of general rule of *I.R.C. Section 1504(a)(3)*).

(n12)Footnote 10. *I.R.C. § 1504(a)(5)*. Section 7 of *Rev. Proc. 2002-32* provides that if a deconsolidated corporation cannot qualify for an automatic waiver, a waiver under section 1504(a)(3)(B) may only be obtained through a letter ruling request. It further provides that the letter ruling request must: (1) contain information establishing that federal tax savings was not a purpose of the disaffiliation, and that the amount of any federal tax savings attributable to the disaffiliation or a subsequent consolidation is not significant; and (2) state whether the deconsolidated corporation or a predecessor of such corporation was, at any time during the period of disaffiliation, in the effective control of any member (or successor of any member) of the current group or the former group.

(n13)Footnote 11. *Treas. Reg. § 1.1504-4*.

(n14)Footnote 11a. See also *J.D. & A.B. Spreckels Co. v. Commissioner*, 41 B.T.A. 370 (1940) (court found no business purpose at all for the acquisition of a corporation, only the tax avoidance purpose); *Canaveral International Corp. v. Commissioner*, 61 T.C. 520 (1974), *acquiesced to*, 1974- 2 C.B.1 (application of *I.R.C. Section 269* to prevent benefits of stock purchase and consolidation). See also Tech. Adv. Memo. 88-37-003 (May 31, 1988) (newly-acquired subsidiary cannot be deemed to be affiliated with the group because the ownership of such corporation was transitory and its acquisition was for the ultimate purpose of acquiring its assets).

(n15)Footnote 12. See P TX11.03[2] *supra*.

(n16)Footnote 13. See P TX11.06 *supra*.

(n17)Footnote 14. See P 11.08[9], [10] *infra*.

(n18)Footnote 15. *Treas. Reg. § 1.1502-21A*; *Treas. Reg. § 1.1502-21(a)*; and *Temp. Treas. Reg. § 1.1502-21T(a)*.

(n19)Footnote 16. *Treas. Reg. § 1.1502-21A(b)*; *Treas. Reg. § 1.1502-21(b)*; and *Temp. Treas. Reg. § 1.1502-21T(b)*.

(n20)Footnote 16a. *Temp. Treas. Reg. § 1.1502-21T(b)(2)(B)* (this rule is effective for taxable years for which the due date of the original return (without extensions) is after August 29, 2003).

(n21)Footnote 17. *Treas. Reg. § 1.1502-79A(a)*; *Treas. Reg. § 1.1502-21(b)(2)(iv)*, Example 2; and *Temp. Treas. Reg. § 1.1502-21T(b)(2)(iv)*.

(n22)Footnote 18. See P TX11.08[11] *infra*.

(n23)Footnote 19. See P TX11.08[3][c] *infra*.

(n24)Footnote 20. *Treas. Reg. § 1.1502-11(b)*. See TX11.08[3][c] *infra* for a discussion of *Treasury Regulation*

Section 1.1502-11(c), which sets forth anti-circular basis rules which take into account the reduction of NOLs attributable to the departing member (i.e., sold subsidiary) if any member of Consolidated Group realizes discharge of indebtedness income that is excluded from gross income under *I.R.C. Section 108(a)* during the taxable year of the departure.

(n25)Footnote 21. *See also P TX11.08[11] infra*, for discussion of revised "loss disallowance rules."

(n26)Footnote 22. *Treas. Reg. § 1.1502-21A; Treas. Reg. § 1.1502-21(b); and Temp. Treas. Reg. § 1.1502-21T(b).*

(n27)Footnote 22a. *Treas. Reg. § 1.1502-21(b)(3)(ii)(B).*

(n28)Footnote 23. *Treas. Reg. § 1.1502-21(b)(3). But see Temp. Treas. Reg. § 1.1502-21T(b)(3) and Plumb v. Commissioner, 97 T.C. 632 (1991) for consolidated return tax years ending before June 26, 1999.*

(n29)Footnote 24. *In re Feiler, 218 F.3d 948 (9th Cir. 2000) .*

(n30)Footnote 24a. *See P TX 11.01 supra.*

(n31)Footnote 24b. *T.D. 8997, 67 FR 38000 (May 31, 2002); Notice of Proposed Rulemaking 67 FR 38039 (May 31, 2002) .*

(n32)Footnote 24c. *See 2003-16 I.R.B. 808, Announcement 2003-23 (April 21, 2003) and T.D. 9048, 68 FR 16430 (April 4, 2003) for corrections to the text of Temporary Regulation § 1.1502-21T(b)(3)(ii)(C).*

(n33)Footnote 25. *1974-2 C.B. 288, Rev. Rul. 74-610 . Cf. J. A. Tobin Construction Co. v. Commissioner, 85 T.C. 1005 (1985) .*

(n34)Footnote 26. *Treas. Reg. § 1.1502-21(b)(2)(ii)(B)* (disregarding the predecessor and successor rules for taxable years ending after June 25, 1999); and *Temp. Treas. Reg. § 1.1502-21T(b)(2)(ii)(B)* (taking into account the predecessor and successor rules for taxable years ending before June 26, 1999).

(n35)Footnote 27. *Treas. Reg. § 1.1502-21(b)(2)(ii)(B); and Temp. Treas. Reg. § 1.1502-21T(b)(2)(ii)(B).*

(n36)Footnote 27a. *TD 9089, 68 FR 52487 and a notice of proposed rulemaking (REG-132760-03) was published in 68 FR 52542 .*

(n37)Footnote 27b. A notice of proposed rulemaking (REG-167265-03) (the 2004 proposed regulations) was published in *69 FR 12091 .*

(n38)Footnote 28. *Temp. Treas. Reg. § 1.1502-28T(a)(2).*

(n39)Footnote 28a. *Temp. Treas. Reg. § 1.1502-28T(a)(3).*

(n40)Footnote 28b. *Temp. Treas. Reg. § 1.1502-28T(a)(4).*

(n41)Footnote 28c. *T.D. 9098 , 68 FR 69024 .*

(n42)Footnote 28d. *Temp. Treas. Reg. § 1.1502-28T(b)(3).*

(n43)Footnote 28e. *Temp. Treas. Reg. § 1.1502-28T(b)(2).*

(n44)Footnote 28f. *Temp. Treas. Reg. § 1.1502-28T(a)(3)(ii).*

(n45)Footnote 28g. *Temp. Treas. Reg. § 1.1502-28T(a)(3)(ii).*

(n46)Footnote 28h. Temp. Treas. Reg. § 1.1502-28T(b)(4).

(n47)Footnote 28i. Temp. Treas. Reg. § 1.1502-28T(b)(1)(iii).

(n48)Footnote 28j. *TD 9192*, 70 FR 14395.

(n49)Footnote 28k. Chief Couns. Adv. 2007-14-017, 2006 IRS CCA Lexis 85 (Dec.1, 2006).

(n50)Footnote 29. *Treas. Reg. § 1.1502-76(b)(6)*.

(n51)Footnote 30. Former *Treas. Reg. § 1.1502-76(b)(5)*. Caution must be exercised in making such an election. Consideration must be given to the effects of *I.R.C. § 382* which could result in the recognition of income by the selling group which may not be sheltered by the subsidiary's NOLs. See *J.D. & A.B. Spreckels Co. v. Commissioner*, 41 B.T.A. 370 (1940).

(n52)Footnote 31. *Treas. Reg. § 1.1502-6(a)*. But see *In re Imperial Corp. of Am.*, 91-2 U.S. Tax. Cas. (CCH) P 50,342 (Bankr. S.D. Cal. 1991), in which the Bankruptcy Court held that the liability of a non-debtor member of the Consolidated Group for taxes of the Consolidated Group was not a first priority administrative expense in the debtor-parent's bankruptcy case because that tax was not "incurred by" the debtor parent; this was because, according to the court, the parent was merely secondarily liable as a surety for the tax on the subsidiary's items of income). In a field service advice (slip opinion; date and cite redacted), the I.R.S. considered whether a common parent's several liability under *Treasury Regulation Section 1.1502-6(a)* for the tax of its subsidiary is a primary liability, so that the tax is considered "incurred by the debtor's estate" under the Bankruptcy Code and is, therefore, entitled to first priority as an administrative expense. The I.R.S. insisted that the court in the Imperial case "erred by failing to understand that the consolidated return regulations use some separate and some aggregate concepts," and that there is only one tax for the group.

(n53)Footnote 31a. See *Koppers Co. v. Commissioner*, 8 T.C. 886 (1947) supplemental opinion 11 T.C. 894 (1948) (citing Restatement Restitution, sections 81 and 82; *Williston on Contracts*, Rev. Ed., section 345, and the 1937 United States Supreme Court's decision in *Phillips-Jones Corp. v. Parmley*, 302 U.S. 233 (1937)).

(n54)Footnote 32. For taxable years beginning before June 28, 2002, see *Treas. Reg. § 1.1502-77A* and for taxable years beginning on or after June 28, 2002, see *Treas. Reg. § 1.1502-77*. See *Lone Star Life Insurance Co. v. Commissioner*, T.C. Memo, 1997-465 (parent's waiver of statute of limitations binding on subsidiary despite issuance of separate RAR's and 30 day letter); *Alumax Inc. v. Comm'r*, 165 F.3d 822 (11th Cir. 1999) (parent's extension of statute of limitations binding on subsidiary subsequently held not part of consolidated group); *Craigie Inc. v. Commissioner*, 84 T.C. 466 (1985).

(n55)Footnote 33. *Treas. Reg. § 1.1502-77(a)(1)(i) and (iii)*; *Priv. Ltr. Rul. 199908003* (Nov. 6, 1998).

(n56)Footnote 34. *Interlake Corp. v. Comm'r*, 112 T.C. 103 (1999) and *Acme Steel Company* (formerly known as *Acme Steel Co. v. Comm'r*, T.C. Memo 2003-118 (April 28, 2003)).

(n57)Footnote 35. *Treas. Reg. § 1.1502-78(b)*. But see *Treas. Reg. § 301.6402-7* (regarding refunds on carrybacks from insolvent financial institutions) and *Treas. Reg. § 1.1502-78* (to the extent a consolidated net operating loss, a consolidated net capital loss, or a consolidated unused business credit is apportioned to a corporation for a separate return year or that is to be carried back to a corporation that was not a member of a consolidated group in the carryback year, the corporation and not the common parent shall make the application under *I.R.C. Section 6411* for tentative carryback adjustment of the taxes). See *In re White Metal Rolling and Stamping Corp.*, 222 B.R. 417 (S.D.N.Y. 1998), holding that other members of affiliated group may utilize the debtor's NOL, and that parent may take worthless stock deduction if debtor cannot show ability to utilize NOL. See *White Metal*, for a general discussion of the duty, if any, owed by the members of the consolidated group to the debtor with NOL's.

(n58)Footnote 36. *See* 11 U.S.C. § 502(b)(2).

(n59)Footnote 37. 93 T.C. 166 (1989) .

(n60)Footnote 38. IRS FSA 200127008, 2001 FSA LEXIS 61 (March 30, 2001) .

(n61)Footnote 39. *But see Aetna Cas. & Surety Co. v. LTV Steel Co., Inc. (In re Chateaugay Corp.)*, 94 F3d 772 (2d Cir. 1996) (in the context of setoffs, the Court of Appeals for the 2d Circuit noted that taxes owed by the subsidiaries are "not owed" by the common parent despite several liability of the common parent for such taxes); *Phillips-Jones Corp. v. Parmley*, 302 U.S. 233 (1937) ; *Jump v. Manchester Life & Cas. Corp.*, 579 F2d 449 (8th Cir. 1978) ; and *In re Bob Richards Chrysler-Plymouth Corp. Inc.*, 473 F.2d 262 (9th Cir. 1973) (the *Jump* and *Bob Richards* courts concluded that, in the absence of a differing agreement, a tax refund resulting solely from offsetting the losses of one member of a consolidated group against the income of that same member in a prior or subsequent year should inure to the benefit of that member).

(n62)Footnote 39a. *Oakridge Consulting, Inc. v. United States (In re Consolidated FGH Liquidating Trust)*, 325 B.R. 564 (Bankr. S.D. Miss, 2005) .

(n63)Footnote 39b. *Treas. Reg. § 1.1502-78(b)*. *But see* *Treas. Reg. § 301.6402-7*, regarding refunds on carryforwards from insolvent financial institutions.

(n64)Footnote 39c. *See In re White Metal Rolling & Stamping Corp.*, 222 B.R. 417 (Bankr. S.D.N.Y. 1998) , *citing In re Prudential Lines, Inc.* (928 F.2d at 570), and holding that other members of an affiliated group may utilize the debtor's NOLs, and that a parent may take a worthless stock deduction if the debtor cannot show an ability to utilize its NOLs (the case also has a general discussion of the duty, if any, owed by the members of the Consolidated Group to the debtor with NOLs).

(n65)Footnote 39d. IRS Chief Couns. Adv. 2007-07-002 (Dec. 20, 2006).

(n66)Footnote 40. *Treas. Reg. § 1.1502-1(f)*.

(n67)Footnote 41. 1998-2 C.B. 222.

(n68)Footnote 42. *Treas. Reg. § 1.1502-21A(c)*.

(n69)Footnote 43. *Treas. Reg. § 1.1502-15(f)*.

(n70)Footnote 44. *Treas. Reg. § 1.1502-79(a)(4)*, 49 Fed. Reg. 30528 (1984), *withdrawn by* 56 Fed. Reg. 4228 (1991).

(n71)Footnote 45. *Treas. Reg. § 1.1502-1(f)(4)*.

(n72)Footnote 46. *Treas. Reg. § 1.1502-21A(c)*.

(n73)Footnote 47. *Treas. Reg. § 1.1502-21A(c)(1)*.

(n74)Footnote 48. *See P TX11.03[2] supra*.

(n75)Footnote 49. Consider the "anti-mirror" amendment to *I.R.C. § 337* by the Revenue Act of 1987 that eliminates *General Utilities* benefits of *Treas. Reg. § 1.1502-34* in the case of liquidations of subsidiaries owned by more than one member of the Consolidated Group. This amendment can also affect a planned liquidation. This may affect the *I.R.C. § 338* consistency rules, *I.R.C. § 338(e)*, because the basis of property received in the liquidation is not determined *wholly* by the subsidiary's basis.

(n76)Footnote 50. *Treas. Reg. § 1.1502-3(c)*. See also *Prop. Treas. Reg. § 1.1502-3(c)*.

(n77)Footnote 51. *Treas. Reg. § 1.1502-4(f)*.

(n78)Footnote 52. *Treas. Reg. § 1.1502-22A(c)*.

(n79)Footnote 53. See *P TX11.08*[6], [7] *infra*.

(n80)Footnote 54. *Treas. Reg. § 1.1502-21(c)(2)*.

(n81)Footnote 55. *Treas. Reg. § 1.1502-21(c)(1)*.

(n82)Footnote 56. See *P TX 11.08*[7] *infra*.

(n83)Footnote 57. *Treas. Reg. § 1.1502-21(b)(2)(ii)(B)*.

(n84)Footnote 58. *Treas. Reg. § 1.1502-22(c)*.

(n85)Footnote 59. *Treas. Reg. § 1.1502-21(g)(2)*. It should be noted that *I.R.S. Notice 2000-53, 2000-2 C.B. 293 (Sept. 18, 2000)*, provides for regulations which will permit an election by members leaving a consolidated group pursuant to a binding written agreement in effect prior to June 26, 1999 to not have the overlap rule apply.

(n86)Footnote 60. *Treas. Reg. § 1.1502-21(g)(3)*.

(n87)Footnote 61. *Treas. Reg. § 1.1502-21(g)(4)*.

(n88)Footnote 62. *Treas. Reg. § 1.1502-21(c)(2)*. See *Priv. Ltr. Rul. 9715035 (Jan. 14, 1997)* (applying the subgroup concept with respect to successor members).

(n89)Footnote 63. *Treas. Reg. § 1.1502-15(c)(2)*.

(n90)Footnote 64. *Treas. Reg. § 1.1502-21(c)(2)(iv)*. See also, the general anti-avoidance rule of *Treas. Reg. § 1.1502-91(d)(5)*.

(n91)Footnote 65. *Treas. Reg. § 1.1502-91(d)(1)*.

(n92)Footnote 66. See *P TX11.08*[10][a] *infra*.

(n93)Footnote 67. *Treas. Reg. § 1.1502-21(c)(1)*. See *Priv. Ltr. Rul. 1997-15-035 (Jan. 14, 1997)* (applying the cumulative contribution concept with respect to successor members of a subgroup).

(n94)Footnote 68. *Treas. Reg. § 1.1502-21(b)*.

(n95)Footnote 69. *Treas. Reg. § 1.1502-21(b)(3)(iii)*. See *Priv. Ltr. Rul. 200002003 (October 4, 1999)* (treating a reverse acquisition as a section 381 transaction for the normal acquiring corporation).

(n96)Footnote 70. *Treas. Reg. § 1.1502-21(b)(3)(i)*.

(n97)Footnote 71. *Treas. Reg. § 1.1502-21(b)(3)(ii)*.

(n98)Footnote 72. *Treas. Reg. § 1.1502-1(f)(4)*.

(n99)Footnote 73. See *P TX11.08*[3][b] *supra*.

(n100)Footnote 74. *Treas. Reg. § 1.1502-21(b)(2)(ii)(B)*.

(n101)Footnote 75. *Treas. Reg. § 1.1502-96(a)(1)(i).*

(n102)Footnote 76. *Treas. Reg. § 1.1502-96(a)(1)(ii).*

(n103)Footnote 77. Temp. *Treas. Reg. § 1.1502-21T(h)(6)* and *Treas. Reg. § 1.1502-21(h)(7).*

(n104)Footnote 77a. *Treas. Reg. § 1.1502-21A(h).*

(n105)Footnote 78. *Treas. Reg. § 1.1502-21(h)(3).*

(n106)Footnote 78a. REG-102144-04, 70 FR 29868 .

(n107)Footnote 79. *Treas. Reg. § 1.1502-15A(a).*

(n108)Footnote 80. *See P TX11.04[7][a] supra.*

(n109)Footnote 81. *Treas. Reg. § 1.1502-15A(a)(1).*

(n110)Footnote 82. *Treas. Reg. § 1.1502-15A(a)(4).* *See also* Idaho First National Bank v. Commissioner, 93-2 U.S.T.C. (CCH) P 50,373 (9th Cir. 1993) (deductions are built-in and not rehabilitative [as such deductions did not result from post- acquisition economic investment], and could not be offset against other consolidated group members' taxable income.).

(n111)Footnote 83. *Treas. Reg. § 1.1502-15(b)(1); see P TX11.04[7][a] supra.*

(n112)Footnote 84. *Treas. Reg. § 1.1502-15(g)(1); see* subsection [5], *supra*. It should be noted that *I.R.S. Notice 2000-53, 2000-32 C.B. 293 (Sept. 18, 2000)* , provides for regulations which will permit an election by members leaving a consolidated group pursuant to a binding written agreement in effect prior to June 26, 1999 to not have the overlap rule apply.

(n113)Footnote 85. *Treas. Reg. § 1.1502-15(g)(2)(ii).*

(n114)Footnote 86. *Treas. Reg. § 1.1502-15(g)(3).*

(n115)Footnote 87. *Treas. Reg. § 1.1502-15(g)(5).*

(n116)Footnote 88. *Treas. Reg. § 1.1502-15(b)(2)(iii).*

(n117)Footnote 89. *Treas. Reg. § 1.1502-15(c)(2).*

(n118)Footnote 90. *Treas. Reg. § 1.1502-15(c)(3).*

(n119)Footnote 91. *Treas. Reg. § 1.1502-15(h); See* subsection [5] *supra*.

(n120)Footnote 92. *Treas. Reg. §§ 1.1502-21A(e).*

(n121)Footnote 93. Temp. *Treas. Reg. § 1.1502-21T(d).*

(n122)Footnote 94. *Treas. Reg. § 1.1502-21A(c)(1).*

(n123)Footnote 95. *See Woods Investment Co. v. Commissioner, 85 T.C. 274 (1985)* (holding that when non-consolidated return statutory rules change, the IRS should amend the Consolidated Return Regulations rather than rely on judicial authority); *Gottesman & Co., Inc. v. Commissioner, 77 T.C. 1149 (1981)* (construing ambiguity in the Consolidated Return Regulations against the Commissioner). These cases provide little guidance when considered in

the light of *Wyman-Gordon Co. & Rome Industries, Inc. v. Commissioner*, 89 T.C. 202 (1987) , which distinguishes *Woods Investment* and holds that a subsidiary does not have an investment adjustment for earnings and profits resulting from cancellation of indebtedness excluded under I.R.C. § 108 despite the literal language of I.R.C. § 312(1) and *Treas. Reg. § 1.1502-32* of the Consolidated Return Regulations. *See also Wegman's Properties, Inc. v. Commissioner*, 78 T.C. 786 (1982) . In *CSI Hydrostatic Testers, Inc. v. Commissioner*, 103 T.C. 398 (1994), *aff'd per curiam*, 62 F. 3d 136 (5th Cir. 1995), dealing with the effect on an excess loss account of cancellation of indebtedness of a subsidiary, the Tax Court held that if the Commissioner did not like the result under the Consolidated Return Regulations as written, the regulations should have been changed.

(n124)Footnote 96. Prop. *Treas. Reg. § 1.1502-99(c)(1)*.

(n125)Footnote 97. *Treas. Reg. § 1.1502-99A(a)* and *(c)(2)*. In a cryptic ruling involving an affiliated group, the IRS ruled that the I.R.C. Section 382 limitation is applied against all of the income of the consolidated group, but is subject to the SRLY limitations, presumably on a corporation-by-corporation basis under what is now denominated as *Treas. Reg. section 1.1502-21A(c)*. *PLR. 9543020 (Jul. 26, 1995)*.

(n126)Footnote 98. Temp. *Treas. Reg. § 1.1502-21T*; Temp. *Treas. Reg. § 1.1502-15T*.

(n127)Footnote 99. Temp. *Treas. Reg. § 1.382-5T*; Temp. *Treas. Reg. § 1.382-8T*.

(n128)Footnote 100. Temp. *Treas. Reg. §§ 1.1502-90T* through *-99T*.

(n129)Footnote 101. *See Treas. Reg. § 1.1502-91(a)*.

(n130)Footnote 102. *Treas. Reg. § 1.1502-91(c)*.

(n131)Footnote 103. *Treas. Reg. § 1.1502-91(d)(1)* and *(2)*.

(n132)Footnote 104. *Treas. Reg. § 1.1502-91(d)(4)* and *(7)*, Example 4.

(n133)Footnote 105. *Treas. Reg. § 1.1502-91(d)(5)*.

(n134)Footnote 106. *Treas. Reg. § 1.1502-91(d)(5)*.

(n135)Footnote 107. *See text accompanying n. 94 supra*.

(n136)Footnote 108. *Treas. Reg. § 1.1502-92(b)*.

(n137)Footnote 109. *Treas. Reg. § 1.1502-92(b)(3)(ii)*.

(n138)Footnote 110. *Treas. Reg. § 1.1502-92(c)(1)*.

(n139)Footnote 111. *Treas. Reg. § 1.1502-92(c)(2)*.

(n140)Footnote 112. *Treas. Reg. § 1.1502-92(c)(4)(ii)*.

(n141)Footnote 113. *Treas. Reg. § 1.1502-92(c)(4)(ii)*.

(n142)Footnote 114. *Treas. Reg. § 1.1502-92(c)(3)(i)*.

(n143)Footnote 115. *Treas. Reg. § 1.1502-92(c)(3)(ii)*.

(n144)Footnote 116. *Treas. Reg. § 1.1502-92(c)(5)* Example 2.

(n145)Footnote 117. *Treas. Reg. § 1.1502-96(b)(1)*.

(n146)Footnote 118. *Treas. Reg. § 1.1502-96(b)(1)*.

(n147)Footnote 119. *Treas. Reg. § 1.1502-96(b)(2)*.

(n148)Footnote 120. *Treas. Reg. § 1.1502-96(a)*.

(n149)Footnote 121. *Treas. Reg. § 1.1502-92(e)*.

(n150)Footnote 122. *Treas. Reg. § 1.1502-92(e)(2)*.

(n151)Footnote 123. *Treas. Reg. § 1.1502-93(a)(1)*.

(n152)Footnote 124. *Treas. Reg. § 1.1502-93(b)(1)*.

(n153)Footnote 125. *Treas. Reg. § 1.1502-93(b)(1)(ii)*.

(n154)Footnote 126. *See P TX11.04[7] supra*.

(n155)Footnote 127. *Treas. Reg. § 1.1502-93(b)(2)*.

(n156)Footnote 128. *Treas. Reg. § 1.1502-91(g)(1)*.

(n157)Footnote 129. *Treas. Reg. § 1.1502-91(d)(2)*.

(n158)Footnote 130. *Treas. Reg. § 1.1502-96(a)(3)*.

(n159)Footnote 131. *Treas. Reg. § 1.1502-91(g)(2)(i)*.

(n160)Footnote 132. *Treas. Reg. § 1.1502-91(g)(2)(ii)*.

(n161)Footnote 133. *Treas. Reg. § 1.1502-91(g)(2)(iii)*.

(n162)Footnote 134. *Treas. Reg. § 1.1502-91(g)(2)(iv)*.

(n163)Footnote 135. *Treas. Reg. § 1.1502-91(g)(1)*.

(n164)Footnote 136. *Treas. Reg. § 1.1502-91(g)(1)*.

(n165)Footnote 137. *Treas. Reg. § 1.1502-91(g)(4)*.

(n166)Footnote 138. *Treas. Reg. § 1.1502-91(g)(5)*.

(n167)Footnote 139. *Treas. Reg. § 1.1502-91(h)(1)*.

(n168)Footnote 140. *See P TX11.08[11] infra*.

(n169)Footnote 141. *Treas. Reg. § 1.1502-91(h)(2)*.

(n170)Footnote 142. *Treas. Reg. § 1.1502-91(h)(3)*. Note that these rules differ from the treatment of installment sales under *I.R.S. Notice 90-27, 1990-1 C.B. 336*. *See P TX11.06, n.6 supra*.

(n171)Footnote 143. *Treas. Reg. § 1.1502-91(h)(4)*.

(n172)Footnote 144. *Treas. Reg. § 1.1502-93(d)(1)*.

(n173)Footnote 145. *Treas. Reg. § 1.1502-93(d)(2)*.

(n174)Footnote 146. *Treas. Reg. § 1502-95(c)(2)*. It should be noted that *I.R.S. Notice 2000-53, 2000-32 C.B. 293 (Sept. 18, 2000)* , provides for regulations which will permit an election by members leaving a consolidated group pursuant to a binding written agreement in effect prior to June 26, 1999 to not have the overlap rule of Sections 1.1502-15(g), -21(g), and -22(g) apply.

(n175)Footnote 147. *Treas. Reg. § 1502-95(b)(2)(iv)*.

(n176)Footnote 148. *1987-1 C.B. 445* . *See also* Internal Revenue Service F.S.A. 1999-16-007 (April 23, 1999) for a discussion of whether loss disallowance rules were promulgated in accordance with the Administrative Procedure Act and can be applied retroactively.

(n177)Footnote 149. *I.R.S. Notice 87-14, 1987-1 C.B. 445* .

(n178)Footnote 150. *Treas. Reg. § 1.1502-32*.

(n179)Footnote 151. *Treas. Reg. § 1.1502-20(g)(1)*.

(n180)Footnote 152. *Treas. Reg. § 1.1502-20(g)(2)*.

(n181)Footnote 153. For a detailed analysis of the impact of the loss disallowance rules and the effect of using unaffiliated subsidiaries to perform "son of mirrors" and related transactions, *see Freeman, Response to Loss Disallowance Rule: Partial Deconsolidation, 47 Tax Notes 1349 (1990)*.

(n182)Footnote 154. *Temp. Treas. Reg. § 1.338(h)(10)-1T(c)*.

(n183)Footnote 155. *Treas. Reg. § 1.338(h)(10)-IT(d)(3)(c) & (d)(7)*.

(n184)Footnote 156. *See Rite Aid Corp. v. United States, 255 F.3d 1357 (Fed. Cir. 2001)* .

(n185)Footnote 157. *2002-1 C.B. 526* .

(n186)Footnote 158. *2002-1 C.B. 644* .

(n187)Footnote 159. *See* Description of the Chairman's Mark on the "Tax Administration Good Government Act of 2004," dated January 29, 2004 (JCX-2-04).

(n188)Footnote 159a. General Explanation of Tax Legislation Enacted in the 108th Congress, Part Seventeen: American Jobs Creation Act of 2004, Joint Committee Print, May 2005.

(n189)Footnote 160. *Temp. Treas. Reg. §§ 1.337(d)-2T, 1.1502-20T(i) and 1.1502-32T(b)(4)(v)*.

(n190)Footnote 161. *T.D. 8984 , 67 FR 11034* .

(n191)Footnote 162. *T.D. 8998, 67 FR 37998, and 67 FR 38000* .

(n192)Footnote 163. *Prop. Treas. Reg. § 1.1502-35, 2002-47 I.R.B. 892 , 67 F.R. 65060* .

(n193)Footnote 164. *Prop. Treas. Reg. § 1.1502-35(b)(2)*.

(n194)Footnote 165. *Prop. Treas. Reg. § 1.1502-35(b)(3)*.

(n195)Footnote 166. Prop. Treas. Reg. § 1.1502-35(c).

(n196)Footnote 167. Prop. Treas. Reg. § 1.1502-35(c)(4).

(n197)Footnote 168. Prop. Treas. Reg. § 1.1502-35(c)(5).

(n198)Footnote 169. Prop. Treas. Reg. § 1.1502-35(f).

(n199)Footnote 170. Prop. Treas. Reg. § 1.1502-35(j).

(n200)Footnote 171. See Temp. Treas. Reg. §§ 1.1502-21T(b)(1) and (b)(3)(v), 1.1502-32T(a)(2), (b)(3)(iii)(C), (b)(3)(iii)(D), and (b)(4)(vi) and 1.1502-35T,T.D 9048, 2003-1 C.B. 644.

(n201)Footnote 172. Temp. Treas. Reg. § 1.1502-35T(b).

(n202)Footnote 173. Temp. Treas. Reg. § 1.1502-35T(f)(1).

(n203)Footnote 174. Temp. Treas. Reg. § 1.1502-35T(f)(2).

(n204)Footnote 175. Temp. Treas. Reg. § 1.1502-35T(g)(2).

(n205)Footnote 176. Treas. Reg. §§ 1.337(d)-2T(g), 1.1502-35T(f) and 1.1502- 80T(c).

(n206)Footnote 177. *Notice 2004-58* , I.R.B. 2004-39 (September 15, 2004).

(n207)Footnote 177a. Prop. Treas. Reg. § 1.1502-36.

(n208)Footnote 177b. Prop. Treas. Reg. § 1.1502-36(b)(2)(i)(A).

(n209)Footnote 177c. Prop. Treas. Reg. § 1.1502-36(b)(2)(i)(B).

(n210)Footnote 177d. Prop. Treas. Reg. § 1.1502-36(b)(2)(ii).

(n211)Footnote 177e. Prop. Treas. Reg. § 1.1502-36(b)(2)(iii)(B)(1).

(n212)Footnote 177f. Prop. Treas. Reg. § 1.1502-36(b)(2)(iii)(B)(2).

(n213)Footnote 177g. Prop. Treas. Reg. § 1.1502-36(b)(1)(ii)(A).

(n214)Footnote 177h. Prop. Treas. Reg. § 1.1502-36(b)(1)(ii)(B).

(n215)Footnote 177i. Prop. Treas. Reg. § 1.1502-36(f)(11).

(n216)Footnote 177j. Prop. Treas. Reg. § 1.1502-36(c)(2)(i).

(n217)Footnote 177k. Prop. Treas. Reg. § 1.1502-36(c)(4).

(n218)Footnote 177l. Prop. Treas. Reg. § 1.1502-36(c)(3).

(n219)Footnote 177m. Prop. Treas. Reg. § 1.1502-36(c)(6).

(n220)Footnote 177n. Prop. Treas. Reg. § 1.1502-36(d)(2)(i).

(n221)Footnote 177o. Prop. Treas. Reg. § 1.1502-36(d)(3)(i).

(n222)Footnote 177p. Prop. Treas. Reg. § 1.1502-36(d)(3)(ii).

(n223)Footnote 177q. Prop. Treas. Reg. § 1.1502-36(d)(3)(iii).

(n224)Footnote 177r. Prop. Treas. Reg. § 1.1502-36(d)(4)(i).

(n225)Footnote 177s. Prop. Treas. Reg. § 1.1502-36(d)(4)(ii).

(n226)Footnote 177t. Prop. Treas. Reg. § 1.1502-36(d)(4)(ii)(A)(1).

(n227)Footnote 177u. Prop. Treas. Reg. § 1.1502-36(d)(4)(ii)(A)(2).

(n228)Footnote 177v. Prop. Treas. Reg. § 1.1502-36(g).

(n229)Footnote 178. *Treas. Reg. § 1.1502-75(d)(3)*. See *Adobe Resources Corp. v. United States*, 967 F.2d 152 (5th Cir. 1992) *reh'g denied*, 975 F.2d 1119 (5th Cir. 1992) (cross ownership of stock). *Tech. Adv. Mem. 9351002* (Aug. 31, 1993) (series of transactions integrated to prevent reorganization or reverse acquisition treatment).

(n230)Footnote 179. *Treas. Reg. § 1.1502-75(d)(3)(i)*.

(n231)Footnote 180. *Treas. Reg. § 1.1502-75(d)(2)(ii)*.

(n232)Footnote 181. 1982-2 C.B. 205, *Rev. Rul. 82-152*. But see *Priv. Ltr. Rul. 8946006* (July 31, 1989) (the IRS stated the rationale of *Rev. Rul. 82-152* would not apply to transactions that separate the common parent from the other members of the group or from a substantial portion of the assets of the group). Recently, in *Priv. Ltr. Rul. 200603009* (Oct. 6, 2005), the IRS considered transaction in which Parent, an S corporation, owned stock in Target and it was proposed that the other shareholders of Target would transfer their Target shares to Parent in exchange for shares of Parent, that Parent would transfer the Target shares to a new corporation, Holdco, and that Parent would remain an S corporation after the transactions. The Service ruled that the acquisition of Target by Holdco would qualify as a "reverse acquisition" within the meaning of *Treasury Reg. § 1.1502-75(d)(3)*, that the tax attributes of Target would survive for consolidated return purposes, that the proposed transaction would qualify as a "group structure change," and that the earnings and profits of Holdco would be adjusted to reflect the earnings and profits of Target immediately before Target ceased to be the common parent.



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CHAPTER TX12 State and Local Tax Aspects of Bankruptcy

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CHAPTER TX12 State and Local Tax Aspects of Bankruptcy

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P TX12.01 Introduction

State and local tax issues related to title 11 cases fall into two general categories. The first category consists of title 11 issues such as priority, discharge, and procedures for adjudicating state and local tax controversies. These issues arise when state and local tax claims are addressed in the context of a case under the Bankruptcy Code. Priority and discharge issues concerning state and local taxes generally are resolved based on whether the taxes are incurred pre-petition or post-petition. n1 The second category consists of issues of state and local taxation, such as determining taxable income, the carryover of tax attributes, and the taxability of the discharge of indebtedness. This chapter will focus on problems of state and local taxation of individuals and entities that are the subject of a title 11 case. Tax issues involving questions of priority and discharge are addressed elsewhere in this volume. n2

Three sets of tax rules govern the state and local taxation of individuals, corporations, and partnerships that have commenced a case under title 11. First, there are the applicable state and local tax laws. Second, the Internal Revenue Code is applicable to the extent it has been incorporated into the relevant state and local income tax rule, which is normally the case. Third, the Bankruptcy Code contains special tax provisions that exclusively apply to state and local taxation.

The special state and local tax provisions contained in the Bankruptcy Code have an unusual history. The Bankruptcy Reform Act of 1978, as the bill was originally introduced in Congress, contained provisions applicable to federal, state and local taxes. Prior to enactment, however, these provisions were limited to state and local taxes so that the tax writing committees of Congress could address the federal tax issues. n3 At the time, it was anticipated that these special provisions would be amended once the federal bankruptcy tax rules were adopted; however this did not occur. Instead, Congress enacted the Bankruptcy Tax Act of 1980 without amending the special state and local tax provisions of the Bankruptcy Code, even though the Bankruptcy Tax Act contained provisions inconsistent with these earlier drafted provisions. As a result, inconsistencies exist between the federal rules and the state and local rules. These inconsistencies cause interpretive and computational difficulties, particularly in states and localities that rely on the Internal Revenue Code to determine taxable income.

Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act"), n4 however, section 346, principally concerned with state and local tax issues, was largely rewritten. Once more, the provisions previously found in section 728 and sections 1146(a) and (b) are, by and large, transferred to section 346.

The new rules provide for uniformity among federal, state, and local tax administrative rules. First, the new rules prevent a bankruptcy filing from resulting in the creation of a new taxable estate, or the termination of the debtor's taxable year, for federal purposes, but not for state and local purposes--or vice versa. Second, the new rules conform the federal, state, and local tax consequences of property transfers from the debtor to the estate (or from the estate to the debtor). Third, the new rules prevent state or local tax from being imposed on discharge of indebtedness income unless that income is also subject to tax under the Internal Revenue Code. Fourth, the new rules require states and localities to reduce tax attributes to reflect untaxed discharge of indebtedness income consistent with the same rules applicable for federal purposes.

The new rules accomplish this goal by the explicit referencing of applicable federal law. Under the revised section 346, the resolution of matters arising from state and local tax issues should be considerably more straightforward than under the provision as previously worded--as changes in federal tax law will automatically apply to the treatment of state and local tax issues.

This chapter's outline of the law under the old section 346 is still relevant to cases filed before the effective date of the new statute and as an interpretive guidepost as courts and parties deal with issues under the new law. Thus, the discussion of the old section 346, as updated for new section 346 developments, follows.

This chapter primarily addresses the special state and local tax provisions of the Bankruptcy Code, n5 because an analysis of the tax laws of each state and local taxing jurisdiction is beyond the scope of this treatise, and the federal income tax rules are fully discussed elsewhere. n6 These provisions generally preempt conflicting state and local rules, except that, presumably, these provisions are intended to be protective only. Further, they likely do not apply if they would give rise to a more adverse state and local tax result than the applicable state and local rules. n7

FOOTNOTES:

(n1)Footnote 1. *See* ch. TX4 *supra*.

(n2)Footnote 2. The Supreme Court confirmed the general power of a state to tax a party in bankruptcy in *California State Bd. of Equalization v. Sierra Summit, Inc.*, 490 U.S. 844, 109 S. Ct. 2228, 104 L. Ed. 2d 910, 20 C.B.C.2d 1501 (1989). The Court held that a state and local transfer tax on liquidating sales in bankruptcy did not place such a burden on the federal function of the bankruptcy court so as to violate the principle of intergovernmental immunity. Further, the Court held that such a tax was not in violation of 28 U.S.C. § 960 regarding the taxation of the business activities of officers and agents of federal courts. Not at issue in *Sierra Summit*, however, was the applicability of the section 1146(c) bar against the imposition of "a stamp tax or similar tax" in connection with a transfer under a plan of reorganization. This was because the liquidating sale in *Sierra Summit* was not in connection with such a plan.

(n3)Footnote 3. Pub. L. No. 96-56, 93 Stat. 387 (1979), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(a)(i)(A) (Matthew Bender 15th Ed. Revised). *See* Kenneth N. Klee, *Legislative History of the New Bankruptcy Law*, 28 Depaul L. Rev. 941 (1979).

(n4)Footnote 4. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n5)Footnote 5. 11 U.S.C. §§ 346, 728, 1146, 1231.

(n6)Footnote 6. *See* chs. TX1-TX11 *supra*; chs. TX13-TX16 *infra*.

(n7)Footnote 7. Strict application of the Bankruptcy Code's state and local rules can lead to absurd results, and

legislation is needed to bring these provisions into conformity with the Internal Revenue Code. Many states, for example, use the federal measures of gross income, adjusted gross income, or taxable income as a starting point for determining state taxable income. Strict adherence to the Bankruptcy Code's state and local tax provisions in many instances requires recomputing these federal measures of income for state income tax purposes despite the acceptability of these measures for the purpose of determining federal income tax liability in the context of a title 11 case. It is probable that many taxpayers and state and local taxing authorities in practice ignore the Bankruptcy Code's substantive state and local tax provisions, particularly in instances where the state tax code borrows heavily from the Internal Revenue Code.



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CHAPTER TX12 State and Local Tax Aspects of Bankruptcy

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P TX12.02 Jurisdiction of the Bankruptcy Court Over State and Local Taxing Authorities

[1] In General

State and local taxing authorities play a significant role as creditors in bankruptcy proceedings because of the frequency with which state and local tax obligations arise in title 11 cases. The issues that arise in connection with the tax claims of state and local governmental entities are no different than the issues of other creditors. Questions often arise as to the validity, amount, priority, and treatment of tax claims; the continuation and violation of the automatic stay; the avoidance of transfers; and the propriety of discharge in connection with the tax claims of state and local governmental entities.

The extent of the bankruptcy court's jurisdiction to resolve disputes involving state and local taxing authorities is restricted by the principle of sovereign immunity as contained in the *Eleventh Amendment to the United States Constitution*. n1 Congress ostensibly abrogated the immunity of "governmental unit[s]" n2 from suit in bankruptcy courts by amending section 106, as part of the Bankruptcy Reform Act of 1994, to clarify its intention to abrogate *Eleventh Amendment* sovereign immunity of the states, overrule the Supreme Court's decisions in *Hoffman v. Connecticut Department of Income Maintenance* n3 and *United States v. Nordic Village, Inc.*, n4 and subject "governmental unit[s]" to suits in federal court. n5 Because governmental unit[s] include the state and its agencies as well as municipalities and municipal agencies, bankruptcy courts have exercised jurisdiction over suits against state and local taxing authorities. n6

[2] *Central Virginia Community College v. Katz*

[a] In General

In 1996, the Supreme Court's decision in *Seminole Tribe of Florida v. Florida*, n7 raised questions concerning the extent of the bankruptcy court's jurisdiction over state and local taxing authorities. The court in *Seminole Tribe* held that Congress's legislative powers could not be used to abrogate a state's constitutional sovereign immunity for suit in federal court. Courts and commentators interpreted the decision to mean that state sovereign immunity could be asserted and would be recognized in bankruptcy cases.

In *Central Virginia Community College v. Katz*, n8 the Court ruled that these bankruptcy-related assumptions derived from *Seminole Tribe* were erroneous. In a 5-4 opinion, the Court held that state agencies do not enjoy sovereign

immunity with respect to a proceeding to set aside a debtor's preferential transfer because states implicitly subordinated their sovereign immunity to the bankruptcy clause when the U.S. Constitution was ratified.

At issue in *Central Virginia* was a bankruptcy trustee-initiated proceeding to set aside preferential transfers to Central Virginia Community College--a state agency. The Court held that states, in ratifying the Constitution, had waived their sovereign immunity--at least for ancillary bankruptcy proceedings.

The Court relied, in part, on its decision in *Tennessee Student Assistance Corp. v. Hood*.ⁿ⁹ *Hood* recognized a bankruptcy exception to states' constitutional sovereign immunity in connection with dischargeability proceedings. The *Central Virginia* court seized upon *Hood's* analysis of bankruptcy jurisdiction over nonconsenting states in the context of *in rem* matters as a springboard to conclude that, historically, the bankruptcy clause supersedes--to a degree it declined to specify--sovereign immunity protections. The Court conducted an extensive analysis of the historical background to the inclusion of the bankruptcy clause in the Constitution. The Court concluded that "the history of the bankruptcy clause, the reasons it was inserted in the Constitution, and the legislation both proposed and enacted under its auspices immediately following ratification of the Constitution, demonstrate that it was intended not just as a grant of legislative authority to Congress, but also to authorize limited subordination of state sovereign immunity in the bankruptcy arena." Furthermore, while the Court considered the matter primarily in the context of *in rem* actions, it left open the question of whether the scope of that consent might also extend to other types of proceedings.

The Court determined that the enactment of section 106(a) was not necessary to authorize the bankruptcy court's jurisdiction over avoidance actions. The Court instead concluded that "[i]n ratifying the bankruptcy clause, the states acquiesced in subordination of whatever sovereign immunity they might otherwise have asserted in proceedings necessary to effectuate the *in rem* jurisdiction of the bankruptcy courts." Accordingly, the Court concluded that Congress may, at its option, enact provisions such as section 106 that "either treats states in the same way as other creditors insofar as concerns laws on the subject of bankruptcies" or "exempt them from operation of such laws."

The Court's language leaves unclear the types of bankruptcy proceedings, other than preferential transfers, that would overcome the defense of sovereign immunity. The Court focused on how courts "historically have had the power to issue ancillary orders enforcing their *in rem* adjudication."ⁿ¹⁰ The decision, however, lacks a clear definition of ancillary. The enforcement of an automatic stay, which prohibits a creditor from taking actions to collect from a debtor who has filed for bankruptcy, likely, would fall under a definition of ancillary. Less clear is whether sovereign immunity applies to a debtor's action against the state to suppress the application of a state law, a debtor's cause of action arising against the state after commencement of the bankruptcy proceedings, or a cause of action against the state that arises pre-petition and passes from the debtor to the bankruptcy estate.

Katz, however, may not be the final word on the subject of sovereign immunity. Justice Sandra Day O'Connor, one of the majority members, has retired. O'Connor's successor, Justice Alito, is thought to be more sympathetic to states' rights.

[b] Related Matters

Katz does not alter the ability of debtors to sue and recover from federal governmental units, including the Internal Revenue Service, in bankruptcy courts. Section 106(a) continues to serve as a waiver of the federal government's sovereign immunity because it contains Congress' explicit consent (and only Congress can consent) to suits against the United States.ⁿ¹¹

To the extent that *Katz* has not eliminated a sovereign immunity defense in contexts outside of certain ancillary proceedings relating to a bankruptcy court's exercise of *in rem* jurisdiction, a claimant still may have other legal principles to ground a suit against a nonconsenting state.

First, because *Eleventh Amendment* immunity does not extend to municipalities, n12 section 106(a) continues to apply to municipalities and municipal agencies. Consequently, the *Eleventh Amendment* does not prohibit the bankruptcy court from exercising jurisdiction over municipal taxing authorities. It should be noted that municipal and local taxing authorities may still possess immunity if the relief sought would in fact be paid by the state. Whether the monetary relief ultimately would be the responsibility of the state depends on how a particular state organizes its municipal and local governments.

Second, subsections (b) and (c) of section 106 may continue to provide bases for the bankruptcy court to exercise jurisdiction over state governmental units. n13 In general, these subsections express the principle that a state waives its sovereign immunity when it chooses to sue a private party in federal court. n14 Accordingly, consenting state taxing authorities may be sued in bankruptcy court. What remains unclear is what action by the state will be sufficient to waive sovereign immunity, and further, what relief can be recovered from a state that has consented. The case law decided prior to the Bankruptcy Reform Act of 1994 and after the Supreme Court's decisions in *Hoffman* n15 and *Nordic Village* n16 may provide an indication of how courts will rule on the question of a state's waiver of sovereign immunity. n17 Even if a state is found to have waived its immunity, there is authority for the proposition that claims against the state are limited to compulsory counterclaims and only in an amount sufficient to setoff the state's claim. n18 Under this view, no affirmative recovery is permitted. This theory of waiver calls into question the validity of section 106(b) and (c) because section 106(b) provides for an affirmative recovery against states and section 106(c), on its face, is not limited to compulsory counterclaims.

Third, the doctrine of *Ex parte Young* n19 would permit an individual to sue a state officer in federal court if the relief sought in the bankruptcy court is prospective injunctive relief. For example, if a state taxing authority has been garnishing a debtor's pre-petition wages, an unauthorized post-petition garnishment by a state that failed to file a proof of claim or otherwise participate in the case could be enjoined in the bankruptcy court by a suit against the officer of the state taxing authority. After *Katz*, the application of *Ex parte Young* is bolstered. The court may now read section 106(a) to permit suits in bankruptcy court against state officials. If the language of section 106 is a grant of legal applicability but not an abrogation of sovereign immunity, that language could be read to suggest that Congress intended for bankruptcy courts to exercise jurisdiction over state officials.

After *Katz*, there is still a question as to whether private parties asserting federal claims for damages against a state--including claims arising from bankruptcy cases--could, without a waiver of sovereign immunity, maintain such actions in state court. The Supreme Court had appeared to answer that question in *Alden v. Maine*. n20 *Alden* involved a federal fair labor standards Act claim against the State of Maine brought by a probation officer seeking overtime pay and liquidated damages. The federal district court that originally heard the case had dismissed it following the *Seminole Tribe* decision. The *Alden* petitioners re-filed in state court. Consistent with its reasoning in *Seminole Tribe*, the Supreme Court held that absent a waiver of sovereign immunity, states are not subject in state court to provide actions for damages arising from federal claims. n21 It is uncertain what the implications of *Katz* on the *Alden* holding are.

[c] Conclusion

As things currently stand, bankruptcy courts now have jurisdiction to adjudicate disputes involving state agencies--at least in in rem adjudications and in ancillary proceedings arising from the exercise of *in rem* jurisdiction.

The bankruptcy court continues to retain jurisdiction over the United States, municipalities, localities, and consenting states to the extent of a claim for setoff, and over state officials to the extent of a claim for prospective injunctive relief.

If a claim arises from a bankruptcy case but is not a part of a case under title 11, the state courts would have to provide the forum. Whether the concurrent jurisdiction of state courts will provide a forum for every suit against a state remains unclear.

FOOTNOTES:

(n1)Footnote 1. The *Eleventh Amendment* provides that "[t]he Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State." *U.S. Const. Amend. XI*.

(n2)Footnote 2. *11 U.S.C. § 101(27)*.

(n3)Footnote 3. *492 U.S. 96, 109 S. Ct. 2818, 106 L. Ed. 2d 76, 20 C.B.C.2d 1204 (1989)* .

(n4)Footnote 4. *503 U.S. 30, 112 S. Ct. 1011, 117 L. Ed. 2d 181, 26 C.B.C.2d 9 (1992)* .

(n5)Footnote 5. For a discussion of sovereign immunity, see *11 U.S.C. § 106*, as discussed in 2 Collier on Bankruptcy, ch. 106 (Matthew Bender 15th Ed. Revised) and *P TX5.06[7] supra* ; see generally S. Elizabeth Gibson, *Congressional Response to Hoffman and Nordic Village: Amended Section 106 and Sovereign Immunity*, 69 *Am. Bankr. L.J.* 311 (1995) (review and analysis of sovereign immunity before and after Bankruptcy Reform Act of 1994).

(n6)Footnote 6. *In re 995 Fifth Ave. Assoc., L.P.*, 963 F.2d 503, 26 C.B.C.2d 1162 (2d Cir. 1992) , *cert. denied*, 506 U.S. 947, 113 S. Ct. 395, 121 L. Ed. 2d 302 (1992) (filing administrative expense claim for additional tax was a waiver of immunity); *Roberts v. Sullivan County (In re Penning Trust)*, 196 B.R. 389 (Bankr. E.D. Tenn. 1996) (jurisdiction under § 505(a)(2)(B) for refund of property taxes); *Field v. Montgomery County (In re Anton Motors, Inc.)*, 177 B.R. 58 (Bankr. D. Md. 1995) (sovereign immunity waived as to bankruptcy fraudulent transfer provision but not as to state law fraudulent transfer provision); *T.F. Stone Cos. v. Harper (In re T.F. Stone Companies, Inc.)*, 170 B.R. 884 (Bankr. N.D. Tex. 1994) , *aff'd*, 72 F.3d 466 (5th Cir. 1995) (postpetition foreclosure amounted to waiver). *But see California State Bd. of Equalization v. Kupetz (In re Vanguard Mfg. Co.)*, 27 C.B.C.2d 1490, 145 B.R. 644 (B.A.P. 9th Cir. 1992) (accepting and cashing check for payment of postpetition taxes was not a waiver).

(n7)Footnote 7. *517 U.S. 44, 116 S. Ct. 1114, 134 L. Ed. 2d 252, 34 C.B.C.2d 1199 (1996)* .

(n8)Footnote 8. *546 U.S. 356, 126 S. Ct. 990 (2006)* .

(n9)Footnote 9. *541 U.S. 440, 124 S. Ct. 1905, 158 L. Ed. 2d 764, 51 C.B.C.2d 627 (2004)* .

(n10)Footnote 10. *Katz*, 126 S. Ct. at 995.

(n11)Footnote 11. *United States v. Lee*, 106 U.S. 196, 1 S. Ct. 240, 27 L. Ed. 171 (1882) .

(n12)Footnote 12. *Dekalb County Div. of Family & Children Servs. v. Platter (In re Platter)*, 140 F.3d 676, 680 (7th Cir. 1998) (when state voluntarily elects to enter case, state removes itself from *Eleventh Amendment* protection).

(n13)Footnote 13. Gibson, *Sovereign Immunity in Bankruptcy: The Next Chapter*, 70 *Am. Bankr. L.J.* 195, 212 (1996).

(n14)Footnote 14. *Dekalb County Div. of Family & Children Servs. v. Platter (In re Platter)*, 140 F.3d 676, 680 (7th Cir. 1998) (when state voluntarily chooses to enter the case, the state removes itself from *Eleventh Amendment* protection).

(n15)Footnote 15. *492 U.S. 96, 109 S. Ct. 2818, 106 L. Ed. 2d 76, 20 C.B.C.2d 1204 (1989)* .

(n16)Footnote 16. *503 U.S. 30, 112 S. Ct. 1011, 117 L. Ed. 2d 181, 26 C.B.C.2d 9 (1992)* .

(n17)Footnote 17. For example, the following decisions required the filing of a formal proof of claim to find a

waiver under former section 106(a) and (b): *Graham v. United States (In re Graham)*, 981 F.2d 1135, 28 C.B.C.2d 78 (10th Cir. 1992) ; *State ex rel Guste v. Public Investors Life Ins. Co.*, 866 F. Supp. 301, 304 (W.D. La. 1993) , *aff'd*, 35 F.3d 216 (5th Cir. 1994) . *See also In re NVR L.P.*, 206 B.R. 831, 851 (Bankr. E.D. Va. 1997) , *rev'd and vacated in part*, 189 F.3d 442 (4th Cir. 1999) , *cert. denied*, 528 U.S. 1117 (2000) ("[t]he filing of a claim should at most be interpreted only as an express consent to the adjudication of that claim."). Decisions not requiring the filing of a formal proof of claim include: *In re Town & Country Home Nursing Services, Inc.*, 963 F.2d 1146, 26 C.B.C.2d 1446 (9th Cir. 1992) (postpetition offset functional equivalent of claim, thus immunity waived); *Official Comm. of Unsecured Creditors of Operation Open City v. New York State Dep't of State (In re Operation Open City)*, 170 B.R. 818 (S.D.N.Y. 1994) (exercise of postpetition setoff waives immunity as to compulsory counterclaims); *Taylor v. United States*, 148 B.R. 361 (S.D. Ga. 1992) (postpetition withholding of refund waives immunity). *See 2 Collier on Bankruptcy, P 106.02[1][ii]* (Matthew Bender 15th Ed. Revised).

(n18)Footnote 18. Gibson, *Sovereign Immunity in Bankruptcy: The Next Chapter*, 70 Am. Bankr. L.J. 195, 209-11 (1996). A growing number of federal circuits are adopting the principle that when a state or arm of a state files a proof of claim in a bankruptcy proceeding, the state waives its *Eleventh Amendment* immunity with regard to the bankruptcy estate's claims that arise from the same transaction or occurrence as the state's claim. It is, however, uncertain whether this test is limited to claims in the nature of compulsory counterclaims or recoupments or would encompass broader affirmative recovery. *See Schulman v. State of California (In re Lazar)*, 237 F.3d 967, 976-79 (9th Cir. 2001) , *cert. denied*, 534 U.S. 992 (2001) .

(n19)Footnote 19. 209 U.S. 123, 28 S. Ct. 441, 52 L. Ed. 714 (1908) . Under this doctrine, a federal court may enjoin state officials to conform their future conduct to the requirements of federal law without violating the *Eleventh Amendment*.

(n20)Footnote 20. *Alden v. Maine*, 527 U.S. 706, 119 S. Ct. 2240, 144 L. Ed.2d 636 (1999) .

(n21)Footnote 21. *Id.*



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CHAPTER TX12 State and Local Tax Aspects of Bankruptcy

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P TX12.03 Income Tax

[1] Procedural Rules

[a] Burden of Proof

In proceedings before the Tax Court for the redetermination of deficiencies, before the district courts or the Court of Federal Claims for refunds and before many state tribunals, the taxpayer bears the burden of proving by credible evidence the allegations asserted. n1 In bankruptcy proceedings, a properly filed claim constitutes *prima facie* evidence of the validity and amount of the claim. n2 Once the debtor or the trustee rebuts the *prima facie* validity, the ultimate burden is on the claimant. n3

When the claim is for taxes, courts had previously failed to reach consensus on whether to import into the bankruptcy setting the burden of proof generally imposed on taxpayers.

The Supreme Court decided the issue in *Raleigh v. Illinois Department of Revenue*. n4 In *Raleigh*, the Court unanimously concluded that "in the absence of modification expressed in the Bankruptcy Code the burden of proof on a tax claim in bankruptcy remains where the substantive law puts it." n5

[b] Individuals

Under the 2005 Act, n6 section 346, principally concerned with state and local tax issues, is largely rewritten. Once more, the provisions previously found in section 728 and sections 1146(a) and 1146(b) are, by and large, transferred to section 346.

The new rules provide for uniformity among federal, state, and local tax administrative rules. First, the new rules prevent a bankruptcy filing from resulting in the creation of a new taxable estate, or the termination of the debtor's taxable year, for federal purposes, but not for state and local purposes--or vice versa. Second, the new rules conform the federal, state, and local tax consequences of property transfers from the debtor to the estate (or from the estate to the debtor). Third, the new rules prevent state or local tax from being imposed on discharge of indebtedness income unless that income is also subject to tax under the Internal Revenue Code. Fourth, the new rules require states and localities to reduce tax attributes to reflect untaxed discharge of indebtedness income consistent with the same rules applicable for federal purposes.

The new rules accomplish this goal by the explicit referencing of applicable federal law. Under the revised section 346, the resolution of matters arising from state and local tax issues should be considerably more straightforward than under the provision as previously worded--as changes in federal tax law will automatically apply to the treatment of state and local tax issues.

This chapter's outline of the law under the old section 346 is still relevant to cases filed before the effective date of the new statute and as an interpretive guidepost as courts, and parties, deal with issues under the new law. Thus, the discussion of the old section 346, as updated for new section 346 developments, follows.

[i] Taxable Entity

In a case under chapter 7, 11 or 12 of the Bankruptcy Code, the estate of an individual is the taxable entity under state or local law, and income generated by the estate may not be taxed to the individual. n7 In a case under chapter 13, however, only the individual debtor, and not the estate, may be subject to state and local income tax. n8 These rules parallel the federal rules, except that the federal rules do not treat the estate as separately taxable in a case under chapter 12. n9

[ii] Computation of Tax

Where the estate is separately taxable, *i.e.*, in a case under chapter 7, 11 or 12 of the Bankruptcy Code, the state and local rules for the income taxation of a decedent's estate apply. n10 This differs from the federal rules for the taxation of a separately taxable estate in a case under the Bankruptcy Code, which require that the income tax liability of the estate be computed as if the estate were an individual. n11

[iii] Taxable Year and Accounting Method

In a case under chapter 7, 11, or 12 of the Bankruptcy Code, the tax year of an individual debtor automatically terminates on the date of the order for relief. n12 This rule does not apply if a case has been converted to a chapter 7, 11, or 12 case under *section 706, 1112, or 1208 of the Bankruptcy Code*. n13 Presumably, if a case is converted under one of these sections, then the existing taxable year remains in effect unless state or local law dictates to the contrary. The federal rules deviate slightly from the state and local rules by providing for the termination of the debtor's taxable year on an elective basis. n14 Thus, the taxable year for federal purposes, as opposed to state and local, could differ if a debtor does not elect to terminate his or her taxable year upon commencement of the case. n15

If an estate is the taxable entity, the estate is required to use the same accounting method that the debtor used immediately before the commencement of the case. n16 This principle parallels the federal rule, except that there is no state and local tax provision comparable to the federal provision allowing an estate to make a one time change in accounting method without taxing authority approval. n17

[iv] Partnership Returns

In the case of an individual under chapter 7 of the Bankruptcy Code, the trustee need only file state and local tax returns if the estate has net taxable income for the entire period of the case. n18 If the estate has net taxable income at the close of the case, the trustee is required to file a return for each taxable period during which the case was pending. n19 Presumably, no penalty could be imposed under state and local law for this otherwise late filing, and presumably, no returns are required if not required by state or local law. This latter situation could be presented, for example, if required threshold levels of income are not met. The federal rules are substantially more detailed. n20

In a case of an individual debtor under chapter 11 or 12, the trustee must file a state or local income tax return for each taxable period after the order for relief during which the case is pending. n21 But no returns are required to be filed if

state or local law does not require returns; for example, if required threshold levels of income are not met. The federal rules are roughly parallel for a case filed under chapter 11, but the debtor, rather than the trustee, must file returns on the federal level for a case filed under chapter 12 because the estate is not separately taxable on the federal level. n22

In a case under chapter 13, all income is taxed to the debtor, rather than the estate; therefore, the debtor is responsible for filing all state and local income tax returns. n23 The federal rule is the same. n24

[v] Other Reporting Obligations

In a case under chapter 11, the trustee or debtor in possession must furnish to the appropriate taxing authority any information reasonably available to the trustee or debtor in possession regarding a tax (income or otherwise) for which the debtor did not file a return. n25 In a case under chapter 7, if the business of the debtor is authorized to be operated, the trustee shall file periodic reports and summaries of the operation of the business, including income and expense statements with the court, United States trustee, and the appropriate taxing authorities. n26

[vi] Withholding Tax Liability

The Bankruptcy Code specifically requires a trustee to withhold and pay in the same time and manner any amount to be withheld or collected under applicable state or local tax law. The amounts withheld are entitled to the same priority as the claims from which the withheld amounts emerged. n27

[vii] Procedure for Prompt Determination of Postpetition Tax Liability

A trustee may request a determination of any unpaid postpetition state or local tax liability (income tax or otherwise) of the estate by submitting a return and a request for such a determination to the appropriate taxing authority. Unless the return is fraudulent or it contains a material misrepresentation, the trustee, debtor, and any successor to the debtor are discharged from any future liability upon any one of the following three events: (1) payment of the tax shown on the return, provided however, that the taxing authority does not either (a) notify the trustee within 60 days that the return will be subject to examination; or (b) complete its examination within 180 days or within such additional time as the court may permit; (2) payment of the taxes determined to be due by the taxing authority; or (3) in the event of a dispute, payment of the tax amount as determined by the court. n28 These rules apply equally to federal, state, and local taxes. n29

[viii] Rulings on Tax Consequences of Reorganization

The bankruptcy court may authorize a proponent of a plan to request a determination, limited to questions of law, from an appropriate state or local tax authority of the income tax consequences of a plan of reorganization under chapter 11 or 12. If an actual controversy arises over the purported tax consequences of a plan, the court may make a determination of such tax consequences after the earlier of the date on which the taxing authority responds to the request or 270 days after the request. n30

[c] Corporations

[i] Continuity of Tax Status

Consistent with the federal rule, no separate taxable entity is created for state or local tax purposes in the case of a corporation that has commenced a case under the Bankruptcy Code. n31 Income of the estate may be taxed as though the case had not been commenced. n32

[ii] Returns

Except for a case under chapter 7, a trustee or debtor in possession must file any tax return otherwise required by state or local law in the same time and manner as the debtor corporation is required to file. n33 In a case under chapter 7, *section 728(b) of the Bankruptcy Code* provides that the trustee or debtor in possession is required to file returns only if the corporation has net taxable income for the entire period after the order of relief. n34 A return must then be filed for each taxable period during which the case was pending. n35 Read literally, section 728(b) could be interpreted to prohibit imposition of a tax where the debtor corporation has no net income. This interpretation, however, probably does not reflect Congressional intent. The statute appears to be addressed more to the issue of providing relief from the administrative burden of filing multiple returns during the course of a chapter 7 case rather than to the issue of providing relief from payment of taxes which are otherwise due under state and local law.

[iii] Other Procedural Issues

The state and local tax rules for corporate debtors and their estates and trustees are the same as those for individuals regarding other reporting requirements, withholding, prompt determination of postpetition tax liability, and reorganization tax consequences rulings. n36

[d] Partnerships

[i] Continuity of Tax Status of Partnership

The commencement of a case under the Bankruptcy Code does not give rise to a change in the state or local tax status of a partnership. n37 If a partnership is taxable under state or local law, the partnership may be taxed under state or local income tax law as though a bankruptcy case had not been commenced.

[ii] Taxation of Individual Partners

Only the estate of an individual partner who has commenced a case under the Bankruptcy Code is subject to state and local income tax, and the income and tax are computed in the same manner as the income and tax of a bankruptcy estate. n38 This principle parallels the federal rule, except that on the federal level, the estate of an individual partner is taxed as an individual and not as an estate. n39

[iii] Returns

As with corporations, partnership returns must be filed by the trustee or debtor in possession in the same manner and form as the partnership would have been required to file. n40 Unlike the rules for corporate and individual debtors, however, there is no exception to the filing requirement where the partnership has no net taxable income in a case under chapter 7. n41 Because the items of income, gain, loss, deduction and credit of a partnership generally flow through to its partners, the trustee must file a return for each taxable period so that each partner's taxable income can be determined.

[iv] Marshalling Rules for Tax Claims

If cases under chapter 7 are pending regarding both a partnership and one of its partners, the bankruptcy court is required to disallow a state or local income tax claim against the partner and allow the claim against the partnership to the extent that the tax liability arose from the inclusion of undistributed earnings in the partner's taxable income. n42 If the partnership assets are insufficient to fully satisfy the claim, however, then the trustee of the partnership may assert a claim for the unsatisfied tax against the estate of the partner. n43 This marshalling rule applies only for purposes of allowance and distribution. Thus, a taxing authority could continue to maintain a nondischargeable claim against an individual partner. n44 There is no comparable provision for federal income tax claims, and therefore, a federal income tax claim arising from a partner's share of undistributed partnership income generally would be a claim against the partner's estate. n45

[v] Apportionment of Tax Refunds

If cases under chapter 7 are pending for both a partnership and one of its partners, any state or local tax refund or reduction in tax owed to a partner which would otherwise have been the property of the estate of the partner becomes the property of the estate of the partnership if the refund or reduction is "fairly apportionable" to losses sustained by the partnership and not reimbursed by the partner. n46 Making a "fairly apportionable" determination presents substantial administrative problems. The legislative history of the Bankruptcy Code suggests that a distribution under this tax refund allocation provision would not impose a duty to make a second refund to either the partner or the partnership. n47 Presumably, the estate of the partnership or the partner could recover any erroneously directed refund payment.

[vi] Other Procedural Issues

The state and local tax rules for partner or partnership debtors regarding other reporting requirements, withholding, prompt determination of postpetition tax liability, and reorganization tax consequences rulings are the same as those for individuals. n48

[2] Substantive Rules

[a] Administrative Expense Deductions

Similar to *I.R.C. section 1398(h)*, *section 346(e) of the Bankruptcy Code* provides that a claim allowed under section 502(f) or *section 503 of the Bankruptcy Code* is deductible to the entity to which the income of the estate is taxed. No deduction is allowed for a nondeductible tax or a nondeductible capital expenditure. In addition, the claim cannot have been deducted by another entity, notably an accrual basis debtor. A claim deductible under section 346(e) is deemed to be a deduction attributable to a business. n49

Section 346(e) differs from *I.R.C. section 1398(h)* in several respects. First, section 346(e) provides that administrative claims under section 503 are deductible as business expenses. However, *I.R.C. section 1398(h)* allows the deduction but does not characterize the deduction as a business expense. Thus, other provisions of the Internal Revenue Code will determine the characterization of the deduction. n50 Because the Bankruptcy Code alone confirms administrative expenses on the state and local level as business expenses, such expenses generally will be considered in measuring the net operating loss of the estate. This is true both for purposes of determining the net operating loss carrybacks to the debtor's prebankruptcy periods and for purposes of determining the net operating loss to which the debtor will succeed at the conclusion of the case. On the federal level, administrative expenses that are not business expenses will not enter into such calculations. n51

Second, *section 346(e) of the Bankruptcy Code* provides that claims under section 502(f) are deductible business expenses, while *I.R.C. section 1398* is silent on this issue. *Section 502(f) of the Bankruptcy Code* addresses claims in involuntary cases which arise in the ordinary course of the debtor's business or financial affairs after the commencement of the case but before the earlier of either the appointment of a trustee or the order for relief. Because *I.R.C. section 1398* does not address the deductibility of section 502(f) claims, the federal deductibility and characterization of section 502(f) claims will be determined by provisions of the Internal Revenue Code other than *I.R.C. section 1398*. n52 Accordingly, some section 502(f) claims may be deductible for state and local, but not federal income tax purposes.

Third, unlike *I.R.C. section 1398(h)*, *section 346 of the Bankruptcy Code* does not have a special provision that provides that the fees or charges assessed against the estate under *28 U.S.C. sections 1911-1923* are deductible. n53 Still, such fees and charges may be deductible or tantamount to deductible under state and local law, particularly in instances in which federal taxable income serves as the starting point for determining state or local taxable income.

[b] Nonrecognition of Gain on Transfers to and from Estate

No gain or loss is recognized on the transfer of property in any of the following three circumstances:

- (a) from the debtor to the estate by operation of law, n54
- (b) from the estate to the debtor, except by sale, n55 or
- (c) in a case under chapter 11 or 12, to an affiliate participating in a joint plan with the debtor or a successor to the debtor under the plan except that gain "may be recognized to the extent that such transfer results in the recognition of gain or loss under *Section 371 of the Internal Revenue Code of 1954*." n56

A problem arises under the exception to the general nonrecognition rule described in (c) above because *I.R.C. section 371* was repealed by the Bankruptcy Tax Act of 1980. n57 Thus, there are at least four plausible interpretations of the rule: (1) the exception will never apply because *I.R.C. section 371* has been repealed, and therefore, gain is never recognized under such section; n58 (2) the exception applies only if *I.R.C. section 371* would have applied to the transaction and gain would have been recognized under section 371; (3) the same as (2) except that gain is also recognized if the transaction would not have fallen within the scope of the *I.R.C. section 371* nonrecognition rules; or (4) gain is recognized to the extent boot was received but not distributed to shareholders or creditors regardless of whether the transaction otherwise would have qualified for nonrecognition under *I.R.C. section 371*.

Taxpayers generally will favor interpretations (1) and (2), while taxing authorities generally will favor interpretations (3) and (4). The most sensible solution, perhaps, would be to protect debtors (and their estates and affiliates) from recognition of state and local gain only if they currently are protected under the Internal Revenue Code. n59 This resolution, however, would require congressional action.

Under the 2005 Act, n60 however, section 346, principally concerned with state and local tax issues, is largely rewritten. Once more, the provisions previously found in section 728 and sections 1146(a) and 1146(b) are, by and large, transferred to section 346.

The new rules provide for uniformity among federal, state, and local tax administrative rules. First, the new rules prevent a bankruptcy filing from resulting in the creation of a new taxable estate, or the termination of the debtor's taxable year, for federal purposes, but not for state and local purposes--or vice versa. Second, the new rules conform the federal, state, and local tax consequences of property transfers from the debtor to the estate (or from the estate to the debtor). Third, the new rules prevent state or local tax from being imposed on discharge of indebtedness income unless that income is also subject to tax under the Internal Revenue Code. Fourth, the new rules require states and localities to reduce tax attributes to reflect untaxed discharge of indebtedness income consistent with the same rules applicable for federal purposes.

The new rules accomplish this goal by explicitly referencing applicable federal law. Under the revised section 346, the resolution of matters arising from state and local tax issues should be considerably more straightforward than under the provision as previously worded because changes in federal tax law will automatically apply to the treatment of state and local tax issues.

This chapter's outline of the law under the old section 346 is still relevant to cases filed before the effective date of the new statute and as an interpretive guidepost as courts, and parties, deal with issues under the new law. Thus, the discussion of the old section 346, as updated, follows.

[c] Transfer of Tax Attributes Between Debtor and Estate

Similar to the rules under *I.R.C. section 1398(g)*, the Bankruptcy Code contains state and local tax rules regarding the succession by the estate to the tax attributes of the debtor. Specifically, in a case under chapter 7, 11, or 12 of the Bankruptcy Code concerning an individual, the estate generally succeeds to the state and local tax attributes of the

debtor. This includes any loss, capital loss, investment credit, or foreign tax credit carryovers, any recovery exclusion, and any claim of right. n61 The estate or debtor also succeeds to the basis, holding period, and character of asset where property is transferred in a transaction of the kind specified in section 346(g). n62 As previously noted, the estate of an individual debtor must continue to use the accounting method of the debtor. n63 After a case is closed or dismissed, the debtor succeeds to the unutilized tax attributes of the estate, and any applicable time limits on the utilization of such attributes are suspended during the pendency of the case. n64

There are two major differences between the state and local rules and the federal rules regarding succession of tax attributes. First, while the state and local rules apply to a case under chapter 12, the federal rules do not. This is because a separate taxable estate is not created for federal income tax purposes in a case under chapter 12, while such an estate is created for state and local income tax purposes. n65 Second, no federal law counterpart exists to the state and local rule, providing that the debtor may use tax attributes of the estate to which the debtor succeeds as though any applicable time limitations on such utilization by the debtor were suspended during the pendency of the case. n66

[d] Loss Carrybacks and Carryforwards

For state and local tax purposes in a case under chapter 7, 11, or 12 of the Bankruptcy Code concerning an individual, the estate may carry back any loss of the estate to a taxable period of the debtor that ended before the order for relief in the same manner as the debtor could have in the absence of the bankruptcy case. n67 A similar rule applies on the federal level. n68 In *In re Prudential Lines*, n69 the Court of Appeals for the Second Circuit held that the right to carryforward the net operating losses of a subsidiary-debtor was property of the estate of the subsidiary-debtor and not the parent corporation. The court reasoned that the inapplicability of section 346(i) to corporations did not imply that Congress intended to treat net operating loss carryforwards of corporate debtors any differently than those of individuals. Because the bankruptcy estate of a corporate debtor is not a separate taxable entity, n70 Congress would not have had to provide that carryovers are transferred to the estate and then back to the corporate debtor.

In determining for state and local tax purposes the number of taxable periods for which the estate may carry back its losses, the taxable year of the debtor is deemed not to have been terminated by the commencement of the case. n71 No comparable federal provision exists in this respect. Accordingly, in instances in which the debtor elects to terminate its federal taxable year, n72 and termination of such year is required by the state and local rules, n73 the short taxable year is counted for federal but not state and local loss carryback and carryover purposes.

The debtor's carryback of losses for periods ending after the commencement of the case to prebankruptcy periods is prohibited for state and local tax purposes in a case under chapter 7, 11, or 12 of the Bankruptcy Code. n74 This prohibition is lifted, however, after the case is closed. n75 For federal purposes, this prohibition is absolute and is not lifted upon termination of the case. n76

It should be emphasized that the special state and local tax provisions of the Bankruptcy Code regarding loss carrybacks and carryovers only govern the application of loss carryback and carryover rules in states and localities that allow loss carrybacks and carryovers. While the Bankruptcy Code does not require a state or locality to allow for carrybacks or carryovers in the first instance, some states prohibit it. Similarly, the Bankruptcy Code does not address the carryover of net operating losses to successor corporations, because it is again left to state and local law.

[e] Cancellation of Indebtedness Income and Attribute Reduction

Section 346(j) of the Bankruptcy Code sets forth the general rule that income is not realized for state and local income tax purposes by the estate, debtor, or a successor to the debtor by reason of the forgiveness or discharge of indebtedness in a bankruptcy case. n77 Importantly, this section does provide for attribute reduction. n78 These attribute reduction provisions correspond roughly to the federal rules set forth in *I.R.C. section 108*, but there are significant differences. Read literally, the section 346(j) attribute reduction rules are mandatory. There appears to be no federal interest,

however, in requiring a harsher state and local tax result than would otherwise be generated by the applicable state and local tax rules. Thus, it could be argued that the section 346(j) attribute reduction rules presumably should not apply in such instances.

Under the 2005 Act, n79 however, section 346, principally concerned with state and local tax issues, is largely rewritten. Once more, the provisions previously found in section 728 and sections 1146(a) and 1146(b) are, by and large, transferred to section 346.

The new rules provide for uniformity among federal, state, and local tax administrative rules. First, the new rules prevent a bankruptcy filing from resulting in the creation of a new taxable estate, or the termination of the debtor's taxable year, for federal purposes, but not for state and local purposes--or vice versa. Second, the new rules conform the federal, state, and local tax consequences of property transfers from the debtor to the estate (or from the estate to the debtor). Third, the new rules prevent state or local tax from being imposed on discharge of indebtedness income unless that income is also subject to tax under the Internal Revenue Code. Fourth, the new rules require states and localities to reduce tax attributes to reflect untaxed discharge of indebtedness income consistent with the same rules applicable for federal purposes.

The new rules accomplish this goal by the explicit referencing of applicable federal law. Under the revised section 346, the resolution of matters arising from state and local tax issues should be considerably more straightforward than under the provision as previously worded because changes in federal tax law will automatically apply to the treatment of state and local tax issues.

This chapter's outline of the law under the old section 346 is still relevant to cases filed before the effective date of the new statute and as an interpretive guidepost for courts and parties dealing with issues under the new law. Thus, the discussion of the old section 346, as updated, follows.

[i] General Attribute Reduction Rules

Income generally is not realized by the estate, debtor or successor to the debtor by reason of discharge of indebtedness. Sometimes, however, reduction of certain tax attributes is required. Specifically, the state and local net operating loss of an individual or corporate debtor, including a net operating loss carryover to the debtor, is reduced by the amount of indebtedness canceled in a bankruptcy case. n80 If discharged amounts exceed net operating loss and net operating loss carryovers, the basis of the debtor's property is reduced, but not below the debtor's total liabilities that were liabilities both before and after the cancellation of debt. n81 The legislative history describes this limitation on basis reduction as a "basis solvency" limitation with the effect of limiting basis reduction to a level equal to undischarged liabilities. n82

[ii] Exceptions to Attribute Reduction Rules

Attribute reduction is generally not required if no prior tax benefit was generated. For example, section 346(j)(2) denies the debtor "a deduction with respect to a liability" for any period during or after which the liability is forgiven or discharged. n83 Thus, if a deduction for a discharged debt is disallowed under this provision, no attribute reduction is required. For the purpose of section 346(j)(2), "a deduction with respect to a liability" includes a capital loss incurred on the disposition of a capital asset with respect to a liability that was incurred in connection with the acquisition of such asset. n84

Similarly, no attribute reduction is required if the canceled liability consists of items of a deductible nature that have not been deducted by the debtor or that resulted in an expired net operating loss carryover or other deduction that did not offset income for any taxable period and did not contribute to a net operating loss in, or a net operating loss carryover to, a taxable period during or after which the indebtedness was canceled. n85

Finally, reduction of basis is not required to the extent the debtor elects to treat as taxable income the amount of forgiven or discharged indebtedness that otherwise would have been applied in reduction of basis. n86

Under the 2005 Act, n87 however, section 346, principally concerned with state and local tax issues, is largely rewritten. Once more, the provisions previously found in section 728 and sections 1146(a) and 1146(b) are, by and large, transferred to section 346.

The new rules provide for uniformity among federal, state, and local tax administrative rules. First, the new rules prevent a bankruptcy filing from resulting in the creation of a new taxable estate, or the termination of the debtor's taxable year, for federal purposes, but not for state and local purposes--or vice versa. Second, the new rules conform the federal, state, and local tax consequences of property transfers from the debtor to the estate (or from the estate to the debtor). Third, the new rules prevent state or local tax from being imposed on discharge of indebtedness income unless that income is also subject to tax under the Internal Revenue Code. Fourth, the new rules require states and localities to reduce tax attributes to reflect untaxed discharge of indebtedness income consistent with the same rules applicable for federal purposes.

The new rules accomplish this goal by explicitly referencing of applicable federal law. Under the revised section 346, the resolution of matters arising from state and local tax issues should be considerably more straightforward than under the provision as previously worded because changes in federal tax law will automatically apply to the treatment of state and local tax issues.

This chapter's outline of the law under the old section 346 is still relevant to cases filed before the effective date of the new statute and as an interpretive guidepost as courts, and parties, deal with issues under the new law. Thus, the discussion of the old section 346, as updated, follows.

[iii] Differences Between Federal, State and Local Debt Cancellation and Attribute Reduction Provisions

Under previous law, there are a number of differences between the federal, state, and local debt cancellation and attribute reduction rules in the title 11 context. n88 First, unlike *I.R.C. section 108(d)(8)*, no clear indication exists under *section 346(j) of the Bankruptcy Code* that, in the case of an individual, the tax attributes reduced are the attributes of the estate rather than the debtor. n89 Because, however, section 346(i)(1) requires that the estate succeed to the tax attributes, including net operating losses of the debtor, section 346(j)(3) likely requires the reduction of net operating losses to which the estate has succeeded and does not require the reduction of net operating losses generated by the debtor after commencement of the bankruptcy case.

Second, a similar issue arises under section 346(j)(5), which requires a reduction in the basis of either "the debtor's property or of property transferred to an entity required to use the debtor's basis." This provision is inconsistent with federal law to the extent it suggests, for example, that when the bankruptcy estate has succeeded to the debtor's property, the basis may be reduced by property acquired by the individual debtor after the bankruptcy filing. However, this provision would probably be interpreted to parallel the federal rule and require only a basis reduction of the property of the bankruptcy estate.

Third, unlike *I.R.C. section 108(b)(4)(B)*, *section 346(j) of the Bankruptcy Code* does not contain ordering rules providing first for the reduction of the loss for the taxable year of discharge and then of carryovers to such taxable year in the order in which the carryovers arose. Presumably, however, the federal ordering rules would be followed.

Fourth, *section 346(j)(6) of the Bankruptcy Code* allows the debtor, in lieu of reducing basis, to elect to treat the amount of any cancellation of indebtedness as taxable income in the taxable period during which the indebtedness is canceled. No comparable provision exists under *I.R.C. section 108*.

Fifth, unlike *I.R.C. section 108, section 346(j) of the Bankruptcy Code* only subjects net operating losses, net operating loss carryovers, and basis to attribute reduction. For federal purposes, reduction is also required of credit carryovers, capital losses, capital loss carryovers, and passive activity losses. n90

Sixth, unlike *I.R.C. section 108(b)(5)*, no election exists under section 346(j) to reduce the basis of depreciable property first before reducing other tax attributes, such as net operating losses and net operating loss carryovers. n91

Seventh, as mentioned above, *section 346(j)(2) of the Bankruptcy Code* provides that a deduction with respect to a liability may not be allowed for any taxable period during or after which the liability is canceled. Thus, an accrual basis debtor is prohibited, for state and local tax purposes, from taking a deduction for a liability that is later discharged in a title 11 case. No comparable provision exists for federal tax purposes. However, the IRS ruled (prior to the Bankruptcy Tax Act) that an accrual basis taxpayer could deduct an expense even if the liability were subsequently discharged in a bankruptcy case. n92

Eighth, unlike *I.R.C. section 108, section 346(j) of the Bankruptcy Code* does not contain a provision expressly providing that attributes be reduced after determining the tax liability for the year of discharge. n93 Despite this silence, carryovers presumably could be used for state and local tax purposes in the taxable year of discharge prior to being reduced by the amount of canceled debt.

Ninth, unlike *I.R.C. section 1017(c)(1), section 346(j) of the Bankruptcy Code* does not expressly prohibit the reduction of basis of exempt property. n94 In the case of an individual, however, the basis reduction provisions of section 346(j)(5) will probably apply, only to property transferred to the bankruptcy estate and not to exempt property retained by the individual.

[f] Exchange of Equity for Debt

Section 346(j)(7) of the Bankruptcy Code eases the effect of discharge of indebtedness income in instances where equity securities are exchanged for debt by providing that no discharge of indebtedness will be deemed to have occurred when an equity security of a debtor corporation or its successor is issued in satisfaction of the debtor corporation's debt. This rule also applies when debt is forgiven as a contribution to capital by an equity security holder. This rule does not apply, however, to the interest of a limited partner in a limited partnership. n95

The equity for debt rule is further limited in that it does not apply if the indebtedness consists of items of a "deductible nature," such as accrued interest, unless the issuance of the equity security would have the same income tax consequence to the creditor as would a cash payment equal to the value of the equity security. Nonetheless, the equity for debt rule will still apply in such a case to the extent of the lesser of (i) the amount taxable as income to the creditor or (ii) the fair market value of the equity security. n96

Although the legislative history is murky, the exclusion of the discharge of "items of a deductible nature" from the protection of the equity for debt rule and the limitations on this exclusion appear to be motivated by a desire to give equal treatment to cash basis and accrual basis taxpayers as well as to counterbalance the consequences of the now legislatively overruled *Carman* doctrine. n97 In *Carman*, the court held that the exchange of stock for accrued interest in the context of a title 11 reorganization did not result in recognition of interest income to the bondholder. Thus, the equity for debt exception apparently was written so that a debtor would realize discharge of indebtedness income in instances in which a creditor avoided income recognition under the *Carman* doctrine. When the *Carman* doctrine was eliminated, however, the rule was crafted to prevent recognition of discharge of indebtedness income.

To illustrate, assume that a cash basis debtor exchanges \$80 of equity for the cancellation of \$100 of accrued interest indebtedness. Applying the rules discussed above, the cash basis debtor generally should (1) be allowed an \$80 current deduction (the fair market value of the equity security), (2) recognize no discharge of indebtedness income, and (3)

suffer no attribute reduction on the \$20 of canceled debt because the cash basis debtor received no prior tax benefit from this liability. n98

Applying the same facts to an accrual basis debtor and assuming the \$100 accrued interest was previously deducted (and not "lost" upon expiration of an unused net operating loss), the accrual basis debtor generally will have attribute reduction of \$20, which is the amount equal to the excess of the \$100 of deductible accrued interest over the \$80 fair market value of the equity security. n99 In the final analysis, both the cash and accrual debtors in the above examples each have a net deduction equal to the fair market value of the equity security exchanged for the deductible portion of the canceled liability.

By authorizing an exception to the recognition of discharge of indebtedness income for exchanges of equity for debt, the state and local rule is considerably broader than, and in conflict with, the corresponding federal rule. Current federal law does not recognize the stock for debt exception. n100 For stock transferred after December 31, 1994 in satisfaction of debt, (unless the issuing corporation was in a title 11 or similar case filed on or before December 31, 1993) the debtor corporation is treated as if it satisfied its debt with an amount of money equal to the fair market value of the stock issued. n101

FOOTNOTES:

(n1)Footnote 1. 26 U.S.C. § 7491, or as added by the IRS Restructuring and Reform Act of 1998; *Welch v. Helvering*, 290 U.S. 111, 54 S. Ct. 8, 78 L. Ed. 212 (1933) (Tax Court), and *Tax Court Rule 142*; *King v. United States*, 641 F.2d 253 (5th Cir. 1981) (District Court); *Arrington v. United States*, 34 Fed. Cl. 144 (1995), *aff'd*, 108 F.3d 1393 (Fed. Cir. 1997) (Court of Federal Claims).

(n2)Footnote 2. *Fed. R. Bankr. P. 3001(f)*.

(n3)Footnote 3. *In re Holm*, 931 F.2d 620 (9th Cir. 1991) .

(n4)Footnote 4. 530 U.S. 15, 120 S. Ct. 1951, 147 L. Ed. 2d 13, 43 C.B.C.2d 869 (2000) .

(n5)Footnote 5. *Id.*, at 26, 120 S. Ct. at 1958, 147 L. Ed. 2d at 23, 43 C.B.C.2d at 874 (2000) .

(n6)Footnote 6. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n7)Footnote 7. 11 U.S.C. § 346(b)(1).

(n8)Footnote 8. 11 U.S.C. § 346(d).

(n9)Footnote 9. I.R.C. § 1398. *See* ch. TX2 *supra*.

(N10)Footnote 10. 11 U.S.C. § 346(b)(2). H. Rep. No. 595, 95th Cong., 1st Sess. 278 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n11)Footnote 11. I.R.C. § 1398(c)(1). *See* ch. TX2 *supra*.

(n12)Footnote 12. 11 U.S.C. §§ 728(a), 1146(a), 1231(a).

(n13)Footnote 13. 11 U.S.C. §§ 728(a), 1146(a), 1231(a).

(n14)Footnote 14. I.R.C. § 1398(d)(2). *See* ch. TX2 *supra*.

(n15)Footnote 15. For a discussion of this rule, see ch. TX2 *supra*. Attorneys representing debtors should inform their clients at the time of retention about the § 1398 election.

(n16)Footnote 16. 11 U.S.C. § 346(b)(3).

(n17)Footnote 17. I.R.C. § 1398(j)(1). See ch. TX2 *supra*.

(n18)Footnote 18. 11 U.S.C. § 728(b).

(n19)Footnote 19. 11 U.S.C. § 728(b).

(n20)Footnote 20. See I.R.C. § 6012(a)(9); ch. TX3 *supra*.

(n21)Footnote 21. 11 U.S.C. §§ 1146(b), 1231(b).

(n22)Footnote 22. See I.R.C. §§ 1398(d)(2)(E), 6012(a)(9); ch. TX3 *supra*.

(n23)Footnote 23. See 11 U.S.C. §§ 1302(b); 704(8).

(n24)Footnote 24. See I.R.C. § 1399; ch. TX3 *supra*.

(n25)Footnote 25. 11 U.S.C. § 1106(a)(6).

(n26)Footnote 26. 11 U.S.C. § 704(8).

(n27)Footnote 27. 11 U.S.C. § 346(f). *Otte v. United States*, 419 U.S. 43, 95 S. Ct. 247, 42 L. Ed. 2d 212 (1974) (a trustee or other representative of the debtor is responsible for withholding taxes to the extent that the wages are paid by that representative, and filing the appropriate returns and reports). Section 346(f) notwithstanding, a state department of revenue cannot hold a chapter 11 trustee personally liable under section 346(f) for failure to pay withholding taxes. *Illinois Dep't of Revenue v. Schechter*, 195 B.R. 380 (Bankr. N.D. Ill. 1996) ; *Schechter v. Dep't of Revenue (In re Markos Gurnee P'ship)*, 182 B.R. 211 (Bankr. N.D. Ill. 1995) , *aff'd*, 195 B.R. 380 (N.D. Ill. 1996) (a chapter 11 trustee's failure to pay state taxes did not subject him to personal liability because nonpayment was within the scope of the authority as trustee and he had no bankruptcy-related fiduciary duty to pay the taxes when they became due). See 3 *Collier on Bankruptcy*, P 323.02 (Matthew Bender 15th Ed. Revised).

(n28)Footnote 28. 11 U.S.C. § 505(b). For discussion of litigation with the IRS, see P TX5.04 *supra*. For the effect of *Seminole Tribe of Florida v. Florida*, 517 U.S. 44, 116 S. Ct. 1114, 134 L. Ed. 2d 252, 34 C.B.C.2d 1199 (1996) , on litigation with state taxing authorities, see P TX12.02 *supra*.

(n29)Footnote 29. For further coverage of tax reporting requirements, see ch. TX3 *supra*.

(n30)Footnote 30. 11 U.S.C. §§ 1146(d) and 1231(d).

(n31)Footnote 31. 11 U.S.C. § 346(c)(1); I.R.C. § 1399. In *Missouri Dep't of Revenue v. L.J. O'Neill Shoe Co. (In re L.J. O'Neill Shoe Co.)*, 64 F.3d 1146 (8th Cir. 1995) , the state department of revenue filed a claim for corporate income taxes and argued that although eleven months of the debtor's tax year transpired prepetition, the entire year's taxes, not just the one postpetition month, were administrative expenses. The court held that apportioning state corporate income taxes to pre- and postpetition periods did not violate the requirement of section 346(c)(1) and I.R.C. § 1399 and that the tax year of the corporation remain unchanged. *Missouri Dep't of Revenue v. L.J. O'Neill Shoe Co. (In re L.J. O'Neill Shoe Co.)*, 64 F.3d 1146 (8th Cir. 1995) . For further coverage of tax reporting requirements, see ch. TX3 *supra*.

(n32)Footnote 32. 11 U.S.C. § 346(c)(1).

(n33)Footnote 33. 11 U.S.C. § 346(c)(2). *Holywell Corp. v. Smith*, 503 U.S. 47, 112 S. Ct. 1021, 117 L. Ed. 2d 196 (1992) (liquidating trustee of corporate and individual debtors required to file returns and pay taxes). For further coverage of tax reporting requirements, see ch. TX3 *supra*.

(n34)Footnote 34. 11 U.S.C. § 728(b). *In re Olson*, 100 B.R. 458 (Bankr. N.D. Iowa 1989), *aff'd*, 930 F.2d 6 (8th Cir. 1991) (because abandonment of real estate by the trustee was not a taxable event, the trustee was not required to file a fiduciary return unless there was other income of the estate). *In re Nab Food Services, Inc.*, 7 C.B.C.2d 944, 25 B.R. 221 (Bankr. S.D. Ohio 1982) (the code provides no guidance on the tax consequences to a trustee who holds title to and invests liquidated funds of the estate of a chapter 7 debtor; thus, general tax laws apply and the trustee incurs a tax liability on the interest income). This is the same state and local rule applicable to individual debtors in a case under chapter 7. There is no comparable federal rule. See ch. TX3 *supra*.

(n35)Footnote 35. A practical (liberal) interpretation of *Rev. Rul. 84-123, 1984-2 C.B. 244* may provide an exemption to the requirement that a trustee file a federal tax return for estates with less than \$40,000 of income so long as a full disclosure to the IRS is made. See Denis J. Conlon *et al.*, *The IRS Can be Practical*, NABtalk Vol. 12, No. 2, at p. 29; *Rev. Proc. 84-59, 1984-2 C.B. 504* for correspondence requirements. The Conlon article contains form letters requesting relief from filing income tax returns.

(n36)Footnote 36. See P TX12.03[1][b][v], [vi], [vii], and [viii] *supra*.

(n37)Footnote 37. 11 U.S.C. § 346(c)(1). This parallels the federal rule. See I.R.C. § 1399; ch. TX13 *infra*.

(n38)Footnote 38. 11 U.S.C. § 346(b)(1).

(n39)Footnote 39. I.R.C. § 1398(c). See ch. TX13 *infra*.

(n40)Footnote 40. 11 U.S.C. § 346(c)(2).

(n41)Footnote 41. 11 U.S.C. § 728(b).

(n42)Footnote 42. 11 U.S.C. § 728(c).

(n43)Footnote 43. H. Rep. No. 595, 95th Cong., 1st Sess. 385-86 (1977), *reprinted in* Collier on Bankruptcy, Vol. C App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 989, 95th Cong., 2d Sess. 99-100 (1978), *reprinted in* Collier on Bankruptcy, Vol. D App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised). See 11 U.S.C. § 723(c).

(n44)Footnote 44. 11 U.S.C. § 723(c).

(n45)Footnote 45. See ch. TX13 *infra*.

(n46)Footnote 46. 11 U.S.C. § 728(d). There is no analogous federal provision. For federal purposes, a tax refund of a partner in bankruptcy generally will be considered an asset of the partner's estate. See 11 U.S.C. § 541.

(n47)Footnote 47. H. Rep. No. 595, 95th Cong., 1st Sess. 280 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised) *infra*.

(n48)Footnote 48. See P TX12.03[1][b][v], [vi], [vii], and [viii] *supra*.

(n49)Footnote 49. 11 U.S.C. § 346(e).

(n50)Footnote 50. See ch. TX2 *supra*.

(n51)Footnote 51. See ch. TX2 *supra*.

(n52)Footnote 52. *See id.*

(n53)Footnote 53. 28 U.S.C. §§ 1911-1923 (federal court fees and costs).

(n54)Footnote 54. 11 U.S.C. § 346(g)(1)(A).

(n55)Footnote 55. 11 U.S.C. § 346(g)(1)(B).

(n56)Footnote 56. 11 U.S.C. § 346(g)(1)(C).

(n57)Footnote 57. I.R.C. § 371 (repealed 1980). Generally, this section provided that gain was recognized to the extent that boot was received but not distributed to shareholders or creditors of the transferor.

(n58)Footnote 58. *But see* 2A Sutherland Stat. Const. § 51.08 (4th ed. 1984) (repeal of referenced statute will have no effect on the subject statute unless express or strong implication of legislative intent to adopt subsequent changes).

(n59)Footnote 59. *See* ch. TX10 *supra*.

(n60)Footnote 60. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n61)Footnote 61. 11 U.S.C. § 346(i)(1). While the estate succeeds to all state and local tax attributes, I.R.C. § 1398(g) only provides for succession to enumerated tax attributes plus such other attributes as may be provided by regulation. *Treasury Regulation* § 1.1398-1(c) provides that the bankruptcy estate succeeds to the unused passive activity losses and credits of an individual debtor in a chapter 7 or 11 case. *See* ch. TX2 *supra*. It does not appear, however, that there are any significant attributes to which the estate would succeed under state and local law but not federal law. The greater openness of the state and local tax rule might be explained by the fact that there may be attributes under specific state and local rules which do not have federal law counterparts.

(n62)Footnote 62. 11 U.S.C. § 346(g)(2).

(n63)Footnote 63. *Id.* § 346(b)(3). *See* P TX12.03[1][b][iii] *supra*.

(n64)Footnote 64. 11 U.S.C. § 346(i)(2). Presumably, as under I.R.C. § 1398(i), the debtor also succeeds to the state and local tax attributes generated during the pendency of the case, although the Bankruptcy Code is silent on this point.

The statutory period provided in I.R.C. § 6511(d)(2) for filing a refund claim is not tolled during the pendency of the bankruptcy case because section 346(i)(2) is subject to the *Internal Revenue Code*. *Firsdon v. United States*, 95 F.3d 444 (6th Cir. 1996), *cert. denied*, 519 U.S. 1115 (1997); *In re Page*, 163 B.R. 196, 197-98 (Bankr. D. Kan. 1994).

(n65)Footnote 65. *See* P TX12.03[1][b][i] *supra*.

(n66)Footnote 66. *See* ch. TX2 *supra*.

(n67)Footnote 67. 11 U.S.C. § 346(i)(3).

(n68)Footnote 68. I.R.C. § 1398(i)(2). *See* ch. TX11 *supra*.

(n69)Footnote 69. *In re Prudential Lines*, 928 F.2d 565, 24 C.B.C.2d 1503 (2d Cir. 1991), *cert. denied*, 502 U.S. 821, 112 S. Ct. 82, 116 L. Ed. 2d 55 (1991).

(n70)Footnote 70. 11 U.S.C. 346(c)(1).

(n71)Footnote 71. 11 U.S.C. § 346(h).

(n72)Footnote 72. See I.R.C. § 1398(d)(2); ch. TX3 *supra* .

(n73)Footnote 73. 11 U.S.C. §§ 728(a), 1146(a), 1231(a). See P TX12.03[1][b][iii] *supra*.

(n74)Footnote 74. 11 U.S.C. § 346(i)(3). See also *Illinois Department of Revenue v. Envirodyne Industries, Inc.*, 2006 U.S. Dist. LEXIS 80154 ; 56 C.B.C.2d (N.D. Ill. 2006) (11 U.S.C § 346(j)(3) does not preclude a tax payer from carrying back net operating losses incurred pre-petition to offset pre-petition earnings).

(n75)Footnote 75. *Id.*

(n76)Footnote 76. I.R.C. 1398(j)(2)(B). See ch. TX2 *supra*.

(n77)Footnote 77. 11 U.S.C. § 346(j)(1).

(n78)Footnote 78. 11 U.S.C. § 346(j)(2)-(7).

(n79)Footnote 79. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n80)Footnote 80. 11 U.S.C. § 346(j)(3).

(n81)Footnote 81. 11 U.S.C. § 346(j)(5). The parallel federal rule refers to liabilities "after" discharge rather than "before and after." This distinction might give rise to a concern that the state and local rule does not take into account liabilities created by a plan of reorganization which might be argued to arise only at the time of discharge, but not before. I.R.C. § 1017(b)(2). Presumably, however, the state and local rule would be read consistently with the federal rule.

(n82)Footnote 82. S. Rep. No. 989, 95th Cong., 2d Sess. 47 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised).

(n83)Footnote 83. 11 U.S.C. § 346(j)(2).

(n84)Footnote 84. *Id.*

(n85)Footnote 85. 11 U.S.C. § 346(j)(4).

(n86)Footnote 86. 11 U.S.C. § 346(j)(6).

(n87)Footnote 87. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Collier on Bankruptcy, Vol. E-2 App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n88)Footnote 88. Compare I.R.C. § 108 with 11 U.S.C. § 346(j). See generally ch. TX6 *supra*.

(n89)Footnote 89. See I.R.C. § 108(b); ch. TX6 *supra* .

(n90)Footnote 90. I.R.C. § 108(b)(2). See ch. TX6 *supra*.

(n91)Footnote 91. See ch. TX6 *supra*.

(n92)Footnote 92. Rev. Rul. 74-240, 1974-1 C.B. 52 ; ch. TX6 *supra* .

(n93)Footnote 93. See I.R.C. § 108(b)(4)(A).

(n94)Footnote 94. *See* 11 U.S.C. § 522 (property which may be exempt from the bankruptcy estate).

(n95)Footnote 95. 11 U.S.C. § 346(j)(7).

(n96)Footnote 96. 11 U.S.C. § 346(j)(7)(A), (B).

(n97)Footnote 97. *Comm. v. Carman*, 189 F.2d 363 (2d Cir. 1951) . This decision was legislatively overruled by the adoption of I.R.C. § 354(a)(2)(B), as part of the Bankruptcy Tax Act of 1980. *See* ch. TX8 *supra*.

(n98)Footnote 98. *See* 11 U.S.C. § 346(j)(2).

(n99)Footnote 99. 11 U.S.C. § 346(j)(7)(B).

(n100)Footnote 100. I.R.C. § 108(e)(8). The Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13226 (Aug. 10, 1993), repealed the federal stock for debt exception.

(n101)Footnote 101. I.R.C. § 108(e)(8). The Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13226 (Aug. 10, 1993), repealed the federal stock for debt exception. *See* ch. TX8 *supra*.



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CHAPTER TX12 State and Local Tax Aspects of Bankruptcy

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P TX12.04 Other State and Local Taxes

[1] In General

Apart from the net income tax provisions discussed above and two provisions regarding "a stamp or similar tax," n1 the Bankruptcy Code does not expressly address the other state and local tax consequences. A taxpayer should examine the law of the state or local jurisdiction to determine the sales tax, property tax, and other non-income state and local tax aspects of bankruptcy. The Bankruptcy Code does address in detail the bankruptcy aspects of various state and local taxes, including issues of preference, priority, and discharge. These issues are addressed elsewhere. n2

[2] Stamp or Similar Taxes

"A stamp or similar tax" may not be imposed on the issuance, transfer, or exchange of a security, nor the making or delivery of an instrument of transfer under a chapter 11 plan. n3 The Second Circuit Court of Appeals enumerated the following common elements of a section 1146(c) "stamp or similar tax":

- (1) it is imposed only at the time of transfer or sale of the item at issue;
- (2) the amount due is determined by the consideration for, par value of, or value of, the item being transferred;
- (3) the tax rate is a relatively small percentage of the consideration, par value or value of the property;
- (4) the tax is imposed irrespective of whether the transferor enjoyed a gain or suffered a loss on the underlying sale or transfer; and
- (5) in the case of a state documentary transfer tax, the tax must be paid as a prerequisite to recording. n4

The stamp or similar tax exemption has been held applicable to taxes imposed on the transfer of real property. n5 The exemption has also been held to apply where the legal incidence of a real estate transfer tax is on the purchaser, rather than the debtor. n6 It has been held, however, that the exemption does not apply to a recording tax imposed upon the financing of a purchase where the chapter 11 plan does not address the purchaser's financing method, the lender is not party to the plan, and the debtor is not a party to the financing. n7 Thus, the exemption does not generally apply unless

the transfer is made by the debtor itself or an entity that stands in the stead of the debtor. n8 Regarding taxes imposed at the time of transfer on the transferor's gain, it has been held that the section 1146(c) exemption is inapplicable. n9

The courts have not squarely addressed the question of whether a sales or use tax might fall within the scope of the section 1146(c) exemption. Although sales and use tax laws vary from state to state, instruments of transfer are generally not prerequisite to the application of the tax. Accordingly, the literal requirement that the tax subject to the section 1146(c) exemption be imposed on the "making and delivery of an instrument of transfer," is not met. Nevertheless, some bankruptcy courts have concluded in their confirming orders and accompanying memoranda that sales and use taxes fall within the scope of the section 1146(c) exemption. n10 Further, even if the section 1146(c) exemption is not applicable to sales and use tax imposed on transfers of personal property pursuant to a plan, state law sales and use tax exemptions for "isolated" or "casual" sales may apply. This would particularly be the case if all or substantially all of the assets of the debtor business are being transferred. n11

Section 1146(c) requires that the exempt transfer be "under a plan." The U.S. Supreme Court addressed this issue in *Florida Dep't. of Revenue v. Piccadilly Cafeterias, Inc.*, n11a(n12)Footnote 11a. 554 U.S. ___, 128 S. Ct. 2326, 171 L. Ed. 2d 203 (2008). . The decision limits the Bankruptcy Code's transfer tax exemption to transfers that occur "after" confirmation of the Chapter 11 plan. Despite acknowledging that most bankruptcy sales occur before confirmation, the Supreme Court imposed the temporal limitation based on the "natural reading" of the statute in light of competing canons of statutory construction. n12

Shortly after filing for Chapter 11 bankruptcy protection, Piccadilly asked the court for permission to sell substantially all its assets and requested that the sale be exempted from state transfer taxes under section 1146(a). An auction was conducted to find the highest bidder for Piccadilly's assets. The winner of the auction agreed to pay \$80 million for the assets, which were packaged as a going concern in order to maximize value.

Prior to closing the asset sale, Piccadilly entered into a Global Settlement Agreement with its creditors to distribute the proceeds of the assets. The court approved the sale, the Global Settlement Agreement, and the request for section 1146(a) exemption from Florida's stamp tax and other taxes.

Ten days after the sale closed, Piccadilly filed a plan to distribute the proceeds of the sale consistent with the Global Settlement Agreement. Before the plan was confirmed, Florida timely objected, seeking a declaration that section 1146(a) did not exempt \$39,200 of stamp taxes Florida had assessed Piccadilly on the sale of its assets.

The bankruptcy court granted summary judgment to Piccadilly, finding that the words "under a plan confirmed" can indeed mean "before the plan is confirmed" if the sale is necessary to the ultimate confirmation of the plan. The district court and the Eleventh Circuit both affirmed the bankruptcy court's ruling, although under differing rationales. Florida appealed, and the Supreme Court granted certiorari to resolve a split between the circuits as to whether section 1146(a) applies to transfers prior to confirmation.

The Supreme Court narrowly construed section 1146(a) and held that it applied "only to transfers made pursuant to a Chapter 11 plan that has been confirmed." States, counties, and municipalities may impose taxes on transfers in bankruptcy that occur before the plan is confirmed.

Thus, investors are now more likely to carefully evaluate the state and local transfer-tax costs of bankruptcy acquisitions (and any related requirements for exemption) before submitting bids on assets in bankruptcy.

The exemptions and procedures for claiming exemptions vary by state (and sometimes locality) and by type of tax. It is important to note that in several states it is easier to satisfy the state law transfer tax exemption than the Bankruptcy Code exemption in section 1146(a). Since they can no longer rely on broad section 1146(a) language in the sale motion and confirmation order, debtors and investors (who are typically jointly and severally liable for transfer taxes) should

take care to identify and satisfy the relevant state exemptions that are typically broader than the section 1146(a) exemption. Several states have broad occasional or casual sale exemptions that apply to sales and use tax, and less often to real estate and motor vehicle transfer taxes.

The rule to take away from the *Piccadilly* decision is that for bankruptcy sales that take place pre-confirmation, the only current availability for exemption is under state law.

FOOTNOTES:

(n1)Footnote 1. See P TX12.04[2] *infra*.

(n2)Footnote 2. See ch. TX4 *supra*.

(n3)Footnote 3. 11 U.S.C. §§ 1146(c) (chapter 11), 1231(c) (chapter 12). See 8 *Collier on Bankruptcy*, P 1146.LH (Matthew Bender 15th Ed. Revised) for pre-Code law.

(n4)Footnote 4. *In re 995 Fifth Ave. Assoc., L.P.*, 963 F.2d 503, 26 C.B.C.2d 1162 (2d Cir.) , cert. denied, 506 U.S. 947, 113 S. Ct. 395, 121 L. Ed. 2d 302 (1992) .

(n5)Footnote 5. *In re Jacoby-Bender, Inc.*, 758 F.2d 840 (2d Cir. 1985) ; *In re Smoss Enters. Corp.*, 54 B.R. 950 (E.D.N.Y. 1985) . Section 1146(c) has been applied to transfers made by liquidating trusts. *Maryland v. Antonelli Creditors' Liquidating Trust*, 191 B.R. 642 (D. Md. 1995) , *aff'd*, 123 F.3d 777 (4th Cir. 1997) . For coverage of the tax treatment of liquidating trusts, see ch. TX14, P TX14.06 *infra* .

(n6)Footnote 6. *In re Cantrup*, 13 C.B.C.2d 682, 53 B.R. 104 (Bankr. D. Colo. 1985) .

(n7)Footnote 7. *In re Eastmet Corp.*, 907 F.2d 1487 (4th Cir. 1990) ; *In re Amsterdam Ave. Dev. Assoc.*, 103 B.R. 454 (Bankr. S.D.N.Y. 1989) ; but see *In re Baldwin League of Independent Schools*, 110 B.R. 125 (S.D.N.Y. 1990) (mortgage obtained by debtor to finance plan of reorganization exempt from recording tax).

(n8)Footnote 8. *In re Kerner Printing Co.*, 188 B.R. 121 (Bankr. S.D.N.Y. 1995) (transferor was creditor/assignee of debtor); *Maryland v. Antonelli Creditors' Liquidating Trust*, 191 B.R. 642, 646 (D. Md. 1995) , *aff'd*, 123 F.3d 777 (4th Cir. 1997) (the exemption applies even where the debtor is not the transferor so long as the transferor entity is created by the plan of reorganization for the purpose of benefiting the estate and its creditors and the transferor does not gain from the transfer).

(n9)Footnote 9. *In re 995 Fifth Ave. Assoc., L.P.*, 963 F.2d 503, 26 C.B.C.2d 1162 (2d Cir.) , cert. denied, 506 U.S. 947, 113 S. Ct. 395, 121 L. Ed. 2d 302 (1992) .

(n10)Footnote 10. See *In re A.H. Robins Co.*, 88 B.R. 742 (E.D. Va. 1988) , *aff'd sub nom.*, *Menard-Sanford v. Mabey (In re A.H. Robins Co.)*, 880 F.2d 694 (4th Cir. 1989) , cert. denied, 493 U.S. 959, 110 S. Ct. 376, 107 L. Ed. 2d 362 (1989) ; see generally Goldring, *The Bankruptcy Code's Tax Exemption for Sales During Chapter 11 Reorganization*, Corp. Tax'n, Nov.-Dec. 1989, at 55; Melanie Rovner Cohen & Donna M. Zak, *Beyond The Summit Decision: The Still Unresolved Issues of the Applicability Of State Transfer Taxes to Bankruptcy Sales*, 95 Com. L.J. 46 (1990).

(n11)Footnote 11. See, e.g., Ariz. Comp. Admin. R. & Regs. § R15-5-103 (1995) (sale of business as going concern is exempt); Cal. Tax Code § 6006.5(b) (1995) (exemption for transfer of substantially all property if "substantially similar ownership"); 61 Pa. Code § 32.4(a)(2)(iii) (1995) (sale of entire business exempt).

(n13)Footnote 12. This discussion relies on and incorporates much of the 2008 Special Alert on the subject written

by Charollette Noel, Esq.



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CHAPTER TX12 State and Local Tax Aspects of Bankruptcy

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P TX12.05 Legislative History

The special state and local tax provisions contained in the Bankruptcy Code have an unusual history. The Bankruptcy Reform Act of 1978, as originally introduced in Congress, contained provisions applicable to federal, state and local taxes. Prior to enactment, however, these provisions were limited to state and local taxes so that the tax writing committees of Congress could address the federal tax issues. n1 At the time, it was anticipated that these special provisions would be amended once the federal bankruptcy tax rules were adopted; however, this did not occur. Instead, even though the Bankruptcy Tax Act contained provisions inconsistent with these earlier drafted provisions, Congress enacted the Bankruptcy Tax Act of 1980, without amending the special state and local tax provisions of the Bankruptcy Code. As a result, inconsistencies exist between the federal rules and the state and local rules. These inconsistencies cause both interpretive and computational difficulties, particularly in states and localities which rely on the Internal Revenue Code in determining taxable income.

Under the 2005 Act, n2 however, section 346, principally concerned with state and local tax issues, is largely rewritten. Once more, the provisions previously found in section 728 and sections 1146(a) and 1146(b) are, by and large, transferred to section 346.

The new rules provide for uniformity among federal, state, and local tax administrative rules. First, the new rules prevent a bankruptcy filing from resulting in the creation of a new taxable estate, or the termination of the debtor's taxable year, for federal purposes, but not for state and local purposes--or vice versa. Second, the new rules conform the federal, state, and local tax consequences of property transfers from the debtor to the estate (or from the estate to the debtor). Third, the new rules prevent state or local tax from being imposed on discharge of indebtedness income unless that income is also subject to tax under the Internal Revenue Code. Fourth, the new rules require states and localities to reduce tax attributes to reflect untaxed discharge of indebtedness income consistent with the same rules applicable for federal purposes.

The new rules accomplish this goal by the explicit referencing of applicable federal law. Under the revised section 346, the resolution of matters arising from state and local tax issues should be considerably more straightforward than under the provision as previously worded because changes in federal tax law will automatically apply to the treatment of state and local tax issues.

This chapter's outline of the law under the old section 346 is still relevant to cases filed before the effective date of the

new statute and as an interpretive guidepost as courts, and parties, deal with issues under the new law. Thus, the discussion of the old section 346, as updated, follows.

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 96-56, 93 Stat 387 (1979), *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(a)(i) (Matthew Bender 15th Ed. Revised). *See* Klee, *Legislative History to the New Bankruptcy Law*, 28 *DePaul L. Rev.* 941 (1979).

(n2)Footnote 2. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).



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CHAPTER TX13 Financially Troubled Partnerships

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§ TX13.syn Synopsis to Chapter TX13: Financially Troubled Partnerships

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CHAPTER TX13 Financially Troubled Partnerships

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P TX13.01 Introduction

This chapter examines the federal income tax consequences of the discharge of partnership n1 debt, focusing on partnerships that are insolvent or in a title 11 case. n1a The interplay between subchapter K of the Internal Revenue Code n2 and the body of rules governing the tax consequences of discharge of indebtedness n3 is complex and, in many instances, uncertain. This complexity and uncertainty exists for two reasons. First, subchapter K and the discharge of indebtedness rules developed separately. The drafters of subchapter K intended to create a set of rules to govern the entire range of a partnership's activities and did not attempt to address issues unique to discharge of partnership indebtedness. n4 In contrast, the rules governing discharge of indebtedness, which began with the United States Supreme Court's decision in *United States v. Kirby Lumber Co.*, n5 "were conceived and elaborated outside the partnership context. Their application to partnerships and their partners has been either absent entirely or, as in the case of the Bankruptcy Tax Act of 1980 ... , spotty and inconsistent." n6 Although the Bankruptcy Tax Act of 1980 n7 attempted to apply the discharge of indebtedness rules to partnerships and partners, many questions remain to be answered.

The second source of complexity in the interplay between subchapter K and the discharge of indebtedness rules is the tension between the entity and the aggregate concepts of partnerships. n8 The Bankruptcy Tax Act of 1980 resolved some uncertainty by providing that certain discharge of indebtedness rules apply at the partner level rather than at the partnership level. However, in other instances, it is still unclear whether certain rules should apply at the partnership level or the partner level.

To provide a framework for the analysis of the interaction between subchapter K and the discharge of indebtedness rules, this chapter begins with a discussion of the basic principles of partnership taxation relevant to the discharge of partnership debt. P TX13.02 covers tax-free contribution of property to a partnership in exchange for a partnership interest, determination of a partner's basis in the partner's partnership interest ("outside basis"), allocation of partnership liabilities, operation of a partnership as a pass-through entity, and liquidation of a partnership.

As explained in P TX13.03, when a partnership obtains a discharge of a partnership debt, the discharge of indebtedness rules and the subchapter K rules will apply and the original issue discount rules may apply. In general, two things occur. First, discharge of partnership debt generates discharge of indebtedness income at the partnership level, which passes through to the partners. Based on their individual status, the partners may be eligible to exclude some or all of the discharge of indebtedness income under *I.R.C. section 108(a)*. Second, discharge of a partnership debt triggers a

deemed distribution of money from the partnership to the partners under *I.R.C. section 752(b)*. *I.R.C. section 731(a)(1)* makes that deemed distribution taxable to the partners to the extent the deemed distribution exceeds their outside bases. The discharge of indebtedness income passed through to the partners increases their outside basis. n9 Depending on how the partnership allocates the discharge of indebtedness to each partner, this increase may equal the amount of the deemed distribution under *I.R.C. section 752(b)*. If so, the discharge of partnership debt will not result in a taxable distribution under *I.R.C. section 731(a)(1)*. However, in some instances the deemed distribution under *I.R.C. section 752(b)* may cause the partners to recognize gain. Further, the discharge of a nonrecourse partnership debt may trigger income to the partners in the form of a "minimum gain chargeback" under *I.R.C. section 704(b)*. Finally, if the discharge of partnership debt involves a "material modification" to a debt instrument, the original issue discount rules may apply. n10

In addition to discussing a partner's ability to exclude discharge of indebtedness income passed through by a partnership, P TX13.03 addresses exceptions to partnership realization of discharge of indebtedness income. P TX13.03 concludes with a discussion of the special rules relating to acquisition of partnership debt by a "related person" and a partnership's acquisition of a "related" partner's debt.

Finally, P TX13.04 deals with the federal income tax consequences of a partnership's or a partner's filing for relief as a debtor under title 11.

FOOTNOTES:

(n1)Footnote 1. For federal income tax purposes, *Treas. Reg. § 301.7701-2(c)(1)* defines the term "partnership" as "a business entity that is not a corporation under [*Treas. Reg. § 301.7701-2(b)*] and that has at least two members." The so-called "check-the-box" regulations, *Treas. Reg. § 301.7701-3*, allow business entities that are not classified as corporations under *Treas. Reg. § 301.7701-2(b)* and that have at least two members ("eligible entities") to elect to be treated as corporations for federal income tax purposes. "Eligible entities" that do not make such an election are treated as partnerships for federal income tax purposes. *Treas. Reg. § 301.7701-3(b)*. Thus, many limited liability companies (LLCs) with two or more members and limited liability partnerships (LLPs) are taxed under subchapter K of the Internal Revenue Code. Note, however, that a LLC or LLP, even if treated as partnership for federal income tax purposes, will be treated as a corporation for purposes of title 11. *11 U.S.C. § 101(9)*:

(9) The term "corporation"-

(A) includes-

(i) association having a power or privilege that a private corporation, but not an individual or a partnership, possesses;

(ii) partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association;

(iii) joint-stock company;

(iv) unincorporated company or association; or

(v) business trust; but

(B) does not include limited partnership.

A corporation, like a partnership, is eligible to be a debtor in a title 11 case. *11 U.S.C. §§ 109(a) and 101(41)*. The federal income tax treatment of a LLC or LLP in a title 11 case should be essentially the same as the treatment of a partnership in a title 11 case. One commentator has raised interesting questions about application of title 11 to "series" LLCs:

Whether a single series of a series LLC would itself constitute a corporation and hence a person for purposes of bankruptcy eligibility is a question of first impression. Bankruptcy courts likely would look first to the degree of separateness conferred on a designated series by the law of the series LLC's state of incorporation. The court may be inclined to presume rebuttably that a designated series of a series LLC is a separate corporation for purposes of the Bankruptcy Code and may rely on the bankruptcy doctrine of substantive consolidation if necessary to remedy abuse. Substantive consolidation is the equitable doctrine whereby corporate entities are disregarded to create a single pool of assets and a single body of creditors when related but ostensibly separate affiliates have been operated as a single entity.

Michael E. Mooney, *Series LLC's: The Loaves and Fishes of Subchapter K*, 116 Tax Notes 663, 664 n.6 (Aug. 20, 2007). "[A] series LLC is a special form of LLC that provides for the establishment of designated series within the LLC applicable to specified assets or operations, each with a separate business purpose or investment objective. In a series LLC, the debts, liabilities, and obligations relating to one series are enforceable only against the assets of that series and not against the assets of the LLC generally or the assets of any other series." *Id.* at 664.

(n2)Footnote 1a. *11 U.S.C. § 109(a)* (any "person" who resides in the United States or has a domicile, a place of business, or property in the United States can be a debtor in a title 11 case) and *11 U.S.C. § 101(41)* (the term "person" includes a partnership). However, a partnership may not always be eligible for relief under chapter 11 of title 11. *Compare In re [C-TC 9th]Ave. Partnership*, 113 F.3d 1304 (2d Cir. 1997) (a partnership that had dissolved and continued under applicable state law only for the limited purpose of winding up its affairs and had only a single general partner was not eligible for relief under chapter 11) with *In re Shea & Gould*, 38 C.B.C.2d 1453, 214 B.R. 739 (Bankr. S.D.N.Y. 1997) (a partnership in dissolution was eligible to liquidate under chapter 11). *See also 2 Collier on Bankruptcy P 109.02[1][b]* (Matthew Bender 15[th] Ed. Revised).

Section 723 ("Rights of Partnership Trustee Against General Partners") of the Bankruptcy Code was amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, effective as of the date of enactment, October 22, 1994, *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised). Section 723(a) now states that "if there is a deficiency of property of the estate to pay in full all claims" the trustee shall have a claim against a general partner "to the extent that under applicable nonbankruptcy law such general partner is personally liable for such deficiency". *See also Strategies for Partners Under the Bankruptcy Code When the Partnership Is Insolvent*, 61 Am. B.R. L.J. 37 (1987); Kennedy, *The Discharge of Partnerships and Partners Under the Bankruptcy Code*, 38 Vand. L. Rev. 857 (1985); Rosenberg, *Partnership Reorganization Under the Bankruptcy Reform Act: Filling in the Interstices*, 56 N.Y.U. L. Rev. 1173 (1981); Hanley, *Partnership Bankruptcy Under the New Act*, 31 Hastings L.J. 149 (1979).

(n3)Footnote 2. *I.R.C. §§ 701-761*. All references to the "Internal Revenue Code" and "I.R.C." in this chapter are to the Internal Revenue Code of 1986, as amended, unless otherwise specifically noted.

(n4)Footnote 3. For a detailed discussion of the federal income tax consequences of discharge of indebtedness, *see* chapter TX6 *supra*.

(n5)Footnote 4. *See, e.g., Sheffield & Maynes, Selected Tax Issues in Partnership Debt Restructurings*, 68 Taxes 861, 861 (1990) ("Sheffield & Maynes").

(n6)Footnote 5. 284 U.S. 1, 52 S. Ct. 4, 76 L. Ed. 131 (1931) .

(n7)Footnote 6. *Sheffield & Maynes*, n.4 *supra*.

(n8)Footnote 7. Pub. L. No. 96-589, 94 Stat. 3389 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(a) (Matthew Bender 15th Ed. Revised).

(n9)Footnote 8. For a discussion of this tension, see W. McKee, W. Nelson, & R. Whitmire, *Federal Taxation of Partnerships and Partners*, P 1.02[3] (WGL 3d ed. 1997); Rabkin & Johnson, *Federal Tax Guidebook*, P 16.01 (Matthew Bender).

(n10)Footnote 9. *I.R.C.* § 705(a)(1)(A).

(n11)Footnote 10. *I.R.C.* §§ 1271-1275.



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CHAPTER TX13 Financially Troubled Partnerships

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P TX13.02 Basic Principles of Partnership Taxation Relevant to Discharge of Partnership Debt

[1] Introduction

To provide a framework for the discussion of the interaction between subchapter K and the discharge of indebtedness rules later in this chapter, this section covers the following basic aspects of partnership taxation relevant to discharge of partnership debt: n1

1. A contribution of property to a partnership in exchange for an interest in the partnership ordinarily is not a taxable event either for the partner or the partnership.
2. A partnership is not a separate tax-paying entity. Rather, a partnership acts as a conduit, passing through its items of income, gain, deduction, loss and credit to its partners, regardless of whether the partners receive actual distributions from the partnership. Thus, subchapter K includes rules to ensure that a partner will not be taxed on partnership income or gain more than once and that a partner will not benefit from partnership deductions, losses and credits more than once. These rules focus on the computation of a partner's basis in the partner's partnership interest ("outside basis"), which essentially serves as the measuring stick for the partner's tax investment in the partnership.
3. Because a partnership acts as a conduit, subchapter K includes rules governing determination of a partner's "distributive share" of partnership income or loss. Subchapter K ordinarily looks first to the terms of the partnership agreement to determine a partner's distributive share of such items. However, many of the rules in subchapter K represent efforts to ensure that a partnership will allocate such items to its partners in a manner that has economic substance. n2
4. Although all items of partnership income or loss pass through to the partners regardless of whether the partnership makes any actual distributions to the partners, partnerships also make nonliquidating distributions of money or property to partners. In general, subchapter K provides that such distributions are taxable to a partner to the extent the distributions exceed the partner's "outside basis."
5. Sale of a partner's partnership interest and liquidation of a partnership are taxable events which may produce both capital gain and ordinary income.

Any examination of the basic principles of partnership taxation must now begin with the caution that planners must keep in mind so-called "anti-abuse" regulations issued by Treasury under *I.R.C. section 701*.ⁿ³ These regulations permit the Internal Revenue Service to disregard the form of a partnership transaction if the Internal Revenue Service concludes that "a partnership is *formed or availed of* in connection with a transaction *a principal purpose of which is to reduce substantially the present value of the partners' aggregate federal tax liability in a manner inconsistent with the intent of subchapter K ...* ." ⁿ⁴ If the Internal Revenue Service so concludes, it

can recast the transaction for federal tax purposes, as appropriate to achieve tax results that are consistent with the intent of subchapter K, in light of the applicable statutory and regulatory provisions and the pertinent facts and circumstances. Thus, even though the transaction may fall within the literal words of a particular statutory or regulatory provision, the Commissioner can determine, based on the particular facts and circumstances, that to achieve tax results that are consistent with the intent of subchapter K--

- (1) The purported partnership should be disregarded in whole or in part, and the partnership's assets and activities should be considered, in whole or in part, to be owned and conducted, respectively, by one or more of its purported partners;
- (2) One or more of the purported partners of the partnership should not be treated as a partner;
- (3) The methods of accounting used by the partnership or a partner should be adjusted to reflect clearly the partnership's or the partner's income;
- (4) The partnership's items of income, gain, loss, deduction, or credit should be reallocated; or
- (5) The claimed tax treatment should otherwise be adjusted or modified. ⁿ⁵

The regulations explain that the phrase "intent of subchapter K" reflects the congressional intent to permit taxpayers to conduct joint business activities through a flexible economic arrangement without incurring an entity-level tax. ⁿ⁶ The following requirements are implicit in this intent:

- (1) The partnership must be *bona fide* and each partnership transaction or series of transactions must have a substantial business purpose; ⁿ⁷
- (2) The form of the partnership transaction must be able to withstand form over substance analysis; ⁿ⁸ and
- (3) The tax consequences to each partner of partnership operations and of transactions between the partner and the partnership must accurately reflect the partners' economic agreement and must clearly reflect the partners' income. ⁿ⁹

[2] Tax-Free Contribution of Property to a Partnership; I.R.C. section 721(a)

In general, when a partner contributes property ⁿ¹⁰ to a partnership in exchange for a partnership interest, neither the contributing partner nor the partnership recognizes gain or loss as a result of the contribution. ⁿ¹¹ This rule applies whether the partner makes a contribution to a partnership in the process of formation or to an operating partnership. ⁿ¹² The depreciation recapture provisions do not override this rule. ⁿ¹³

There are, however, several exceptions to the general rule of nonrecognition. First, if a partner contributes property

subject to liabilities, the partner may recognize gain. n14 Second, if the partner contributes services, *I.R.C. section 721(a)* cannot apply because services are not "property" within the meaning of the statute. n15 Third, *I.R.C. section 721(a)* does not apply to contributions to a partnership that would be treated as an "investment company" within the meaning of *I.R.C. section 721*. n16 Fourth, if the contribution of property is part of a "disguised sale" of the property, *I.R.C. section 707(a)*, rather than *I.R.C. section 721(a)*, will govern the taxation of the transaction. Finally, if the contributing partner receives "boot" from the partnership, the Code will treat the boot as either (1) a distribution, resulting in recognition of gain to the extent the distribution exceeds the partner's basis in the partner's partnership interest n17 or (2) consideration received by the partner for the partial sale of the property. n18

[3] Partner's Basis in Partnership Interest

[a] Overview

When a person contributes property to a partnership in exchange for an interest in the partnership, subchapter K assigns a basis to that interest. That basis is sometimes referred to as "outside" basis, in contrast to "inside basis," which is the partnership's basis in the property held by the partnership. n19 Determining a partner's outside basis is important for several purposes. First, a partner can deduct partnership losses only to the extent of the partner's outside basis. n20 Second, outside basis plays a role in determining the income tax consequences to a partner when a partnership makes a distribution to a partner. n21 Third, outside basis is important for determining gain or loss when a partner disposes of his or her partnership interest or when the partnership liquidates that interest. n22

As the following discussion explains, there are several interrelated rules governing computation of a partner's outside basis:

Increases in Outside Basis

1. A partner's outside basis increases by the amount of money n23 and the adjusted basis of any property (other than money) the partner contributes to the partnership. n24
2. A partner's outside basis increases by that partner's distributive share of partnership income. n25

Decreases in Outside Basis

1. A partner's outside basis decreases (but not below zero) by the amount of money n26 and the adjusted basis of any property (other than money) distributed to the partner by the partnership. n27
2. A partner's outside basis decreases by that partner's distributive share of partnership losses. n28

[b] Partner's Initial Outside Basis

When a person enters into a transaction governed by *I.R.C. Section 721(a)*, *I.R.C. section 722* n29 provides, as a general rule, that the person's initial outside basis equals the sum of the cash transferred to the partnership plus the adjusted basis of any property transferred to the partnership.

Example:

Mary Smith contributes cash of \$10,000 and unimproved real estate with a fair market value of \$45,000 to a partnership in exchange for a partnership interest. She paid \$30,000 for the land. Her basis in her partnership interest is \$40,000 [\$10,000 (cash) + \$30,000 (adjusted basis of the land)].

[c] Adjustments to a Partner's Outside Basis; I.R.C. section 705(a)

A partner must adjust his or her outside basis up and down to "keep track of [the] partner's 'tax investment' in the partnership, with a view toward preventing double taxation or exclusion from taxation of income items upon ultimate disposition of the partnership interest." n30 The need for this requirement becomes clear when one considers that the partners must report their distributive shares of partnership income and loss *regardless of whether the partnership makes any actual distributions to the partners.* n31

Determination of a partner's outside basis begins with *I.R.C. section 722*. From that point, a partner must increase the outside basis by the distributive share of taxable income of the partnership as determined under *I.R.C. section 703(a)*, n32 tax exempt income n33 and the excess of the deductions for depletion over the basis of the property subject to depletion. n34 A partner must decrease the outside basis (but not below zero) by the distributive share of partnership losses n35 and expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account. n36

[d] Effect of Partnership Liabilities on Outside Basis

If a partner contributes property subject to a liability in exchange for a partnership interest, n37 or if the partnership borrows money, n38 computation of the partner's outside basis requires reference to *I.R.C. sections 752* and *733* as well as to *I.R.C. section 722*. Under *I.R.C. section 752(a)*, n39 any *increase* in a partner's share of partnership liabilities or any increase in a partner's individual liabilities by reason of the partner's assumption of partnership liabilities triggers a deemed cash contribution by the partner to the partnership. Under *I.R.C. section 752(b)*, n40 any *decrease* in a partner's share of partnership liabilities or any decrease in a partner's individual liabilities by reason of the partnership's assumption of the partner's individual liabilities triggers a deemed cash distribution by the partnership to the partner. For purposes of *I.R.C. section 752*, "a liability to which property is subject shall, to the extent of the fair market value of such property, be considered as a liability of the owner of the property." n41

Any *increase* in a partner's liabilities which triggers a deemed cash contribution will *increase* the partner's outside basis n42 and any *decrease* in a partner's liabilities which triggers a deemed cash distribution will *decrease* the partner's outside basis (provided that a partner's outside basis cannot be reduced below zero). n43 If the deemed cash distribution exceeds the partner's outside basis, the partner must recognize gain to the extent of such excess. n44 The following examples illustrate the operation of these rules:

Example 1:

A, B, C and D form the Real Estate Development Partnership, agreeing to share income and losses equally. D contributes undeveloped land in exchange for a 25% interest in the Partnership. On the date of contribution, the property had a fair market value of \$100,000, an adjusted basis in D's hands of \$50,000 and was subject to a mortgage securing a \$40,000 recourse debt. The Partnership assumes the \$40,000 mortgage debt but has no other liabilities. As a result of the Partnership's assumption of the mortgage, A, B and C become liable for 75% of the mortgage ($\$40,000 \times 75\% = \$30,000$), thus in effect reducing D's individual liability by \$30,000. Under *I.R.C. section 752(b)*, that reduction triggers a deemed cash distribution of \$30,000 to D, which, under *I.R.C. section 733*, reduces his outside basis from \$50,000 (his basis in the contributed land) to \$20,000. As to A, B and C, whose shares of Partnership liabilities increase from zero to \$10,000 each as a result of the Partnership's assumption of the mortgage, *I.R.C. section 752(a)* produces a deemed capital contribution by each of \$10,000 which, under *I.R.C. section 722*, increases their outside bases by \$10,000 each.

Example 2:

Same facts as in Example 1, except the property is subject to recourse debt of \$80,000. As a result of the Partnership's assumption of the mortgage, A, B and C become liable for 75% of the mortgage [$\$80,000 \times 75\% = \$60,000$], thus in effect reducing D's individual liability by \$60,000. Under *I.R.C. section 752(b)*, that reduction triggers a deemed cash distribution of \$60,000 to D, which, under *I.R.C. section 733*,

reduces his outside basis from \$50,000 (his basis in the contributed land) to \$0. Under *I.R.C. section 731(a)(1)*, D has \$10,000 of gain (excess of the deemed \$60,000 cash distribution over D's \$50,000 adjusted basis in the contributed property). The \$10,000 gain will be capital gain. n45

Example 3:

Same facts as Example 1, except the Partnership existed before D became a partner and the Partnership had \$20,000 of recourse debt in addition to assuming the \$40,000 debt on the property contributed by D.

(a) When D becomes a partner, he becomes liable for 25% of the \$20,000 existing partnership liability--\$5,000. Thus, *I.R.C. section 752(a)* produces a deemed capital contribution by D of \$5,000, which, under *I.R.C. section 722*, increases D's outside basis by \$5,000 to \$55,000 (\$50,000 adjusted basis in land + \$5,000 deemed cash contribution).

(b) As a result of the Partnership's assumption of the mortgage, A, B and C become liable for 75% of the mortgage [\$40,000 x 75% = \$30,000], thus in effect reducing D's individual liability by \$30,000.

(c) The regulations n46 require netting of the \$5,000 increase in D's share of the Partnership's liabilities and the \$30,000 reduction in his individual liability, yielding a net \$25,000 decrease in D's liabilities for purposes of *I.R.C. section 752*. Under *I.R.C. section 752(b)*, that reduction triggers a deemed cash distribution of \$25,000 to D, which, under *I.R.C. section 733*, reduces his outside basis from \$50,000 (D's adjusted basis in the contributed land) to \$25,000.

(d) With the admission of D as a partner, the shares of the \$20,000 partnership liability allocated to A, B and C decreased by \$1,667 each (\$6,667 each before; \$5,000 each after), triggering a deemed distribution of \$1,667 each to A, B and C under *I.R.C. section 752(b)*. When the partnership assumed the \$40,000 liability on D's property, the liabilities allocated to A, B and C increased by \$10,000 each (25% of \$40,000 allocable to each). Under *I.R.C. section 752(a)*, this increase triggers a deemed capital contribution by each of \$10,000. Thus, A, B and C each have a net increase in liabilities of \$8,333, which, under *I.R.C. section 722*, produces an increase of \$8,333 each in their respective outside bases.

[e] Allocation of Partnership Liabilities

The discussion in the preceding section assumed a particular allocation of partnership liabilities. However, to appreciate fully how partnership liabilities affect a partner's outside basis, one must understand the rules governing allocation of such liabilities among the partners in a partnership. These rules appear in two sets of regulations: (1) regulations generally applicable to liabilities incurred or assumed by a partnership *before* December 28, 1991; n47 and (2) regulations generally applicable to liabilities incurred or assumed *on or after* December 28, 1991. n48 This section discusses only the new regulations. n49

The new regulations base the sharing of partnership liabilities on the characterization of liabilities as recourse or nonrecourse. As a broad generalization, a partnership must allocate *recourse* liabilities among its partners in the manner the partners share partnership *losses*. This rule reflects the manner in which the partners would share responsibility for payment of a partnership liability if the partnership fails to satisfy the liability. In contrast, a partnership must, in general, allocate *nonrecourse* liabilities among the partners in the manner the partners share partnership *profits*. This rule recognizes that the partners have no economic responsibility for the payment of nonrecourse liabilities and that such liabilities will be satisfied, if at all, out of partnership income or assets securing the liability.

[i] Allocation of Recourse Liabilities

The regulations provide that "[a] partnership liability is a recourse liability to the extent that any partner or related person n50 bears the economic risk of loss for that liability under section 1.752-2." n51 A partner's share of any recourse partnership liability equals the portion of that liability, if any, for which the partner bears the economic risk of loss. n52 The determination of the extent to which a partner bears the "economic risk of loss" for a partnership liability depends on an extremely complicated set of rules set forth in the regulations, full discussion of which is beyond the scope of this chapter. n53 However, the following material provides a summary of the most significant aspects of those rules.

In general, the regulations provide that a partner bears the "economic risk of loss" for a partnership liability if the partner or a person related to the partner would bear the economic burden of paying the loan if the partnership defaulted. n54 The regulations adopt a constructive liquidation analysis to determine whether the partner or a related person would have such a burden. n55 This analysis takes into account (1) the manner in which the partners have agreed to share economic losses and (2) all arrangements among the partners, related persons and the partnership. The constructive liquidation analysis assumes the following events occur simultaneously:

1. All of the partnership's liabilities become due and payable in full; n56
2. All of the partnership's assets (including money) become worthless, with the exception of the property contributed to secure a partnership interest; n57
3. The partnership disposes of all its assets in a fully taxable transaction for no consideration (other than relief from liabilities for which a creditor's right to repayment is limited solely to one or more partnership assets); n58
4. The partnership allocates its items of income, gain, loss, deduction and credit among the partners; n59 and
5. The partnership liquidates completely. n60

In a general partnership in a state governed by section 15(b) of the Uniform Partnership Act (or an equivalent provision), if a partnership's assets are not sufficient to satisfy the partnership's liabilities, the general partners must pay the deficiency. Section 34 of the Uniform Partnership Act provides that if one partner pays more than his or her share of the deficiency, that partner has a right of contribution from those partners who have not paid their share. Thus, unless the partnership agreement provides to the contrary, general partners are equally liable for recourse partnership debt and would have equal "economic risk of loss" within the meaning of the regulations.

In a limited partnership in a state that has adopted section 303 of the Uniform Limited Partnership Act (or an equivalent provision), a limited partner has no liability for the debts of the limited partnership. Thus, ordinarily a limited partner will not bear the "economic risk of loss" of any recourse partnership liability. A limited partner will bear the "economic risk of loss" for a recourse partnership debt only if, and to the extent, the limited partner has an obligation to make a direct payment to a creditor, n61 reimburse another partner for a payment made by the other partner, n62 make a capital contribution to the partnership, n63 or restore a deficit in the limited partner's capital account on liquidation. n64

[iii] Allocation of Nonrecourse Debt

The regulations provide that "[a] partnership liability is a nonrecourse liability to the extent that no partner or related person n65 bears the economic risk of loss for that liability under section 1.752-2." n66 A partner's share of the nonrecourse liability of a partnership equals the sum of (in order of priority):

1. The partner's share of "partnership minimum gain" determined in accordance with *I.R.C. section 704(b)* and the regulations thereunder; n67

2. The amount of any taxable gain that would be allocated to the partner under *I.R.C. section 704(c)* n68 if the partnership disposed (in a taxable transaction) of all partnership property subject to one or more nonrecourse liabilities of the partnership in full satisfaction of the liabilities and for no other consideration; n69 and

3. The partner's share of the nonrecourse liabilities of the partnership not allocated under either of the preceding paragraphs, determined either in accordance with the partner's share of the partnership profits or in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. n70

The following examples illustrate the general application of the rules for allocation of nonrecourse debt:

Example 4: The AB Partnership purchases depreciable property using a \$1,000 purchase money note that is a nonrecourse liability within the meaning of the *I.R.C. section 752* regulations. n71 No principal payments are due on the note for a year. The AB Partnership Agreement provides that the partners A and B will share all items of income, gain, loss and deduction equally. Immediately after AB Partnership purchases the depreciable property, A and B share the nonrecourse liability equally because they each have equal interests in the partnership profits. A and B are treated as if each had contributed \$500 to the partnership, thus reflecting each partner's increase in her share of partnership liabilities from \$0 to \$500. n72

The partnership minimum gain with respect to an item of partnership property subject to a nonrecourse liability equals the amount of gain the partnership would recognize if it disposed of the property in full satisfaction of the nonrecourse liability and for no other consideration. n73 Therefore, if the AB Partnership claims a depreciation deduction of \$200 for the depreciable property in the year it acquired the property, AB Partnership's partnership minimum gain for that year will increase by \$200 (the excess of the \$1,000 nonrecourse liability over AB Partnership's adjusted basis of \$800 in the property). A and B each have a \$100 share of the partnership minimum gain at the end of that year because *Treas. Reg. section 1.704-2(b)(1)* treats the \$200 of depreciation as a nonrecourse deduction. Thus, at the end of the year, AB Partnership allocates A and B \$100 each of nonrecourse liability to match their shares of partnership minimum gain. n74 Under *Treas. Reg. section 1.752-3(a)(3)*, AB Partnership will allocate the remaining \$800 of the nonrecourse liability equally between A and B. n75

Example 5: The facts are the same as in Example #4, except the AB Partnership Agreement provides for allocation of all depreciation deductions to A. A and B agree to allocate nonrecourse liabilities in accordance with the manner in which it is reasonably expected that the deductions attributable to those nonrecourse liabilities will be allocated. Provided the allocation of all depreciation to A is valid under *I.R.C. section 704(b)*, immediately after the AB Partnership purchases the depreciable property, A's share of the nonrecourse liability is \$1,000. *I.R.C. section 752(a)* treats A as contributing \$1,000 to the AB Partnership. n76

[f] Relationship of Outside Bases, Partnership Liabilities and Capital Accounts

As a general proposition, the aggregate of the partners' outside bases will equal the aggregate adjusted bases of the assets held by the partnership. n77 Similarly, a partner's outside basis will generally equal the sum of (1) the partner's *I.R.C. section 704(b)* capital account (which can have a negative balance because a partner's share of partnership liabilities is ignored for purposes of calculating a partner's capital account) and (2) the partner's share of partnership liabilities. n78

[4] Operation of a Partnership

[a] The Partnership as a Conduit; Partners, Not Partnership, Subject to Tax

A partnership is not a taxable entity. n79 Partners must take into account their respective distributive shares n80 of

partnership income and loss, regardless of whether the partnership makes any actual distributions to the partners. n81 However, the character of income or loss is determined at the partnership level. n82 Thus, if a partnership sells land it is holding for sale to its customers in the ordinary course of its business, the gain is ordinary income to the partners even if they are not in the trade or business of buying and selling real estate. n83

A partner must include on a tax return his or her distributive share of partnership income and loss for the partnership's taxable year ending within or with his or her taxable year. n84 For example, suppose Paul Peters, a calendar year taxpayer, is a partner in the ABC Partnership, which has properly adopted a fiscal taxable year ending on January 31. n85 Peters must report his distributive share of ABC's income and loss for the taxable year ending January 31, 1992 in his tax return for calendar year 1992, due April 15, 1993.

[b] Determining a Partner's Share of Partnership Items

[i] I.R.C. section 704(a)

Because a partnership acts as a conduit, passing all of its income, gains, losses, deductions and credits through to its partners, the rules for allocating such items to the partners are of great importance. The starting point is that the partnership agreement determines a partner's share of partnership income, gain, loss, deduction or credit. n86 For this purpose:

a partnership agreement includes any modifications of the partnership agreement made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions) which are agreed to by all the partners, or which are adopted in such other manner as may be provided in the partnership agreement. n87

A partnership must file an information return (IRS Form 1065) not later than three and one-half months after the end of its taxable year. n88 Thus, the partners in a calendar year partnership could amend the allocation provisions of their partnership agreement for the taxable year ending on December 31, 1992 at any time on or before April 15, 1993. This rule provides significant planning flexibility because the partners can make decisions about allocations with the full year's information available to them.

The preceding discussion suggests that the partners in a partnership have great freedom in allocating items of partnership income, gain, loss, deduction and credit. In the first instance, the partners can establish the rules for allocating such items. However, as the following discussion explains, the partners do not have carte blanche in establishing such rules. n89

[ii] I.R.C. section 704(b)

Notwithstanding I.R.C. *Section 704(a)*, I.R.C. section 704(b) provides that (1) if the partnership agreement does not include rules for determining a partner's distributive share n90 or (2) if the agreement includes such rules but those rules do not have "substantial economic effect," n91 a partner's distributive share "shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances)." I.R.C. *section 704(b)* became effective for partnership taxable years beginning after December 31, 1975. Beginning in 1983, Treasury has published several sets of regulations under I.R.C. *section 704(b)*. n92 The following material covers only the present I.R.C. *section 704(b)* regulations.

The I.R.C. *section 704(b)* regulations provide a set of rules for determining when the IRS will respect the allocation scheme established in a partnership agreement. As the following summary explains, the concept of economic substance is central to these rules.

If a partner will benefit economically from an item of partnership income or gain, that item must be

allocated to him so he bears the correlative tax burden. Conversely, if a partner will suffer the economic burden of an item of partnership loss or deduction, he must be allocated the associated tax benefit. n93

The regulations link proper maintenance of partners' capital accounts during the operation of a partnership to the determination of whether the allocations of items of partnership income or loss have "substantial economic effect." n94

If a partnership agreement includes a provision for the allocation of income, gain, loss, deduction or credit to its partners, the IRS will respect the allocation if it satisfies *one* of three tests:

1. the allocation has "substantial economic effect" as defined in *Treas. Reg. section 1.704-1(b)(2)*;
2. the allocation is in accordance with each partner's interest in the partnership, taking into account all of the facts and circumstances, as provided in *Treas. Reg. section 1.704-1(b)(3)*; or
3. the allocation is deemed to be in accordance with each partner's interest in the partnership under the set of rules dealing with special situations set forth in *Treas. Reg. sections 1.704-1(b)(4)* and 1.704-2. n95

The "substantial economic effect" test is largely mechanical. An allocation must have "economic effect" as defined by the regulations n96 and the "economic effect" must be "substantial." n97 If the allocation scheme in a partnership agreement does not pass the "substantial economic effect" test, the IRS may still respect the allocation if, taking into account all the facts and circumstances, the allocation is in accordance with each partner's underlying economic interest in the partnership. Finally, if an allocation lacks "economic effect" with respect to any partner because the allocation relates to nonrecourse debt, the IRS will respect the allocation if the partnership agreement contains provisions required by the regulations to prevent shifting of the burden of an allocation to other partners.

[A] The "Substantial Economic Effect" Test

Although a full discussion of the "substantial economic effect" test is beyond the scope of this chapter, n98 the following summary of the most important aspects of the test provides sufficient information for the purposes of this chapter. The test consists of two parts: (1) a mechanical "economic effect" test; n99 and (2) a somewhat more subjective "substantiality" test. n100

The regulations establish three alternative tests for determining whether an allocation has "economic effect:" (1) The primary test; n101 (2) the alternate economic effect test; n102 and (3) the economic effect equivalence test. n103

Primary Test for Economic Effect. An allocation will satisfy the primary test for "economic effect" if, and only if, throughout the full term of the partnership, the partnership agreement provides:

1. for determination and maintenance of partners' capital accounts in accordance with the *I.R.C. section 704* regulations; n104
2. upon liquidation of the partnership, the partnership will distribute its assets in accordance with the positive capital account balances of the partners; n105 and
3. a partner has an obligation to restore a deficit balance in his or her capital account upon the liquidation of a partnership interest. n106

A partner's capital account is a record of that partner's investment in the partnership. For that reason, the partners' capital accounts are central to the determination of whether partnership allocations have "substantial economic effect." Thus, a

partnership must maintain capital accounts for its partners according to detailed rules established by the regulations. n107 The partnership must make the following credits and debits to a partner's capital account:

Credits

1. the amount of money a partner has contributed to the partnership; n108
2. the fair market value of property the partner has contributed to the partnership (net of liabilities encumbering the contributed property that the partnership is considered to assume or take subject to under *I.R.C. section 752*); n109 and
3. the partner's distributive share of partnership "book" income and gain (or items thereof), including income and gain exempt from tax. n110

Debits

1. the amount of money distributed to the partner by the partnership; n111
2. the fair market value of property distributed to the partner by the partnership (net of liabilities encumbering the distributed property that the partner is considered to assume or take subject to under *I.R.C. section 752*); n112
3. the partner's distributive share of partnership expenditures described in *I.R.C. section 705(a)(2)(B)*; n113 and
4. the partner's distributive share of partnership "book" loss and deductions (or items thereof), other than items already accounted for as distributive shares of partnership *I.R.C. section 705(a)(2)(B)* expenditures. n114

In certain circumstances, a partnership can permit the increase or decrease in partners' capital accounts to reflect a revaluation of partnership property (including intangible assets such as goodwill) on the partnership's books. n115 Any such increases or decreases must conform to the requirements set forth in the regulations. n116

The following examples illustrate the basic elements of the capital account maintenance rules:

Example 6:

A, B, C and D form the Real Estate Development Partnership, agreeing to share income and losses equally. D contributes \$50,000 cash and undeveloped land in exchange for a 25% interest in the Partnership. On the date of the contribution, the property had a fair market value of \$100,000 and an adjusted basis in D's hands of \$80,000. D's capital account is \$150,000 [\$50,000 cash + \$100,000 fair market value of contributed land]. In contrast, D's basis in her partnership interest (outside basis) is \$130,000 [\$50,000 cash + \$80,000 adjusted basis in the land].

Example 7:

Same facts as Problem #6, except the land is encumbered by a \$20,000 recourse liability which the Partnership assumes. D's capital account is \$130,000 [\$50,000 cash + \$80,000 net fair market value of contributed land (\$100,000 fair market value - \$20,000 liability)]. The assumption of the \$20,000 by the Partnership is not treated as a distribution of money to D by the Partnership for purposes of the capital account maintenance rules because that assumption triggers a deemed cash distribution under *I.R.C. section 752(b)*. In contrast, D's basis in her partnership interest (outside basis) is \$115,000 [\$50,000 cash + \$80,000 adjusted basis in the land - \$15,000 deemed *I.R.C. section 752(b)* cash distribution].

Example 8:

The facts are the same as in Example #6. At the end of Real Estate Development Partnership's first

taxable year, D's distributive share of the Partnership's operating income is \$10,000 and she receives a cash distribution of \$5,000 from the Partnership. The distributive share increases D's capital account from \$150,000 to \$160,000 and the cash distribution decreases her capital account from \$160,000 to \$155,000. D's outside basis would receive a net upward adjustment of \$5,000 to \$135,000 [\$10,000 increase (distributive share) - \$5,000 decrease (cash distribution)].

Alternative Test for Economic Effect. Suppose a partnership agreement requires maintenance of capital accounts in accordance with the regulations and requires that liquidation distributions be based on the positive capital account balances of the partners but does not require the partners to restore deficits in their capital accounts upon liquidation. Such an agreement does not satisfy the requirements of the primary test for "economic effect" n117 but the allocations in the agreement may still have "economic effect" under an alternative test for economic effect. n118 The effect of the alternative test is to respect allocations to a partner who has no obligation to restore a negative capital account provided the allocation does not make the capital account negative. To qualify under the test, the partnership agreement must at all times satisfy all of the requirements set forth in *Treas. Reg. section 1.704-1(b)(2)(ii)(d)*. This test is of particular importance in connection with allocations to limited partners who have no obligation to restore negative capital accounts.

Economic Effect Equivalence Test. If an allocation fails both the primary test and the alternate test for economic effect, the economic effect equivalence test may save the allocation. In essence, the economic effect equivalence test provides that the IRS will respect an allocation if a liquidation of the partnership at the end of its taxable year would produce the same economic results to the partners as would occur if the partnership had satisfied all the requirements of the primary test. This test apparently has rather limited application. One example to which this test could apply would be a general partnership based either on an oral agreement or on a written agreement that does not satisfy the requirements of the primary test.

In contrast to the mechanical requirements of the "economic effect" test, the regulations provide that, in general, the "economic effect" of an allocation is "substantial" if there is "a reasonable possibility that the allocation ... will affect substantially the dollar amounts to be received by the partners from the partnership, independent of tax consequences." n119

[B] The "Partners' Interests in the Partnership" Test

If an allocation in a partnership agreement cannot satisfy the "substantial economic effect" test, the IRS will examine all of the facts and circumstances to determine whether the allocation reflects the partners' underlying economic interests in the partnership. n120 The regulations establish two tests to determine a partner's interest in a partnership: (1) The general facts and circumstances test; n121 and (2) a special limited deficit restoration test. n122 The first test is the most important and is discussed below. The second test is limited in scope, applying only if the partnership agreement contains no obligation to restore deficit capital accounts and the partnership cannot satisfy the alternate economic effect test.

In applying the general facts and circumstances test, the IRS will consider the following factors, among others:

1. the partners' relative contributions to the partnership; n123
2. the interests of the partners in economic profits and losses (if different than their interests in taxable income or loss); n124
3. the interests of the partners in cash flow and other nonliquidating distributions; n125 and
4. the rights of the partners to distributions of capital upon liquidation. n126

The following example illustrates the basic aspects of the "substantial economic effect" test and the "partners' interests in the partnership" test:

Example 9:

A and B form a general partnership with cash contributions of \$40,000 each. The partnership uses the cash to purchase depreciable personal property at a cost of \$80,000. The partnership agreement provides that A and B will have equal shares of taxable income and loss (computed without regard to cost recovery deductions) and cash flow and that all cost recovery deductions on the property will be allocated to A. The agreement further provides that the partners' capital accounts will be determined and maintained in accordance with *Treas. Reg. section 1.704-1(b)(2)(iv)*, but that upon liquidation of the partnership, distributions will be made equally between the partners (regardless of capital account balances) and no partner will be required to restore the deficit balance in her capital account for distribution to partners with positive capital account balances. In the partnership's first taxable year, it realizes operating income equal to its operating expenses and has an additional \$20,000 cost recovery deduction, which is allocated entirely to A. The fact that A and B will be entitled to equal distributions on liquidation even though A is allocated the entire \$20,000 cost recovery deduction indicates that A will not bear the full risk of the economic loss corresponding to such deduction if such loss occurs. Thus, the allocation lacks "substantial economic effect" and will be disregarded. The partners made equal contributions to the partnership, share equally in other taxable income and loss, and will share equally in liquidation proceeds, indicating that their actual economic arrangement is to bear the risk imposed by the potential decrease in the value of the property equally. Thus, the partners' interests in the partnership are equal and the cost recovery deduction must be reallocated equally between A and B. n127

[C] Allocations Attributable to Nonrecourse Liabilities

The regulations establish a special set of rules to govern allocation of "nonrecourse deductions," *i.e.*, deductions attributable to a nonrecourse liability. n128 The term "nonrecourse liability" has the same meaning under the *I.R.C. section 704(b)* regulations as the term has under the *I.R.C. section 752* regulations. In other words, a liability is nonrecourse if no partner or related person bears any economic risk of loss for such liability. n129 A "nonrecourse deduction" is an item of loss, deduction or a *I.R.C. section 705(a)(2)(B)* expenditure that is attributable to a nonrecourse liability. n130 Because the nonrecourse lender, rather than the partners, bears the economic risk of loss attributable to nonrecourse deductions, allocation of nonrecourse deductions cannot have "substantial economic effect." Similarly, allocations of gain the partnership would realize if it surrendered the property securing the nonrecourse debt for no consideration other than full satisfaction of the nonrecourse debt cannot have "substantial economic effect" because such allocations merely offset the nonrecourse deductions.

To understand the definition of the term "nonrecourse deduction," one must understand the concept of "partnership minimum gain" because the regulations base the allocation of nonrecourse deductions on that concept. A partnership computes its "partnership minimum gain" separately for each nonrecourse liability, then aggregates the "partnership minimum gain," if any, for each such liability. n131 For each nonrecourse liability, the partnership must determine how much gain, if any, it would realize if it disposed of the property securing the nonrecourse liability for no consideration other than full satisfaction of the nonrecourse liability. Thus, if a partnership owned property with an adjusted basis to the partnership of \$40,000, encumbered by a nonrecourse liability of \$60,000, the partnership would have "partnership minimum gain" of \$20,000 (the amount of gain the partnership would realize if it disposed of the property for no consideration other than full satisfaction of the \$60,000 nonrecourse liability). A partnership's "partnership minimum gain" may increase (if, for example, the partnership takes cost recovery deductions, reducing the basis of the property while the principal amount of the nonrecourse liability remains the same) or decrease (if, for example, the partnership reduces the principal amount of the nonrecourse debt).

The amount of nonrecourse deductions for a partnership taxable year equals the net increase in "partnership minimum gain" during the taxable year, reduced (but not below zero) by the aggregate distributions made during the taxable year of proceeds of a nonrecourse liability that are allocable to an increase in "partnership minimum gain." n132 A partnership determines its net increase in "partnership minimum gain" by comparing its current year's "partnership minimum gain" with its prior year's "partnership minimum gain." n133 The partnership's nonrecourse deductions consist first of depreciation or cost recovery deductions from the property securing the nonrecourse liability. n134 If such depreciation or cost recovery deductions do not cover the partnership's nonrecourse deduction amount, the partnership must treat a *pro rata* share of its other deductions as nonrecourse deductions. n135 The following example illustrates the operation of these rules:

Example 10:

LP, the limited partner, and GP, the general partner, form a limited partnership to acquire and operate a commercial office building. LP contributes \$180,000 and GP contributes \$20,000. The partnership obtains an \$800,000 nonrecourse loan and purchases a building on leased land for \$1,000,000. A mortgage on the building secures the nonrecourse loan, on which the partnership owes no principal payments for five years. The partnership agreement provides that the partnership will allocate all partnership items 90% to LP and 10% to GP until the first time when the partnership has recognized items of income and gain that exceed the items of loss and deduction it has recognized over its life. Thereafter, the partnership will allocate all partnership items equally between LP and GP. In each of the partnership's first two taxable years, it generates rental income of \$95,000, operating expenses (including land lease payments) of \$10,000, interest expense of \$80,000 and a depreciation deduction of \$90,000, resulting in a net taxable loss of \$85,000 in each of those years. Assume that the allocation of these losses 90% to LP and 10% to GP have "substantial economic effect."

If the partnership were to dispose of the building in full satisfaction of the nonrecourse liability at the end of the third year, it would realize \$70,000 of gain [\$800,000 amount realized less \$730,000 adjusted basis in the building (\$1,000,000 cost--\$270,000 depreciation for three years)]. Thus, the partnership would have \$70,000 of "partnership minimum gain" at the end of the third year. In this instance, the partnership's net increase in "partnership minimum gain" in the third year would also be \$70,000 (\$0 "partnership minimum gain" at the end of the second year; \$70,000 "partnership minimum gain" in the third year). Thus, there are partnership nonrecourse deductions for that year of \$70,000, consisting entirely of depreciation deductions with respect to the building. n136

In general, if a partnership has a net decrease in "partnership minimum gain" for a taxable year, the "minimum gain chargeback" rules require the partnership to allocate income to the partners who previously received allocations of nonrecourse deductions or received distributions allocable to nonrecourse liability proceeds. n137 The "minimum gain chargeback" requirement ensures that partners who received nonrecourse deductions must replace those deductions with income in appropriate circumstances. The partnership income used to satisfy the "minimum gain chargeback" requirement consists first of the gain from the sale of the property subject to the nonrecourse liability. n138 The partnership must satisfy any remaining "minimum gain chargeback" requirement with a *pro rata* portion of the partnership's other items of income or gain. n139

Because partners do not bear any economic risk of loss for a nonrecourse liability, allocations of nonrecourse deductions cannot have economic effect. n140 Therefore, the partnership must allocate nonrecourse deductions in accordance with the interests of the partners in the partnership. n141 If the partners comply with certain basic safe harbor requirements, n142 the partners can allocate the partnership's nonrecourse deductions in any manner that is "reasonably consistent with allocations, which have substantial economic effect," of some other significant partnership item attributable to the property encumbered by the nonrecourse liability. n143 If the partners fail to satisfy the safe harbor requirements, the partnership must allocate the nonrecourse deductions in accordance with the economic interests of the partners in the partnership. n144

Note that, if a partner or a person "related" n145 to a partner is the nonrecourse lender, in general the loan will be "partner nonrecourse liability." n146 As a result, the partnership must allocate all "partner nonrecourse deductions" n147 attributable to such liability to the lender or the "related person." n148 However, the regulations provide a *de minimis* exception to this rule. Under this exception, a loan from a partner or a "related person" to a partnership will be treated as nonrecourse liability (as opposed to partner nonrecourse liability) if (1) the lender's interest in each item of partnership income, gain, loss, deduction, or credit for every taxable year that the lender is a partner in the partnership is 10% or less and (2) the loan is "qualified nonrecourse financing" within the meaning of *I.R.C. section 465(b)(6)*, determined without regard to the type of activity financed. n149

[iii] I.R.C. section 704(c)

As explained earlier, n150 the *I.R.C. section 704* regulations use the capital account to ensure that allocations of partnership income, gain, loss, deduction and credit are related to the economic reality of the partners' arrangement. However, in certain instances, the capital account maintenance rules ("book" rules) and the tax accounting rules treat a partnership transaction differently. These differences, if not taken into account, would create problems, as illustrated by the following example.

Example 11:

Andy Adams and Bobbi Brooks form the Adams-Brooks Partnership. Adams contributes \$20,000 in cash and Brooks contributes property with a fair market value on the date of contribution of \$20,000 and an adjusted basis in Brooks' hands of \$15,000. Adams and Brooks each receive a 50% interest in the Partnership. Each would have an opening capital account of \$20,000--Adams (\$20,000 cash) and Brooks (the \$20,000 fair market value of the property). However, Adams would have a \$20,000 basis in his partnership interest, while Brooks would have a \$15,000 basis in her partnership interest. If the Partnership sold the property for \$20,000, it would recognize a gain of \$5,000 [\$20,000 sale price - \$15,000 basis]. If this gain increases the partners' capital accounts, their aggregate capital accounts would increase from \$40,000 to \$45,000, yet the Partnership only has \$40,000 in total assets. The problem arises because the basic capital account maintenance rules do not properly account for either built-in gain (as in this example) or built-in loss.

I.R.C. section 704(c), as amended by the Deficit Reduction Act of 1984, authorizes Treasury to promulgate regulations to deal with this problem. *I.R.C. section 704(c)* provides that if the basis of contributed property differs from its value, the partnership must allocate income, gain, loss and deduction with respect to the contributed property among the partners "so as to take account of the variation between the basis of the property to the partnership and its fair market value at the time of contribution." n151 Under the regulations promulgated pursuant to *I.R.C. section 704(c)*, the partnership in the Example above would ignore the \$5,000 of gain on the sale of the property for purposes of maintaining the capital accounts of the partners, and would allocate the entire \$5,000 of gain to Brooks. n152 As a result, Brooks would increase her basis in her partnership interest from \$15,000 to \$20,000 and both she and Adams would have capital accounts of \$20,000.

The regulations explain that "[t]he purpose of section 704(c) is to prevent the shifting of tax consequences among partners with respect to precontribution gain or loss" n153 and that, in general, *I.R.C. section 704(c)* applies on a property-by-property basis. n154 "[T]he allocations must be made using a reasonable method that is consistent with the purpose of section 704(c)." n155 The regulations describe three allocation methods "that are generally reasonable." n156 The first of these methods, the "traditional method," n157 limits the amount of gain or loss the partnership can allocate to the partners with respect to a property in any taxable year to the amount of gain or loss with respect to that property for the taxable year. n158 The following example illustrates the application of this "ceiling" rule:

Example 12:

Andy Adams and Bobbi Brooks form the Adams-Brooks Partnership. Adams contributes \$20,000 in cash and Brooks contributes raw land with a fair market value on the date of contribution of \$20,000 and an adjusted basis in Brooks' hands of \$15,000. Adams and Brooks each receive a 50% interest in the Partnership. Each would have an opening capital account of \$20,000--Adams (\$20,000 cash) and Brooks (the \$20,000 fair market value of the land). However, Adams would have a \$20,000 basis in his partnership interest, while Brooks would have a \$15,000 basis in her partnership interest. Assume the Partnership sells the land for \$19,000, recognizing a book loss of \$1,000 [\$20,000 book value--\$19,000 sale price] but recognizing a \$4,000 gain [\$19,000 sale price--\$15,000 basis] for tax purposes. Under *I.R.C. section 704(c)*, the partnership must allocate the entire \$4,000 tax gain to Brooks. Adams in effect paid \$10,000 for a one-half interest in the property, but because his one-half share of the sale price is only \$9,500, Adams has suffered an economic loss of \$500. Nevertheless, the "ceiling" rule imposed by the regulations limits the amount allocable to either partner to the amount of gain realized by the Partnership--in this instance \$4,000, which must go entirely to Brooks. Thus, Adams cannot currently claim his \$500 share of the \$1,000 book loss suffered by the partnership. Note that if the partnership liquidated immediately after the sale of the land, Adams and Brooks would each receive a liquidating distribution of \$19,500 [total assets of \$39,000 (\$20,000 cash contributed by Adams and the \$19,000 proceeds from the sale of the land) divided by two]. Adams would realize the \$500 loss [\$20,000 outside basis--\$19,500 distribution] which the "ceiling" rule prevented him from claiming upon the sale of the land.

In addition to governing allocation of gain and loss, the regulations also govern allocation of items of income and deduction with respect to contributed property. The partnership must allocate such items based on the fair market value of the property for purposes of adjustments to the capital accounts of the partners. n159 The "ceiling" rule discussed above applies to allocations of depreciation and depletion with respect to contributed property. n160

Example 13:

Andy Adams and Bobbi Brooks form the Adams-Brooks Partnership. Adams contributes \$100,000 in cash and Brooks contributes property with a fair market value on the date of contribution of \$100,000 and an adjusted basis in Brooks' hands of \$25,000. Adams and Brooks each receive a 50% interest in the Partnership. Each would have an opening capital account of \$100,000--Adams (\$100,000 cash) and Brooks (the \$100,000 fair market value of the property). Adams would have a \$100,000 basis in his partnership interest, while Brooks would have a \$25,000 basis in her partnership interest. Assume the property has a remaining useful life of five years and the Partnership properly claims tax depreciation of \$5,000 per year on the property. However, because the "book" value of the property is \$100,000, "book" depreciation would be \$20,000 per year. Thus, the Partnership would charge the respective capital accounts of Adams and Brooks \$10,000 per year in "book" depreciation. To determine how to allocate the \$5,000 of tax depreciation claimed by the Partnership each taxable year during the remaining five years of the property's useful life, the regulations establish a two step procedure. n161 First, determine the amount of depreciation to which Adams (the cash contributor) would have been entitled each year if both partners had contributed cash and the Partnership had purchased the property for \$100,000, then allocate that amount to Adams. Adams has, in effect, purchased a one-half interest in the property for \$50,000. If Adams had actually purchased a one-half interest in the property for \$50,000, he would have been entitled to claim \$10,000 a year in depreciation [\$50,000 divided by five year remaining useful life]. Thus, Adams' allocable share of the depreciation appears to be \$10,000 per year. However, the second step in the procedure established by the regulations is to apply the "ceiling" rule, limiting allocable depreciation to the amount of tax depreciation allowable to the Partnership (\$5,000) each year. The Partnership would allocate the entire \$5,000 of each year's tax depreciation to Adams as his distributive share of that depreciation, reducing his outside basis by that amount each year. Brooks' distributive share of the depreciation for each year would be zero. Note that the effect of the "ceiling" rule in this example is to force Adams to defer \$25,000 of depreciation deductions until the liquidation of

the Partnership. Assume the Partnership liquidates when the property contributed by Brooks is worthless and its only asset is the \$100,000 originally contributed by Adams. Adams would receive a liquidating distribution of \$50,000 (one-half of the \$100,000 cash) and would recognize a \$25,000 loss [\$75,000 outside basis - \$50,000 distribution]. Although this loss is equal in amount to the \$25,000 of depreciation Adams had to defer, the loss will be a capital loss rather than an ordinary deduction. n162

Example 14:

The same facts as in Example 13, except Brooks' basis in the property was \$75,000 when she contributed it to the Partnership. The Partnership's allowable depreciation for tax purposes would be \$15,000 per year [\$75,000 divided by five years], of which the Partnership would allocate \$10,000 to Adams and the remaining \$5,000 to Brooks.

The preceding examples demonstrate that the "ceiling" rule can create distortions. To correct such distortions, the regulations permit partnerships using the "traditional method" of making *I.R.C. section 704(c)* allocations to "make reasonable curative allocations to reduce or eliminate disparities between book and tax items of noncontributing partners. A curative allocation is an allocation of income, gain, loss, or deduction for tax purposes that differs from the partnership's allocation of the corresponding book item." n163

[c] Effect of Distributions to Partners

As previously explained, partners must report their distributive shares of partnership income for each taxable year, regardless of whether they receive actual distributions of such income. Thus, when a partnership makes a nonliquidating distribution of cash or property to its partners, the distribution should not result in taxable income to the partners to the extent the distribution represents previously taxed distributive shares of partnership income. n164 The mechanism for avoiding double taxation is the partner's adjusted basis in the partner's partnership interest ("outside basis").

A partner who receives a nonliquidating distribution of money will not recognize gain unless the amount of money distributed exceeds the partner's outside basis. n165 Similarly, a partner who receives a distribution of property will not recognize gain unless the adjusted basis of the property exceeds the partner's outside basis and generally will take a carryover basis in the distributed property. n166 A partner who receives a nonliquidating distribution of money must reduce outside basis (but not below zero) by the amount of money received. n167 If the partner receives a nonliquidating distribution of property, the partner must reduce outside basis by an amount equal to the partnership's basis in the distributed property. n168

[5] Liquidation

[a] Liquidation of a Partnership Interest

When a partner wishes to leave a partnership, the partner may, with the agreement of the other partners, sell his or her partnership interest to a third party. In that instance, the selling partner must recognize gain or loss based on the difference between the selling price and the partner's outside basis. n169 *I.R.C. section 741* treats the sale as the sale or exchange of a capital asset, thus, in most instances, giving the selling partner capital gain or loss. However, any portion of the selling price attributable to unrealized partnership receivables or "substantially appreciated" partnership inventory will be treated as an amount realized from the sale or exchange of property *other than* a capital asset. n170

A retiring partner may also have the partnership buy out his or her interest in the partnership. In that instance, the purchase is treated as if the partnership were purchasing the retiring partner's share of the partnership assets from a stranger. n171 The Code breaks the payments into two categories: (1) payments for the retiring partner's interest in the partnership's unrealized receivables and unspecified goodwill; n172 and (2) payments for the retiring partner's interest in all other partnership property. n173 Prior to amendments made to *I.R.C. section 736* by the Revenue Reconciliation Act of 1993 n174 (the "1993 Act"), the partnership and the remaining partners could take an immediate deduction for

any part of the payment attributable to unrealized receivables and partnership goodwill. n175 The Code treated the payment for the retiring partner's interest in the partnership's unrealized receivables and unspecified goodwill in part as a distributive share n176 and in part as ordinary income. n177 The payment for the remaining partnership property produced capital gain or loss. n178

The 1993 Act amended *I.R.C. section 736*, creating, in effect, separate rules for service-oriented partnerships and capital-oriented partnerships. n179 Analysis under *I.R.C. section 736* as amended by the 1993 Act begins with section 736(b)(1), which asks whether a payment is "in exchange for the interest of [the retiring or deceased] partner in partnership property." If the payment appears to be "in exchange for the interest of [the retiring or deceased] partner in partnership property," *I.R.C. section 736(b)(3)* asks whether capital is "a material income-producing factor for the partnership" n180 and whether the retiring or deceased partner was a *general partner* in the partnership. n181 If the payment appears to be "in exchange for the interest of [the retiring or deceased] partner in partnership property" but either (1) capital is *not* a material income producing factor or (2) the retiring or deceased partner was not a general partner, *I.R.C. section 736(b)(2)* asks whether the payment is for either (1) "unrealized receivables" of the partnership as defined in *I.R.C. section 751(c)* n182 or (2) partnership goodwill. n183 If the payment is "in exchange for the interest of [the withdrawing] partner in partnership property" and neither of the exceptions in *I.R.C. section 736(b)(2)* apply, the payment will be treated as a "distribution," which may either produce ordinary income if *I.R.C. section 751(b)* applies or reduce the partner's "outside basis" and then produce capital gain. The Code treats the balance of the payment, including amounts described in *I.R.C. section 736(b)(2)*, as an "*I.R.C. section 736(a)* payment," taxable either as (1) a "distributive share" of partnership income if the amount is determined with regard to the income of the partnership n184 or (2) a "guaranteed payment" described in *I.R.C. section 707(c)* if the amount is determined without regard to the income of the partnership. n185 The following example illustrates the operation of *I.R.C. section 736* as amended by the 1993 Act:

Anne Abrams is a general partner in ABC Associates, a three person general partnership in which capital is not "a material income producing factor." n185a Each of the partners share income and losses equally. The partnership has the following assets:

	Basis	Value
Cash	\$30,000	\$30,000
Accounts Receivable	0	\$30,000
Capital Asset	\$15,000	\$30,000
	\$45,000	\$90,000

Abrams retires from the partnership, receiving a \$30,000 cash payment from the partnership. *I.R.C. section 736(b)(1)* asks whether all of the \$30,000 represents a payment "in exchange for the interest of [Abrams] in partnership property." Because Abrams is a general partner and because capital is not a material income-producing factor to the partnership, *I.R.C. section 736(b)(2)* provides that a payment representing Abrams' interest in the "unrealized receivables" of the partnership is not a payment "in exchange for the interest of [Abrams] in partnership property." Such a payment becomes an "*I.R.C. section 736(a)* payment." Of the \$30,000 cash payment, \$10,000 represents Abrams' interest in the "unrealized receivables," and, because the amount is determined without regard to the partnership's income, the amount is an *I.R.C. section 736(a)(2)* "guaranteed payment" which will be ordinary income to Abrams and will produce a \$10,000 deduction to the partnership. The remaining \$20,000 will be an *I.R.C. section 736(b)* payment, treated as a distribution to Abrams. If Abrams' "outside basis" immediately before the cash payment was \$5,000, the \$20,000 *I.R.C. section 736(b)* payment would reduce her "outside basis" to \$0 and generate \$15,000 of capital gain.

If capital were a material income-producing factor for the partnership, *I.R.C. section 736(b)(2)* would not apply to the payment, with the result that *I.R.C. section 736(b)(1)* would treat the entire payment as a distribution. *I.R.C. section 751(b)(1)(B)* would treat Abrams' share of the "unrealized receivables" (\$10,000) as ordinary income. The remainder of

the distribution (\$20,000) would reduce Abrams' "outside basis" from \$5,000 to \$0 and generate \$15,000 of capital gain.

[b] Liquidation of a Partnership

A partnership may terminate voluntarily by ceasing to carry on any part of its business, financial operation or venture. n186 Alternatively, a partnership will be deemed to have terminated if, within a twelve month period, there is a sale or exchange of 50% or more of the total interest in partnership capital or profits. n187 When a partnership liquidates completely, subchapter K treats the liquidation as a sale of the partnership's assets. In general, *I.R.C. sections 731, 732 and 735* govern the liquidation. However, if the partnership makes liquidating distributions to the partners that are not *pro rata* with respect to each partner's share of *I.R.C. section 741* and *751* assets, the rules in *I.R.C. section 751(b)* governing disproportionate distributions will govern. In general, *I.R.C. section 736(a)*, which is relevant to the liquidation of a partner's interest in a partnership, does not apply to a single distribution of assets to the partners in complete liquidation of a partnership.

FOOTNOTES:

(n1)Footnote 1. For a complete discussion of partnership taxation, see W. McKee, W. Nelson & R. Whitmire, *Federal Taxation of Partnerships and Partners* (WGL 3d ed. 1997) ("McKee, Nelson & Whitmire"); A. Willis, J. Pennell & P. Postlewaite, *Partnership Taxation* (WGL 6th ed. 1997) ("Willis, Pennell & Postlewaite"); Rabkin & Johnson, *Federal Tax Guidebook*, Vol. 1, Ch. 16 (Matthew Bender) ("Rabkin & Johnson").

(n2)Footnote 2. See P TX13.02[4][b][ii] *infra* for a discussion of the concept of "economic substance."

(n3)Footnote 3. *Treas. Reg. § 1.701-2*, proposed May 17, 1994, adopted December 29, 1994 by T.D. 8588 (corrected February 21, 1995), and amended April 12, 1995 by T.D. 8592 .

(n4)Footnote 4. *Treas. Reg. § 1.701-2(b)* (emphasis added).

(n5)Footnote 5. *Treas. Reg. § 1.701-2(b)* (emphasis added).

(n6)Footnote 6. *Treas. Reg. § 1.701-2(a)*.

(n7)Footnote 7. *Treas. Reg. § 1.701-2(a)(1)*.

(n8)Footnote 8. *Treas. Reg. § 1.701-2(a)(2)*

(n9)Footnote 9. *Treas. Reg. § 1.701-2(a)(3)*. The regulations recognize exceptions to the "clear reflection of income" requirement to the extent necessary to protect the operation of subchapter K provisions that were adopted to promote administrative convenience or other tax policy objectives and that produce tax results that do not "clearly reflect income." *Treas. Reg. § 1.701-2(a)(3)*.

(n10)Footnote 10. For a discussion of the definition of "property" for purposes of *I.R.C. § 721(a)*, see McKee, Nelson & Whitmire, n.1 *supra* , P 4.02[1]; Rabkin & Johnson, n.1 *supra* , P 16.02[2]. For a discussion of whether a lender who exchanges debt for an equity interest in a partnership has contributed "property" within the meaning of *I.R.C. § 721(a)*, see P TX13.03[3][d][ii] *infra*.

(n11)Footnote 11. *I.R.C. § 721(a)* provides:

No gain or loss shall be recognized to a partnership or to any of its partners in the case of

contribution of property to the partnership in exchange for an interest in the partnership.

(n12)Footnote 12. *Treas. Reg. § 1.721-1(a)*.

(n13)Footnote 13. *I.R.C. § 1245(b)(3)* provides that a transfer of depreciable property to a partnership will result in depreciation recapture if and only to the extent that the contributor must recognize gain notwithstanding *I.R.C. § 721(a)*. *I.R.C. § 1250(d)(3)* contains an identical provision.

Note that a contribution of depreciable tangible personal property to a partnership within five years of the date a taxpayer put such property in service may cause recapture of investment tax credit claimed on that property, depending upon when the contributor placed the property in service. Congress repealed the regular investment tax credit as part of the Tax Reform Act of 1986. Tax Reform Act of 1986, Pub. L. No. 99-514, § 211, 100 Stat. 2085, 2166. In general, the regular investment tax credit formerly allowed by Section 46(a)(1) of the 1954 Code does not apply to property placed in service after December 31, 1985, in taxable years ending after that date. § 211, § 211(e)(1), 100 Stat. 2085, 2169. *See I.R.C. § 47* as in effect prior to the Revenue Reconciliation Act of 1990 and the regulations thereunder for the rules governing such recapture.

(n14)Footnote 14. *See I.R.C. §§ 752(b) and 731(a)(1)*.

(n15)Footnote 15. For a discussion of the distinction between "property" and "services," *see McKee, Nelson & Whitmire, P 4.02[1], n.1 supra* ; *Willis, Pennell & Postlewaite, P 4.02[3], n.1 supra* ; *Rabkin & Johnson P 16.02[1]*.

(n16)Footnote 16. *I.R.C. § 721(b)*.

(n17)Footnote 17. *I.R.C. § 731(a)*.

(n18)Footnote 18. *I.R.C. § 707(a)(2)(B)*.

(n19)Footnote 19. For a discussion of "inside basis" and its relationship to "outside basis," *see McKee, Nelson & Whitmire, n.1 supra PP 4.01[1][b]&[c] and 6.01*; *Rabkin & Johnson, n.1 supra , P 16.02[4]*.

(n20)Footnote 20. *I.R.C. § 704(d)*. Of course, the I.R.C. may impose other limitations on a partner's right to deduct partnership losses. *See, e.g., I.R.C. § 465* (deductions limited to amounts "at-risk") and § 469 (limitation on deduction of "passive activity losses").

(n21)Footnote 21. *I.R.C. § 731*.

(n22)Footnote 22. *See I.R.C. §§ 741 and 1001*.

Although a partner has a unitary outside basis, the partner's holding period in the partnership interest may be in part short-term and in part long-term. Holding period depends on several factors, including whether the partner acquired portions of the partnership interest at different times, whether the partner transferred property with different holding periods to the partnership under section 721, and whether the partner transferred both property described in section 1221 and 1231 and ordinary income property. *See I.R.C. § 1223(1)*. If a partner has a divided holding period in a partnership interest, the Treasury Regulations provide:

The portion of a partnership interest to which a holding period relates shall be determined by reference to a fraction, the numerator of which is the fair market value of the portion of the partnership interest received in the transaction to which the holding period relates, and the denominator of which is the fair market value of the entire partnership interest (determined immediately after the transaction).

Treas. Reg. § 1.1223-3(b)(1). Commentators have argued that *Treasury Regulation Section 1.1223-3* could interfere with real estate workouts that involve additional contributions by partners. See Sheldon I. Banoff & Richard M. Lipton, *Partnership Holding Period Prop. Regs. Will Thwart Real Estate Workouts*, 92 J. TAX'N 253 (2000). The Proposed Regulations to which the title refers became final on September 21, 2000.

(n23)Footnote 23. As discussed in *P TX13.02[3][d] infra*, if a partner's share of partnership liabilities increases, *I.R.C. § 752(a)* treats the amount of such increase as a deemed contribution of money to the partnership, triggering an increase in outside basis under *I.R.C. § 722*.

(n24)Footnote 24. *I.R.C. § 722*.

(n25)Footnote 25. *I.R.C. § 705(a)(1)*. For a discussion of the allocation of a partnership's income and loss to its partners, see *P TX13.02[4] infra*.

(n26)Footnote 26. As discussed in *P TX13.02[3][d] infra*, if a partner's share of partnership liabilities decreases, *I.R.C. § 752(b)* treats the amount of such decrease as a deemed distribution of money from the partnership to the partner, triggering a decrease in outside basis under *I.R.C. § 733*.

(n27)Footnote 27. *I.R.C. § 733*.

(n28)Footnote 28. *I.R.C. § 705(a)(2)*.

(n29)Footnote 29. *I.R.C. § 722* provides:

The basis of an interest in a partnership acquired by a contribution of property, including money, to the partnership shall be the amount of such money and the adjusted basis of such property to the contributing partner at the time of the contribution increased by the amount (if any) of gain recognized under section 721(b) to the contributing partner at such time.

(n30)Footnote 30. *McKee, Nelson & Whitmire*, n.1 *supra*, *P 6.02[2]* at 6-7; *Rabkin & Johnson*, n.1 *supra*, *P 16.02[4]*.

(n31)Footnote 31. *I.R.C. § 702(c)*.

(n32)Footnote 32. *I.R.C. § 705(a)(1)(A)*.

(n33)Footnote 33. *I.R.C. § 705(a)(1)(B)*.

(n34)Footnote 34. *I.R.C. § 705(a)(1)(C)*.

(n35)Footnote 35. *I.R.C. § 705(a)(2)(A)*.

(n36)Footnote 36. *I.R.C. § 705(a)(2)(B)*. Typical examples of nondeductible partnership expenditures not chargeable to capital account include (1) charitable contributions under *I.R.C. § 170*; (2) premiums on life insurance contracts that are not deductible under *I.R.C. § 264(a)*; (3) expenses and interest relating to tax-exempt income that are nondeductible under *I.R.C. § 265*; and (4) losses, expenses and interest disallowed by *I.R.C. § 267*. In certain circumstances, a partner must decrease his or her outside basis (but not below zero) by the amount of the partner's deduction for depletion for any oil and gas property. *I.R.C. § 705(a)(3)*.

(n37)Footnote 37. This discussion assumes a true contribution of property to a partnership, not a disguised sale of the property governed by *I.R.C. § 707(a)*. For a discussion of the disguised sale rules, see *McKee, Nelson & Whitmire*,

n.1 *supra* , P 13.02[3][b]; Willis, Pennell & Postlewaite, n.1 *supra* , P 4.02[7]; Rabkin & Johnson, n.1 *supra* , P 16.02[2][a], [b].

(n38)Footnote 38. This discussion assumes that the partnership has incurred a real debt and not entered into some other relationship with a person purporting to be a lender.

(n39)Footnote 39. *I.R.C. § 752(a)* provides:

Any increase in a partner's share of the liabilities of a partnership, or any increase in a partner's individual liabilities by reason of the assumption by such partner of partnership liabilities, shall be considered as a contribution of money by such partner to the partnership.

(n40)Footnote 40. *I.R.C. § 752(b)* provides:

Any decrease in a partner's share of the liabilities of a partnership, or any decrease in a partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities, shall be considered as a distribution of money to the partner by the partnership.

(n41)Footnote 41. *I.R.C. § 752(c)*. For a discussion of *I.R.C. § 752(c)* and some of the issues relating to its purpose and application, see Stafford, *Section 752(c): The Other Issue in Tufts v. Commissioner*, 42 *Tax Law* 93 (1988).

(n42)Footnote 42. *I.R.C. § 722*.

(n43)Footnote 43. *I.R.C. § 733*, which provides, in pertinent part:

In the case of a distribution by a partnership to a partner other than in liquidation of a partner's interest, the adjusted basis to such partner of his interest in the partnership shall be reduced (but not below zero) by--(1) the amount of any money distributed to such partner

(n44)Footnote 44. *I.R.C. § 731(a)(1)* provides, in pertinent part:

In the case of a distribution by a partnership to a partner--(1) gain shall not be recognized to such partner, except to the extent that any money distributed exceeds the adjusted basis of such partner's interest in the partnership immediately before the distribution Any gain ... recognized under this subsection shall be considered as gain ... from the sale or exchange of the partnership interest of the distributee partner.

(n45)Footnote 45. *I.R.C. §§ 731(a)* (flush language) and 741.

(n46)Footnote 46. *Treas. Reg. § 1.752-1(f)* (netting of increases and decreases in liabilities resulting from the same transaction).

(n47)Footnote 47. *Treas. Reg. § 1.752-1(e)* (1956).

(n48)Footnote 48. *Treas. Reg. §§ 1.752-1 and -2* (1991).

(n49)Footnote 49. For a discussion of the old regulations [*Treas. Reg. S 1.752-1(e)* (1956)], see McKee, Nelson & Whitmire, n.1 *supra* P 8.02; Willis, Pennell & Postlewaite, n.1 *supra* , P 6.01[1]; Rabkin & Johnson, *Federal Income Gift and Estate Taxation*, Volume 3, P 16.08[5].

(n50)Footnote 50. *Treas. Reg. § 1.752-1(a)(3)* provides that the term "related person" means a person having a relationship to a partner described in *Treas. Reg. § 1.752-4(b)*. *Treas. Reg. § 1.752-4(b)* provides that, in general, a person is related to a partner if the person and the partner bear a relationship to each other described in either *I.R.C. § 267(b)* or *I.R.C. § 707(b)(1)*, subject to modifications set forth in *Treas. Reg. § 1.752-4(b)(1)(i)-(iii)*.

(n51)Footnote 51. *Treas. Reg. § 1.752-1(a)(1)*.

(n52)Footnote 52. *Treas. Reg. § 1.752-2(a)*.

(n53)Footnote 53. *Treas. Reg. § 1.752-2(b)-(j)*. For a discussion of these rules, see *McKee, Nelson & Whitmire*, n.1 *supra*, P 8.03; *Willis, Pennell & Postlewaite*, n.1 *supra*, P 6.02[4][a]; *Rabkin & Johnson*, n.1 *supra*, P 16.01[2][c]; P 16.02[4][b].

(n54)Footnote 54. The partner might bear the burden by direct payment to the partnership creditor or by an additional contribution to the capital of the partnership, assuming the partner had no right to reimbursement or contribution from another partner, a person related to another partner or the partnership.

(n55)Footnote 55. *Treas. Reg. § 1.752-2(b)*.

(n56)Footnote 56. *Treas. Reg. § 1.752-2(b)(1)(i)*.

(n57)Footnote 57. *Treas. Reg. § 1.752-2(b)(1)(ii)*.

(n58)Footnote 58. *Treas. Reg. § 1.752-2(b)(1)(iii)*.

(n59)Footnote 59. *Treas. Reg. § 1.752-2(b)(1)(iv)*.

(n60)Footnote 60. *Treas. Reg. § 1.752-2(b)(1)(v)*.

(n61)Footnote 61. *Treas. Reg. § 1.752-2(b)(3)(i)*.

(n62)Footnote 62. *Treas. Reg. § 1.752-2(b)(3)(i)*.

(n63)Footnote 63. *Treas. Reg. § 1.752-2(b)(3)(ii)*.

(n64)Footnote 64. *Treas. Reg. § 1.752-2(b)(3)(ii)*.

(n65)Footnote 65. *Treas. Reg. § 1.752-1(a)(3)* provides that the term "related person" means a person having a relationship to a partner described in *Treas. Reg. § 1.752-4(b)*. *Treas. Reg. § 1.752-4(b)* provides that, in general, a person is related to a partner if the person and the partner bear a relationship to each other described in either *I.R.C. § 267(b)* or *I.R.C. § 707(b)(1)*, subject to modifications set forth in *Treas. Reg. § 1.752-4(b)(1)(i)-(iii)*.

(n66)Footnote 66. *Treas. Reg. § 1.752-1(a)(2)*.

(n67)Footnote 67. *Treas. Reg. § 1.752-3(a)(1)*. This rule ensures that a partner will have sufficient outside basis to cover the partner's allocable share of nonrecourse deductions and any distributions of proceeds from nonrecourse financing. For a discussion of "partnership minimum gain," see P TX13.02[4][b][ii][C] *infra*. In general, a partner's share of partnership minimum gain equals the sum of (1) nonrecourse deductions allocated to that partner and (2) distributions to that partner of the proceeds of nonrecourse liabilities allocable to an increase in partnership minimum gain, reduced by that partner's aggregate share of net decreases in partnership minimum gain. *Treas. Reg. § 1.704-2(g)(1)*.

(n68)Footnote 68. For a discussion of *I.R.C. § 704(c)*, see P TX13.02[4][b][iii] *infra*.

(n69)Footnote 69. *Treas. Reg. § 1.752-3(a)(2)*. This amount essentially reflects the deductions taken or cash received in respect of the nonrecourse liability by the partner prior to contribution of the property to the partnership. Frankel & Coffin, *New Section 752 Regulations Clarify Treatment of Partnership Liabilities*, 6 J. Part. Tax 179, 185-87 (1989).

(n70)Footnote 70. *Treas. Reg. § 1.752-3(a)(3)*. This amount equals the portion of the nonrecourse liability that has not yet produced deductions for or distributions by the partnership.

(n71)Footnote 71. *Treas. Reg. § 1.752-1(a)(2)*.

(n72)Footnote 72. *I.R.C. § 752(a)*.

(n73)Footnote 73. *Treas. Reg. § 1.704-2(d)(1)*.

(n74)Footnote 74. *Treas. Reg. § 1.752-3(a)(1)*.

(n75)Footnote 75. *Treas. Reg. § 1.752-3(c)*, ex.(1).

(n76)Footnote 76. *Treas. Reg. § 1.752-3(c)*, ex.(2).

(n77)Footnote 77. W. McKee, W. Nelson, & R. Whitmire, *Federal Taxation of Partnerships and Partners*, P 6.01 at 6- 3-6-4 (WGL 3d ed. 1997); A. Willis, J. Pennell & P. Postlewaite, *Partnership Taxation*, P 5.04[1] (WGL 6th ed. 1997).

(n78)Footnote 78. W. McKee, W. Nelson, & R. Whitmire, *Federal Taxation of Partnerships and Partners*, P 6.05 (WGL 3d ed. 1997); cf. A. Willis, J. Pennell & P. Postlewaite, *Partnership Taxation*, P 5.02[1] (WGL 6th ed. 1997).

(n79)Footnote 79. "A partnership as such shall not be subject to the income tax imposed by this chapter. Persons carrying on business as partners shall be liable for income tax only in their separate or individual capacities." *I.R.C. § 701*. However, *I.R.C. § 703* requires a partnership to compute its income and deductions separately before allocating those items to its partners and *I.R.C. § 6031(a)* requires a partnership to file annual information returns.

(n80)Footnote 80. *I.R.C. § 704* defines the term "distributive share" for purposes of *I.R.C. § 702(a)*.

(n81)Footnote 81. *I.R.C. § 702(a)*.

(n82)Footnote 82. *I.R.C. § 702(b)*.

(n83)Footnote 83. *I.R.C. § 1221(1)*.

(n84)Footnote 84. *I.R.C. § 706(a)*.

(n85)Footnote 85. In certain instances, a partnership may be required to adopt a calendar year as its taxable year. See *I.R.C. § 706(b)*. See also *I.R.C. §§ 444 & 7519* (election of taxable year other than "required taxable year" specified by *I.R.C. 706(b)*). for a discussion of the rules governing selection of a partnership taxable year, see McKee, Nelson & Whitmire, n.1 *supra* , P 9.04; Willis, Pennell & Postlewaite, n.1 *supra* , P 9.05; Rabkin & Johnson, n.1 *supra* , P 16.01[1][b].

(n86)Footnote 86. *I.R.C. § 704(a)*.

(n87)Footnote 87. *I.R.C. § 761(c)*.

(n88)Footnote 88. *Treas. Reg. § 1.6031-1(e)(2)*.

(n89)Footnote 89. Although *I.R.C. § 704(b)*, discussed in the next section, is the principal limitation on the partners' right to establish an allocation scheme, other *I.R.C.* sections also limit that right. *See, e.g., I.R.C. §§ 704(c)* (allocations related to property contributed to partnership), *704(e)(2)* (allocation of income between donor and donee of partnership interest), and *706(d)* (special rules for allocation to partner who sells or exchanges partnership interest during taxable year or whose partnership interest is liquidated during taxable year or whose partnership interest varies during taxable year).

(n90)Footnote 90. *I.R.C. § 704(b)(1)*.

(n91)Footnote 91. *I.R.C. § 704(b)(2)*.

(n92)Footnote 92. Treasury first published proposed regulations under *I.R.C. Section 704(b)* on March 9, 1983 (*48 Fed. Reg. 9871 (1983)*) and published final regulations relating to recourse debt on December 31, 1985. *50 Fed. Reg. 53,420 (1985)*. On September 9, 1986, Treasury published final regulations dealing with allocations attributable to nonrecourse debt. *51 Fed. Reg. 32,061 (1986)*, corrected in *52 Fed. Reg. 10 (March 31, 1987)*. On December 30, 1988, Treasury published temporary regulations revising the rules dealing with allocations attributable to nonrecourse debt. *53 Fed. Reg. 53,140 (1988)*. Finally, on December 27, 1991, Treasury published final regulations dealing with allocations attributable to nonrecourse debt. *56 Fed. Reg. 66978 (1991)*, corrected in *57 Fed. Reg. 6072 (Feb. 20, 1992)*.

(n93)Footnote 93. *McKee, Nelson & Whitmire*, n.1 *supra*, P 10.02[1].

(n94)Footnote 94. *Treas. Reg. § 1.704-1(b)(2)(iv)*.

(n95)Footnote 95. *Treas. Reg. § 1.704-1(b)(1)(i)*.

(n96)Footnote 96. *Treas. Reg. § 1.704-1(b)(2)(ii)*.

(n97)Footnote 97. *Treas. Reg. § 1.704-1(b)(2)(iii)*.

(n98)Footnote 98. For such a discussion, *see McKee, Nelson & Whitmire*, n.1 *supra*, P 10.02[2]; *Willis, Pennell & Postlewaite*, n.1 *supra*, P 10.04; *Rabkin & Johnson*, n.1 *supra*, P 16.01[2][b]; [c].

(n99)Footnote 99. *Treas. Reg. § 1.704-1(b)(2)(ii)*.

(n100)Footnote 100. *Treas. Reg. § 1.704-1(b)(2)(iii)*.

(n101)Footnote 101. *Treas. Reg. § 1.704-1(b)(2)(ii)(a)-(c)*.

(n102)Footnote 102. *Treas. Reg. § 1.704-1(b)(2)(ii)(d)*.

(n103)Footnote 103. *Treas. Reg. § 1.704-1(b)(2)(ii)(i)*.

(n104)Footnote 104. *Treas. Reg. § 1.704-1(b)(2)(ii)(b)(1)*. The rules for maintaining capital accounts appear in *Treas. Reg. § 1.704-1(b)(2)(iv)*.

(n105)Footnote 105. *Treas. Reg. § 1.704-1(b)(2)(ii)(b)(2)*.

(n106)Footnote 106. *Treas. Reg. § 1.7041(b)(2)(ii)(b)(3)*.

(n107)Footnote 107. *Treas. Reg. § 1.7041(b)(2)(iv)*.

(n108)Footnote 108. *Treas. Reg. § 1.7041(b)(2)(iv)(b)(1)*. "Money contributed" by a partner includes the amount of any partnership liabilities assumed by that partner, but does *not* include a partner's share of partnership liabilities that

generated a deemed cash contribution by the partner to the partnership under *I.R.C. § 752(a)*. *Treas. Reg. § 1.704-1(b)(2)(iv)(c)(1)*.

(n109)Footnote 109. *Treas. Reg. § 1.7041(b)(2)(iv)(b)(2)*.

(n110)Footnote 110. *Treas. Reg. § 1.704-1(b)(2)(iv)(b)(3)*.

(n111)Footnote 111. *Treas. Reg. § 1.704-1(b)(2)(iv)(b)(4)*. "Money distributed" by a partner includes the amount of any of the partner's individual liabilities assumed by the partnership, but does *not* include decreases in a partner's share of partnership liabilities that generated a deemed cash distribution to the partner by the partnership under *I.R.C. § 752(b)*. *Treas. Reg. § 1.704-1(b)(2)(iv)(c)(2)*.

(n112)Footnote 112. *Treas. Reg. § 1.704-1(b)(2)(iv)(b)(5)*.

(n113)Footnote 113. *Treas. Reg. § 1.704-1(b)(2)(iv)(b)(6)*. *I.R.C. § 705(a)(2)(B)* covers "expenditures of the partnership not deductible in computing its taxable income and not properly chargeable to capital account." Examples of such expenditures include losses disallowed under *I.R.C. §§ 267(a)(1)* or *707(b)* and charitable contributions made by the partnership.

(n114)Footnote 114. *Treas. Reg. § 1.704-1(b)(2)(iv)(b)(7)*.

(n115)Footnote 115. *Treas. Reg. § 1.704-1(b)(2)(iv)(f)*.

(n116)Footnote 116. *Treas. Reg. § 1.704-1(b)(2)(iv)(f)*. For a discussion of the effect of *I.R.C. § 704(c)* and the regulations promulgated thereunder on the rules governing maintenance of capital accounts, see *P TX13.02[4][b][iii] infra*.

(n117)Footnote 117. *Treas. Reg. § 1.704-1(b)(2)(ii)(b)*.

(n118)Footnote 118. *Treas. Reg. § 1.704-1(b)(2)(ii)(d)*.

(n119)Footnote 119. *Treas. Reg. § 1.704-1(b)(2)(iii)(a)*.

(n120)Footnote 120. *Treas. Reg. § 1.704-1(b)(3)*.

(n121)Footnote 121. *Treas. Reg. § 1.704-1(b)(3)(ii)*.

(n122)Footnote 122. *Treas. Reg. § 1.704-1(b)(3)(iii)*.

(n123)Footnote 123. *Treas. Reg. § 1.704-1(b)(3)(ii)(a)*.

(n124)Footnote 124. *Treas. Reg. § 1.704-1(b)(3)(ii)(b)*.

(n125)Footnote 125. *Treas. Reg. § 1.704-1(b)(3)(ii)(c)*.

(n126)Footnote 126. *Treas. Reg. § 1.704-1(b)(3)(ii)(d)*.

(n127)Footnote 127. *Treas. Reg. § 1.704-1(b)(5)*, ex.(1).

(n128)Footnote 128. *Treas. Reg. § 1.704-2*.

(n129)Footnote 129. *Treas. Reg. §§ 1.704-2(b)(3)* and *1.752-1(a)(2)*.

(n130)Footnote 130. *Treas. Reg. § 1.704-2(b)(1)*.

(n131)Footnote 131. *Treas. Reg. § 1.704-2(d)(1)*.

(n132)Footnote 132. *Treas. Reg. § 1.704-2(c)*. If a partnership encumbers partnership property with additional nonrecourse debt not used to improve the property, the partnership often will experience an increase in "partnership minimum gain" because the difference between the basis of the property and the total amount of the nonrecourse debt increases. If the partnership distributes the proceeds of a nonrecourse liability, the distributee partner enjoys the economic benefit of immediate use of the proceeds but does not bear the economic risk of loss if the partnership ultimately fails to repay the nonrecourse liability.

(n133)Footnote 133. *Treas. Reg. § 1.704-2(d)(1)*.

(n134)Footnote 134. *Treas. Reg. § 1.704-2(j)(1)(ii)(A)* ("First, depreciation or cost recovery deductions with respect to property that is subject to partnership nonrecourse liabilities ...").

(n135)Footnote 135. *Treas. Reg. § 1.704-2(j)(1)(ii)(B)* ("Then, if necessary, a pro rata portion of the partnership's other deductions, losses, and section 705(a)(2)(B) items.").

(n136)Footnote 136. *Treas. Reg. § 1-704-2(m)*, ex. (1)(i).

(n137)Footnote 137. *Treas. Reg. § 1.704-2(f)*. "For any partnership tax year, the net ... decrease in partnership minimum gain is determined by comparing the partnership minimum gain on the last day of the immediately preceding taxable year with the partnership minimum gain on the last day of the current taxable year." *Treas. Reg. § 1.704-2(d)(1)* (last sentence). A net decrease in "partnership minimum gain" could occur for a number of reasons. For example, a partnership's "partnership minimum gain" will decrease if the partnership reduces the principal amount of the nonrecourse debt. On the last day of Year 1, ABC Partnership held land with an adjusted basis of \$40,000, subject to nonrecourse debt of \$70,000. The "partnership minimum gain" on that date was \$30,000. On the last day of Year 2, the land still has an adjusted basis of \$40,000 but during Year 2, ABC Partnership paid \$10,000 of the \$70,000 nonrecourse debt, leaving a balance of \$60,000. The "partnership minimum gain" on that date was \$20,000. Thus, at the end of Year 2, ABC Partnership had a net decrease of \$10,000 in its "partnership minimum gain."

(n138)Footnote 138. *Treas. Reg. § 1.704-2(j)(2)(i)(A)* ("First, gain from the disposition of property subject to partnership nonrecourse liabilities ...").

(n139)Footnote 139. *Treas. Reg. § 1.704-2(j)(2)(i)(B)* ("Then, if necessary, a pro rata portion of the partnership's other items of income and gain for that year.").

(n140)Footnote 140. *Treas. Reg. § 1.704-2(b)(1)*.

(n141)Footnote 141. *Treas. Reg. § 1.704-2(b)(1)*.

(n142)Footnote 142. *Treas. Reg. § 1.704-2(e)*.

(n143)Footnote 143. *Treas. Reg. § 1.704-2(e)(2)*.

(n144)Footnote 144. *Treas. Reg. § 1.704-2(b)(1)*. *Treas. Reg. § 1.704-1(b)(3)* provides the rules for determining a partner's economic interest in a partnership.

(n145)Footnote 145. *Treas. Reg. § 1.752-4(b)* defines the term "related person."

(n146)Footnote 146. *Treas. Reg. § 1.704-2(b)(4)*.

(n147)Footnote 147. *Treas. Reg. § 1.704-2(i)(2)*.

(n148)Footnote 148. *Treas. Reg. § 1.704-2(i)(1)*.

(n149)Footnote 149. *Treas. Reg. § 1.752-2(d)*.

(n150)Footnote 150. *P TX13.02[4][b][ii][A] supra* .

(n151)Footnote 151. *I.R.C. § 704(c)(1)(A)*.

(n152)Footnote 152. *Treas. Reg. § 1.704-1(b)(2)(iv)(d)*; *Treas. Reg. § 1.704-1(b)(5)*, ex.(13)(i).

(n153)Footnote 153. *Treas. Reg. § 1.704-3(a)(1)*.

(n154)Footnote 154. *Treas. Reg. § 1.704-3(a)(2)*.

(n155)Footnote 155. *Treas. Reg. § 1.704-3(a)(1)*.

(n156)Footnote 156. *Treas. Reg. § 1.704-3(a)(1)*. The three allocation methods are (1) the "traditional method" (*Treas. Reg. § 1.704-3(b)*), (2) the "traditional method with curative allocations" (*Treas. Reg. § 1.704-3(c)*) and (3) the "remedial allocation method" (*Treas. Reg. § 1.704-3(d)*). For a discussion of these three allocation methods, see *McKee, Nelson & Whitmire*, n.1 *supra* , P 10.04[1]-[3]; *Willis, Pennell & Postlewaite*, n.1 *supra* , P 10; *Rabkin & Johnson, Income, Gift and Estate Taxation*, Vol. 3, P 16.07[4].

(n157)Footnote 157. *Treas. Reg. § 1.704-3(b)*.

(n158)Footnote 158. *Treas. Reg. § 1.704-3(b)(1)*.

(n159)Footnote 159. *Treas. Reg. § 1.704-1(b)(2)(iv)(d)(3)*.

(n160)Footnote 160. *Treas. Reg. § 1.704-3(b)(1)* provides: "However, the total income, gain, loss, or deduction allocated to the partners for the taxable year with respect to a property cannot exceed the total partnership income, gain, loss, or deduction with respect to that property for the taxable year (ceiling rule)."

(n161)Footnote 161. *Treas. Reg. § 1.704-3(b)(2)*, ex. (1)(ii).

(n162)Footnote 162. *I.R.C. §§ 731(a)* (flush language) and 741.

(n163)Footnote 163. *Treas. Reg. § 1.704-3(c)(1)*. For a discussion of curative allocations, see *McKee, Nelson & Whitmire*, n.1 *supra* , P 10.04[3][c]; *Willis, Pennell & Postlewaite*, n.1 *supra* , P 10.08[3][b]; *Rabkin & Johnson, Income, Gift and Estate Taxation*, Vol. 3, P 16.07[4].

(n164)Footnote 164. *I.R.C. § 731(b)* provides that, in general, the partnership recognizes neither gain nor loss when it makes a nonliquidating distribution of money or property to a partner.

(n165)Footnote 165. *I.R.C. § 731(a)*.

(n166)Footnote 166. *I.R.C. § 732(a)(1)*. However, see *I.R.C. § 732(a)(2)*, which limits the distributee partner's basis in the distributed property to the partner's predistribution outside basis if the partnership's basis in the property exceeds the partner's predistribution outside basis.

(n167)Footnote 167. *I.R.C. § 733(1)*.

(n168)Footnote 168. *I.R.C. § 733(2)*.

(n169)Footnote 169. *I.R.C. § 1001*.

(n170)Footnote 170. *I.R.C. § 751(a)*.

(n171)Footnote 171. *I.R.C. § 736*.

(n172)Footnote 172. *I.R.C. § 736(a)*.

(n173)Footnote 173. *I.R.C. § 736(b)*.

(n174)Footnote 174. Chapter 1 of Title XIII of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, 416-571 (1993).

(n175)Footnote 175. *I.R.C. § 736(b)(2)*.

(n176)Footnote 176. *I.R.C. § 736(a)(1)*.

(n177)Footnote 177. *I.R.C. § 736(a)(2)*.

(n178)Footnote 178. *I.R.C. § 731*.

(n179)Footnote 179. Pub. L. No. 103-66, § 13262(a), 107 Stat. 541 (1993), adding new *I.R.C. § 736(b)(3)*, effective in general for partners retiring or dying on or after January 5, 1993.

(n180)Footnote 180. *I.R.C. § 736(b)(3)(A)*. The legislative history of *I.R.C. Section 736(b)(3)* explains that:

capital is not a material income-producing factor where substantially all the gross income of the business consists of fees, commissions, or other compensation for personal services performed by an individual. The practice of his or her profession by a doctor, dentist, lawyer, architect, or accountant will not, as such, be treated as a trade or business in which capital is a material income-producing factor even though the practitioner may have a substantial capital investment in professional equipment or in the physical plant constituting the office from which such individuals conducts his or her practice so long as such capital investment is merely incidental to such professional practice.

H.R. Conf. Rep. No. 213, 103d Cong., 1st Sess. 697-698 (1993).

(n181)Footnote 181. *I.R.C. § 736(b)(3)(B)*.

(n182)Footnote 182. *I.R.C. § 736(b)(2)(A)*. The 1993 Act amended *I.R.C. Section 751(c)* to limit the definition of "unrealized receivables" for the purposes of *I.R.C. Section 736(b)* to "rights (contractual or otherwise) to payment for ... goods delivered, or to be delivered, to the extent the proceeds therefrom would be treated as amounts received from the sale or exchange of property other than a capital asset, or ... services rendered or to be rendered."

(n183)Footnote 183. *I.R.C. § 736(b)(2)(B)*.

(n184)Footnote 184. *I.R.C. § 736(a)(1)*.

(n185)Footnote 185. *I.R.C. § 736(a)(2)*.

(n186)Footnote 185a. Generally capital is a "material income-producing factor" if a partnership's business requires "substantial inventories" or "substantial investment in plant, machinery, or other equipment." *Treas. Reg. § 1.704-1(e)(1)(iv)*. The Regulations indicate that capital is not a "material income-producing factor," if partnership income consists principally of "fees, commissions, or other compensation for personal services." *Treas. Reg. § 1.704-1(e)(1)(iv)*. Note, however, that capital may still be a "material income producing factor" in a personal services

partnership, for example, in a medical partnership that owns expensive technical equipment.

(n187)Footnote 186. *I.R.C. § 708(b)(1)(A)*.

(n188)Footnote 187. *I.R.C. § 708(b)(1)(B)*.



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Collier on Bankruptcy Taxation

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CHAPTER TX13 Financially Troubled Partnerships

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P TX13.03 Federal Income Tax Consequences of Discharge of Partnership Debt

When a partnership obtains a discharge n1 of indebtedness, n2 two sets of statutory rules come into play: (1) rules governing the recognition and exclusion of discharge of indebtedness income; n3 and (2) the Subchapter K rules governing the federal income tax treatment of partnerships and partners. n4 A discharge of partnership indebtedness may also involve the original issue discount rules n5 if the discharge is accomplished by the "material" modification of a debt instrument. This section explains how the discharge of indebtedness rules, partnership rules and original issue discount rules apply to the discharge of partnership indebtedness.

[1] Discharge of Indebtedness Income

[a] Realization, Character and Allocation of Discharge of Indebtedness Income

[i] Overview

In general, when a partnership obtains a discharge of its indebtedness, n6 the partnership will realize discharge of indebtedness income n7 unless *I.R.C. section 108* provides the partnership with an exclusion. n8 The exclusions created by *I.R.C. section 108(a)* apply at the partner level rather than at the partnership level. n9 Thus, the fact that the partnership is in a title 11 case or is insolvent when it obtains a discharge of indebtedness will have no effect on the treatment of the discharge of indebtedness income at the partnership level. That income will pass through to each partner as a separately allocated item of income under *I.R.C. section 702(a)(8)*. n10 All partners will recognize their allocable shares n11 of the discharge of indebtedness income as ordinary income n12 unless *I.R.C. section 108(a)* provides the partner with an exception to recognition. If a partner can exclude some or all of the discharge of indebtedness income under *I.R.C. section 108(a)*, the partner, not the partnership, will make the reduction of tax attributes and/or basis reduction required by *I.R.C. section 108(b)*. n13

[ii] Allocation

In general, a partnership must allocate discharge of indebtedness income among its partners under the allocation rules described earlier in this chapter. n14 Those allocation rules focus on the economic substance of the relationship of the partners as reflected in properly maintained capital accounts. Because the *I.R.C. section 108(a)* exclusions apply at the partner level rather than at the partnership level, there may be pressure to allocate partnership discharge of indebtedness income to partners who can exclude some or all of that income under *I.R.C. section 108(a)*, e.g., to partners in title 11

cases or insolvent partners. Ordinarily, the IRS will respect a special allocation of discharge of indebtedness income only if (1) the allocation has "substantial economic effect" or (2) the allocation is in accordance with the partner's economic interest in the partnership, taking into account all the facts and circumstances. n15 Thus, it is unlikely that the IRS would permit a partnership with both discharge of indebtedness income and other income to allocate discharge of indebtedness income solely to an insolvent partner and the other income to solvent partners. n16

In *Revenue Ruling 92-97* n17 the IRS has provided some guidance on the allocation of partnership discharge of indebtedness income. Specifically, the Revenue Ruling provides guidance on the question of when an allocation to a partner of a share of a partnership's discharge of indebtedness income has "substantial economic effect" if that allocation differs from the partner's share of the canceled debt under *I.R.C. section 752(b)*. According to the Revenue Ruling, an allocation to a partner of a share of the partnership's cancellation of indebtedness income that differs from the partner's share of the canceled debt under *I.R.C. section 752(b)* has "substantial economic effect" under *I.R.C. section 704(b)* if:

1. the deficit restoration obligations covering any negative capital account balances resulting from the allocation of discharge of indebtedness income can be invoked to satisfy other partners' positive capital account balances;
2. the partnership otherwise satisfies the requirements of the "economic effect" test; and
3. the partnership independently establishes that the "economic effect" of the allocation is "substantial."

The Revenue Ruling examines two fact patterns:

Fact Pattern 1

In year 1, A contributes \$10x and B contributes \$90x to form AB, a general partnership. A and B share the partnership's losses 10% and 90%, respectively, and share the partnership's income 50% each (*i.e.*, income allocations do not first restore previous losses). The partnership maintains capital accounts under the rules of *Section 1.704-1(b)(2)(iv) of the Treasury Regulations*, and the partners agree to liquidate according to positive capital account balances under the rules of *Section 1.704-1(b)(2)(ii)(b)(2) of the Treasury Regulations*.

Under applicable state law, A and B are jointly and severally liable to creditors for all partnership recourse liabilities. However, A and B do not agree to unconditional deficit restoration obligations as described in *Section 1.704-1(b)(2)(ii)(b)(3) of the Treasury Regulations*. Rather, the partnership agreement obligates A and B to restore deficit capital accounts only to the extent necessary to pay creditors. Thus, if the partnership were to liquidate after paying all creditors, and one partner had a positive capital account balance, the other partner would not be required to restore a deficit capital account to permit a liquidating distribution to the partner with a positive capital account balance.

Because the partners do not have unconditional deficit restoration obligations, the partners do not satisfy the economic effect test of *Section 1.704-1(b)(2)(ii)(b) of the Treasury Regulations*. However, because A and B agree to a qualified income offset, *Section 1.704-1(b)(2)(ii)(c) of the Treasury Regulations* treats A and B as having a limited obligation to restore deficit capital accounts by reason of their liability to the partnership's creditors. Therefore, A and B satisfy the requirements of the alternate test for economic effect set forth in *Section 1.704-1(b)(2)(ii)(d) of the Treasury Regulations*.

The partnership purchases property for \$1000x from an unrelated seller, paying \$100x in cash and borrowing the \$900x balance from an unrelated bank that is not the seller of the property. The note is a general obligation of the partnership, and no partner has been relieved from personal liability. The principal of the loan is due in 6 years; interest is payable semiannually at the applicable federal rate.

A and B bear an economic risk of loss equal to \$90x and \$810x, respectively, for the partnership's \$900x recourse liability. Thus, pursuant to *I.R.C. section 752(a)* and *I.R.C. section 722*, A's basis in his partnership interest increases by \$90x to \$100x (\$10x cash + \$90x deemed cash contribution) and B's interest in her partnership interest increases by \$810x to \$900x (\$90x cash + \$810x deemed cash contribution).

The property generates \$200x of depreciation each year for 5 years. All other partnership deductions and losses exactly equal the partnership's income, so that in each of its first 5 taxable years the partnership has a net loss of \$200x. Under the partnership agreement, the partnership allocates these losses 10% to A and 90% to B. The losses reduce A's capital account from \$10x to negative \$90x (\$10x opening capital account - \$100x aggregate net loss allocated to A) and B's capital account from \$90x to negative \$810x (\$90x opening capital account - \$900x aggregate net loss allocated to B). At the beginning of year 6, after the fair market value of the partnership's property has substantially declined, the creditor cancels the debt as part of a workout arrangement. Because of the cancellation of the debt, A and B are no longer treated as obligated to restore their deficit capital accounts.

Fact Pattern 2

Same as Fact Pattern 1, except that A and B agree to unconditional deficit restoration obligations as described in *Section 1.704-1(b)(2)(ii)(b)(3) of the Treasury Regulations*. A and B thus each have an obligation to restore deficits in their respective capital accounts not only to pay creditors, but also to satisfy the other partner's positive capital account balance on liquidation.

The allocations of losses to A and B in years 1 through 5 in both fact patterns satisfy the economic effect requirements set forth in *Sections 1.704-1(b)(2)(ii)(d)* and *1.704-1(b)(2)(ii)(b) of the Treasury Regulations*. In year 6, when the lender cancels the \$900x recourse liability, the partnership recognizes \$900x of discharge of indebtedness income that it must allocate to A and B as a separately stated item under *I.R.C. section 702(a)*. The AB partnership agreement provides for equal allocation of income between A and B. The Revenue Ruling addresses the question of whether an equal allocation of the discharge of indebtedness income would have "substantial economic effect" n18 in either of the two fact patterns.

In Fact Pattern 1, the equal allocation of the partnership's discharge of indebtedness income (\$450x to A and \$450x to B) would cause A's capital account to equal \$360x (negative \$90x + \$450x) and B's capital account to equal negative \$360x (negative \$810x + \$450x):

A		B	
Basis	Capital	Basis	Capital
\$ 10x Cash	\$ 10x	\$ 90x Cash	\$ 90x
\$ 90x Debt	--	\$ 810x Debt	--
\$ 100x	\$ 10x	\$ 900x	\$ 90x
-100x Yrs 1-5	-100x	-900x Yrs 1-5	-900x
\$ 0x	(90x)	\$ 0x	(810x)
+450x Disch.	+450x	+450x Disch.	+450x
\$450x	\$ 360x	\$ 450x	(360x)

The Revenue Ruling concludes that such an allocation would not have "economic effect" even though the partners maintain capital accounts and liquidate according to positive capital accounts. The cancellation of the debt eliminates both partners' obligations to restore a deficit capital account, and neither partner has an independent deficit restoration obligation that could be invoked to satisfy the other partner's positive capital account. Because the partners' deficit restoration obligations depended on the canceled debt, A can neither enjoy the economic benefit of an allocation of

discharge of indebtedness income exceeding \$90x nor bear the economic burden of an allocation of discharge of indebtedness income of less than \$90x. Similarly, B can neither enjoy the economic benefit of an allocation of discharge of indebtedness income exceeding \$810x nor bear the economic burden of an allocation of discharge of indebtedness income of less than \$810x. Thus, the Revenue Ruling asserts, for the partnership's allocations of the discharge of indebtedness income to have "economic effect," the partnership must allocate that income \$90x to A and \$810x to B, which is the same ratio as the decrease in A's and B's shares of partnership liability.

When the partnership allocates the discharge of indebtedness income \$90x to A and \$810x to B, A and B would increase their respective outside bases by \$90x and \$810x, respectively, to reflect their distributive shares of such income. n19 A and B would then individually determine if they could exclude any portion of their distributive shares from gross income under *I.R.C. section 108(a)*. n20 Finally, A and B would decrease their respective outside bases by \$90x and \$810x, respectively, to reflect their deemed distributions of money under *I.R.C. section 752(b)* resulting from the cancellation of the debt. n21 The Revenue Ruling concludes that A and B would recognize no gain under *I.R.C. section 731* in year 6 because the distributive shares of discharge of indebtedness income provide an outside basis increase for each partner sufficient to cover the distribution of money to that partner. n22

In contrast, the Revenue Ruling concludes that, in Fact Pattern 2, the equal allocation of the partnership's discharge of indebtedness income (\$450x to A and \$450x to B), would have "substantial economic effect" (assuming the partnership can independently establish "substantiality"). Because B's deficit restoration obligation does not depend on the canceled debt and can be invoked to satisfy A's positive capital account, the allocation of discharge of indebtedness income results in B incurring an obligation to contribute \$360x to satisfy A's \$360x positive capital account. Similarly, if the partnership allocated the discharge of indebtedness income so that A had a deficit capital account balance, A would incur an obligation to contribute the amount of the deficit to satisfy B's positive capital account. A and B would increase their respective outside bases by \$450x each to reflect their distributive shares of the partnership's discharge of indebtedness income. n23 Next, A and B would individually determine if they could exclude any portion of their distributive shares from gross income. n24 This allocation, which is not in proportion to the partners' shares of the canceled debt under *I.R.C. section 752(b)*, would cause B to recognize a \$360x capital gain. n25 Although B would increase her outside basis to reflect her \$450x distributive share of discharge of indebtedness income, the \$810x distribution of money resulting from the decrease in B's share of the partnership liability exceeds B's outside basis by \$360x:

A		B	
Basis	Capital	Basis	Capital
\$ 10x Cash	\$ 10x	\$ 90x Cash	\$ 90x
\$ 90x Debt	--	\$ 810x Debt	--
\$ 100x	\$ 10x	\$ 900x	\$ 90x
-100x Yrs 1-5	-100x	-900x Yrs 1-5	-900x
\$ 0x	(90x)	\$ 0x	(810x)
+450x Disch.	+450x	+450x Disch.	+450x
\$450x	\$ 360x	\$ 450x	(360x)
- 90x 752(b)		-810x 752(b)	
\$ 360x	\$ 360x	\$	(360x)
		\$ 360x GAIN	

The following material explores some of the allocation questions that arise when a partnership recognizes discharge of indebtedness income.

Ordinarily, when a partnership obtains a discharge of partnership nonrecourse debt, n26 the discharge will result in a net decrease in "partnership minimum gain." n27 For example, suppose a partnership has property with an adjusted basis to the partnership of \$40,000, encumbered by nonrecourse debt of \$60,000. The partnership would have partnership minimum gain of \$20,000 (the amount of gain the partnership would realize if it disposed of the property for no consideration other than full satisfaction of the nonrecourse debt). If the partnership obtains a discharge of \$5,000 of the \$60,000 nonrecourse debt, the partnership has a net decrease in partnership minimum gain of \$5,000 [\$20,000 "partnership minimum gain" before the discharge; \$15,000 "partnership minimum gain" after the discharge]. The net decrease in partnership minimum gain triggers a \$5,000 minimum gain chargeback, n28 which means that the partnership must allocate \$5,000 of items of partnership income and gain among the partners who had received allocations of the \$20,000 partnership minimum gain. The partnership must first allocate any recognized gain from disposition of partnership property subject to nonrecourse liability, then, if necessary, a *pro rata* portion of the partnership's other items of income and gain for the taxable year. n29 If the partnership's only income or gain for the taxable year is the \$5,000 of discharge of indebtedness income, the partnership must allocate that \$5,000 under the minimum gain chargeback rules.

The allocation becomes more complicated if the partnership's discharge of indebtedness income is greater than the net decrease in the partnership's minimum gain. For example, suppose a partnership has property with an adjusted basis to the partnership of \$40,000, encumbered by nonrecourse debt of \$60,000. The partnership would have partnership minimum gain of \$20,000. If the partnership obtains a discharge of \$25,000 of the \$60,000 nonrecourse debt, the partnership has a net decrease in partnership minimum gain of \$20,000 (\$20,000 partnership minimum gain before the discharge; \$0 partnership minimum gain after the discharge). The net decrease in partnership minimum gain triggers a \$20,000 minimum gain chargeback, which the partnership would allocate as described in the preceding paragraph. If the partnership allocates \$20,000 of the discharge of indebtedness income under the minimum gain chargeback rules, the allocation rules established by the *I.R.C. section 704* regulations would govern the allocation of the remaining \$5,000 of discharge of indebtedness income. n30

How does a partnership allocate discharge of indebtedness income generated by a discharge of a portion of a "partner nonrecourse debt?" n31 As in the case of a discharge of partnership nonrecourse debt, a discharge of partner nonrecourse debt that produces a minimum gain chargeback requires allocation of discharge of indebtedness income to the partner whose share of the nonrecourse debt was reduced. n32 For example, suppose a partnership has property with an adjusted basis to the partnership of \$40,000, encumbered by nonrecourse debt of \$60,000. The nonrecourse lender is A, a partner in the partnership. The partnership would have partnership minimum gain of \$20,000, all of which would be allocated to A. n33 If the partnership obtains a discharge of \$25,000 of the \$60,000 nonrecourse debt, the partnership has a net decrease in partnership minimum gain of \$20,000. The net decrease in partnership minimum gain triggers a \$20,000 minimum gain chargeback, all of which the partnership would allocate to A. If the partnership allocates \$20,000 of the discharge of indebtedness income to A under the minimum gain chargeback rules, the allocation rules established by the *I.R.C. section 704* regulations would govern the allocation of the remaining \$5,000 of discharge of indebtedness income.

Another allocation issue arises when a limited partnership realizes discharge of indebtedness income attributable to reduction of a recourse debt guaranteed by the general partner. Will the limited partners (who have no liability and have not included any part of the debt in their basis) receive a distributive share of the limited partnership's discharge of indebtedness income? The discharge of indebtedness income should be allocated to the general partner, who had the liability for repaying the debt and who benefited from the discharge of the debt.

Revenue Ruling 99-43 n33a addresses the question of the effectiveness of a retroactive amendment to a partnership agreement providing for special allocations of discharge of indebtedness income and offsetting amounts of loss. The Revenue Ruling posits the following facts:

A and B, both individuals, formed a general partnership, PRS. A and B each contributed \$1,000 and also agreed that each would be allocated a 50-percent share of all partnership items. The partnership agreement provides that, upon the contribution of additional capital by either partner, PRS must revalue the partnership's property and adjust the partners' capital accounts under [Treasury Regulation] section 1.704-1(b)(2)(iv)(f).

PRS borrowed \$8,000 from a bank and used the borrowed and contributed funds to purchase nondepreciable property for \$10,000. The loan was nonrecourse to A and B and was secured only by the property. No principal payments were due for 6 years, and interest was payable semi-annually at a market rate.

After one year, the fair market value of the property fell from \$10,000 to \$6,000, but the principal amount of the loan remained \$8,000. As part of a workout arrangement among the bank, PRS, A, and B, the bank reduced the principal amount of the loan by \$2,000, and A contributed an additional \$500 to PRS. A's capital account was credited with the \$500, which PRS used to pay currently deductible expenses incurred in connection with the workout. All \$500 of the currently deductible workout expenses were allocated to A. B made no additional contribution of capital. At the time of the workout, B was insolvent within the meaning of *section 108(a) of the Internal Revenue Code*. A and B agreed that, after the workout, A would have a 60-percent interest and B would have a 40-percent interest in the profits and losses of PRS.

As a result of the property's decline in value and the workout, PRS had two items to allocate between A and B. First, the agreement to cancel \$2,000 of the loan resulted in \$2,000 of cancellation of indebtedness income (COD income). Second, A's contribution of \$500 to PRS was an event that required PRS, under the partnership agreement, to revalue partnership property and adjust A's and B's capital accounts. Because of the decline in value of the property, the revaluation resulted in a \$4,000 economic loss that must be allocated between A's and B's capital accounts.

Under the terms of the original partnership agreement, PRS would have allocated these items equally between A and B. A and B, however, amend the partnership agreement (in a timely manner) to make two special allocations. First, PRS specially allocates the entire \$2,000 of COD income to B, an insolvent partner. Second, PRS specially allocates the book loss from the revaluation \$1,000 to A and \$3,000 to B.

While A receives a \$1,000 allocation of book loss and B receives a \$3,000 allocation of book loss, neither of these allocations results in a tax loss to either partner. Rather, the allocations result only in adjustments to A's and B's capital accounts. Thus, the cumulative effect of the special allocations is to reduce each partner's capital account to zero immediately following the allocations despite the fact that B is allocated \$2,000 of income for tax purposes. n33b

The IRS concluded that the special allocations of the \$2,000 of discharge of indebtedness income and \$4,000 of book loss would not be respected and, instead, must be allocated in accordance with the A's and B's interests in the partnership under Treasury Regulation section 1.704-1(b)(3). The IRS warned that

[c]lose scrutiny also would be required if the changes were made at a time when the events giving rise to the allocations had not yet occurred but were likely to occur or if, under the original allocation provisions of a partnership agreement, there was a strong likelihood that a disproportionate amount of COD income earned in the future would be allocated to any partner who is insolvent at the time of the allocation and would be offset by an increased allocation of loss or a reduced allocation of income to such partner or partners.

Partnership special allocations lack substantiality when the partners amend the partnership agreement to specially allocate COD income and book items from a related revaluation after the events creating such items have occurred if the overall economic effect of the special allocations on the partners' capital accounts does not differ substantially from the economic effect of the original allocations in the partnership agreement. n33c

[iii] Timing

Does a partner recognize the allocable share of discharge of indebtedness income from the partnership on the date the partnership obtains the discharge or on the last day of the partnership's taxable year? Because the insolvency exception applies at the partner level, n34 one might conclude that Congress intended to have *I.R.C. section 108* apply independently of the timing rules in subchapter K. However, the legislative history of the Bankruptcy Tax Act of 1980 n35 does not support such a conclusion. The Senate Finance Committee Report provides that when a partnership has discharge of indebtedness income, "such income is treated as an item of income which is allocated separately to each partner pursuant to *I.R.C. section 702(a) of the Code*." n36 Because *I.R.C. section 702(a)* governs the partner's allocable share of the discharge of indebtedness income, *I.R.C. section 706(a)* governs the timing of the partner's inclusion of that income. *I.R.C. section 706(a)* provides that the partner must include distributive share amounts under *I.R.C. section 702(a)* in the partner's taxable year with which or within which the partnership's taxable year ends. n37 Thus, if a partnership with a fiscal year ending on January 31 obtains a discharge of indebtedness on June 1, 1991, a calendar year partner would report the distributive share of discharge of indebtedness income in 1992, the year in which the partnership's taxable year ends.

The interaction between the rules governing timing of a partner's reporting of a distributive share of partnership discharge of indebtedness income and the rules governing adjustments to a partner's outside basis could result in double taxation. As explained in the preceding paragraph, a partner's distributive share of partnership discharge of indebtedness income passes through to the partner on the last day of the partnership's taxable year. *I.R.C. section 705(a)(1)(A)* provides for an increase in the partner's outside basis to reflect the distributive share of discharge of indebtedness income. *I.R.C. section 752(b)* provides that the reduction in partnership debt will cause a deemed cash distribution to the partners, which in turn reduces outside basis (but not below zero) under *I.R.C. section 733*. To the extent the deemed cash distribution exceeds a partner's outside basis, the partner must recognize gain under *I.R.C. section 731(a)(1)*. Thus, the question is whether the *I.R.C. section 705(a)(1)(A)* basis increase generated by the distributive share of discharge of indebtedness income occurs before or after the *I.R.C. section 733* basis decrease reflecting the decrease in the partner's share of partnership debt.

Fortunately, *Revenue Ruling 92-97* n38 eliminates this potential problem by treating the deemed *I.R.C. section 752(b)* distribution as occurring at the end of the partnership's taxable year, after the allocation of discharge of indebtedness income has increased the partners' basis. In that Revenue Ruling, a lender canceled a partnership's recourse debt. The Revenue Ruling concludes that the partners first increase their outside bases by the amounts of discharge of indebtedness income allocated to them by the partnership. Then the partners reduce their outside bases (but not below zero) by their deemed cash distribution under *I.R.C. section 752(b)*. The Revenue Ruling explains that

[b]ecause of the integral relationship between the COD income and the section 752(b) distribution of money from the canceled debt, section 1.731-1(a)(1)(ii) of the regulations treats the distribution of money to each partner from the cancellation of the debt as occurring at the end of AB's taxable year as an advance or drawing against that partner's distributive share of COD income. n39

Another issue involving both timing and the question of who is the proper taxpayer arises when an individual who is a partner files a title 11 petition. For example, Adam Anderson, a calendar year taxpayer and a partner in a calendar year partnership, files a title 11 petition on April 1, 1992. Commencement of the title 11 case creates a new taxpayer--the bankruptcy estate of Adam Anderson--which succeeds to his partnership interest. n40 If the partnership obtains a

discharge of indebtedness which produces discharge of indebtedness income in 1992, does the partnership send the Schedule K-1 n41 showing the distributive share of discharge of indebtedness income to Anderson or the bankruptcy estate?

The answer is not clear. Although there is presently no judicial decision or other authority taking this position, arguably *I.R.C. section 1398(f)(1)* overrides *I.R.C. section 706(c)(2)(A)*, preventing the partnership's taxable year from closing with respect to a partner whose partnership interest is transferred (other than by sale or exchange) to that partner's bankruptcy estate. n42 Allocations of partnership income and loss occur on the last day of the partnership's taxable year--December 31 for a calendar year partnership. However, *I.R.C. section 706(d)(1)* provides special rules for determining a partner's distributive share when the partner's interest in the partnership "changes" during the partnership's taxable year. while there are no reported judicial decisions or other precedential authorities directly on point, n43 *I.R.C. section 1398(f)(1)* presumably overrides the "varying interests" rule embodied in *I.R.C. section 706(d)*. n44 Thus, in the example, the partnership would allocate the entire year's income or loss to the bankruptcy estate of Adam Anderson, provided the estate still exists when the partnership's taxable year ends on December 31, 1992. n45

[b] Exclusion of Discharge of Indebtedness Income by Partners; I.R.C. section 108(a)

The tax treatment of a partner's allocable share of the partnership's discharge of indebtedness income will depend upon whether the partner is in a title 11 case or, if not, whether the partner is insolvent or solvent. n46 The tax treatment will also depend on whether the partnership indebtedness was "qualified real property business indebtedness" n46a or "qualified farm indebtedness." n46b The following fact pattern will help explain the exclusions that may be available to a partner who receives a distributive share of partnership discharge of indebtedness income:

ABC Associates, a general partnership, files a title 11 petition and, pursuant thereto, obtains a discharge of a partnership liability of \$60,000 in 1992. The liability was not "qualified farm indebtedness" as defined in *I.R.C. section 108(g)* and neither the partnership nor the partners have engaged in the trade or business of farming. The partnership has three partners, A, B and C, each with an equal 1/3 share of the partnership's income and losses. A has filed his own title 11 petition, B has not filed her own title 11 petition but has liabilities in excess of the fair market value of her assets of \$15,000, and C is solvent. As a result of the discharge of the partnership liability, ABC Associates will realize \$60,000 of discharge of indebtedness income. A, B and C will each have a distributive share of \$20,000 of the \$60,000 discharge of indebtedness income. n47

[i] Partners in Title 11 Cases; I.R.C. section 108(a)(1)(A)

Because A is subject to the jurisdiction of the bankruptcy court, he can exclude the entire \$20,000 of discharge of indebtedness income under *I.R.C. section 108(a)(1)(A)* n48 but must reduce his net operating losses and other tax attributes by the \$20,000 he excludes. n49 The statute prescribes the order in which he must reduce his tax attributes n50 unless he elects to reduce his basis in his depreciable property first. n51

[ii] Insolvent Partners; I.R.C. section 108(a)(1)(B)

In contrast, B, the insolvent partner who has not filed her own title 11 petition, can exclude the discharge of indebtedness income only to the extent she is insolvent immediately before the discharge. n52 B is insolvent only to the extent of \$15,000 (her liabilities exceed the fair market value of her assets by \$15,000). Thus, of the \$20,000 of discharge of indebtedness income allocated to her, B can exclude \$15,000 under *I.R.C. section 108(a)(1)(B)* but must include \$5,000 in income under *I.R.C. section 61(a)(12)*. B must reduce her net operating losses and other tax attributes by the \$15,000 she excludes unless she elects to reduce her basis in her depreciable property first.

The preceding discussion assumed that partner B was insolvent to the extent of \$15,000. Although an extended discussion of the definition of insolvency for purposes of *I.R.C. section 108(a)(1)(B)* is beyond the scope of this chapter,

n53 the extent to which a partner should take into account that partner's share of partnership assets and liabilities in determining whether and to what extent he or she is insolvent deserves discussion. The question of whether a partner is insolvent within the meaning of *I.R.C. section 108(a)(1)(B)* turns on whether the partner's liabilities exceed the fair market value of the partner's assets immediately before the discharge. n54 *I.R.C. section 108(d)(3)* defines the term "insolvent" as "the excess of liabilities over the fair market value of assets." However, *I.R.C. section 108(d)(3)* does not explain whether a partner's assets include only the partner's partnership interest or the partner's *pro rata* share of the assets and liabilities of the partnership.

The answer to this question depends, in large part, on whether one views a partnership as a separate entity or as an aggregate of its partners. The aggregate view would support allocating each partner a *pro rata* share of partnership assets and liabilities. However, for most purposes, subchapter K adopts an entity view, treating a partner as owning a partnership interest, not an undivided interest in the partnership assets. Under the entity view, the proper result would be to count only the partner's partnership interest for purposes of determining the partner's solvency. n55 Thus, a limited partner who has no personal liability for the debts of the limited partnership would count only the fair market value of the limited partnership interest in determining the limited partner's solvency. Presumably, this result would obtain even if the partnership is insolvent and the partnership interest has no value. n56

However, suppose GP, the sole general partner in a limited partnership, is personally liable for the recourse partnership debt. Suppose further that the recourse debt exceeds the fair market value of the partnership assets by \$500. Arguably, GP should be able to count the \$500 excess as a personal liability for purposes of *I.R.C. section 108(d)(3)*. n57 Similarly, if a partner is secondarily liable on partnership indebtedness and the partnership is insolvent, arguably the partner should be entitled to count the liability for purposes of *I.R.C. section 108(d)(3)* to the extent that the assets of the partnership will not cover such indebtedness and the partner would be called upon to satisfy the liability. n58

One commentator offers a somewhat different approach to this problem. n58a First, he argues that "[i]f a partnership is solvent and has a net positive value, the taxpayer's partnership interest should be included as an asset at its market value, less costs of disposal." n58b He also asserts that a minority partner should be able to claim a discount for lack of control and lack of liquidity. n58c Second, he argues that "[t]he value of a taxpayer's general partnership interest must take into account both the partner's liability to partnership creditors, and any deficit capital account restoration obligation (DRO) of the partner required by the partnership agreement or by law." To determine such liabilities and obligations, he proposes a hypothetical sale of all partnership assets followed by adjustment of all capital accounts based on the hypothetical sale.

If the partners all have positive capital accounts after the hypothetical allocation, each partner's positive capital account should represent the value of the partnership interest (less disposal costs and less any minority discount). If the taxpayer has a negative capital account balance after the allocation, however, the negative balance represents the taxpayer's liability to the partnership creditors and to those partners with positive capital accounts. If the capital account balance is negative, the taxpayer's partnership interest should be included as a liability rather than as an asset. If several partners have negative capital accounts and it is unlikely that all of the other partners will be able to satisfy their DROs, the taxpayer's liability should be increased to the extent that the taxpayer will have to pay more than the deficit capital account balance. n58d

The question of the application of the *I.R.C. section 108(a)(1)(B)* insolvency exception in the context of a tiered partnership adds a bit of complexity to the foregoing analysis. Consider the following example:

Hyde Parke Associates, a general partnership, has three partners: (1) BBC Enterprises (a general partnership); (2) Sellers Corporation (an S corporation); and (3) S. Milligan, Inc. (a C corporation). Michael Bentine and Harry Secombe are the two partners of BBC Enterprises. If Hyde Park Associates recognizes discharge of income, for purposes of determining whether and to what extent *I.R.C. section*

108(a)(1)(B) applies, at what level is insolvency tested?

As previously explained, it is irrelevant whether Hyde Parke Associates is solvent or insolvent because *I.R.C. section 108(d)(6)* provides for insolvency testing at the partner level. Hyde Park Associates would allocate the discharge of indebtedness income to each of its three partners. Thus, S. Milligan, Inc. (the C corporation) could benefit from *I.R.C. section 108(a)(1)(B)* only if and to the extent it is insolvent. The same analysis applies to Sellers Corporation (the S corporation), because *I.R.C. section 108(d)(7)(A)* provides for determination of the insolvency of an S corporation at the corporate level. However, BBC Enterprises (the general partnership) poses a problem. Should the insolvency determination be made as to BBC Enterprises or as to its two partners, Bentine and Secombe? In Field Service Advice issued in 1999, the IRS concluded that the insolvency determination should be made as to Bentine and Secombe. The discharge of indebtedness income allocated by Hyde Parke Associates to BBC Enterprises would retain its character as discharge of indebtedness income, the solvency of BBC Enterprises would be irrelevant, and Bentine and Secombe could benefit from *I.R.C. section 108(a)(1)(B)* only if and to the extent each was insolvent. n59

[iii] Solvent Partners

In the ABC Associates fact pattern above, because partner C is solvent, he will recognize \$20,000 of discharge of indebtedness income under *I.R.C. section 61(a)(12)*. Since the Tax Reform Act of 1986 repealed the "qualified business indebtedness" exception for discharges occurring after 1986 n60 a solvent partner who is not a debtor in a title 11 case n61 and who is not covered by either the exception for discharge of "qualified real property business indebtedness" n62 or the exception for discharge of "qualified farm indebtedness" n63 cannot avoid recognition of discharge of indebtedness income passed through from the partnership. We will assume that partner C is not a debtor in a title 11 case and that the partnership debt is neither "qualified real property business indebtedness" nor "qualified farm indebtedness."

Suppose that ABC Associates had filed a voluntary chapter 11 petition. Suppose further that the trustee in bankruptcy for ABC Associates filed a plan of reorganization, providing in pertinent part, that in exchange for contributions from partners B and C to the partnership's bankruptcy estate, these two partners, who had not commenced title 11 cases, would receive a discharge of all their liabilities as partners of ABC Associates. Finally, suppose that the bankruptcy court handling the ABC Associates title 11 case issued an order approving the plan, specifically discharging partners B and C from their liabilities as partners of ABC Associates, and asserting that partners B and C were "subject to the jurisdiction of the bankruptcy court." Should the tax consequences to partners B and C in this altered fact pattern differ from those under the original fact pattern?

Although, for the reasons explained below, partners B and C should have the same tax consequences under either the original or the altered fact pattern, the Tax Court, in four Memorandum Opinions, n64 reached the opposite conclusion. These four opinions, all arising from the chapter 11 case of the same partnership, reflect a misreading of the applicable statutory provisions and reach a conclusion at odds with sound bankruptcy tax policy.

The taxpayers in each of the four opinions had been partners in Notchcliff Associates, a Maryland general partnership. Notchcliff borrowed a total of almost \$21 million from The Commercial Bank and the general partners personally guaranteed the debt. On June 30, 1988, Notchcliff filed a voluntary chapter 11 petition and, in due course, the bankruptcy court appointed a chapter 11 trustee for Notchcliff. The trustee negotiated with the general partners of Notchcliff to obtain some contribution from them to pay Notchcliff's debts. The trustee filed a reorganization plan that, among other things, proposed that the general partners of Notchcliff would contribute to a partnership release fund to be used to resolve claims by Notchcliff and Notchcliff's creditors as against Notchcliff's general partners. On November 27, 1990, the bankruptcy court confirmed the plan. Subsequently, the Notchcliff general partners who decided to participate in funding the release fund executed a formal contribution agreement and made their contributions to

Notchcliff's bankruptcy estate in exchange for release of "all claims or potential claims of creditors against * * * [the partners] arising out of or related to the partnership." On December 19, 1995, the bankruptcy court entered an order approving the contribution agreement. In its order, the bankruptcy court specifically discharged and released the contributing partners from any and all liability to the trustee and the bank. In addition, the bankruptcy court's order released the contributing partners from "the claims or potential claims of all creditors" of Notchcliff. The bankruptcy court's order recited that the contributing partners were all "subject to the jurisdiction of the Bankruptcy Court."

Notchcliff issued each of its partners a Schedule K-1, allocating to each partner that partner's share of Notchcliff's discharge of indebtedness income. Three of the contributing partners did not report any of their allocable shares of the discharge of indebtedness income on their personal income tax returns, apparently relying on the exclusion in *I.R.C. section 108(a)(1)(A)*. Two of the four contributing partners were solvent immediately before the Notchcliff debt was discharged n65 and a third was insolvent immediately before the discharge. n66 The fourth contributing partner was insolvent immediately before the discharge and relied on the insolvency exclusion in *I.R.C. section 108(a)(1)(B)*. n67 The Internal Revenue Service assessed deficiencies against each of the four contributing partners. n68

The Tax Court concluded that all four contributing partners were entitled to exclude their entire allocations of discharge of indebtedness income under *I.R.C. section 108(a)(1)(A)*. The court properly recognized that, under *I.R.C. section 108(d)(6)*, the determination of whether the *I.R.C. section 108(a)(1)(A)* exclusion applied had to be made at the partner level. In light of *I.R.C. section 108(d)(6)*, the court properly framed the question: "whether [each partner's] debt (as opposed to the partnership's debt) was discharged 'in a title 11 case'." However, despite having correctly framed the question, the court reached an incorrect answer. First, the court cited *I.R.C. section 108(d)(2)*, which defines the term "title 11 case" as "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." Second, the court noted that the bankruptcy court order specifically discharged the four contributing partners and "explicitly asserted its jurisdiction over [the four contributing partners] for this purpose." Third, the court stated that "[g]iving due regard to the principles of judicial comity, we discern no reason to second-guess the bankruptcy court's assertion of jurisdiction over [the four contributing taxpayers] in the partnership's chapter 11 bankruptcy case." Thus, the court concluded, the debts of the four contributing partners were discharged in a "title 11 case" within the meaning of *I.R.C. section 108(a)(1)(A)*.

To appreciate why the Tax Court's conclusion in these four Memorandum Opinions was wrong, we must first look at the language and legislative history of *I.R.C. section 108(a)(1)(A)*. The exclusion created by *I.R.C. section 108(a)(1)(A)* applies only if "the discharge occurs in a title 11 case." *I.R.C. Section 108(d)(2)* *I.R.C. section 108(d)(2)* defines the term "title 11 case" as "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.*" (emphasis supplied) The statutory requirement that the taxpayer be "under the jurisdiction of the [bankruptcy] court *in such case*" means that the taxpayer seeking the benefit of *I.R.C. section 108(a)(1)(A)* must be a debtor in a title 11 case. The legislative history of *I.R.C. sections 108(a)(1)(A)* and *108(d)(2)* makes it clear that Congress intended *I.R.C. section 108(a)(1)(A)* to apply only to debtors who had commenced a title 11 case:

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. n69

The references to "bankrupt debtors" and to "a debtor *coming out of bankruptcy*" could only be to debtors who had commenced title 11 cases. In the partnership context, the legislative history explains that "[t]he 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 a bankruptcy case), or is solvent (and not in a bankruptcy case).*" n70 To allow a taxpayer who was not a debtor in a title 11 case to have the relief granted by *I.R.C. section 108(a)(1)(A)* ignores the clear meaning of both the statute and the legislative history. n71

In addition, allowing the partners in these four cases to have the benefit of *I.R.C. section 108(a)(1)(A)* conflicts with the basic principles of bankruptcy taxation. *I.R.C. section 108(a)(1)(A)* exists to ensure that a taxpayer who obtains a "fresh start" by means of a discharge in a title 11 case does not find that "fresh start" curtailed or eliminated as a result of immediate post-bankruptcy tax liability. n72

To get the "fresh start," a person must be a debtor in a title 11 case. A solvent partner has no bankruptcy "fresh start" to protect and thus is entitled to no protection under *I.R.C. section 108(a)(1)(A)*.

[iv] Reduction of Tax Attributes; Partner's Partnership Interest as Depreciable Property

As explained above, if a partner in a title 11 case or an insolvent partner receives a distributive share of discharge of indebtedness income from a partnership, the "price" for excluding such income under either *I.R.C. section 108(a)(1)(A)* or (B) is the reduction of tax attributes under *I.R.C. section 108(b)*. *I.R.C. section 108(b)(5)* gives a partner faced with an obligation to reduce tax attributes the option to elect to reduce the partner's basis in depreciable property before reducing the partner's other tax attributes. n73

A partner considering this option should note that *I.R.C. section 1017(b)(3)(C)* provides that a partner can elect to treat his or her partnership interest as depreciable property to the extent of such partner's proportionate share of the basis of depreciable property held by the partnership. For this purpose, the Senate Finance Committee Report states that "depreciable property" also includes real property held by the partner for sale to customers in the ordinary course of business. n74

A partner may treat a partnership interest as depreciable property only if the partnership consents to a corresponding reduction in the basis of the partnership property with respect to that partner. n75 The Senate Report states that this reduction is similar to the adjustment which would be required if the partnership had a *I.R.C. section 754* election in effect. n76 Although Treasury has not yet issued regulations under *I.R.C. section 1017(b)(3)(C)*, it appears the reference in the Senate Report to the adjustments that would be required if a *I.R.C. section 754* election had been in effect is for purposes of guidance only and does not require that the partnership must actually make a *I.R.C. section 754* election. Thus, an amendment to the partnership agreement providing for this basis adjustment should be sufficient to permit the applicable reduction in basis.

[c] Discharge of "Qualified Farm Indebtedness"; I.R.C. section 108(a)(1)(C)

The exception for a discharge of "qualified farm indebtedness" provides relief for a solvent taxpayer who satisfies the requirements of *I.R.C. section 108(g)*. As the following material explains, this exception may provide relief for solvent partners in a financially troubled partnership.

I.R.C. sections 108(a)(1)(C) and *108(g)*, n77 added by the Tax Reform Act of 1986, provide that when a "qualified person" n78 discharges "qualified farm indebtedness" of a solvent taxpayer, the taxpayer can exclude some or all of the discharge of indebtedness income generated by the discharge. n79 The amount a taxpayer can exclude cannot exceed the sum of the taxpayer's "adjusted tax attributes" n80 and the "aggregate adjusted bases" of the taxpayer's "qualified property." n81 "Qualified farm indebtedness" means debt the taxpayer incurred directly in connection with the operation by the taxpayer of the trade or business of farming, n82 provided that 50 percent or more of the taxpayer's annual gross

receipts for the three taxable years prior to the year of discharge were attributable to the trade or business of farming. n83 The price for this exclusion is reduction of tax attributes. n84

The exclusion created by *I.R.C. sections 108(a)(1)(C)* and *108(g)* applies at the partner level rather than at the partnership level. n85 As a result, the partnership would have discharge of indebtedness income from the discharge of "qualified farm indebtedness" and that income would pass through to the partners, whose tax consequences would depend on whether they could qualify for an exclusion under *I.R.C. section 108(a)(1)*. Consider the following fact situation:

In 1979, A and B formed a partnership to carry on the business of raising soy beans. A has always managed the partnership business and derives all of his income from the partnership business. B, an attorney, has never been involved in the day-to-day operation of the partnership's business and derives more than 50 percent of his income from the practice of law. After several consecutive years of financial difficulties, the partnership is insolvent. In view of the serious financial condition of the partnership, a local bank that lent the partnership \$100,000 five years ago has agreed to forgive \$60,000 of the debt. The debt is recourse debt, secured by certain partnership assets. Both A and B are solvent and have not filed title 11 petitions. If the bank forgives \$60,000 of the \$100,000 debt, the partnership will realize \$60,000 of discharge of indebtedness income, which will pass through to A and B. If the bank is a "qualified person," can either A or B exclude his share of the discharge of indebtedness income under *I.R.C. section 108(a)(1)(C)*?

Stated another way, the question is whether the partnership debt is "qualified farm indebtedness." The answer to that question depends on the following analysis. First, *I.R.C. section 108(g)(2)*, which defines "qualified farm indebtedness," refers to "indebtedness of a taxpayer." *I.R.C. section 108(d)(1)* defines "indebtedness of the taxpayer" as "any indebtedness--(A) for which the taxpayer is liable, or (B) subject to which the taxpayer holds property." Because the partnership is a general partnership and the debt is recourse debt, both A and B are personally liable for the debt. n86 Thus, as to both A and B, the debt should qualify as "indebtedness of a taxpayer" within the meaning of *I.R.C. section 108(g)(2)*.

Second, *I.R.C. section 108(g)(2)(A)* requires that the debt be "incurred directly in connection with the operation by the taxpayer of the trade or business of farming." n87 A may satisfy this requirement because he manages the partnership farming business. However, B, an attorney, is not involved in the day-to-day management of the farming business and thus will not satisfy this requirement.

Third, *I.R.C. section 108(g)(2)(B)* requires that 50% or more of the taxpayer's gross receipts for the three years prior to the year in which the discharge occurs must be attributable to the trade or business of farming. A appears to satisfy this requirement because all of his income comes from the partnership's farming operation. In contrast, B does not satisfy this requirement because more than 50% of his gross receipts come from the practice of law.

Finally, if the debt is "qualified farm indebtedness" as to A, he cannot exclude discharge of indebtedness income in excess of the sum of his "adjusted tax attributes" and "aggregate adjusted bases" of his "qualified property."

[d] Discharge of "Qualified Real Property Business Indebtedness"; I.R.C. section 108(a)(1)(D)

[i] Overview of I.R.C. section 108(a)(1)(D)

The exception for a discharge of "qualified real property business indebtedness" provides relief for a solvent noncorporate taxpayer who satisfies the requirements of *I.R.C. section 108(c)*. As the following material explains, this exception may provide relief for solvent partners in a financially troubled partnership.

As part of the Revenue Reconciliation Act of 1993, n88 Congress added new *I.R.C. sections 108(a)(1)(D)* and *108(c)* n89 to the Code. These provisions allow solvent taxpayers other than C corporations to elect to exclude discharge of indebtedness income generated by the discharge of "qualified real property business indebtedness." The price for exclusion is reduction of the taxpayer's basis in depreciable real property. n90

I.R.C. section 108(c)(3) defines the term "qualified real property business indebtedness" as indebtedness that satisfies the following requirements:

- (1) The taxpayer must have incurred or assumed the indebtedness in connection with n91 real property used n92 in a trade or business *and* the real property must secure the indebtedness; n93
- (2) The taxpayer must have incurred or assumed the indebtedness before January 1, 1993, n94 or, if the taxpayer incurred or assumed the indebtedness after that date, the indebtedness must be "qualified acquisition indebtedness;" n95 and
- (3) The taxpayer must elect to have *I.R.C. section 108(a)(1)(D)* apply. n96

The term "qualified real property business indebtedness" does not include "qualified farm indebtedness." n97

I.R.C. section 108(c) places two limitations on the amount a taxpayer can exclude under *I.R.C. section 108(a)(1)(D)*. First, the amount excluded cannot exceed the excess, if any, of (1) the outstanding principal amount of the "qualified real property business indebtedness" immediately before the discharge over (2) the fair market value of the real property immediately before the discharge, reduced by the outstanding principal amount of any other "qualified real property business indebtedness" secured by such property. n98

Second, the amount excluded cannot exceed the aggregate adjusted bases of depreciable real property (determined *after* any reductions under *I.R.C. sections 108(b)* and *108(g)*) held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of such discharge). n99 The following example illustrates the application of these two limitations:

On July 1, 1994, A, an individual, owns a building with a fair market value of \$150,000 used in A's trade or business. The building is subject to a first mortgage securing "qualified real property business indebtedness" of \$110,000 and to a second mortgage securing "qualified real property business indebtedness" of \$90,000. A is solvent and has not filed a bankruptcy petition. Neither debt is "qualified farm indebtedness" within the meaning of *I.R.C. section 108(g)*. Including the building subject to these two mortgage debts, A owns depreciable real property with an aggregate basis of \$40,000. A and the holder of the second mortgage agree to reduce the principal amount of the debt from \$90,000 to \$30,000, causing A to realize \$60,000 of discharge of indebtedness income. A can elect under *I.R.C. section 108(a)(1)(D)* to exclude a portion of the \$60,000 of the discharge of indebtedness income as determined under *I.R.C. section 108(c)(2)*. *I.R.C. section 108(c)(2)(A)* limits A's exclusion to \$50,000 (the excess of the outstanding principal amount of the "qualified real property business indebtedness" immediately before the discharge (\$90,000) over the fair market value of the real property immediately before the discharge (\$150,000), reduced by outstanding principal amount of any other "qualified real property business indebtedness" secured by such property (\$110,000), is \$50,000). *I.R.C. section 108(c)(2)(B)* then further limits A's exclusion to \$40,000 because A's aggregate basis in depreciable real property is only \$40,000. Thus, A can exclude \$40,000 of the discharge of indebtedness income at a cost of reducing aggregate basis in depreciable real property to zero and must report \$20,000 of discharge of indebtedness income. n100

I.R.C. section 108(c) raises an interesting planning issue. The interaction between *I.R.C. section 108(c)* and *I.R.C.*

section 1017(d) suggests that using *I.R.C. section 108(c)* may create a problem for a taxpayer who cannot retain the real property encumbered by the "qualified real property business indebtedness." The following example illustrates the nature of the problem. Suppose a taxpayer, who reports on a calendar year basis, owns an office building with a fair market value of \$800,000 and an adjusted basis of \$800,000 that is subject to non-recourse debt in the principal amount of \$1,000,000. The debt is "qualified real property business indebtedness." In 1995, as part of a non-bankruptcy workout, the lender reduces the \$1,000,000 non-recourse debt to \$800,000. The taxpayer excludes the \$200,000 of discharge of indebtedness income under *I.R.C. section 108(c)* and reduces its basis in the building by \$200,000. In 1996, the taxpayer concludes that the attempted workout has failed and surrenders the building, which still has a fair market value of \$800,000, to the lender in satisfaction of the non-recourse debt. Under *I.R.C. section 1017(d)*, the taxpayer would have to recapture the \$200,000 it excluded under *I.R.C. section 108(c)* as ordinary income. In contrast, if the taxpayer had simply surrendered the building to the lender in 1995, it would have recognized \$200,000 of *I.R.C. section 1231* gain, n101 which probably would have been treated as long term capital gain. The conversion of \$200,000 of long term capital gain into \$200,000 of ordinary income would, in most instances, be unacceptable to a taxpayer. Thus, a taxpayer considering using *I.R.C. section 108(c)* should have a reasonable expectation of being able to retain the encumbered real property.

[iii] I.R.C. section 108(a)(1)(D) in the Partnership Context

I.R.C. section 108(d)(6) provides that the exclusion created by *I.R.C. sections 108(a)(1)(D)* and *108(c)* applies at the partner level rather than at the partnership level. However, the legislative history explains that both the determination of whether debt is "qualified real property business indebtedness" and the application of the fair market value limitation n102 occur at the partnership level. n103 "For example, if partnership debt is discharged, the determination of whether the debt was incurred or assumed in connection with real property used in a trade or business is made by reference to the trade or business of the partnership and real property owned by the partnership." n104 As a result, if a partnership receives a discharge of "qualified real property business indebtedness" (determined at the partnership level), the partnership will have discharge of indebtedness income and that income will pass through to the partners. A solvent partner who is not a C corporation would be eligible to elect to exclude the partner's share of the discharge of indebtedness income under *I.R.C. section 108(c)(2)*. For purposes of applying the aggregate basis limitation imposed by *I.R.C. Section 108(c)(2)(B)*, *I.R.C. section 1017(b)(3)(C)* and *I.R.C. section 1017(b)(3)(F)(i)* provide that a partner shall treat the partner's interest in the partnership as depreciable real property to the extent of the partner's proportionate interest in depreciable real property held by the partnership. n105 If a partner makes an election under *I.R.C. section 108(a)(1)(D)*, the last sentence of *I.R.C. section 1017(b)(3)(C)* provides that the partnership must reduce its "inside basis" in its depreciable real property with respect to the electing partner. n106

The legislative history also provides some guidance on the subchapter K consequences of the discharge of "qualified real property business indebtedness." The pass-through of the discharge of indebtedness income to the partners will increase their respective "outside bases" by the amount of the pass-through. The reduction of the "qualified real property business indebtedness" will trigger a deemed cash distribution under *I.R.C. section 752(b)*, which in turn will decrease the partner's "outside basis" under *I.R.C. section 733*. The reduction in "outside basis" under *I.R.C. section 733* is separate from any reduction in the partner's "outside basis" that occurs under *I.R.C. section 108(c)(1)* if the partner treats his or her partnership interest as depreciable real property to the extent of the partner's proportionate interest in the depreciable real property held by the partnership. n107 Consider the following example:

The AB Partnership has two equal partners, A and B, both individuals, who share profits, losses and liabilities equally. A and B each have an "outside basis" of \$400,000, both are solvent and neither has filed a bankruptcy petition. The Partnership owns a depreciable building used in its trade or business. The building has an adjusted basis to the Partnership of \$800,000 and a fair market value of \$800,000. The building is subject to a recourse debt with an outstanding principal balance of \$1,000,000. The debt is "qualified real property business indebtedness." The lender agrees to reduce the principal amount of the debt from \$1,000,000 to \$800,000. As a result, the Partnership realizes \$200,000 of discharge of

indebtedness income, which passes through to A and B in equal shares of \$100,000 each. If A and B elect to exclude their respective shares of discharge of indebtedness income under *I.R.C. section 108(a)(1)(D)*, A and B will each make the following adjustments to their "outside basis." First, each will increase his or her "outside basis" by the \$100,000 of pass-through discharge of indebtedness income (\$400,000 + \$100,000 = \$500,000). Second, each will reduce his or her "outside basis" by the \$100,000 deemed cash distribution under *I.R.C. section 752(b)* (\$500,000 - \$100,000 = 400,000). Third, as required by *I.R.C. section 108(c)(1)*, each will reduce his or her "outside basis" by the \$100,000 excluded under *I.R.C. section 108(a)(1)(D)*, leaving each with an "outside basis" of \$300,000. Finally, the Partnership will reduce its "inside basis" in the building by \$200,000, leaving it with an "inside basis" of \$600,000.

On January 7, 1997, Treasury published Proposed Regulations under *I.R.C. sections 108* and *1017* providing guidance on limits on the exclusion of income from discharge of indebtedness and on basis reductions required as a result of exclusion of discharge of indebtedness income, n108 including basis reductions required by *I.R.C. section 108(c)* for partners and partnerships. n109 On October 22, 1998, Treasury issued a revised version of the Proposed Regulations as Final Regulations. n110 The Final Regulations add *Treasury Regulation section 1.108-6*, which deals with the limitations on the exclusion of income from the discharge of "qualified real property business indebtedness" described in *I.R.C. section 108(c)* and *Treasury Regulation section 1.1017-1(i)*, which deals with basis reductions required under *I.R.C. section 1017* as a result of exclusion of discharge of indebtedness income under *I.R.C. section 108*.

[A] Limitation on Income Exclusion From Discharge of "Qualified Real Property Business Indebtedness" Under section 108(a)(1)(D)

Treasury Regulation section 1.108-6 applies to discharges of "qualified real property business indebtedness" occurring on or after October 22, 1998. n111 *Treasury Regulation section 1.108-6(a)* provides that the amount excluded from gross income under *I.R.C. section 108(a)(1)(D)* shall not exceed the excess, if any, of the "outstanding principal amount" of that indebtedness immediately before the discharge over the "net fair market value" of the "qualifying real property," as defined in *Treasury Regulation section 1.1017-1(c)(1)*, n112 immediately before the discharge. For purposes of *Treasury Regulation section 1.108-6*, the phrase "net fair market value" means the fair market value of the "qualifying real property" (notwithstanding *I.R.C. section 7701(g)*, relating to fair market value of property encumbered by nonrecourse debt), reduced by the "outstanding principal amount" of any "qualified real property business indebtedness" (other than the discharged indebtedness) that is secured by such property immediately before and after the discharge. For purposes of *I.R.C. section 108(c)(2)(A)* n113 and *Treasury Regulation section 1.108-6*, "outstanding principal amount" means the principal amount of indebtedness together with all additional amounts owed that, immediately before the discharge, are equivalent to principal, in that interest on such amounts would accrue and compound in the future, n114 except that the "outstanding principal amount" shall not include amounts that are subject to *I.R.C. section 108(e)(2)* n115 and shall be adjusted to account for unamortized premium and discount consistent with *I.R.C. section 108(e)(3)*. n116

Treasury Regulation section 1.108-6(b) restates the overall limitation imposed by *I.R.C. section 108(c)(2)(B)*. n117 The amount excluded from gross income under *I.R.C. section 108(a)(1)(D)* cannot exceed the aggregate adjusted bases of all depreciable real property held by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of the discharge) reduced by the sum of any

1. Depreciation claimed for the taxable year the taxpayer excluded discharge of indebtedness from gross income under *I.R.C. section 108(a)(1)(D)*; and
2. Reductions to the adjusted bases of depreciable real property required under *I.R.C. section 108(b)* or *I.R.C. section 108(g)* for the same taxable year. n118

[B] Special Rules for Debtors Who Elect to Apply I.R.C. section 108(c)

The Final Regulations take into account *I.R.C. section 108(c)*'s special basis reduction rules relating to the discharge of "qualified real property business indebtedness." *I.R.C. section 108(c)* requires the reduction of the basis of "depreciable real property" in exchange for the exclusion of income from discharge of "qualified real property business indebtedness." If a debtor elects to apply *I.R.C. section 108(c)*, the debtor may reduce only the adjusted basis of property described in paragraphs (1) and (3) of *Treasury Regulation section 1.1017-1(a)* and, within paragraphs (1) and (3) of *Treasury Regulation section 1.1017-1(a)*, may reduce only the adjusted bases of depreciable real property. Further, for basis reductions under *I.R.C. section 108(c)*, a debtor must reduce the adjusted basis of "qualifying real property" to the extent of the discharged "qualified real property business indebtedness" before reducing the adjusted bases of other depreciable property. The term "qualifying real property" means real property with respect to which the indebtedness is "qualified real property business indebtedness" within the meaning of *I.R.C. section 108(c)(3)*.

[C] Interaction of Rules Governing Partnership Interests and Basis Reductions Under I.R.C. section 108(b)(5) and (c)

I.R.C. section 1017(b)(3)(C) provides that a debtor partner must treat a partnership interest as "depreciable property" when reducing adjusted bases under *I.R.C. section 108(b)(5)*, and as "depreciable real property" when reducing adjusted bases under *I.R.C. section 108(c)*, but only to the extent the partnership correspondingly reduces the debtor partner's proportionate interest in the adjusted bases of the partnership's "depreciable property" (or "depreciable real property").

In general, the Proposed Regulations provided that a debtor partner has the right to decide whether to ask the partnership to reduce its "inside basis" in its "depreciable property" (or "depreciable real property") with respect to the debtor partner. n119 However, the Proposed Regulations also provided that, in general, the partnership is free to grant or deny its consent to such reduction. n120 Notwithstanding these general rules, the Proposed Regulations required a debtor partner to request consent to such a reduction if the debtor partner owns (directly or indirectly) more than 50 percent of the capital and profits interests of the partnership, or if the debtor partner receives a distributive share of discharge of indebtedness income from the partnership. n121 The Proposed Regulations further provided that the partnership must grant its consent to a request for reduction of its "inside basis" if the request is from partners owning (directly or indirectly) more than 50 percent of the capital and profits interests of the partnership. n122

The Preamble to the Final Regulations notes that one person commenting on the Proposed Regulations requested revisions to the mandatory request and consent rules contained in the Proposed Regulations. n123

This commentator argued that the proposed regulations, as written, could unduly burden certain large partnerships in situations where the partnership's refusal to consent was not motivated by tax avoidance. The commentator requested that the mandatory consent rule be revised to require a partnership to consent only if the partnership receives requests from five or fewer partners who own, in the aggregate, more than 50 percent of the capital and profits of the partnership. n124

Treasury concluded that the commentator's concern had merit and, to ensure that partnerships are not unduly burdened by the mandatory request and consent rules, adopted the commentator's proposal, in part, in the Final Regulations. However, to preserve the general ordering rules of the Final Regulations, Treasury concluded that it is appropriate to require a partnership to consent to reduce the basis of its depreciable property (or depreciable real property) where a substantial majority of its partners elect to exclude the discharge of indebtedness income under *I.R.C. sections 108(b)(5)* or *108(c)*. Therefore, the final regulations provide that a partnership must consent to reduce its partners' shares of the partnership's depreciable basis in depreciable property (or depreciable real property) if consent is requested by: (i) partners owning (directly or indirectly) an aggregate of more than 80 percent of the capital and profits interests of the partnership; or (ii) five or fewer partners owning (directly or indirectly) an aggregate of more than 50 percent of the capital and profits interests of the partnership. n125

The Proposed Regulations provided that a debtor partner requesting a reduction in "inside basis" must make the request before the due date (including extensions) for filing the debtor partner's Federal income tax return for the taxable year in which the debtor partner has discharge of indebtedness income. n126 The Final Regulations adopt this requirement. n127 The Proposed Regulations provided that a partnership that consents to a basis reduction must include a consent statement with its Form 1065 (the partnership tax return) for the taxable year of the partnership that ends with or within the taxable year the debtor partner excludes discharge of indebtedness income from gross income under *I.R.C. section 108(a)* and must also provide a copy of that statement to the debtor partner on or before the filing date of the Form 1065. n128 The Final Regulations require the partnership to attach the consent statement to its Form 1065 for the taxable year of the partnership *following* the partnership's taxable year that ends with or within the taxable year the debtor partner excludes discharge of indebtedness income from gross income under *I.R.C. section 108(a)*. n129

The Preamble to the Final Regulations acknowledges that a partner might not always have sufficient information with which to decide whether to request a basis reduction until on or shortly before the due date (including extensions) for filing the partner's federal income tax return. n130 For that reason, Treasury requested comments on whether it should require a partnership to inform its partners of discharge of indebtedness income *prior* to the date the partnership files its Form 1065, or to adopt any other rules necessary to ensure that the partnership and the partners exchange information in a timely fashion. n131 The Final Regulations do not require partnerships to inform their partners of discharge of indebtedness income prior to the date of the filing of the Form 1065. Treasury and the IRS concluded that "any additional administrative burdens imposed on partnership should be the result of an understanding between the partners and the partnership." n132

As in the Proposed Regulations, the Final Regulations do not require a partnership to reduce the basis of its depreciable property (or depreciable real property) in all situations where the partnership is the source of the discharge of indebtedness income. n133 However, where a partnership is the source of the discharge of indebtedness income and partners elect to exclude such income, such partners are required to request that the partnership reduce its basis in such property. n134 The Final Regulations make it clear that a partnership's consent to reduce the basis of the partnership's depreciable property (or depreciable real property) is neither required nor relevant where a partner reduces the basis in its partnership interest under *I.R.C. section 108(b)(2)(E)*. n135

[iii] Specific Partnership Issues

As noted earlier, n136 the legislative history of *I.R.C. section 108(a)(1)(D)* explains that the determination of whether debt is "qualified real property business indebtedness" occurs at the partnership level. n137 In general, the issue of whether a particular activity rises to the level of a "trade or business" turns on the facts and circumstances of each case. n138 However, in the context of rental real estate ownership, a long line of Tax Court cases establishes that rental of even a single property may constitute a "trade or business." n139 The Tax Court's definition of "trade or business" in this context is the appropriate definition for purposes of *I.R.C. section 108(a)(1)(D)* and the Internal Revenue Service apparently agrees. n140

Absent an amendment to the *I.R.C. section 704* regulations, the minimum gain chargeback rules n141 may nullify the benefits of *I.R.C. section 108(a)(1)(D)* if the partnership debt discharged by a lender is nonrecourse debt. A minimum gain chargeback could create problems in two situations:

- (1) The first situation arises because of the interaction of the rules governing computation of changes in "partnership minimum gain" and the rules governing basis adjustments. "Partnership minimum gain" is the excess (if any) of nonrecourse debt encumbering a property over the partnership's adjusted basis for the property. A partnership must compute changes in its "partnership minimum gain" for a taxable year by comparing the "partnership minimum gain" on the last day of the prior taxable year with the "partnership minimum gain" on the last day of the current taxable year. *I.R.C. section 1017(a)* provides

that, if a partnership receives a discharge of indebtedness, the required basis reduction applies only to property held by the partnership on the first day of the *next* taxable year following the year in which the discharge occurred. Thus, as a result of a discharge of nonrecourse debt in 1994, a calendar year partnership might experience a decrease in "partnership minimum gain," triggering a minimum gain chargeback, in 1994 because the partnership would not make the corresponding decrease in its asset basis until January 1, 1995.

(2) The second situation arises because a partnership will not always use the discharge of indebtedness income realized by the partnership as the result of discharge of nonrecourse debt to satisfy the minimum gain chargeback triggered by the discharge. Under the regulations, if the partnership does not dispose of the encumbered property, the partnership must satisfy the minimum gain chargeback using a *pro rata* portion of all of the partnership's items of income and gain for taxable year. n142 Thus, the partnership may not properly allocate the discharge of indebtedness income among the partners.

Another important issue involves application of *I.R.C. section 108(a)(1)(D)* in the context of tiered partnerships. Suppose four limited partnerships (the "Upper Tier Partnerships") are partners in a general partnership (the "Lower Tier Partnership"). The Lower Tier Partnership owns a commercial office building which is acquired with "qualified real property business indebtedness." The Lower Tier Partnership obtains a discharge of a portion of the "qualified real property business indebtedness" which results in discharge of indebtedness income to the Lower Tier Partnership. This example raises two questions. First, can the Upper Tier Partnerships treat their respective shares of the Lower Tier Partnership's indebtedness as "qualified real property business indebtedness"? If so, solvent partners (who are not C corporations) in the Upper Tier Partnerships can elect to exclude their respective shares of the discharge of indebtedness income under *I.R.C. section 108(a)(1)(D)*. Second, for purposes of *I.R.C. section 1017(b)(3)(C)* (treating a partner's interest in a partnership as depreciable real property), can the Upper Tier Partnerships treat their interests in the Lower Tier Partnership as depreciable real property to the extent of their proportionate interest in the depreciable real property of the Lower Tier Partnership? If so, partners in the Upper Tier Partnership who want to elect under *I.R.C. section 108(a)(1)(D)* would get the benefit of such treatment.

The proper answer to both questions is yes, and the Internal Revenue Service appears to agree. In a series of Private Letter Rulings n143 involving essentially the fact pattern just described, the Internal Revenue Service ruled that solvent partners (who were not C corporations) of the Upper Tier Partnerships could elect to exclude their respective shares of discharge of indebtedness income realized by the lower Tier Partnership under *I.R.C. section 108(a)(1)(D)*, subject to the limitations in *I.R.C. section 108(c)(2)(A)* and *(B)*. The Internal Revenue Service also ruled that, for purposes of *I.R.C. section 1017(b)(3)(C)*, the Upper Tier Partnerships would treat their interests in the Lower Tier Partnership as depreciable real property to the extent of their respective proportionate interests in the depreciable real property held by the Lower Tier Partnership, provided the Lower Tier Partnership makes a corresponding reduction in its "inside basis" in its depreciable real property with respect to the Upper Tier Partnerships. Similarly, the Internal Revenue Service ruled, partners of the Upper Tier Partnerships would treat their interest in the Upper Tier Partnerships as depreciable real property to the extent of their proportionate interests in the depreciable real property held by the Upper Tier Partnerships, provided the Upper Tier Partnerships make corresponding reductions in their "inside basis" of their depreciable real property with respect to the partners.

The interaction of the basis reduction required by *I.R.C. section 108(c)(1)* and the *I.R.C. section 465(e)* at-risk recapture rule raises an interesting question. Suppose a partner's basis in the partner's partnership interest is attributable in part to "qualified nonrecourse financing," as defined in *I.R.C. section 465(b)(6)*, which is also "qualified real property business indebtedness" for purposes of *I.R.C. section 108(a)(1)(D)*. Suppose further that the partnership realizes discharge of indebtedness income as a result of discharge of a portion of such indebtedness and the partner elects to exclude his or her share of the discharge of indebtedness income under *I.R.C. section 108(a)(1)(D)*. Assume *I.R.C. section 108(c)(1)* and *I.R.C. section 1017(b)(3)(C)* require a reduction in the partner's basis in the partner's interest in the partnership. If that reduction reduces the partner's at-risk amount below zero, would *I.R.C. section 465(e)* require recapture? Such a

result would undercut the relief granted by *I.R.C. section 108(a)(1)(D)*. To avoid such a result, Treasury should by regulation create an exception to the *I.R.C. section 465(e)* recapture rule when a partner's at-risk amount drops below zero as a result of the operation of *I.R.C. section 108(c)*.

Another question involves the application of *I.R.C. section 108(c)(2)(B)* in a partnership context. *I.R.C. section 108(c)(2)(B)* provides that, for purposes of determining the amount of discharge of indebtedness income a taxpayer can exclude under *I.R.C. section 108(a)(1)(D)*, the taxpayer cannot count the adjusted basis of "depreciable real property acquired in contemplation of such discharge." Congress included this rule to prevent taxpayers from acquiring additional depreciable real property for the purpose of using the basis of such property to offset discharge of indebtedness income generated by the discharge of "qualified real property business indebtedness." However, it is not clear whether this rule applies in the partnership context, and if so, how it applies. For example, if, prior to obtaining a discharge of "qualified real property business indebtedness," a partnership acquires additional depreciable real property, could *I.R.C. section 108(c)(2)(B)* prevent the partners in the partnership from treating such property as depreciable real property held by the partnership for purposes of *I.R.C. section 1017(b)(3)(C)*? The threshold question is whether the partnership acquired the depreciable real property "in contemplation of" the discharge of the "qualified real property business indebtedness." If so, to what extent does *I.R.C. section 108(c)(2)(B)* treat the intent of the partnership as the intent of an individual partner?

[2] Collateral Consequences of Discharge of Partnership Debt

[a] Subchapter K Consequences

The interaction of the discharge of indebtedness rules and subchapter K involves three sets of rules in subchapter K: (1) the rules governing allocation of items of partnership income to partners; n144 (2) the rules governing the consequences of reduction of a partner's share of partnership liabilities; n145 and (3) the rules governing minimum gain chargebacks. n146 The discussion of discharge of indebtedness income and the allocation rules appears earlier in this section. n147

[i] Consequences of Reduction of Partner's Share of Partnership Liabilities

The discharge of a partnership debt reduces the partners' shares of partnership liabilities, n148 thereby generating a deemed distribution of money to the partners. n149 The deemed distribution is taxable to a partner if, and to the extent, the deemed distribution exceeds the adjusted basis of that partner's interest in the partnership (outside basis). n150 The legislative history of the Bankruptcy Tax Act of 1980 suggests that Congress expected discharge of a partnership debt would always result in the following adjustments to a partner's outside basis. First, the discharge of indebtedness income allocated to a partner would increase the partner's outside basis under *I.R.C. section 705(a)(1)(A)* in an amount exactly equal to the amount of the *I.R.C. section 752(b)* deemed distribution of money. Then, the deemed distribution would decrease the partner's outside basis under *I.R.C. section 733(1)*. n151 Thus, Congress apparently believed, these adjustments would always cancel each other out and would cause neither a net change in the partner's outside basis nor a taxable distribution under *I.R.C. sections 752(b)* and *731(a)(1)*. n152

Unfortunately, the brief discussion in the legislative history is terse and does not address several important points. For example, Congress apparently assumed that the increase in outside basis triggered by the distributive share of discharge of indebtedness income occurs at the same time as the decrease in outside basis triggered by the *I.R.C. section 752(b)* deemed distribution of money. However, prior to publication of *Revenue Ruling 92-97*, n153 there was some concern over whether Congress had incorporated this assumption into the language of the applicable statutory provisions. *I.R.C. section 731(a)(1)* focuses on the partner's outside basis immediately before the deemed distribution of money. n154 In contrast, a partner's distributive share of discharge of indebtedness income passes through to the partner on the last day of the partnership's taxable year. n155 If a partnership obtains a discharge of a partnership debt during its taxable year, might the partners have to compute the tax consequences of the *I.R.C. section 752(b)* deemed distribution when the discharge occurred without the benefit of the increase in outside basis attributable to their year-end distributive shares of

the discharge of indebtedness income? The following example illustrates the problem:

Example 15

A, B and C are equal partners in ABC Associates, a general partnership. Each has a \$4,000 outside basis. Each is solvent and not in a title 11 case. Because ABC Associates is experiencing financial difficulty, Lender agrees to cancel \$30,000 of an outstanding \$100,000 partnership debt (not "qualified farm indebtedness"). The cancellation, which occurs in the middle of the partnership's taxable year, generates \$30,000 of discharge of indebtedness income to the partnership and also triggers a *I.R.C. section 752(b)* deemed distribution of \$10,000 to each partner.

If A, B and C must determine the consequences of the *I.R.C. section 752(b)* deemed distribution on the date of the discharge but do not get the benefit of the increase in outside basis attributable to the pass-through of the discharge of indebtedness income until the end of the partnership's taxable year, they would recognize gain under *I.R.C. section 731(a)(1)*. Each would have a deemed cash distribution of \$10,000 and an outside basis of \$4,000, so each would recognize \$6,000 of gain.

In contrast, if A, B and C can increase their outside bases to reflect their distributive shares of the discharge of indebtedness income before taking the *I.R.C. section 752(b)* deemed distribution into account, they will not recognize gain under *I.R.C. section 731(a)(1)*. Each partner's \$10,000 distributive share of the discharge of indebtedness income would increase their respective outside bases from \$4,000 to \$14,000. n156 The deemed distributions of \$10,000 to each partner would reduce their respective bases to \$4,000. However, because the deemed distributions would not exceed their outside bases, they would not recognize any gain. n157 In this instance, the only tax consequence to the partners of the cancellation of \$30,000 of partnership debt would be that they each would recognize \$10,000 of discharge of indebtedness income.

Congress apparently believed that the increase in outside basis triggered by a partner's distributive share of discharge of indebtedness income would occur immediately before the decrease in basis triggered by the *I.R.C. section 752(b)* deemed distribution. However, prior to publication of *Revenue Ruling 92-97*, n158 apart from the legislative history of the Bankruptcy Tax Act of 1980, there was no clear answer to this problem. The regulations under *I.R.C. section 752* provide that a partner's share of partnership liabilities must be determined "whenever the determination is necessary in order to determine the tax liability of the partner" n159 Similarly, the regulations under *I.R.C. section 705* provide that a partner's outside basis is determined whenever necessary to determine the partner's tax liability, although ordinarily the determination occurs at the end of the partnership's taxable year. n160 The proper result is that a partner should test the consequences of a *I.R.C. section 752(b)* deemed distribution at the end of the partnership's taxable year, immediately after the outside basis increase triggered by a distributive share of discharge of indebtedness income. n161 *Revenue Ruling 92-97* n162 confirms this result, eliminating the previously discussed concern. n163

Although it is now clear that the increase in outside basis triggered by a partner's distributive share of discharge of indebtedness income occurs immediately before the decrease in outside basis triggered by the *I.R.C. section 752(b)* deemed distribution, the exact balancing of outside basis adjustments anticipated by Congress does not always occur. n164 For example, the partnership agreement may not allocate items of income and loss to partners in the same manner as the regulations under *I.R.C. section 752(b)* allocate the deemed distribution of money. In such a situation, a partner's share of partnership discharge of indebtedness income (and the resulting increase in the partner's outside basis) might be smaller than the amount of the deemed distribution, causing the partner to recognize gain under *I.R.C. section 731(a)(1)*. For example, "[s]uch a divergence could occur if the canceled debt is recourse and profit and loss sharing ratios differ, since recourse debt is generally shared among partners in accordance with their shares of partnership losses while the debt discharge income would presumably be allocated in accordance with the profit-sharing ratios." n165 Similarly, because nothing in *I.R.C. section 704* or the regulations thereunder prohibits a special allocation of discharge of indebtedness income, such a special allocation could result in a smaller increase in a partner's outside basis than the

amount of the deemed distribution of money allocable to that partner. n166

Suppose a partner who is either insolvent or in a title 11 case receives a deemed distribution under *I.R.C. section 752(b)* that exceeds the partner's outside basis. *I.R.C. section 108(a)* permits such a partner to exclude the discharge of indebtedness income. Is there an insolvency or title 11 exception that protects the partner from recognizing gain under *I.R.C. section 731(a)(1)*? *Revenue Ruling 71-301*, published well before the Bankruptcy Tax Act of 1980, the IRS in effect recognized an insolvency exception to *I.R.C. section 731(a)(1)*. n167 The IRS ruled that, to the extent a deemed cash distribution triggered by discharge of a partnership debt exceeded an insolvent partner's basis in his or her partnership interest, the partner had no recognized gain. The Ruling emphasized that the discharge did not render the partner solvent. The Bankruptcy Tax Act of 1980 caused considerable doubt about the continued vitality of *Revenue Ruling 71-301* because *I.R.C. section 108(e)(1)* expressly provides that *I.R.C. section 108* is the only insolvency exception from the general rule that gross income includes discharge of indebtedness income. n168 *Revenue Ruling 95-21*, n169 the IRS declared *Revenue Ruling 71-301* obsolete for transactions after the effective date of the amendments to *I.R.C. section 108* made by the Bankruptcy Tax Act of 1980.

The preceding material has discussed the consequences of the reduction of a partner's share of partnership liabilities in the context of a discharge of the *partnership's* debt. However, suppose a partner is a debtor in a title 11 case and the bankruptcy court discharges the *partner* from liability for the partner's share of the partnership's debt. In Technical Advice Memorandum 96-19002, n170 the IRS concluded that when a bankruptcy court order discharges a partner from his share of a partnership recourse debt, the partner must determine his tax consequences under *I.R.C. sections 731* and *752*, rather than under *I.R.C. sections 61(a)(12)* and *108(a)*. The partner had filed a voluntary bankruptcy petition under chapter 7 and had listed his share of the partnership's secured recourse debt as a liability. The bankruptcy court issued an order releasing the partner from all dischargeable debts including his share of the partnership secured recourse debt.

Citing *Marcaccio v. Commissioner*, n171 the partner argued that the discharge in bankruptcy of his share of the partnership secured recourse debt produced discharge of indebtedness income under *I.R.C. section 61(a)(12)*, which the partner could exclude under *I.R.C. section 108(a)(1)(A)*. The taxpayer in *Marcaccio* guaranteed a portion of his partnership's nonrecourse debt. The partnership subsequently defaulted on the debt, and the creditor foreclosed on the partnership property securing the nonrecourse debt, leaving a balance due on the note. The creditor then sued Marcaccio on the guarantee, eventually settling the debt for less than the guaranteed amount. The Tax Court held that Marcaccio had discharge of indebtedness income equal to the difference between the amount he paid the creditor in cancellation of the debt and the amount of the guaranteed debt. n172

The Service distinguished the holding in *Marcaccio* on the basis that Marcaccio received a discharge of a portion of his personal debt. n173 In contrast, in the situation described in the Technical Advice Memorandum, the underlying partnership liability remained fully enforceable. The partnership had no discharge of its indebtedness, and therefore no discharge of indebtedness income to pass through to the partner. Unlike Marcaccio, the partner in the situation described in the Technical Advice Memorandum had only derivative liability for the partnership's secured recourse debt. The bankruptcy discharge would prevent the partnership and the remaining partners from asserting any claim against the bankrupt partner for his share of the partnership secured recourse debt, but the discharge in no way affected the partnership's obligation to pay the debt.

The IRS relied on two Tax Court memorandum decisions, *Slavin v. Commissioner*, n174 and *Moore v. Commissioner*. n175 *Slavin* holds that a partner's transfer of his partnership interest to another partner, including his share of partnership debt owed a bank, did not result in discharge of indebtedness absent evidence that the bank forgave a portion of the debt. *Moore* holds that, when a purchaser of a partnership interest assumes the selling partner's share of partnership debt, the partnership does not discharge the selling partner's liability by allowing the assumption. Like the taxpayers in *Slavin* and *Moore*, who had no discharge of indebtedness within the meaning of *I.R.C. section 61(a)(12)* because in each case another person had assumed responsibility for paying the taxpayers' debts, the partner in the situation described in the Technical Advice Memorandum had no discharge of indebtedness within the meaning of

I.R.C. section 61(a)(12), because the partnership and the remaining partners were responsible for paying the partnership's debt.

Because there was no discharge of the underlying partnership debt, *I.R.C. sections 61(a)(12)* and *108* cannot govern the federal income tax consequences of the bankruptcy court's discharge order. Rather, as the Technical Advice Memorandum correctly concludes, under *I.R.C. section 752(b)*, the bankruptcy court's order discharging his share of the partnership's secured recourse liability triggered a deemed cash distribution from the partnership to the partner in the amount of the partner's share of the secured recourse debt. To the extent the deemed cash distribution exceeded the partner's basis in his partnership interest, the partner had to recognize gain.

[ii] Minimum Gain Chargeback

As explained previously, n176 the *I.R.C. section 704* regulations employ the device of "partnership minimum gain" to ensure that a partner will have a sufficient basis in the partner's partnership interest (outside basis) to cover the partner's share of nonrecourse deductions n177 and any distributions of proceeds from nonrecourse financing. Ordinarily, when a partnership obtains a discharge of partnership nonrecourse debt, the discharge will result in a net decrease in partnership minimum gain. In general, such a decrease triggers a "minimum gain chargeback." n178 For example, suppose a partnership has property with an adjusted basis to the partnership of \$40,000, encumbered by nonrecourse debt of \$60,000. The partnership would have partnership minimum gain of \$20,000 (the amount of gain the partnership would realize if it disposed of the property for no consideration other than full satisfaction of the nonrecourse debt). If the partnership obtains a discharge of \$5,000 of the \$60,000 nonrecourse debt, the partnership has a net decrease in partnership minimum gain of \$5,000 [\$20,000 "partnership minimum gain" before the discharge; \$15,000 "partnership minimum gain" after the discharge]. The net decrease in partnership minimum gain triggers a \$5,000 "minimum gain chargeback," which means that the partnership must allocate \$5,000 of items of partnership income and gain among the partners who had received allocations of the \$20,000 partnership minimum gain. n179

[b] Original Issue Discount Consequences

In addition to involving *I.R.C. section 108* and subchapter K, discharge of partnership indebtedness may involve the original issue discount rules if the discharge is accomplished by the "material" modification of a partnership debt instrument. The following example illustrates the application of the original issue discount rules in the context of discharge of partnership indebtedness.

Example 16

ABC Associates, a limited partnership, is a debtor in a title 11 case. A, the sole general partner, who holds a 50% interest in the capital and profits of ABC Associates, is a debtor in a separate title 11 case. B and C, both limited partners, each with a 25% interest in the capital and profits of ABC Associates, are solvent and neither is in a title 11 case. ABC Associates owns real estate it purchased for \$1,000,000 (\$200,000 in cash (\$100,000 from A and \$50,000 each from B and C) and \$800,000 in the form of a nonrecourse loan secured by the real estate). The nonrecourse lender did not sell the real estate to the partnership. Assume the current fair market value of the real estate has declined from \$1,000,000 to \$600,000, which is also ABC Associates' current adjusted basis for the real estate. Assume further that ABC Associates has not reduced the principal amount of the \$800,000 nonrecourse loan. A, B and C have the following capital accounts and bases in their respective partnership interests:

	A	B	C
Capital Account	\$100,000	<\$ 50,000>	<\$ 50,000>
n180			
Basis n181	\$300,000	\$150,000	\$150,000

Assume that B and C have no obligation to restore their negative capital accounts. ABC Associates' title 11 reorganization plan modifies the \$800,000 nonrecourse debt by reducing the principal amount to \$650,000 and reducing the interest rate. As a result of these modifications, the "issue price" of the modified debt instrument, as defined by *I.R.C. section 1274*, is \$600,000. Thus, there would be \$50,000 of original issue discount on the new \$650,000 debt because its "stated redemption price at maturity" (\$650,000) exceeds its "issue price" (\$600,000) by \$50,000.

[c] Partnership Withholding Obligations; I.R.C. section 1446

If a partnership with a foreign partnerⁿ¹⁸² has discharge of indebtedness income that the partnership allocates to the foreign partner, *I.R.C. section 1446(a)* may require the partnership to pay a withholding tax. *section 1446(a)* requires partnership withholding if a partnership has "effectively connected taxable income"ⁿ¹⁸³ and any portion of such income is allocable under *I.R.C. section 704* to a foreign partner. Thus, if the partnership has discharge of indebtedness income that is "effectively connected taxable income" and if the partnership allocates any of that income to a foreign partner, *section 1446* will apply.

The *section 1446* tax is imposed on the partnership. *I.R.C. section 1461* provides that any person required to deduct and withhold any tax under Chapter 3 of Subtitle A of Title 26 of the U.S.C. is liable for such payments. The Internal Revenue Service takes the position that the general partners of the partnership are withholding agents for collection of the tax and are jointly and severally liable for the tax and any nonpayment penalties.ⁿ¹⁸⁴

Section 1446(b) establishes the rules for computing the amount of the withholding tax. The determination turns on whether the foreign partner is a corporation. If the foreign partner is a corporation, the withholding rate is the highest rate of tax established by *I.R.C. section 11(b)(1)*.ⁿ¹⁸⁵ If the foreign partner is not a corporation, the withholding rate is the highest rate of tax specified in *I.R.C. section 1*.ⁿ¹⁸⁶

Section 1446(d)(1) allows each foreign partner in a partnership a tax credit under *I.R.C. section 33*. The amount of the tax credit is the foreign partner's share of the *section 1446* withholding tax. *Section 1446(d)(2)* treats the foreign partner's share of the withholding tax as distributed to the foreign partner on the *earlier* of (1) the day on which the partnership paid the withholding tax or (2) the last day of the partnership's taxable year for which the partnership paid the tax.

[3] Exceptions to Partnership Realization of Discharge of Indebtedness Income

[a] A Threshold Question; the Scope of I.R.C. section 108(d)(6)

I.R.C. section 108(d)(6), enacted as part of the Bankruptcy Tax Act of 1980, provides "in the case of a partnership, subsections (a), (b), (c) and (g) [of *I.R.C. section 108*] shall be applied at the partner level" rather than at the partnership level. However, under prior law, courts reached conflicting conclusions. In *Gershkowitz v. Commissioner*ⁿ¹⁸⁷ the Tax Court concluded that the exclusions granted by *I.R.C. section 108* prior to its amendment in 1980 applied at the partner level. However, in *Estate of Newman v. Commissioner*,ⁿ¹⁸⁸ the Court of Appeals for the Second Circuit reversed the Tax Court on facts identical to those in *Gershkowitz*, holding that the pre-1980 exclusions applied at the partnership level. The following example illustrates the importance of the answer to this question.

Example 17

A and B are equal partners in AB Associates, a general partnership. Each has a \$5,000 outside basis. Each is solvent and not in a title 11 case. Because AB Associates is experiencing financial difficulty, Lender agrees to discharge \$40,000 of an outstanding \$100,000 partnership debt (not "qualified farm indebtedness"). The discharge generates \$40,000 of discharge of indebtedness income to the partnership. If *I.R.C. section 108(a)* applied at the partnership level, AB Associates would have no discharge of indebtedness income to pass through to A and B. However, *I.R.C. section 752(b)* would still treat the

discharge as a deemed distribution of \$20,000 cash to each partner. The partners each would reduce their respective outside bases by \$20,000 to account for the deemed cash distribution, n189 dropping their outside bases to \$0 and requiring recognition of \$15,000 of capital gain. n190 In contrast, if *I.R.C. section 108(a)* applied at the partner level, the partnership would have \$40,000 of discharge of indebtedness income, which it would pass through to A and B, increasing their outside bases and preventing recognition of gain under *I.R.C. section 731(a)(1)*.

Under current law, *I.R.C. section 108(d)(6)* answers this question at least in part by providing that *I.R.C. sections 108(a)*, n191 (b) n192 and (g) n193 apply at the partner level, not the partnership level. The scope of *I.R.C. section 108(d)(6)* is not entirely clear. According to the portion of the legislative history of the Bankruptcy Tax Act of 1980 describing *I.R.C. section 108(d)(6)*, "[t]he 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." n194 A footnote to the foregoing statement explains that "[t]he effect of these provisions of the bill is to overturn the decision in *Stackhouse v. U.S.*, 441 F.2d 465 (5th Cir. 1971)." n195 In *Stackhouse v. United States*, n196 an insolvent partnership settled a debt for less than its face amount, and the IRS concluded that the partners had discharge of indebtedness income to the extent of their solvency immediately after the discharge. The district court agreed with the IRS and found that the partners had ordinary income under *I.R.C. section 61(a)(12)*. n197 However, the Court of Appeals for the Fifth Circuit held that the discharge of the partnership indebtedness resulted in a deemed cash distribution to the partners under *I.R.C. section 752(b)*, so that each partner recognized capital gain under *I.R.C. section 731(a)(1)* to the extent the amount distributed exceeded each partner's adjusted basis in the partner's partnership interest. n198

The cryptic statement in the legislative history of the Bankruptcy Tax Act of 1980 could mean that Congress intended to adopt the aggregate view of partnerships for purposes of applying *I.R.C. section 108*. If so, *I.R.C. section 108* applies at the partner level rather than the partnership level for all purposes. However, the statement in the legislative history might mean that Congress intended only to overrule the result in *Stackhouse*. If so, *I.R.C. section 108(d)(6)* applies only to *I.R.C. sections 108(a)*, (b) and (g), leaving unanswered the question of whether the exceptions in *I.R.C. section 108(e)* apply at the partner level or the partnership level.

I.R.C. section 108 contains two additional references to partnerships, but those do not eliminate the ambiguity. *I.R.C. section 108(e)(4)*, which deals with the consequences of acquisition of debt by "related parties," includes a reference to *I.R.C. section 707(b)(1)* for purposes of determining who is a "related party." n199 *I.R.C. section 108(e)(7)(E)* directs Treasury to issue regulations for partnerships establishing rules similar to those in *I.R.C. section 108(e)(7)(A)-(D)* for corporations. n200

Thus, pending legislative change or administrative guidance, the question of the scope of *I.R.C. section 108(d)(6)* remains open. The following discussion covers *I.R.C. section 108* exemptions that appear to apply at the partnership level, notwithstanding the ambiguity created by *I.R.C. section 108(d)(6)*.

[b] I.R.C. section 108(e)(2); The Deduction Exception

I.R.C. section 108(e)(2) provides that a taxpayer will not realize discharge income to the extent that, if the taxpayer had paid the debt, the taxpayer would have been entitled to a deduction. for example, if a cash basis taxpayer engaged in a trade or business owes her landlord \$1,000 for rent and the landlord forgives the debt, the taxpayer does not realize discharge of indebtedness income. The reason, of course, is that a formal application of the federal income tax rules would produce a "wash" due to the deductibility of the payment. n201 This provision may be beneficial to a cash basis business debtor such as a lawyer, doctor or accountant with a significant number of trade creditors if the payment of those trade debts would have been deductible under *I.R.C. section 162*. A nonbusiness debtor would look to *I.R.C. section 212* for qualification under this exception.

As discussed earlier, n202 it is not clear whether *I.R.C. section 108(e)(2)* applies at the partnership or the partner level. If *I.R.C. section 108(e)(2)* applies at the partner level, one must treat the liability as held by the partners. The method for allocating the liability is not clear. Possibilities include the ratio established by the partnership agreement for allocating profits, the ratio established by the partnership agreement for allocating losses, or the formula for distributing assets on liquidation of the partnership. n203 "One resolution, which is by far the most beneficial to the partners, is to allocate the asset basis in proportion to the allocation of the income from the discharge of indebtedness." n204

Another unresolved question is whether *I.R.C. section 108(e)(2)* applies to accrual method taxpayers. *I.R.C. section 108(e)(2)* refers to liabilities the "payment" of which would have given rise to a deduction, thus suggesting that this exception applies only to cash method taxpayers. Does *I.R.C. section 108(e)(2)* also apply to accrual method taxpayers in certain circumstances? To answer this question, one must first understand the interaction between *I.R.C. section 108* and the tax benefit rule as codified in *I.R.C. section 111*, illustrated by the following example. In 1989, an accrual method taxpayer engaged in a trade or business accrues but does not pay \$1,000 of interest on indebtedness owed by the taxpayer to a creditor. In 1990, the creditor forgives both the underlying indebtedness and the \$1,000 of interest. If the taxpayer is insolvent or in a title 11 case, *I.R.C. section 108(a)* will permit the taxpayer to exclude the discharge of indebtedness income generated by the forgiveness of the principal amount of the debt. As to the \$1,000 of interest, the taxpayer must first apply *I.R.C. section 111(a)* to determine whether the taxpayer can exclude any of the \$1,000 of tax benefit income created by the forgiveness of the interest. To the extent *I.R.C. section 111* does not provide an exclusion, the taxpayer can find relief under *I.R.C. section 108(a)* if the taxpayer is either insolvent or in a title 11 case. n205

If the taxpayer in the example is neither insolvent nor in a title 11 case, does *I.R.C. section 108(e)(2)* offer any relief? The correct answer appears to be no, because the taxpayer has received a tax benefit from the deduction. If so, cancellation of the liability that gave rise to the deduction should result in discharge of indebtedness income, excludible, if at all, under *I.R.C. section 108(a)*, not *I.R.C. section 108(e)(2)*. However, if an accrual method taxpayer did not enjoy a tax benefit from the deduction of an accrued but unpaid liability, cancellation of the liability that gave rise to the deduction should not generate discharge of indebtedness income. n206 Likewise, if the accrual of the deduction was prevented because the "all events" test of economic performance under *I.R.C. section 461(h)* was not satisfied, *I.R.C. section 108(e)(2)* should be available.

If *I.R.C. section 108(e)(2)* applies at the partnership level, cancellation of a liability covered by *I.R.C. section 108(e)(2)* will not generate any discharge of indebtedness income to pass through to the partners. This result creates a potential problem, depending on how subchapter K treats the cancellation of the liability. If the canceled liability is a "liability" for purposes of *I.R.C. section 752(b)*, n207 cancellation of the liability will result in a deemed distribution of money under *I.R.C. section 752(b)*, which will generate taxable gain to the extent the deemed distribution exceeds each partner's outside basis. n208 Because the partnership would have no discharge of indebtedness income to provide the partners with an increase in outside basis equal to the amount of the deemed distribution, partners with low outside bases might have to recognize gain under *I.R.C. section 731(a)*.

How likely is such recognition? The answer depends on the definition of "liability" for purposes of *I.R.C. section 752(b)*. Although the final *I.R.C. section 752* regulations do not define the term "liability," *Revenue Ruling 88-77* n209 provides some insight. The Revenue Ruling explains that the terms "liability of a partnership" and "partnership liabilities" for purposes of *I.R.C. section 752* include an obligation:

only if and to the extent that incurring the liability creates or increases the basis to the partnership of any of the partnership's assets (including cash attributable to borrowings), gives rise to an immediate deduction to the partnership, or, under section 705(a)(2)(B), currently decreases a partner's basis in the partner's partnership interest. n210

Thus, accrued but unpaid expenses of a cash method partnership are not "liabilities of a partnership" or "partnership liabilities" for purposes of *I.R.C. section 752*. Such expenses do not create basis in a partnership asset, do not increase a

partnership's basis in a partnership asset and do not give rise to a deduction for the partnership when incurred. In contrast, under *Revenue Ruling 88-77*, if an accrual method partnership incurs an expense that gives rise to a deduction, the obligation to pay that expense is a "liability of the partnership" or a "partnership liability" for purposes of *I.R.C. section 752(b)*. When the partnership incurs a deductible expense, the partners' outside bases decrease (in the aggregate) by the amount of the partnership deduction n211 and increase (in the aggregate) by the same amount to reflect the partnership's obligation to pay the liability. n212 When the partnership pays the liability, the partners decrease their outside bases (in the aggregate) by the amount of the payment to reflect the elimination of the liability. n213

[c] The Purchase Price Reduction Exception

[i] Overview

An extended discussion of the development and current status of the non-statutory purchase price exception to the *Kirby Lumber* rule is beyond the scope of this chapter. n196 The following brief overview of the non-statutory purchase price exception serves to place the statutory safe harbor, *I.R.C. section 108(e)(5)*, in context.

Courts recognized a distinction between discharge of indebtedness and purchase price reduction existed prior to enactment of *I.R.C. section 108(e)(5)*. For example, in *Hirsch v. Commissioner*, n214 the taxpayer purchased real estate in 1928 for \$29,000, paying \$10,000 in cash and assuming a mortgage debt of \$19,000. In 1936, when the taxpayer had reduced the mortgage debt to \$15,000, the value of the mortgaged property had declined to \$8,000. The taxpayer negotiated with the lender, who agreed to accept \$8,000 in full satisfaction of the mortgage debt. The Seventh Circuit, reversing the Board of Tax Appeals, held that the taxpayer did not have discharge of indebtedness income because the transaction was a reduction of the purchase price. n215 The court concluded that the taxpayer could not determine the income tax consequences of the transaction until the taxpayer disposed of the property. To account for the purchase price reduction, the court ordered the taxpayer to reduce his basis in the property by \$7,000, the amount of the reduction in the purchase price.

Courts created uncertainty about the scope of the exception to the *Kirby Lumber* rule for purchase price adjustments by refusing to apply the exception in some instances. for example, in *Edwards v. Commissioner*, n216 the Tax Court refused to apply the rule in *Hirsch* to a reduction in non-purchase money debt. Similarly, in *Fifth Avenue-Fourteenth Street Corp.*, n217 the Court of Appeals for the Second Circuit held that there was no purchase price adjustment when the taxpayer satisfied its mortgage debt by tendering mortgage certificates it had purchased from the public for less than their face value. After expressing doubt about the existence of a purchase price reduction exception, the court held that if such an exception existed, it could not apply when the debtor obtained the debt reduction without direct negotiation with the lender.

Congress enacted *I.R.C. section 108(e)(5)* to end the uncertainty generated by the case law by establishing objective requirements for the application of this rule. n218 The legislative history of the Bankruptcy Tax Act of 1980 suggests that *I.R.C. section 108(e)(5)* is a safe harbor and that the judicial exception still has vitality. Evidence of this intent appears in the statement that the Senate Finance Committee intended *I.R.C. section 108(e)(5)* to help debtors by eliminating "disagreements between the [IRS] 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." n219 In addition, with respect to the basis reduction rules, the Senate Finance Committee Report explains that "[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." n220 In *Sutphin v. United States*, n221 the United States Claims Court recognized, albeit in dicta, the continued viability of the judicial exception when *I.R.C. section 108(e)(5)* by its terms did not apply. Although the precise contours of the judicial exception are uncertain, the case law demonstrates that the judicial exception is broader than *I.R.C. section 108(e)(5)*. n222

For example, the court in *Hirsch* applied the exception even though the debtor obtained the reduction from a lender that was not the original seller of the property. n223

Further, availability of the judicial exception apparently does not depend on the solvency of the debtor. n224

Revenue Ruling 92-99, the IRS recognized that *I.R.C. section 108(e)(5)* is a safe harbor and that a nonstatutory purchase price exception still exists. n225 Although the IRS apparently views that exception narrowly, n226 *Revenue Ruling 92-99* addresses only one aspect of the scope of that exception. The Ruling focuses on the tax consequences to a debtor when a third party lender reduces the principal amount of undersecured nonrecourse debt.

The taxpayer in *Revenue Ruling 92-99* purchased an office building from another individual in 1988 for \$1,000,000, its fair market value. To pay for the building, the purchaser signed a note payable to a third party lender for \$1,000,000. n227 The note bore interest at a fixed market rate payable annually and was secured by the building. In 1989, the building had declined in value to \$800,000, but the purchaser had not paid any of the \$1,000,000 principal amount of the debt. The third party lender agreed to modify the note's terms by reducing the principal amount to \$800,000.

The IRS first explained that, on these facts, the purchaser could not exclude any discharge of indebtedness income under *I.R.C. section 108(a)* because the discharge did not occur in a title 11 case, the purchaser was not insolvent and the debt was not "qualified farm indebtedness." The IRS then noted that the purchaser could not treat the debt reduction as a purchase price adjustment under *I.R.C. section 108(e)(5)* because the debt was not a debt of the purchaser "to the seller." Thus, the question was whether the purchaser could treat the debt reduction as a purchase price adjustment under a nonstatutory purchase price adjustment exception to the *Kirby Lumber* rule.

The Revenue Ruling takes the position that if a third party lender reduces the principal amount of an undersecured nonrecourse debt related to the purchase of property, the debtor may treat the debt reduction as a purchase price adjustment only to the extent that the lender based the reduction "on an infirmity that clearly relates back to the original sale," such as the seller's inducement of a higher price by misrepresenting a material fact or by fraud. The IRS will not treat any other debt reduction by a third-party lender as a purchase price adjustment. n228

The IRS relied on *Fifth Avenue-Fourteenth Street Corp. v. Commissioner*, n229 in which the court stated that a purchase price adjustment exists only if the seller-mortgagee agreed to the debt reduction. The IRS announced that generally it will not follow cases permitting a purchase price adjustment by third party lenders, such as *Hirsch*, and *Allen v. Courts*. n230

An agreement to reduce a debt between a purchaser and a third-party lender is not a true adjustment of the purchase price paid for the property because the seller has received the entire purchase price from the purchaser and is not a party to the debt reduction agreement. The debt reduction relates solely to the debt and results in discharge of indebtedness income to the debtor. n231

According to the IRS, *Hirsch* and *Allen* relied on *Bowers v. Kerbaugh-Empire Co.* n232 to conclude that no discharge of indebtedness income resulted from a reduction of third party debt. These cases reasoned that the proceeds of third party debt should be traced to the investment for which the debtor used the proceeds, and the debtor could use any loss (realized or unrealized) on that investment to offset any discharge of indebtedness income.

However, the IRS asserts, subsequent Supreme Court decisions and other court cases, when viewed together, have discredited *Kerbaugh-Empire*. n233 The Revenue Ruling notes that the Ninth Circuit in *Vukasovich v. Commissioner* n234 stated that *Kerbaugh-Empire* was inconsistent with the later judicial decisions cited in the Revenue Ruling. Thus, when a debtor has an accession to wealth resulting from the discharge of indebtedness that is otherwise includible in gross income, *Kerbaugh-Empire* does not prevent the taxation of that income.

Revenue Ruling 92-99 leaves a number of questions about the scope of the nonstatutory purchase price adjustment exception. For example, is the exception available to a purchaser who buys the property from the original purchaser? Suppose Paula purchases property from Silas, who takes back a mortgage on the property to cover payment of a portion of the purchase price. Subsequently, Paula sells the property to Peter, subject to the mortgage debt owed to Silas. If Silas then agrees to reduce the principal balance of the debt, does the nonstatutory purchase price adjustment exception protect Peter? Apparently, the IRS would answer "no." n235 What would the result be if Paula becomes a partner in a partnership and contributes the property to the partnership subject to the mortgage, after which Silas agrees to reduce the principal balance of the debt? Again, the answer is unclear, but may depend on the size of Paula's interest in the partnership. n236

I.R.C. section 108(e)(5) provides that, in certain instances, the reduction of a purchase money debt will not be subject to the discharge of indebtedness rules. n237 The debt must be a purchase money debt owed by the purchaser of the property to the seller of the property. n238 The reduction must not occur in a title 11 case or when the purchaser is insolvent. Finally, the amount of the reduction must otherwise qualify as discharge of indebtedness income. n239 For example, suppose a taxpayer purchases property and the seller of the property provides financing for the purchase price. Subsequently, the seller reduces the amount of the purchase money debt. At the time of the reduction, the taxpayer was neither insolvent nor in a title 11 case. *I.R.C. section 108(e)(5)* will treat the reduction as a purchase price adjustment and not as discharge of indebtedness income. n240 Thus, the taxpayer will reduce basis in the property in an amount equal to the amount of the purchase price reduction. n241 Note that *I.R.C. section 108(e)(5)* is not elective. If a transaction satisfies the statutory requirements, *I.R.C. section 108(e)(5)* applies.

[iii] Application of I.R.C. section 108(e)(5) Safe Harbor in the Partnership Context

Application of *I.R.C. section 108(e)(5)* in the partnership context raises several questions, perhaps the most important of which is whether *I.R.C. section 108(e)(5)* applies at the partnership or the partner level. If *I.R.C. section 108(e)(5)* applies at the partnership level, a partnership that obtains a purchase price reduction covered by that provision will have no discharge of indebtedness income to pass through to the partners. Thus, the partners will not have to rely on *I.R.C. section 108(a)* to exclude discharge of indebtedness income and will not have to reduce their tax attributes under *I.R.C. section 108(b)*. n242

Although no reported decisions have addressed this problem to date, the IRS has issued a Technical Advice Memorandum in effect concluding that *I.R.C. section 108(e)(5)* applies at the partnership level. n243 The Technical Advice Memorandum considers the following facts. A general partnership purchased a single asset, an office building, under an installment contract with the seller. The contract provided that the partnership could, by paying the seller a certain sum, reduce the principal amount owed under the contract to an amount equal to what the seller owed on two mortgage notes secured by the building. The partnership took advantage of this opportunity and treated the reduction in its debt as a purchase price adjustment under *I.R.C. section 108(e)(5)*.

On audit of the partnership return, the IRS agent requested technical advice on whether the transaction was a discharge of partnership indebtedness generating discharge of indebtedness income at the partnership level. If so, the agent asked whether *I.R.C. section 108(d)(6)* required determination of the excludability of such income be made at the partner level.

The Technical Advice Memorandum discusses both *I.R.C. sections 108(d)(6)* and *108(e)(5)*, noting that different purposes motivated Congress to enact those two sections. *I.R.C. section 108(d)(6)* addresses the problem of conversion of ordinary discharge of indebtedness income into capital gain. n244 In contrast, *I.R.C. section 108(e)(5)* addresses the problem of when a purchase price adjustment will produce discharge of indebtedness income. The Technical Advice Memorandum holds that the transaction described was a reduction of purchase price covered by *I.R.C. section 108(e)(5)*. As a result, the partnership realized no discharge of indebtedness income. Because the partnership realized no discharge of indebtedness income, the Technical Advice Memorandum concludes there was no need to apply *I.R.C.*

section 108(d)(6).

Note that the application of *I.R.C. section 108(e)(5)* at the partnership level produces anomalous results. By providing that *I.R.C. section 108(e)(5)* will not apply if the debtor is in a title 11 case or insolvent, Congress expressed a preference that the general rules of *I.R.C. section 108(a)* should prevail over the purchase price reduction rule. n245 However, if an insolvent partnership with solvent partners obtains a reduction in the seller financing, neither *I.R.C. section 108(e)(5)* nor *I.R.C. section 108(a)* will apply under current law.

Fortunately, the IRS has provided relief from this anomalous result in *Revenue Procedure 92-92*. n246 This Revenue Procedure provides that if a partnership is either insolvent or is a debtor in a title 11 case, the IRS will not challenge the partnership's treatment of a reduction (in whole or in part) of a debt owed 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)* but for the bankruptcy or insolvency. n247 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. Thus, for a partnership that is either insolvent or a debtor in a title 11 case to benefit from *Revenue Procedure 92-92*, all of the partners must characterize the debt reduction as a purchase price adjustment.

Because *I.R.C. section 108(e)(5)* applies only if the partnership is solvent, an obvious question is how to determine whether a partnership is solvent. For purposes of *I.R.C. section 108*, the term "insolvent" means that a person's liabilities exceed the fair market value of the person's assets immediately before a discharge of indebtedness. n248 In many instances, application of this rule is relatively straightforward. However, in certain instances the application of the rule requires additional consideration. For example, suppose a partnership has property with a fair market value of \$500,000, subject to a nonrecourse purchase money mortgage with an outstanding principal balance of \$550,000. The partnership also has an unencumbered asset with a fair market value of \$20,000. Is the partnership insolvent? The answer depends on whether the partnership should take the nonrecourse purchase money mortgage into account only to the extent of the fair market value of the encumbered property. If so, the partnership is solvent because the fair market value of the partnership's assets (\$520,000) exceeds the partnership's liabilities (\$500,000). If not, the partnership is insolvent. Under present law, the answer appears relatively clear. *Commissioner v. Tufts* n249 accepts the argument that nonrecourse debt is true debt. n250 *Tufts* thus suggests that the partnership must count the full amount of the partnership's purchase money nonrecourse debt in determining whether it is solvent for purposes of *I.R.C. section 108(e)(5)*.

A related question is whether a partnership is insolvent if it has at least one solvent general partner or guarantor from whom partnership creditors can collect debts of the partnership that the partnership cannot satisfy. The answer to this question is not clear. The Court of Appeals for the Second Circuit, in a case not involving a purchase price reduction and decided under the law prior to the Bankruptcy Tax Act of 1980, considered the partners' personal liability for the debts of the partnership and the solvency of the general partners in determining whether a partnership was insolvent. n251 The answer may depend on whether the debt is recourse or nonrecourse. Partnership creditors presumably cannot recover anything from partners based on the unpaid nonrecourse debt of the partnership.

If a partnership that wants the benefit of *I.R.C. section 108(e)(5)* is insolvent, can the partners eliminate the insolvency by making contributions to capital? An attempt to render the partnership solvent momentarily for purposes of taking advantage of *I.R.C. section 108(e)(5)* by contributing capital and then almost immediately withdrawing the capital contributions for no independent business reason should fail as a sham transaction. However, a bona fide contribution to capital that renders the partnership solvent should qualify the partnership for *I.R.C. section 108(e)(5)*, provided the purchase price reduction otherwise meets the requirements of *I.R.C. section 108(e)(5)*. n252

If a partnership is insolvent but all of its partners are solvent, can the partnership permit its partners to use *I.R.C. section 108(e)(5)* by distributing the encumbered property to the partners? The partners would negotiate the reduction in purchase price after distribution. Even if the distribution survived a *Court Holding* n253 analysis, *I.R.C. section*

108(e)(5) would not apply because only the original purchaser of the property is eligible for *I.R.C. section 108(e)(5)* protection. In this instance, only the partnership, as original purchaser, could use *I.R.C. section 108(e)(5)*. n254 Although the Uniform Partnership Act n255 treats partners as tenants in partnership with respect to partnership property, that interest is not substantial enough to treat the partners as original purchasers of the encumbered property. n256

If a partnership obtains a reduction in purchase money indebtedness while insolvent or in a title 11 case and if no non-statutory purchase price reduction exception to the *Kirby Lumber* rule applies, n257 the partnership will recognize discharge of indebtedness income. That income will pass through to the partners, who must report the income unless *I.R.C. section 108(a)* applies. If a partner who receives such income is insolvent, *I.R.C. section 108(a)(1)(B)* will protect the partner to the extent of the partner's insolvency. *I.R.C. section 108(a)(1)(A)*, the exception for a person in a title 11 case, would not apply because the discharge of indebtedness occurred as a result of a negotiated reduction of the purchase price, not as a result of an order of the court or pursuant to a plan approved by the court. n258

As noted earlier, although *I.R.C. section 108(e)(5)* does not explicitly require the debtor to reduce the basis of the property encumbered by the purchase money debt, the debtor must make such an adjustment. If the debtor is a partnership, the partnership must reduce the basis of the encumbered partnership property ("inside basis"). The partners must reduce their bases in their partnership interests ("outside bases") pursuant to *I.R.C. sections 752(b)* and 733. If the purchase money debt is nonrecourse debt, the reduction of that debt may trigger a minimum gain chargeback.

[d] Equity for Debt Exception for Partnerships

In 1993, Congress amended *I.R.C. Section 108(e)(8)* to eliminate the judicially created stock for debt exception. n259 The 1993 legislation provided that a corporation that issues its stock in satisfaction of its debt is treated as if it satisfied the debt with an amount of money equal to the fair market value of the stock. n260 The 1993 legislation did not address the question of whether a partnership equity for debt exception existed. However, in 2004, as part of the American Jobs Creation Act, n261 Congress amended *I.R.C. Section 108(e)(8)* to provide an equivalent rule for partnership equity for debt exchanges. n261a This amendment, which is prospective only, became effective on October 22, 2004. n260b

In 2008, Treasury issued Proposed Regulations under *I.R.C. Section 108(e)(8)* relating to partnership equity for debt exchanges. n261c The Proposed Regulations would add new section 1.108-8, dealing with valuation of a partnership interest transferred in satisfaction of partnership debt, and new section 1.721-1(d), dealing with application of *I.R.C. Section 721* to partnership debt for equity exchanges.

I.R.C. Section 108(e)(8) refers to the "fair market value" of the partnership equity interest transferred in satisfaction of the partnership debt. Proposed Regulation section 1.108-8 in effect creates a safe harbor valuation rule, under which the creditor and the debtor partnership can treat the liquidation value of the partnership interest as the fair market value of the interest. n261d To fit within the safe harbor, the following requirements must be satisfied:

1. The debtor partnership must determine and maintain capital accounts of its partners in accordance with the capital accounting rules of *Treasury Regulation section 1.704-1(b)(2)(iv)*; n261e
2. The creditor, debtor partnership, and its partners must treat the fair market value of the indebtedness as being equal to the liquidation value of the debt for equity interest for purposes of determining the tax consequences of the debt-for-equity exchange; n261f
3. The debt for equity exchange must be an arm's-length transaction; n261g and
4. Subsequent to the debt for equity exchange, the partnership must not redeem and no person related to the partnership must purchase the debt for equity interest "as part of a plan at the time of the

debt-for-equity exchange which has as a principal purpose the avoidance of COD income by the partnership." n261h

The Proposed Regulations employ a constructive liquidation approach to determine liquidation value. Liquidation value equals the amount of cash that the creditor would receive with respect to the debt for equity interest if, immediately after the transfer, the partnership sold all of its assets (including goodwill, going concern value, and any other intangibles associated with the partnership's operations) for cash equal to the fair market value of those assets, and then liquidated. n261i

The Proposed Regulations provide the following example of the operation of the safe harbor:

(i) AB partnership has \$1,000 of outstanding indebtedness owed to C. In an arm's-length transaction, C agrees to cancel the \$1,000 indebtedness in exchange (debt-for-equity exchange) for an interest (debt-for-equity interest) in AB. AB's partnership agreement provides that its partners' capital accounts will be determined and maintained in accordance with the capital accounting rules in § 1.704-1(b)(2)(iv). The fair market value of the \$1,000 indebtedness is \$700 at the time of the debt-for-equity exchange. Under § 1.704-1(b)(2)(iv)(b), C's capital account is increased by \$700 as a result of the debt-for-equity exchange. This amount equals the liquidation value of C's debt-for-equity interest, which is the amount of cash that C would receive with respect to that interest if AB partnership sold all of its assets for cash equal to the fair market value of those assets and then liquidated. C, AB partnership, and its partners treat the fair market value of the indebtedness as being equal to the liquidation value of C's debt-for-equity interest (\$700) for purposes of determining the tax consequences of the debt-for-equity exchange. Subsequent to the debt-for-equity exchange, neither AB partnership redeems nor any person related to AB partnership purchases C's debt-for-equity interest as part of a plan at the time of the debt-for-equity exchange which has as a principal purpose the avoidance of COD income by AB partnership.

(ii) Because the requirements in paragraph (b)(1) of this section are satisfied, the fair market value of C's debt-for-equity interest in AB partnership for purposes of determining AB partnership's COD income is the liquidation value of C's debt-for-equity interest, or \$700. Accordingly, AB partnership is treated as satisfying the \$1,000 indebtedness with \$700 under section 108(e)(8). n261j

The Proposed Regulations under *I.R.C. Section 721(a)* n261k provide that when there is a partnership debt for equity exchange, in general, *I.R.C. Section 721(a)*

should apply to the creditor's contribution of partnership indebtedness (other than unpaid interest or accrued original issue discount) to the partnership in exchange for the partnership interest. Such a rule is consistent with the policies underlying section 721 to defer the recognition of gain or loss where persons join together to conduct joint business (including investment). n261l

Note that the Proposed Regulations provide that *I.R.C. Section 721(a)* does not apply to the transfer of a partnership interest to a creditor in satisfaction of a partnership's indebtedness for unpaid rent, royalties, or interest on indebtedness (including accrued original issue discount). n261m Similarly, the Proposed Regulations would not supersede the rules under *I.R.C. Section 453B* relating to dispositions of installment obligations. n261n

The Preamble to the Proposed *I.R.C. Section 721(a)* Regulations explains that because *I.R.C. Section 721(a)* would apply to a partnership debt for equity exchange, *I.R.C. Section 722* would determine the creditor's outside basis. n261o At the time of the drafting of these Proposed Regulations, the Internal Revenue Service and Treasury had concluded

that a creditor should not recognize a loss in a debt-for-equity exchange subject to section 721 in which the liquidation value of the debt-for-equity interest is less than the outstanding principal balance of the indebtedness. Rather, the creditor's basis in the debt-for-equity interest received in the debt-for-equity exchange that is subject to section 721 will be increased by the adjusted basis of the indebtedness. n261p

The Preamble also notes that the creditor should determine its holding period in the partnership equity interest under *I.R.C. Section 1223(1)*. n261q

As noted above, the 2004 amendment to *I.R.C. Section 108(e)(8)* was prospective only. In addition, the legislative history of the 2004 amendment makes it clear that "no inference is intended as to the treatment under present law of the transfer of a partnership interest in satisfaction of partnership debt." n261r Thus, for situations to which the 2004 amendment does not apply, the question is whether there was a partnership equity for debt exception. Prior to the effective date of the 2004 amendment to *I.R.C. Section 108(e)(8)*, *I.R.C.* did not explicitly recognize a partnership equity for debt exception. The following material discusses the existence of such an exception prior to the 2004 amendment and examines the collateral federal income tax consequences of the pre-amendment exception. n261s

Prior to the 2004 Amendment, there was sufficient authority to support the existence of a partnership equity for debt exception to the *Kirby Lumber* rule. n262 The first question is whether the exception existed by reason of the principles of *Capento Securities Corp. v. Commissioner* n264 and similar cases addressing a corporate stock for debt exception or by reason of *I.R.C. section 721*.

[i] Rationale of *Capento Securities* as the Basis for the Pre-2004 Amendment Partnership Equity for Debt Exception

The reported judicial decisions on equity for debt exchanges all involve corporations rather than partnerships. n265 This judicially created exception to the *Kirby Lumber* rule applied regardless of whether the debt constituted a "security" for tax purposes, the creditor was previously a shareholder, or the stock issued was worth less than the face amount of the debt satisfied. n266 As the IRS n267 and commentators n268 have explained, *Capento Securities Corp. v. Commissioner* n269 first articulated this exception. In *Capento Securities*, a corporation exchanged 5,000 shares of \$100 par preferred stock worth \$50,000 n270 for \$500,000 of the corporation's debt. The Commissioner argued that the corporation realized \$450,000 of discharge of indebtedness income as a result of the exchange. The Board of Tax Appeals rejected the Commissioner's argument, identifying two theories to support a stock for debt exception to the *Kirby Lumber* rule: the "subscription price" theory and the "substitution of liability" theory.

Regarding the "subscription price" theory, the Board noted the transfer of the bond to the debtor corporation is the equivalent of payment of the subscription price for the stock. Thus, the predecessor of *I.R.C. section 1032*, which provided that a corporation does not recognize gain or loss on transactions in its own stock, applied and the corporation had no income. This conclusion "would seem no less true when the subscription price, instead of being newly paid, is the amount which has already been paid in as the principal of a bond loan." n271

As to the "substitution of liability" theory, the Board stated that, when the corporation canceled the \$500,000 in bonds, it created a new balance sheet liability called capital stock. According to the Board, the substitution of a capital stock liability for a bonded indebtedness is not a realization event because the substitution does not free the corporation's assets. Because par value measures capital stock liability, the corporation had merely substituted \$500,000 par value of preferred stock for \$500,000 of debt. "While the bond loan has been terminated, the amount borrowed is now committed to capital stock liability instead of to the liability of a fixed indebtedness." n272 Reported judicial decisions after *Capento Securities* appear to rely only on the "substitution of liability" theory. n273

The legislative history of former *I.R.C. section 108(e)(10)* suggests that Congress believed the judicially created equity

for debt exception applied to partnerships as well as to corporations. The House version of what became the Bankruptcy Tax Act of 1980 would have allowed an exception only for exchange of stock for outstanding "securities," which the House Bill defined as debt that met the *I.R.C. section 354* definition of "securities" *and* either (1) was in registered form or (2) had interest coupons. n274 The Ways and Means Committee Report explained that "[s]imilar rules apply in the case of discharge of partnership indebtedness if an equity interest in the partnership is exchanged for a partnership debt" n275 One can infer from this explanation that the Ways and Means Committee believed that the judicial equity for debt exception applied to partnerships. n276

The Senate Finance Committee Report contains no similar reference to partnerships because the Senate version of the bill, like the final version of Bankruptcy Tax Act of 1980, retained the equity for debt exception. n277 Like the Act, the Senate bill provided that the stock for debt exception would not apply if the corporation issued only a "nominal or token" amount of stock for its debt or if the corporation issued stock on a non-*pro rata* basis. Although the Senate Report does not discuss a partnership equity for debt exception, that fact is equivocal and should not, by itself, establish that the Bankruptcy Tax Act of 1980 retained the equity for debt exception only for corporations. n278 Indeed, taken in its entirety, the legislative history of the Bankruptcy Tax Act of 1980 suggests that Congress recognized the continued existence of the judicial equity for debt rule first articulated in *Capento Securities*.

The rationale of *Capento Securities* is that, rather than discharging a portion of the debt, the creditor has transformed the debt into an equity investment, the amount of which equals the outstanding principal amount of the debt on the date of the transformation. Thus, if a partnership exchanged an interest in the partnership for its outstanding debt, the partnership books will reflect termination of the debt and substitution of a partnership interest equal the outstanding principal amount of the debt on the date of the exchange. The creditor who agrees to such an exchange gambles that the partnership's business will prosper, permitting the creditor to obtain full payment of the former debt either through distributions or appreciation in the value of the partnership interest or both.

Note, however, that the partnership situation and the corporation situation are not identical. The creditor of a corporation who exchanges corporate debt for corporate stock is not giving up any claim against the shareholders. In contrast, the creditor of a partnership who exchanges partnership debt for a partnership interest is giving up a claim against the partners. Of course, the creditor retains a claim against the partnership, which should be sufficient for the "substitution" rationale to apply. n279

[iii] I.R.C. section 721 as the Basis for the Pre-2004 Partnership Equity for Debt Exception

I.R.C. section 721(a) provides that a partnership will not recognize gain or loss when it receives "property" in exchange for an interest in the partnership. The term "property" for this purpose includes money. n280 Thus, arguably, a contribution of a partnership's debt to the partnership should receive the same treatment accorded a contribution of cash to the partnership in exchange for a partnership interest. "Whether the cancellation of a partnership debt in exchange for a partnership interest falls within the purview of the *I.R.C. section 721* nonrecognition provision should depend upon the nature of the transaction giving rise to the debt." n281 If a partner converts a loan to the partnership into a capital interest in the partnership, *I.R.C. section 721* should apply because it would have applied to a direct contribution of cash. n282 In contrast, if a third party who provided services to a partnership acquires an interest in the partnership by canceling partnership indebtedness related to the services, *I.R.C. section 721* should not apply because *I.R.C. section 721* would not have applied to a direct exchange of services for a partnership interest. n283

Notwithstanding these arguments, two significant questions undermine the use of *I.R.C. section 721* as a basis for the pre-2004 amendment partnership equity for debt exception. First, *I.R.C. section 721* protects the partnership (and its partners) from recognition of "gain or loss." Thus, it is not clear that the language of *I.R.C. section 721* covers discharge of indebtedness income. Second, when a partner transfers "property" to a partnership, the partnership retains the property for use by the partnership. In contrast, when a creditor transfers a partnership debt to a partnership, the debt disappears. These questions suggest that the *Capento Securities* rationale is a better basis than *I.R.C. section 721* for the

pre-2004 amendment partnership equity for debt exception.

[iii] Limitations on the Pre-2004 Amendment Partnership Equity for Debt Exception

If the pre-2004 Amendment partnership equity for debt exception exists by reason of the principles of *Capento Securities*, do any of the limitations imposed by *I.R.C. section 108* apply to the exception? Without legislative authority, Treasury and the IRS have no basis on which to write legislative rules engrafting the limitations in *I.R.C. section 108* on a partnership equity for debt exception. This view, in addition to being consistent with the clear language of the statute, is consistent with its legislative history. As part of its deliberations leading to the Bankruptcy Tax Act of 1980, Congress considered a provision authorizing Treasury to apply limitations similar to those in former *I.R.C. section 108(e)(10)* to partnerships, but rejected that provision. When what is now *I.R.C. section 108(e)(10)* appeared again as part of the Tax Reform Act of 1984, the partnership language was not a part of it.

[iv] Subchapter K Consequences of the Pre-2004 Amendment Partnership Equity for Debt Exception

[A] The Creditor's Capital Account

On a contribution to a partnership of debt of the partnership, do the regulations under *I.R.C. section 704(b)* require that the creditor's capital account be credited with the adjusted issue price of the debt canceled or its fair market value? Although one could interpret the regulations under *I.R.C. section 704(b)* to require either result, the better reading of the regulations requires that the creditor's capital account be credited with the fair market value of the debt. The regulations permit the partnership to adjust the capital accounts of its partners on the admission of a creditor as a partner. n284 If the partnership property has declined in value, these regulations contemplate a downward adjustment in the capital accounts of the existing partners. This adjustment suggests that the creditor should have an opening capital account equal to the fair market value of its interest in the partnership. Further, if one treats the contribution of the debt as a contribution of property, then the regulations seem to require a capital account equal to the fair market value of the debt contributed.

If the *I.R.C. section 704(b)* regulations require crediting the creditor's capital account with the fair market value of the debt, how is the fair market value of the debt determined? Unless there is clear evidence that the parties are not negotiating at arm's length, the agreement of the creditor and the other partners fixing the fair market value of the debt should control.

[B] I.R.C. section 752(b)

Under pre-2004 Amendment law, if a partnership qualifies for the equity for debt exception, the partnership does not recognize any discharge of indebtedness income when a creditor contributes partnership debt in exchange for a partnership interest. As a result, no discharge of indebtedness income flows through to the partners and the partners receive no corresponding upward adjustment of their bases in their partnership interests. However, the creditor's contribution of the debt eliminates the partnership debt, reducing the partners' shares of the liabilities of the partnership and triggering a deemed distribution of money from the partnership to the partners. n285 The deemed distribution reduces the partner's basis in the partner's partnership interest (outside basis). n286 To the extent the deemed distribution exceeds a partner's outside basis, the partner must recognize gain. n287 The following example illustrates the application of *I.R.C. section 752(b)* to an exchange of partnership equity for partnership debt.

Example 18

Assume that, prior to October 22, 2004, the effective date of the 2004 amendment, A B Partnership holds real property with an adjusted basis of \$500,000, subject to nonrecourse debt of \$1,000,000 owed to Creditor. The Partnership maintains capital accounts for A and B in accordance with the regulations under *I.R.C. section 704(b)*. A and B each have an adjusted basis in their respective partnership interests of \$250,000 and each have a negative balance of \$250,000 in their respective capital accounts. As part of

a workout that occurs prior to October 22, 2004, the effective date of the 2004 amendment, Creditor agrees to reduce the principal amount of the nonrecourse debt from \$1,000,000 to \$600,000, in exchange for a 10% interest in the profits of the Partnership. n288 The parties agree that the property has a current value of \$620,000. The parties also agree that Creditor will have an initial capital account of \$20,000, which represents the fair market value of the debt Creditor will discharge. Immediately following this transaction, the Partnership adjusts the value of the real property on its books to \$620,000. n289

Under *I.R.C. section 752(b)*, reduction of the nonrecourse debt from \$1,000,000 to \$600,000 results in a deemed distribution of \$400,000 cash, \$200,000 to A and \$200,000 to B. Of the \$600,000 remaining debt, the partnership must allocate \$100,000 to A and B (\$50,000 each). n290 The partnership must allocate the balance of \$500,000 45% to A (\$225,000), 45% to B (\$225,000) and 10% to Creditor (\$50,000). n291 The allocation of \$50,000 of the debt to Creditor results in an additional deemed distribution under *I.R.C. section 752(b)* of \$50,000, \$25,000 to A and \$25,000 to B. *I.R.C. section 733* requires A and B to reduce their respective partnership bases from \$250,000 to \$25,000 [\$250,000 - \$200,000 - \$25,000]. Because the amount of the deemed distributions did not exceed their respective bases in their partnership interests, neither A nor B must recognize gain under *I.R.C. section 731(a)(1)*.

If the debt involved is nonrecourse debt, a partner willing to do so could, in certain circumstances, limit or avoid recognition of gain under *I.R.C. section 731* by guarantying all or a portion of the remaining nonrecourse debt. n292 The guaranty would increase the partner's individual liabilities, producing a deemed contribution of money by the partner to the partnership under *I.R.C. section 752(a)*. The deemed contribution would, in turn, increase the partner's basis in the partner's partnership interest, offsetting the basis decrease triggered by *I.R.C. section 752(b)*.

[C] Minimum Gain Chargeback

If the debt forgiven by the creditor in exchange for a partnership interest is nonrecourse debt, the forgiveness may also trigger a minimum gain chargeback to the partners under *I.R.C. section 704(b)*. n293 In the preceding example, prior to Creditor's exchange of a portion of the debt for an interest in the Partnership, the Partnership had "partnership minimum gain" of \$500,000 [\$1,000,000 nonrecourse debt--\$500,000 adjusted basis in the real property securing the debt]. n294 After the transaction, the Partnership will have no minimum gain [\$600,000 remaining nonrecourse debt - \$620,000 revised book value of the real property securing the debt]. n295 Thus, the Partnership will have a \$500,000 net decrease in partnership minimum gain for the taxable year in which the transaction occurs.

Generally, if there is a net decrease in partnership minimum gain for a partnership taxable year, the minimum gain chargeback requirement applies. n296 \$120,000 of the net decrease in partnership minimum gain is attributable to the revaluation of the real estate on the Partnership's books. To the extent attributable to such revaluation, the reduction does not trigger a minimum gain chargeback. n297 However, the minimum gain chargeback requirement will apply to the extent of the remaining \$380,000 reduction of partnership minimum gain. n298

[4] I.R.C. Section 108(e)(4); Acquisition of Debt by a "Related Party"

[a] Overview of I.R.C. Section 108(e)(4)

I.R.C. section 108(e)(4) provides that a debtor will realize discharge of indebtedness income, to the extent provided in regulations, n299 if a party related to the debtor acquires an outstanding debt of the debtor from an unrelated creditor. n300 Congress included this provision so a taxpayer could not avoid the general rule of *I.R.C. section 61(a)(12)* by arranging for a related party to acquire the taxpayer's debt for an amount less than face value from an unrelated creditor. n301 To accomplish that purpose, Congress broadly defined the term "related party" as used in *I.R.C. section 108(e)(4)*. n302

Based on the literal language of *I.R.C. section 108(e)(4)*, one might argue that it could not apply until Treasury issued final regulations. However, the IRS takes the position that *I.R.C. section 108(e)(4)* is self-executing, with only the ultimate contours of the provision depending on the final Treasury Regulations issued on December 28, 1992. n303 The IRS argues that *I.R.C. section 108(e)(4)* applies unless the Treasury Regulations provide specific exemptions. *I.R.C. section 108(e)(4)* provides rules for determining who is a related person, so one can make that determination without regulatory guidance. n304 However, the legislative history of *I.R.C. section 108(e)(4)* establishes that Congress contemplated that regulations would address many important issues not directly addressed in the statute. n305

[b] I.R.C. section 108(e)(4) in the Partnership Context

[i] Relationships Covered by I.R.C. section 108(e)(4)

I.R.C. section 108(e)(4) refers to *I.R.C. sections 267(b)* and *707(b)(1)* to define the relationships covered by *I.R.C. section 108(e)(4)*. n306 In the partnership context, *I.R.C. section 108(e)(4)* applies to the following relationships:

1. *Partner/Partnership*: A partner and a partnership are "related persons" if the partner owns more than 50% of the capital interest or the profits interest in the partnership; n307
2. *Partnership/Partnership*: Two partnerships are "related persons" if the same persons own, directly or indirectly, more than 50% of the capital interests or the profits interests in both partnerships; n308
3. *Corporation/Partnership*: A corporation and a partnership are "related persons" if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or the profits interest, in the partnership. n309

Constructive ownership rules apply for purposes of determining each of these relationships. n310 *I.R.C. section 108(e)(4)(B)* provides that, for purposes of applying the constructive ownership rules, an individual's family consists of the individual's spouse, children, grandchildren, parents, and any spouse of the individual's children or grandchildren. For business organizations, *I.R.C. section 108(e)(4)(C)* expands the relationships described in *I.R.C. section 267(b)* to include multiple entities which are treated as a single employer under *I.R.C. section 414(b)* or *(c)*.

[ii] Application of I.R.C. section 108(e)(4) to Acquisition of Partnership's Obligation by a "Related Person"

Suppose a corporation that is related to a partnership within the meaning of *I.R.C. section 267(b)(10)*, n311 or a partner who is a more than 50 percent owner of the capital interests or the profits interests in a partnership, purchases a \$500,000 debt of the partnership from an unrelated person. Assume the debt has a fair market value of \$450,000 on the date of acquisition and the "related person" purchases the debt for \$450,000. Under the *I.R.C. section 108(e)(4)* regulations, n312 which apply to transactions occurring on or after March 21, 1991, the partnership will have \$50,000 of discharge of indebtedness income. n313 However, instead of treating the partnership as if it had acquired and canceled the debt, the proposed regulations treat the partnership as having issued new debt to the "related person" with an issue price equal to the fair market value of the deemed new debt. n314 The excess (if any) of the stated redemption price at maturity of the deemed new debt over the issue price would be original issue discount. n315

[iii] Application of I.R.C. section 108(e)(4) to Acquisition of "Related" Partner's Obligation by the Partnership

If a partnership acquires the debt of a partner who is a "related person," *I.R.C. section 108(e)(4)(A)* will treat the acquisition as if the partner had acquired the debt. As a result, the partner will have discharge of indebtedness income to the extent that the partnership acquired the debt at a discount. The partner's ability to exclude some or all of the discharge of indebtedness income would depend on whether the partner can qualify for one of the exclusions under *I.R.C. section 108(a)(1)*. For purposes of applying the rules governing the reduction of tax attributes, n316 the partner

may elect to treat his or her interest in the partnership as depreciable property to the extent of the partner's proportionate interest in the partnership property. n317 The partnership must make an appropriate corresponding reduction in the partnership's basis in depreciable property with respect to such partner. n318 For transactions occurring after March 20, 1991, the *I.R.C. section 108(e)(4)* regulations treat the partner as having issued new debt to the partnership with an issue price equal to the fair market value of the deemed new debt. n319 The excess of the stated redemption price at maturity of the deemed new debt over its fair market value price would be original issue discount. n320

[5] I.R.C. Section 108(i); Deferral and Ratable Inclusion of Income Arising from Business Indebtedness Discharged by the Reacquisition of a Debt Instrument Before 2011

[a] Overview

I.R.C. Section 108(i), added as part of the American Recovery and Reinvestment Act of 2009, n321 allows a taxpayer who "reacquires" an "applicable debt instrument" and as a result has discharge of indebtedness income to elect to defer reporting the discharge of indebtedness income. If a taxpayer makes an election under *I.R.C. Section 108(i)*, the taxpayer must report the deferred income ratably over a five year period, starting with the taxpayer's fourth or fifth taxable year following the taxable year of the reacquisition. This elective provision offers an alternative to immediate recognition of discharge of indebtedness income and the need to look to *I.R.C. Section 108(a)* for relief. Reporting discharge of indebtedness income ratably over several taxable years may be preferable to paying the price of *I.R.C. Section 108(a)* relief in the form reduction in tax attributes under *I.R.C. Section 108(b)*. *I.R.C. Section 108(i)* will only apply to reacquisitions occurring after December 31, 2008, and before January 1, 2011. n322 The election once made is irrevocable. n323

[i] "Applicable Debt Instrument"

I.R.C. Section 108(i)(3)(A) defines the term "applicable debt instrument" as any debt instrument issued by a C corporation or by any other person in connection with the conduct of a trade or business by that person. The term "debt instrument" means any bond, debenture, note, certificate, or any other instrument or contractual arrangement constituting indebtedness within the meaning of *I.R.C. Section 1275(a)(1)*. n324

[ii] "Reacquisition"

I.R.C. Section 108(i)(4)(A) defines the term "reacquisition" as any acquisition of the debt instrument by the debtor that issued (or is otherwise the obligor under) the debt instrument, or a person related to the debtor under *I.R.C. Section 108(e)(4)*. The term "acquisition" includes an acquisition of the debt instrument for cash or other property, the exchange of the debt instrument for another debt instrument (including an exchange resulting from a modification of the debt instrument), the exchange of the debt instrument for corporate stock or a partnership interest, the contribution of the debt instrument to capital, and the complete forgiveness of the indebtedness by the holder of the debt instrument. n325

[iii] Deferral of Original Issue Discount Deductions

If an electing taxpayer reacquires an "applicable debt instrument" in exchange for a new debt instrument with original issue discount ("OID"), then interest deductions for this OID also are deferred. n326 *Revenue Procedure 2009-37* clarifies that the OID deferral rule applies at the entity level for a partnership. Thus, a partnership or entity treated as a partnership for federal income tax purposes may not deduct currently the OID described in *I.R.C. Section 108(i)(2)(A)(i)*. n327

[b] Acceleration of Reporting of Deferred Discharge of Indebtedness Income and Deferred OID Deductions

I.R.C. Section 108(i)(5)(D), which provides for acceleration of reporting of deferred discharge of indebtedness income and acceleration of reporting of deferred OID deductions, may be a significant trap for the unwary. *I.R.C. Section*

108(i)(5)(D) provides that a taxpayer must take into account any item of income or deduction deferred under *I.R.C. Section 108(i)* in the taxable year in which certain events occur, including "the death of the taxpayer, the liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case), the cessation of business by the taxpayer, or similar circumstances." If the acceleration rule applies, the discharge of indebtedness income (and the OID deductions) "shall be taken into account in the taxable year in which such event occurs (or in the case of a title 11 or similar case, the day before the petition is filed)." The acceleration rule also applies to the sale or exchange or redemption of an interest in a partnership by a partner. n328

[i] Acceleration Events--Death of a Partner

I.R.C. Section 108(i)(5)(D) identifies "the death of the taxpayer" as one of the acceleration events. Exactly how this rule operates when a partner in a partnership that has elected under *I.R.C. Section 108(i)* dies is unclear. *I.R.C. Section 108(i)(5)(D)*

identifies the events that can cause an acceleration of a debtor partnership's deferred COD income: a sale, exchange, or redemption of an interest in the partnership. The death of a partner and the concomitant transfer of his partnership interest are generally not treated as causing a sale or exchange of the decedent's partnership interest. Accordingly, it is unclear whether a partner's death triggers an acceleration of any of the partnership's deferred COD income. Presumably, if any income is accelerated, it is only the share of COD income allocable to the deceased partner. n329

This conclusion is clearly correct and regulations issued under *I.R.C. Section 108(i)* should so provide.

[ii] Acceleration Events--Liquidation or Sale of All or Substantially All of a Partnership's Assets

I.R.C. Section 108(i)(5)(D) provides that "the liquidation or sale of substantially all the assets of the taxpayer (including in a title 11 or similar case)" will trigger acceleration. If the electing taxpayer is a partnership, these events will accelerate the partnership's reporting of deferred discharge of indebtedness income and will accelerate deferred OID deductions. Because the trigger is the sale or exchange of "all or substantially all" of the partnership's assets, some commentators have suggested considering contribution of additional assets to the partnership. n330 Of course, the Service may argue that such a contribution may be disregarded if its only purpose was to avoid the "all or substantially all" test. Thus, any such contribution should have a substantial business purpose other than avoiding *I.R.C. Section 108(i)(5)(D)*.

In general, the reporting under *I.R.C. Section 108(i)(5)(D)* must occur in the taxable year in which the liquidation or sale occurs. However, the statute provides a special rule for liquidations or sales that occur in a title 11 case. In such a case, the acceleration is treated as occurring on the day before the title 11 petition is filed. n331

[iii] Acceleration Events--Sale, Exchange or Redemption of a Partnership Interest

I.R.C. Section 108(i)(5)(D)(ii) provides that the acceleration rule applies to "the sale or exchange or redemption of an interest in a partnership ... or other pass- thru entity by a partner ... or other person holding an ownership interest in such entity." Although Congress probably intended this provision to apply to dispositions of partnership interests, the provision does at least leave open the question of how broadly the "sale or exchange" language would be applied. For example, would this provision apply to a partial redemption under *I.R.C. Section 731(a)*? n332

[c] Partnership Election under I.R.C. Section 108(i)

A taxpayer can make an election under *I.R.C. Section 108(i)* for all or any portion of discharge of indebtedness income realized from the reacquisition of any "applicable debt instrument." A partnership that elects to defer less than all of the discharge of indebtedness income realized from the reacquisition of an "applicable debt instrument" may determine, in

any manner, the portion, if any, of a partner's discharge of indebtedness income amount that is the partner's deferred amount and the portion, if any, of a partner's discharge of indebtedness income amount that is the partner's included amount. n333

If a partnership reacquires an "applicable debt instrument," the partnership, not the partners, must make the election under *I.R.C. Section 108(i)*. n334 Note that *Revenue Procedure 2009-37* permits the partnership to determine on a partner by partner basis whether to defer all, part, or none of each partner's share of discharge of indebtedness income. n335 If a partnership makes such an election, *I.R.C. Section 108(i)(6)* provides the following special rule:

In the case of a partnership, any income deferred under this subsection shall be allocated to the partners in the partnership immediately before the discharge in the manner such amounts would have been included in the distributive shares of such partners under section 704 if such income were recognized at such time. Any decrease in a partner's share of partnership liabilities as a result of such discharge shall not be taken into account for purposes of section 752 at the time of the discharge to the extent it would cause the partner to recognize gain under section 731. Any decrease in partnership liabilities deferred under the preceding sentence shall be taken into account by such partner at the same time, and to the extent remaining in the same amount, as income deferred under this subsection is recognized.

Revenue Procedure 2009-37 provides significant guidance on the application of these special rules:

Allocation of Deferred COD Income on Partnership Indebtedness... . If a partnership elects to defer all or any portion of COD income realized from the reacquisition of an applicable debt instrument, all of the COD income with respect to that debt instrument, without regard to § 108(i), is allocated to the partners in the partnership immediately before the reacquisition in the manner in which the income would be included in the distributive shares of these partners under § 704 and the regulations thereunder, including § 1.704-1(b)(2)(iii). Each partner's share of this COD income is the partner's COD income amount ("COD income amount"). The partner's COD income amount that is deferred under § 108(i) is the partner's deferred amount ("deferred amount"). The partner's COD income amount that is not deferred and is included in the partner's distributive share of partnership income for the taxable year of the partnership in which the reacquisition occurs is the partner's included amount ("included amount").

Partner's Deferred § 752 Amount. A decrease in a partner's share of a partnership liability resulting from the reacquisition of an applicable debt instrument that is not treated as a current distribution of money to the partner under § 752 by reason of § 108(i)(6) is the partner's deferred § 752 amount ("deferred § 752 amount"). A partner's deferred § 752 amount may not exceed the lesser of (i) the partner's deferred amount or (ii) gain that the partner would recognize in the year of reacquisition under § 731 as a result of the reacquisition absent § 108(i)(6). To determine the amount of gain the partner would recognize under clause (ii) of the preceding sentence, the amount of any deemed distribution of money under § 752(b) resulting from the decrease in the partner's share of a reacquired applicable debt instrument that is treated as an advance or draw of money under § 1.731-1(a)(1)(ii) is determined as if no COD income resulting from the reacquisition of the applicable debt instrument is deferred under § 108(i). See *Rev. Rul. 92-97, 1992-2 C.B. 124*, and *Rev. Rul. 94-4, 1994-1 C.B. 195*. A partner's deferred § 752 amount is treated as a distribution of money to the partner under § 752 at the same time, and to the extent remaining in the same amount, as the partner recognizes the COD income deferred under § 108(i). n336

Revenue Procedure 2009-37 establishes the requirements for making an election under *I.R.C. Section 108(i)*. For partnerships, the Revenue Procedure provides that the election must include "a list of partners that have a deferred amount, their identifying information and each partner's deferred amount." n337 The Revenue Procedure also explains

what information an electing partnership must provide to its partners on the K-1 Forms, the requirement that the partnership attach an "election information statement" to each K-1, the responsibility of the partners to provide information to the partnership sufficient to permit the partnership to compute each partner's outside basis and deferred *I.R.C. Section 752* amount, and the partners' responsibility for reporting their individual tax returns. n338 There are also special rules for foreign partnerships that wish to make an election under *I.R.C. Section 108(i)* but that normally are not required to file a Form 1065 n339 and for tiered partnerships. n340

FOOTNOTES:

(n1)Footnote 1. The textual discussion assumes that the partnership has received a discharge of its indebtedness within the meaning of *I.R.C. § 61(a)(12)*. For a discussion of what constitutes a "discharge" of indebtedness in this context, see *P TX6.02[3] supra*.

(n2)Footnote 2. The textual discussion assumes that the partnership obligation was "indebtedness" within the meaning of *I.R.C. § 61(a)(12)*. For a discussion of what constitutes "indebtedness" in this context, see *P TX6.02[2] supra*.

(n3)Footnote 3. *I.R.C. §§ 61(a)(12) and 108*.

(n4)Footnote 4. Subchapter K of the Internal Revenue Code of 1986, *I.R.C. §§ 701-761*.

(n5)Footnote 5. *I.R.C. §§ 1271-1275*.

(n6)Footnote 6. For a general discussion of when a debt is discharged, see *P TX6.02[7][c] supra*. In most instances, the question of whether a partnership has obtained a discharge of indebtedness is easy to answer. However, as *Twenty Mile Joint Venture v. Commissioner*, 200 F.3d 1268 (10th Cir. 1999), *aff'd*, 71 T.C.M. (CCH) 3195 (1996), illustrates, the Internal Revenue Service and the courts may reject the form of transaction. In somewhat simplified form, *Twenty Mile Joint Venture* involved the following fact pattern. A commercial bank had both lent money to and held investment interests in a partnership. The bank negotiated with the partnership to liquidate the bank's partnership interest for a cash payment that was \$ 4.8 million less than the outstanding loan obligation of the partnership to the bank. Although the parties structured the transaction as a \$ 4.8 million "capital contribution" by the bank to the partnership, with reciprocal releases of liabilities between the bank and the partnership, the bank subsequently issued a Form 1099-A to the partnership reflecting a \$ 4.8 million discharge of indebtedness. The partnership reported the discharge of indebtedness income but claimed an offsetting deduction of \$ 4.8 million as a contribution to the capital of the partnership. Both the Tax Court and the Court of Appeals for the Tenth Circuit concluded that, notwithstanding the form of the transaction, the transaction was in substance a discharge of \$4.8 million of indebtedness within the meaning of *I.R.C. § 61(a)(12)*. The Tenth Circuit emphasized that the partnership failed to establish that the transaction was a contribution to capital by the bank in exchange for indemnification from partnership liabilities, because the partnership did not show that the bank was exposed to any partnership liabilities.

(n7)Footnote 7. *I.R.C. § 61(a)(12)*.

(n8)Footnote 8. *I.R.C. § 108(d)(6)* provides that the exclusions in *I.R.C. § 108(a)(1)(A)* (discharge obtained by a taxpayer in a title 11 case), *108(a)(1)(B)* (discharge obtained by an insolvent taxpayer) and *108(a)(1)(C)* (discharge of "qualified farm indebtedness") apply at the partner level, rather than the partnership level. However, a partnership may be able to exclude discharge of indebtedness income under *I.R.C. § 108(e)(2)* (no discharge of indebtedness income to the extent discharged liability would have given rise to deduction) (see *P TX13.03[3][b] infra* or *108(e)(5)* (certain purchase price reductions) (see *P TX13.03[3][c] infra*.) Further, a partnership may be able to avoid discharge of

indebtedness income when it issues an equity interest in the partnership in exchange for partnership debt (*see P TX13.03[3][d] infra*).

(n9)Footnote 9. § 108(d)(6). *I.R.C. § 108(a)* creates four exclusions from gross income:

(a) *I.R.C. § 108(a)(1)(A)* creates an exclusion for discharge of indebtedness income generated by a discharge "in a title 11 case." *I.R.C. § 108(d)(2)* explains that a "title 11 case" is "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."

(b) *I.R.C. § 108(a)(1)(B)* creates an exclusion for discharge of indebtedness income when the taxpayer is "insolvent," but only to the extent of the taxpayer's insolvency. *I.R.C. § 108(a)(3)*. *I.R.C. § 108(d)(3)* defines "insolvency" as "the excess of liabilities over the fair market value of assets." A taxpayer determines insolvency immediately before the discharge.

(c) *I.R.C. § 108(a)(1)(C)* creates an exclusion for discharge of indebtedness income generated by discharge of "qualified farm indebtedness." *I.R.C. § 108(g)* treats a solvent taxpayer who receives such a discharge in the same manner as *I.R.C. § 108(a)(1)(B)* treats an insolvent taxpayer. *I.R.C. § 108(g)(2)* defines the term "qualified farm indebtedness" as debt directly incurred in connection with a farming operation, provided that fifty percent or more of the taxpayer's annual gross receipts for the three taxable years prior to the year of discharge were attributable to the trade or business of farming. *I.R.C. § 108(a)(2)(A)* explains that *I.R.C. § 108(a)(1)(C)* will not apply if the discharge occurs in a title 11 case. *I.R.C. § 108(a)(2)(B)* explains that *I.R.C. § 108(a)(1)(C)* will not apply to the extent a taxpayer is insolvent.

(d) *I.R.C. § 108(a)(1)(D)*, added by Chapter 1 of Title XIII of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, 416-571 (1993) (the "1993 Act"), creates an exclusion for discharge of indebtedness income generated by discharge of "qualified real property business indebtedness" for taxpayers other than C corporations. *I.R.C. § 108(c)*, also added by the 1993 Act, provides the rules governing this exception. *I.R.C. Section 108(c)(3)* defines the term "qualified real property business indebtedness" as indebtedness that satisfies the following requirements: (1) The taxpayer must have incurred or assumed the indebtedness in connection with real property used in a trade or business and the real property must secure the indebtedness; (2) the taxpayer must have incurred or assumed the indebtedness before January 1, 1993, or, if the taxpayer incurred or assumed the indebtedness after that date, the indebtedness must be "qualified acquisition indebtedness;" and (3) the taxpayer must elect to have *I.R.C. Section 108(a)(1)(D)* apply. The term "qualified real property business indebtedness" does not include "qualified farm indebtedness." *I.R.C. § 108(a)(2)(A)* explains that *I.R.C. § 108(a)(1)(D)* will not apply if the discharge occurs in a title 11 case. *I.R.C. § 108(a)(2)(B)* explains that *I.R.C. § 108(a)(1)(D)* will not apply to the extent that a taxpayer is insolvent.

(n10)Footnote 10. S. Rep. No. 1035, 96th Cong. 2d Sess. 21 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised). *But see* discussion of possible partnership level exclusions in *P TX13.03[3] infra*.

(n11)Footnote 11. For a discussion of the rules governing the allocation of items of partnership income, gain, loss, deduction and credit, *see P TX13.02[4][b] supra*.

(n12)Footnote 12. Although *I.R.C. § 469* does not apply to partnerships, it can apply to a partner who is an individual, an estate, a trust, a closely held C corporation or a personal service corporation. *I.R.C. § 469(a)(2)*. Thus,

such a partner's distributive share of partnership discharge of indebtedness income may be income from a passive activity. See *Rev. Rul. 92-92, 1992-2 C.B. 103*, in which the IRS announced that it will treat discharge of indebtedness income as income from a passive activity to the extent that, at the time the indebtedness is discharged, the debt is allocated to passive activity expenditures.

(n13)Footnote 13. *I.R.C. § 108(d)(6)*. For a discussion of the reduction of tax attributes, see *P TX6.03[4] supra*.

(n14)Footnote 14. See *P TX13.02[4][b] supra*.

(n15)Footnote 15. *Treas. Reg. § 1.704-1(b)(1)(i)*.

(n16)Footnote 16. See *Treas. Reg. §§ 1.704-1(b)(2)(iii)(a)* and *1.704-1(b)(5), ex.(5)* (refusing to respect special allocation of taxable interest and dividends to one partner and tax-exempt interest to the other partner in a two person partnership).

(n17)Footnote 17. *Rev. Rul. 92-97, 1992-2 C.B. 124*.

(n18)Footnote 18. For a discussion of the "substantial economic effect" test, see *P TX13.02[4][b][ii][A] supra*.

(n19)Footnote 19. *I.R.C. § 705(a)(1)(A)*.

(n20)Footnote 20. *I.R.C. § 108(d)(6)*.

(n21)Footnote 21. *I.R.C. § 705(a)(2)*.

(n22)Footnote 22. For a discussion of the timing of the allocation of the discharge of indebtedness income under *I.R.C. § 705(a)(1)(A)* and the deemed cash distribution under *I.R.C. § 752(b)*, see *P TX13.03[1][a][iii] infra*.

(n23)Footnote 23. *I.R.C. § 705(a)(1)(A)*.

(n24)Footnote 24. *I.R.C. § 108(d)(6)*.

(n25)Footnote 25. *I.R.C. §§ 752(b)* and *731(a)(1)*.

(n26)Footnote 26. "A partnership liability is a nonrecourse liability to the extent that no partner or related person bears the economic risk of loss for that liability under [*Treas. Reg. § 1.752-2*]." *Treas. Reg. § 1.752-1(a)(2)*. See *P TX13.02[3][e] supra*.

(n27)Footnote 27. For a discussion of "partnership minimum gain," see *P TX13.02[4][b][ii][C] supra*.

(n28)Footnote 28. *Treas. Reg. § 1.704-2(f)(1)*.

(n29)Footnote 29. *Treas. Reg. § 1.704-2(f)(6)*.

(n30)Footnote 30. For a discussion of these rules, see *P TX13.02[4][b][ii] supra*.

(n31)Footnote 31. "Partner nonrecourse debt" is any partnership liability to the extent the liability is nonrecourse and a partner or related person bears the economic risk of loss on the debt. *Treas. Reg. § 1.704-2(b)(4)*. For a discussion of partner nonrecourse debt, see *P TX13.02[4][b][ii][C] supra*.

(n32)Footnote 32. *Treas. Reg. § 1.704-2(i)(4)*.

(n33)Footnote 33. *Treas. Reg. § 1.704-2(i)(1)*.

(n34)Footnote 33a. 1999-2 C.B. 506 .

(n35)Footnote 33b. *Id.*

(n36)Footnote 33c. *Id.*

(n37)Footnote 34. *I.R.C. § 108(d)(6)*.

(n38)Footnote 35. Pub. L. No. 96-589, 94 Stat. 3389 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(a) (Matthew Bender 15th Ed. Revised).

(n39)Footnote 36. S. Rep. No. 1035, 96th Cong., 2d Sess. 21 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised) (emphasis added).

(n40)Footnote 37. Although *I.R.C. § 706(b)* may have diminished the importance of this issue by placing many partnerships on a calendar year, proper resolution of this issue is important for those partnerships still permitted to use a fiscal year.

(n41)Footnote 38. *Rev. Rul. 92-97, 1992-2 C.B. 124* . For a complete discussion of *Rev. Rul. 92-97* , see *P TX13.03[1][a][ii] supra*. See also *Rev. Rul. 94-4, 1994-2 I.R.B. 20* , which holds that:

[a] deemed distribution of money under § 752(b) resulting from a decrease in a partner's share of the liabilities of a partnership is treated as an advance or drawing of money under § 1.731-1(a)(1)(ii) to the extent of the partner's distributive share of income for the partnership year. An amount treated as an advance or drawing of money is taken into account at the end of the partnership taxable year. A deemed distribution of money resulting from a cancellation of debt may qualify for advance or drawing treatment under this revenue ruling and under *Rev. Rul. 92-97* .

Id. at 21.

(n42)Footnote 39. *Rev. Rul. 92-97, 1992-2 C.B. 124, 126* . The principal drafter of *Rev. Rul. 92-97* has acknowledged that the IRS was "stretching a little bit" because the allocation of discharge of indebtedness income is unlike the "classic" advance against a distributive share. Statement of Susan Pace Hamill, Attorney-Advisor, Office of the IRS Chief Counsel, *reproduced in* 92 TNT 235-2 (Nov. 24, 1992) . Note that *Rev. Rul. 92-97* , which involved cancellation of *recourse* debt, does not expressly address the cancellation of *nonrecourse* debt. The principal drafter of *Rev. Rul. 92-97* has expressed the view that the "integral relationship" analysis should apply in the context of a cancellation of nonrecourse debt. *Id.*

(n43)Footnote 40. *I.R.C. § 1398*.

(n44)Footnote 41. Schedule K-1 (Partner's Share of Income, Credits, Deductions, Etc.) to Internal Revenue Service Form 1065 (Partnership Tax Return).

(n45)Footnote 42. For a discussion of why *I.R.C. § 1398(f)(1)* appears to override *I.R.C. § 706(c)(2)(A)*, see *P TX13.04[2][c] infra*. See also Rubin, *Tax Planning for the Debtor in Bankruptcy*, 19 *J. Real Est. Tax'n* 322, 328 (1992).

(n46)Footnote 43. The IRS addressed this issue in *Priv. Ltr. Rul. 9304008 (Oct. 27, 1992)* , concluding that (a) the transfer of a debtor partner's interest in a partnership to the debtor partner's bankruptcy estate does not close the taxable year of the partnership with respect to the debtor partner under *I.R.C. § 706(c)(2)(A)(i)*; and (b) the transfer of the debtor partner's interest in the partnership to the debtor partner's bankruptcy estate is not treated as a change in a partner's interest in the partnership under *I.R.C. § 706(d)*. Therefore, all items of income, gain, loss, deduction or credit of

partnership for the calendar year including the date on which the debtor partner commenced his title 11 case are allocable to the debtor partner's bankruptcy estate. Commentators have also addressed this issue. *Compare Report of the Section 108 Real Estate and Partnership Task Force (Part II)*, 46 *Tax Law* 397, 448-49 (1993) (hereinafter referred to as "Section 108 Task Force Report (Part II)") (concluding that the transfer of the debtor partner's interest in the partnership to the debtor partner's bankruptcy estate is not treated as a change in a partner's interest in the partnership under *I.R.C. § 706(d)*) with Rubin, *Tax Planning for the Debtor in Bankruptcy*, 19 *J. Real Est. Tax'n* 322, 329 (1992) (concluding that *I.R.C. § 706(d)* applies).

(n47)Footnote 44. *Priv. Ltr. Rul.* 9304008 (Oct. 27, 1992) (transfer of debtor partner's interest in partnership to debtor partner's bankruptcy estate not a change in partner's interest in partnership under *I.R.C. § 706(d)*). The *Report of the American Bar Association Section of Taxation Section 108 Real Estate and Partnership Task Force* concludes that *I.R.C. § 1398(f)(1)* overrides *I.R.C. Section 706(d)*. *Section 108 Task Force Report (Part II)*, n.43 *supra* at 448-49. See also P TX2.04[4][b] *supra*.

(n48)Footnote 45. For an argument that *I.R.C. § 1398(f)(1)* does not override *I.R.C. § 706(d)(1)*, see Rubin, *Tax Planning for the Debtor in Bankruptcy*, 19 *J. Real Est. Tax'n* 322, 329 (1992).

(n49)Footnote 46. For a discussion of whether to compute a partner's solvency by taking into account the partnership's assets and liabilities, see P TX13.03[1][b][ii] *infra*.

(n50)Footnote 46a. *I.R.C. §§ 108(a)(1)(D) and 108(c)*. For a discussion of *I.R.C. §§ 108(a)(1)(D) and 108(c)*, see P TX13.03[1][d] *infra*.

(n51)Footnote 46b. *I.R.C. §§ 108(a)(1)(C) and 108(g)*. For a discussion of *I.R.C. §§ 108(a)(1)(C) and 108(b)*, see P TX13.03[1][c] *infra*.

(n52)Footnote 47. *I.R.C. § 704*.

(n53)Footnote 48. Provided, as required by *I.R.C. § 108(d)(2)*, "the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court." For a discussion of the exclusion created by *I.R.C. § 108(a)(1)(A)*, see P TX6.03[3] *supra*.

(n54)Footnote 49. *I.R.C. § 108(b)(1)*.

(n55)Footnote 50. *I.R.C. § 108(b)(2)*. For a discussion of reduction of tax attributes, see P TX6.03[4] *supra*.

(n56)Footnote 51. *I.R.C. § 108(b)(5)*

(n57)Footnote 52. *I.R.C. §§ 108(a)(1)(B) and 108(a)(3)*. If the debt was "qualified farm indebtedness," *I.R.C. § 108(a)(1)(C)* would permit B to exclude some or all of the discharge of indebtedness income not covered by *I.R.C. § 108(a)(1)(B)*. *I.R.C. § 108(a)(2)(B)*.

(n58)Footnote 53. For a full discussion of the definition of "insolvency" in the context of *I.R.C. § 108*, see P TX6.03[3][c][ii] *supra*.

(n59)Footnote 54. *I.R.C. § 108(b)(5)*.

(n60)Footnote 55. Voelker, *Tax Aspects of Real Estate Partnership Debt Restructuring*, 66 *Taxes* 342, 351 (1988) ("Voelker").

(n61)Footnote 56. Voelker, *Tax Aspects of Real Estate Partnership Debt Restructuring*, 66 *Taxes* 342, 351 n.75 (1988).

(n62)Footnote 57. The example assumes that none of the other partners have obligations under the partnership agreement to make capital contributions and that GP has no claim for reimbursement after paying the balance of the recourse debt.

(n63)Footnote 58. Voelker, *Tax Aspects of Real Estate Partnership Debt Restructuring*, 66 *Taxes* 342, 351 n.75 (1988).

(n64)Footnote 58a. Robert C. Livsey, *Determining If a Taxpayer Is Insolvent for Purposes of the COD Income Exclusion*, 76 *J. TAX'N* 224 (1992).

(n65)Footnote 58b. *Id.* at 226.

(n66)Footnote 58c. *Id.*

(n67)Footnote 58d. *Id.*

(n68)Footnote 59. IRS Field Service Advice 1999-877, 1999 TNT 50-29 (March 16, 1999) .

(n69)Footnote 60. Effective for discharges of indebtedness occurring after December 31, 1986, section 822 of the Tax Reform Act of 1986 repealed former *I.R.C. § 108(a)(1)(C)*. That section had provided an exception, i.e., for relief for the discharge of "qualified business indebtedness." *I.R.C. § 108(a)(1)(C) (1982)*, repealed by Tax Reform Act of 1986, Pub. L. No. 99-514, § 822(a), 100 Stat. 2085, 2373 (1986). Congress repealed the exception, because it believed that the prior treatment of the discharge of qualified business indebtedness was "too generous." Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986 547 (Comm. Print 1987). Prior to the 1986 TRA, a solvent business taxpayer could defer income from such a discharge by reducing the basis of depreciable assets, without regard to the taxpayer's current economic ability to pay the tax. Moreover, the solvent taxpayer exception produced disparate results among taxpayers, depending upon the makeup of their depreciable assets. Taxpayers who did not have sufficient amounts of inventory or depreciable assets did not receive the full benefit of deferral under this exception.

(n70)Footnote 61. A person does not have to be insolvent to file a voluntary petition under chapter 7 of title 11 of the United States Code. *See 2 Collier on Bankruptcy, P 109.02* (Matthew Bender 15th Ed. Revised). Thus, a solvent partner could be a debtor in a title 11 case. *See also P TX6.03[3][c][I] n. 51 supra*.

(n71)Footnote 62. *I.R.C. §§ 108(a)(1)(D) and 108(c)*. For a discussion of *I.R.C. §§ 108(a)(1)(D) and 108(c)*, *see P TX13.03[1][d] infra*.

(n72)Footnote 63. *I.R.C. §§ 108(a)(1)(C) and 108(g)*. For a discussion of *I.R.C. §§ 108(a)(1)(C) and 108(b)*, *See P TX13.03[1][c] infra*.

(n73)Footnote 64. *Gracia v. Commissioner*, 87 T.C.M. (CCH) 1423, T.C. Memo 2004-147 (2004) ; *Mirarchi v. Commissioner*, 87 T.C.M. (CCH) 1424, T.C. Memo 2004-148 (2004) ; *Price v. Commissioner*, 87 T.C.M. (CCH) 1426, T.C. Memo 2004-149 (2004) ; and *Estate of Martinez v. Commissioner*, 87 T.C.M. (CCH) 1428, T.C. Memo 2004-150 (2004) .

(n74)Footnote 65. Gracia and Martinez were the partners who were solvent.

(n75)Footnote 66. Price was insolvent at the time of the discharge.

(n76)Footnote 67. The fourth partner was Mararchi.

(n77)Footnote 68. As to Gracia, Martinez and Price, the Internal Revenue Service argued that they were not entitled to rely on *I.R.C. § 108(a)(1)(A)*. As to Price, the Internal Revenue Service calculated the deficiency based on an

insolvency exclusion under *I.R.C. § 108(a)(1)(B)*. As to Mirarchi, the Internal Revenue Service disputed the calculation of the amount of the insolvency, not the entitlement to an insolvency exclusion.

(n78)Footnote 69. S. Rep. No. 1035, 96th Cong., 2d Sess. 9-10 (1980) (emphasis supplied).

(n79)Footnote 70. *Id.* at 21 (emphasis supplied).

(n80)Footnote 71. *See also Yamamoto v. Commissioner*, 60 T.C.M. (CCH) 1050, T.C. Memo 1990-549 (1990), *aff'd in unpublished decision*, 958 F.2d 380 (9th Cir. 1992), 1992 U.S. App. LEXIS 6397 ("The entire structure of section 108, as well as the provision's legislative history makes it plain that the provision operates to provide tax relief to the debtor in bankruptcy and not to the debtor of a debtor in bankruptcy.").

(n81)Footnote 72. S. Rep. No. 1035, 96th Cong., 2d Sess. 9-10 (1980).

(n82)Footnote 73. For a discussion of this election, *see P TX6.03[4][e] supra*.

(n83)Footnote 74. S. Rep. No. 1035, 96th Cong., 2d Sess 21 n.27 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n84)Footnote 75. S. Rep. No. 1035, 96th Cong., 2d Sess 22 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised). The Report does not explain how this reduction in asset basis will affect future depreciation deductions allocated to the partners. One commentator suggests that it seems "equitable to reduce the future depreciation deductions of only the partner who caused the reduction in basis." However, the commentator recognizes that neither the Code nor the regulations require this result. Voelker, *Tax Aspects of Real Estate Partnership Debt Restructuring*, 66 *Taxes* 342, 353 (1988).

(n85)Footnote 76. S. Rep. No. 1035, 96th Cong., 2d Sess 22 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n86)Footnote 77. For a general discussion of *I.R.C. §§ 108(a)(1)(C)* and *108(g)*, *see P TX6.03[3][c][iii] supra*.

(n87)Footnote 78. *I.R.C. § 108(g)(1)(B)* provides that the term "qualified person" has the same meaning given that term by *I.R.C. § 49(a)(1)(D)(iv)*, "except that such term shall include any Federal, State, or local government or agency or instrumentality thereof." *I.R.C. § 49(a)(1)(D)(iv)* defines "qualified person" as:

any person which is actively and regularly engaged in the business of lending money and which is not--(I) a related person with respect to the taxpayer, (II) a person from which the taxpayer acquired the property (or a related person to such person), or (III) a person who receives a fee with respect to the taxpayer's investment in the property (or a related person to such person).

I.R.C. § 49(a)(1)(D)(v) explains that the term "related person" has the meaning given that term by *I.R.C. § 465(b)(3)(C)*, which provides that:

a person (herein after in this paragraph referred to as the "related person") is related to any person if--(i) the related person bears a relationship to such person specified in section 267(b) or section 707(b)(1), or (ii) the related person and such person are engaged in trades or business under common control (within the meaning of subsections (a) and (b) of section 52). For purposes of clause (i), in applying section 267(b) or 707(b)(1), "10 percent" shall be substituted for "50 percent."

I.R.C. §§ 52(a) and *(b)* establish special rules for computing the targeted jobs tax credit for a controlled group of corporations (*I.R.C. § 52(a)*) and for partnerships and proprietorships under common control (*I.R.C. § 52(b)*).

(n88)Footnote 79. As originally enacted, *I.R.C. §§ 108(a)(1)(C) and 108(g)* applied only to farmers who were solvent at the time of the discharge. In effect, the original versions of these provisions treated solvent farmers who obtained discharges of "qualified farm indebtedness" as if they were insolvent:

Limiting the application of the qualified farm indebtedness exclusion to wholly solvent farmers created an anomaly. If a farmer's liabilities exceeded the value of his assets by even a small amount, the farmer could exclude a discharge of indebtedness from gross income only under the bankruptcy or the insolvency exclusion. If the farmer opted for the insolvency exclusion instead of filing for bankruptcy, the farmer could exclude from gross income no more than the difference between the amount of his liabilities and the value of his assets. In contrast, if the value of the farmer's assets exceeded the amount of his liabilities by any amount, the farmer could exclude the entire amount of discharged debt from gross income (provided the debt was qualified farm indebtedness).

Bradford & Murphy, *A Look at the Tax Treatment of Discharges of Indebtedness for Farmers Under TAMRA*, 11 J. Agric. Tax'n & L. 195, 196-197 (1989). The Technical and Miscellaneous Revenue Act of 1988 (TAMRA) eliminated this anomaly. Pub. L. No. 100-647, § 1004, 102 Stat. 3343, 3385-3387 (1988).

(n89)Footnote 80. *I.R.C. § 108(g)(3)(A)(i)*. *I.R.C. § 108(g)(3)(B)* defines the term "adjusted tax attributes" as "the sum of the tax attributes described in subparagraphs (A), (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 (2) to the extent attributable to any passive activity credit carryover." Subparagraphs (A), (B), (C), (D), (F) and (G) of *I.R.C. § 108(b)(2)* describe, respectively, net operating losses, the general business credit, the minimum tax credit, capital loss carryovers, passive activity loss and credit carryovers and foreign tax credit carryovers.

Prior to the amendment of *I.R.C. § 108(g)* by Chapter 1 of Title XIII of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, 416-571 (1993) (the "1993 Act"), *I.R.C. § 108(g)(3)(B)* defined the term "adjusted tax attributes" as "the sum of the tax attributes described in subparagraphs (A), (B), (C), and (E) of subsection (b)(2) determined by taking into account \$3 for each \$1 of the attributes described in subparagraphs (B) and (E) of subsection (b)(2)." Prior to the amendments made by the 1993 Act, subparagraphs (A), (B), (C) and (E) of *I.R.C. § 108(b)(2)* described, respectively, net operating losses, the general business credit, capital loss carryovers and foreign tax credit carryovers.

(n90)Footnote 81. *I.R.C. § 108(g)(3)(A)(ii)*. The taxpayer determines "aggregate adjusted bases" of "qualified property" as of the beginning of the taxable year following the taxable year in which the discharge occurs. *I.R.C. § 108(g)(3)(A)(ii)*. *I.R.C. § 108(g)(3)(C)* defines the term "qualified property" as "any property which is used or is held for use in a trade or business or for the production of income."

(n91)Footnote 82. *I.R.C. § 108(g)(2)(A)*. The legislative history of *I.R.C. § 108* explains that the taxpayer must have incurred the debt "to finance the production of agricultural products (including timber) or livestock in the United States," or the debt must be "farm business debt secured by farmland or farm machinery and equipment used in agricultural production." S. Rep. No. 313, 99th Cong., 2d Sess. 272 (1986).

(n92)Footnote 83. *I.R.C. § 108(g)(2)(B)*.

(n93)Footnote 84. *I.R.C. § 108(b)(1)*. For a discussion of *I.R.C. § 108(b)* and reduction of tax attributes, see *P TX6.03[4] supra*.

(n94)Footnote 85. *I.R.C. § 108(d)(6)*.

(n95)Footnote 86. Uniform Partnership Act § 15(b); Revised Uniform Partnership Act § 306(a).

(n96)Footnote 87. *I.R.C. § 108(g)(2)(A)* (emphasis added).

(n97)Footnote 88. Chapter 1 of Title XIII of the Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, 416-571 (1993).

(n98)Footnote 89. Pub L. No. 103-66, § 13150, 107 Stat. 446-448 (1993).

(n99)Footnote 90. *I.R.C. § 108(c)(1)(A)*. *I.R.C. § 108(c)(1)(B)* provides a cross-reference to *I.R.C. § 1017*, which provides the rules governing basis reduction.

(n100)Footnote 91. Under what circumstances will the Internal Revenue Service treat indebtedness as incurred "in connection with" real property used in a trade or business?

In Technical Advice Memorandum 2000-14-007 (April 7, 2000), the Internal Revenue Service addressed that question in the context of the following facts:

Prior to 1993, Partnership acquired land and constructed improvements on the land using the proceeds of a loan secured by the land and improvements (the Original Loan). Partnership used the land and improvements in its trade or business. The Original Loan was debt "incurred" by Partnership "in connection with" real property used in the partnership's trade or business within the meaning of *I.R.C. Section 108(c)(3)(A)*. Also prior to 1993, Partnership borrowed funds from another lender (the New Loan) and secured by the land and improvements. The amount of the New Loan exceeded Partnership's then existing obligations with respect to the Original Loan. Concurrently with the borrowing, Partnership used a portion of the proceeds of the New Loan to repay its then existing obligations with respect to the Original Loan, pay transaction costs and fees incurred in connection with the New Loan, and establish certain reserves required by the lender. Partnership used the remaining proceeds of the New Loan (the Overborrowing) to make distributions to its partners.

Several years later, after January 1, 1993, the lender canceled a portion of Partnership's obligation to the lender then owed in connection with the New Loan. On its partnership income tax return, Partnership reported cancellation of indebtedness income, in an amount equal to the cancelled portion of the New Loan, attributable to "qualified real property indebtedness." Partnership allocated this amount among its partners, and certain of its eligible partners elected under *I.R.C. Section 108* to exclude their allocable shares of this amount from income.

The Technical Advice Memorandum addressed the question of whether Partnership incurred the New Loan "in connection with" Partnership's business real property within the meaning of *I.R.C. Section 108(c)(3)*. If so, the Memorandum explained, then even the portion of the New Loan proceeds Partnership used to fund distributions to its partners could, assuming all other requirements were satisfied, qualify as "qualified real property business indebtedness" as defined in *I.R.C. Section 108(c)(3)*, and cancellation of such indebtedness could give rise to cancellation of indebtedness income excludible under *I.R.C. Section 108(a)(1)(D)* to the extent of the applicable limitations. Whether the New Loan satisfied "in connection with" requirement is determined as of the time Partnership incurred the New Loan.

The Memorandum notes that, for indebtedness to be "qualified real property business indebtedness," it must have been incurred or assumed prior to 1993, or, if incurred or assumed after 1992, the indebtedness must be "qualified acquisition indebtedness" as defined in *I.R.C. Section 108(c)(4)*.

According to the Memorandum, one must interpret *I.R.C. Sections 108(c)(3)* and *108(c)(4)* so that it is possible for a pre-1993 debt like Partnership's New Loan to satisfy the "in connection with" requirement of *I.R.C. Section*

108(c)(3)(A) without *also* satisfying the definition of "qualified acquisition indebtedness" in *I.R.C. Section 108(c)(4)* applicable to post-1992 debt. A contrary interpretation would eliminate any effective distinction between pre-1993 and post-1992 debt, rendering the *I.R.C. Section 108(c)(4)* "qualified acquisition indebtedness" concept superfluous. By protecting pre-1993 indebtedness from having to satisfy the "qualified acquisition indebtedness" requirement, Congress presumably intended to make it easier for pre-1993 indebtedness to satisfy the definition of "qualified real property business indebtedness." Thus, according to the Memorandum, the question becomes what less restrictive relationship than incurred "to acquire, construct, reconstruct, or substantially improve" such real property (the relationship required in order for a debt to be "qualified acquisition indebtedness") satisfies *I.R.C. Section 108(c)(3)(A)*'s "in connection with" requirement applicable to pre-1993 debt?

The Memorandum argues that the language of *I.R.C. Section 108(c)(3)(A)* requires that the debt be incurred or assumed in connection with qualified real property. Therefore, the nexus of the debt is to the qualified real property, not necessarily to the trade or business. This connection between the debt and the qualified real property must exist when the debt is incurred or assumed. It is the real property, and not the debt, that must satisfy the "used in a trade or business" requirement.

The Memorandum concludes that because the statutorily required connection is between the debt and the qualified real property, it is reasonable to find that pledging the qualified real property as security for the debt when the debt is incurred or assumed constitutes a meaningful connection between the debt and the real property. This interpretation fulfills the statutory requirement. In addition, it preserves a separate meaning for *I.R.C. Section 108(c)(4)*, construes "in connection with" broadly (as suggested by analogous case law), and provides for a less rigorous standard for pre-1993 debt than that which must be met by post-1992 debt.

Therefore, regardless of the fact that Partnership used the proceeds of the New Loan both to refinance the Original Loan and for other purposes bearing a less direct relationship to land and improvements, the fact that the New Loan was secured by the land and improvements satisfied *I.R.C. Section 108(c)(3)(A)*.

(n101)Footnote 92. Because the indebtedness must be "incurred or assumed by the taxpayer in connection with real property *used* in a trade or business", indebtedness secured by a mortgage on unimproved land apparently will not qualify for relief under *I.R.C. § 108(c)*. To determine whether a taxpayer is using real property in a trade or business, the IRS will examine all of the facts and circumstances relating to the use of the real property. Clearly, a garage owned and used by an automobile repair business or a building owned and used by a retail book store qualify as real property used in a trade or business. However, [n]either the statute nor its legislative history offers any guidance on whether leased real estate qualifies as "real property used in a trade or business." Nevertheless, real estate that is leased under an arrangement pursuant to which the lessor must perform significant operation and management services should satisfy this requirement. On the other hand, it is unclear whether real property that is net leased or managed by an independent leasing company will be treated as used by the lessor in a trade or business for this purpose. Pollack, Goldring & Oliver, *Federal Income Tax Consequences of the Discharge of Qualified Real Property Business Indebtedness*, 12 Tax Management R.E.J. 230, 233 (1996) (citations omitted).

(n102)Footnote 93. *I.R.C. § 108(c)(3)(A)* provides that "qualified real property business indebtedness" means indebtedness that "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" (emphasis added). In other words, at the time of the discharge of the "qualified real property business indebtedness", the real property that originally secured the indebtedness must still secure the indebtedness. Thus, if a taxpayer substitutes new real estate as collateral in place of the original real estate that secured "qualified real property business indebtedness" and then obtains a discharge of a portion of the indebtedness, *I.R.C. § 108(c)(3)(A)* will not be satisfied because the original real estate does not secure the indebtedness at the time of the discharge.

(n103)Footnote 94. "Qualified real property business indebtedness" includes debt incurred to refinance "qualified

real property business indebtedness" incurred or assumed before January 1, 1993, but only to the extent the amount refinanced does not exceed the amount of the original "qualified real property business indebtedness." *I.R.C. § 108(c)(3)* ("flush" language). Note that *I.R.C. § 108(c)* does not specifically address the question of whether accrued but unpaid interest on "qualified real property business indebtedness" is itself "qualified real property business indebtedness."

Interest that accrued before 1993 on debt incurred or assumed before 1993 should constitute ["qualified real property business indebtedness"] because this accrued interest is itself indebtedness incurred or assumed before 1993. In addition, a good (although still uncertain) argument can be made that interest accruing after 1992 on debt incurred or assumed before 1993 should be treated similarly because the *obligation* to pay the interest (as and when it accrued) was incurred before 1993. Pollack, Goldring & Oliver, *Federal Income Tax Consequences of the Discharge of Qualified Real Property Business Indebtedness*, 12 Tax Management R.E.J. 230, 234 (1996) (emphasis in original).

(n104)Footnote 95. *I.R.C. § 108(c)(3)(B)*. The term "qualified acquisition indebtedness" means "indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve" the real property secured by the debt. *I.R.C. § 108(c)(4)*. Query what level of improvement will constitute "substantial" improvement for purposes of *I.R.C. § 108(c)(4)*. Note that *I.R.C. § 108(c)* does not directly address the question of whether accrued but unpaid interest on "qualified acquisition indebtedness" is "qualified real property business indebtedness" for purposes of *I.R.C. § 108(c)*. On the one extreme, it may be asserted that interest can never qualify as ["qualified acquisition indebtedness"] in that interest is a cost of money, not a cost of property. This seems an unduly restrictive interpretation, however. For example, interest that must be capitalized during a property's construction period can easily be seen as a cost of the property so that interest accruals on ["qualified acquisition indebtedness"] under these circumstances should themselves be ["qualified acquisition indebtedness"]. Moreover, although a more difficult case, interest that is not construction period interest could still be ["qualified acquisition indebtedness"]. For example, under the general interest allocation rules, accrued interest is allocated in the same manner as the underlying debt, regardless of when the interest is paid. Pollack, Goldring & Oliver, *Federal Income Tax Consequences of the Discharge of Qualified Real Property Business Indebtedness*, 12 Tax Management R.E.J. 230, 235 (1996) (citations omitted).

(n105)Footnote 96. *I.R.C. § 108(c)(3)(C)*. If a taxpayer has losses or other deductions sufficient to offset some discharge of indebtedness income generated by discharge of "qualified real property business indebtedness", the taxpayer might wish to use the *I.R.C. § 108(c)* exclusion only to the extent necessary to cover any discharge of indebtedness income not offset by such losses or deductions. At the moment it is not clear whether a taxpayer can make a partial election under *I.R.C. § 108(c)*.

(n106)Footnote 97. *I.R.C. § 108(c)(3)* ("flush" language).

(n107)Footnote 98. *I.R.C. § 108(c)(2)(A)*.

(n108)Footnote 99. *I.R.C. § 108(c)(2)(B)*.

(n109)Footnote 100. Based on the example in H.R. Rep. 111, 103d Cong., 1st Sess. 624 (1993).

(n110)Footnote 101. *Commissioner v. Tufts*, 461 U.S. 300, 103 S. Ct. 1826, 75 L. Ed. 2d 863 (1983) .

(n111)Footnote 102. *I.R.C. § 108(c)(2)(A)(ii)*.

(n112)Footnote 103. H.R. Rep. 111, 103d Cong., 1st. Sess. 624 (1993).

(n113)Footnote 104. H.R. Rep. 111, 103d Cong., 1st. Sess. 624 (1993).

(n114)Footnote 105. See also H.R. Rep. 111, 103d Cong., 1st Sess. 624 (1993). Note that *I.R.C. § 704(c)* may affect the computation of a partner's proportionate interest in a partnership's depreciable property. For a discussion of this problem, see Pollack, Goldring & Oliver, *Federal Income Tax Consequences of the Discharge of Qualified Real*

Property Business Indebtedness, 12 Tax Management R.E.J. 230, 238-239 (1996).

(n115)Footnote 106. *See also I.R.C. § 1017(b)(3)(F)(i)* and H.R. Rep. 111, 103d Cong., 1st Sess. 624 (1993). Presumably, the partnership would use the principles, embodied in *I.R.C. §§ 743 and 754* in making these reductions.

(n116)Footnote 107. *See also I.R.C. § 1017(b)(3)(F)(i)* and H.R. Rep. 111, 103d Cong., 1st Sess. 624 (1993). Presumably, the partnership would use the principles, embodied in *I.R.C. §§ 743 and 754* in making these reductions.

(n117)Footnote 108. Prop. Treas. Reg. § 1.108-4, 62 Fed. Reg. 955 (Jan. 7, 1997) and Prop. Treas. Reg. § 1.1017-1, 62 Fed. Reg. 955, 958 (Jan. 7, 1997) .

(n118)Footnote 109. Prop. Treas. Reg. § 1.1017-1(f), 62 Fed. Reg. 955, 958 (Jan. 7, 1997) .

(n119)Footnote 110. *T.D. 8787*, 63 Fed. Reg. 56559 (Oct. 22, 1998). *T.D. 8787*, 63 Fed. Reg. 56559 (Oct. 22, 1998).

(n120)Footnote 111. *Treas. Reg. § 1.108-6(c)*.

(n121)Footnote 112. *Treas. Reg. § 1.1017-1(c)(1)* provides that "[t]he term qualifying real property means real property with respect to which the indebtedness is qualified real property business indebtedness within the meaning of section 108(c)(3)."

(n122)Footnote 113. *I.R.C. § 108(c)(2)* limits the amount a taxpayer may exclude under *I.R.C. Section 108(a)(1)(D)*:

(A) Indebtedness in excess of value--The amount excluded under [*I.R.C. § 108(a)(1)(D)*] 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 [*I.R.C. § 108(c)(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 [*I.R.C. § 108(a)(1)(D)*] shall not exceed the aggregate adjusted bases of depreciable real property (determined after any reductions under [*I.R.C. §§ 108(b) and (g)*]) held by the taxpayer immediately before the discharge (other than depreciable property acquired in contemplation of such discharge).

(n123)Footnote 114. The Preamble to the Final Regulations offers the following comment on the definition of the term "outstanding principal amount":

Two commentators requested that the regulations clarify that any outstanding accrued and unpaid interest is included in determining the outstanding principal amount of the indebtedness for purposes of this limitation. Given the purpose of this limitation, which is to prevent taxpayers from using the section 108(a)(1)(D) exclusion to the extent that debt cancellation would create equity in property (H.R. Rep. 103-111, 103d Cong., 1st Sess., 622-23 (1993)), the IRS and Treasury Department believe that it is inappropriate to strictly limit the exclusion by reference to the amount stated as principal in the debt instrument. Accordingly, the final regulations provide that, for purposes of section 108(c)(2)(A) and § 1.108-6 only, outstanding principal amount means the principal amount of an indebtedness and all additional amounts owed that, immediately before the discharge, are equivalent to principal, in that interest on such amounts would accrue and compound in the future.

63 *Fed. Reg.* 56559, 56560 (Oct. 22, 1998) .

(n124)Footnote 115. *I.R.C. § 108(e)(2)* provides that a taxpayer does not have discharge of indebtedness income to the extent that the payment of a discharge liability would have given rise to a deduction for the taxpayer.

(n125)Footnote 116. *I.R.C. § 108(e)(3)* provides that "[t]he 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."

(n126)Footnote 117. *I.R.C. § 108(c)(2)(B)* provides:

The amount excluded under [*I.R.C. § 108(a)(1)(D)*] shall not exceed the aggregate adjusted bases of depreciable real property (determined after any reductions under [*I.R.C. §§ 108(b) and (g)*]) held by the taxpayer immediately before the discharge (other than depreciable property acquired in contemplation of such discharge).

(n127)Footnote 118. *Treas. Reg. § 1.108-6(b)*.

(n128)Footnote 119. Prop. *Treas. Reg. § 1.1017-1(f)(2)(ii)* (1997).

(n129)Footnote 120. *Id.*

(n130)Footnote 121. Prop. *Treas. Reg. § 1.1017-1(f)(2)(ii)(A)* (1997).

(n131)Footnote 122. Prop. *Treas. Reg. § 1.1017-1(f)(2)(B)* (1997).

(n132)Footnote 123. 63 *Fed. Reg.* 56559, 56561 (Oct. 22, 1998) .

(n133)Footnote 124. *Id.*

(n134)Footnote 125. *Treas. Reg. § 1.1017-1(g)(2)(ii)(C)*.

(n135)Footnote 126. Prop. *Treas. Reg. § 1.1017-1(f)(2)(ii)* (1997).

(n136)Footnote 127. *Treas. Reg. § 1.1017-1(g)(2)(ii)(A)*.

(n137)Footnote 128. Prop. *Treas. Reg. § 1.1017-1(f)(2)(iii)* (1997).

(n138)Footnote 129. *Treas. Reg. § 1.1017-1(g)(2)(iii)*.

(n139)Footnote 130. 63 *Fed. Reg.* 56559, 56561-56562 (Oct. 22, 1998) .

(n140)Footnote 131. 62 *Fed. Reg.* 955, 957 (Jan. 7, 1997) .

(n141)Footnote 132. 63 *Fed. Reg.* 56559, 56562 (Oct. 22, 1998) .

(n142)Footnote 133. *Treas. Reg. § 1.1017-1(g)(2)(ii)(A)*.

(n143)Footnote 134. *Treas. Reg. § 1.1017-1(g)(2)(ii)(B)*.

(n144)Footnote 135. *Treas. Reg. § 1.1017-1(g)(3)*.

(n145)Footnote 136. *P TX13.03[1][d][ii] supra* .

(n146)Footnote 137. H.R. Rep. 111, 103d Cong, 1st Sess. 624 (1993).

(n147)Footnote 138. See, e.g., *Bauer v. United States*, 168 F. Supp. 539, 541 (Ct. Cl. 1958) .

(n148)Footnote 139. See, e.g., *Curphey v. Commissioner*, 73 T.C. 766 (1980) ; *Fegan v. Commissioner*, 71 T.C. 791 (1979) , *aff'd* 81-1 U.S.T.C. P 9436 (10th Cir. 1981); *Post v. Commissioner*, 26 T.C. 1055 (1959) , *acq.*, 1958-2 C.B. 7 ; *Hazard v. Commissioner*, 7 T.C. 372 (1946) , *acq.* 1946-2 C.B. 3 .

(n149)Footnote 140. See, e.g., *Priv. Ltr. Rul. 9426016* (March 25, 1994) (Partnership owned one multi-tenant office building, was responsible for all operating expenses up to a base amount, and contracted with a management company to handle day-to-day operations and to act as leasing agent for Partnership. Partnership represented that the leases were not net leases. The IRS held that the Partnership building was property used in a "trade or business" within the meaning of *I.R.C. § 108(a)(1)(D)*). *Private Letter Ruling 9426016* cites *Rev. Rul. 73-522, 1973-2 C.B. 226* , in which the Internal Revenue Service ruled that a lessor who rents real property under a net lease is not engaged in a "trade or business" with respect to such property for purposes of *I.R.C. § 871*. This citation, coupled with the representation that the leases in the Private Letter Ruling were not net leases, suggests that the Internal Revenue Service would have reached a different result if the leases were net leases. However, refusing to treat rental under a net lease as a "trade or business" for purposes of *I.R.C. § 108(a)(1)(D)* appears contrary to the congressional purpose of providing assistance to owners of financially troubled real estate.

(n150)Footnote 141. *P TX13.03[2][a][ii] infra* .

(n151)Footnote 142. *Treas. Reg. § 1.704-2(j)(2)(i)*.

(n152)Footnote 143. *Priv. Ltr. Ruls. 94-26-006 through 94-26-016* (March 25, 1994).

(n153)Footnote 144. *I.R.C. § 704* and the regulations issued thereunder.

(n154)Footnote 145. *I.R.C. §§ 752(b)* and *731(a)(1)*.

(n155)Footnote 146. *Treas. Reg. § 1.704-2(d), (f), (g) and (i)*.

(n156)Footnote 147. See *P TX13.03[1][a][ii] supra*.

(n157)Footnote 148. For a discussion of allocation of partnership liabilities to the partners, see *P TX13.02[3][e] supra*.

(n158)Footnote 149. *I.R.C. § 752(b)*. For a discussion of *I.R.C. § 752(b)*, see *P TX13.02[3][d] supra*.

(n159)Footnote 150. *I.R.C. § 731(a)(1)*. See *P TX13.02[3][d] supra*.

(n160)Footnote 151. S. Rep. No. 1035, 96th Cong., 2d Sess. 21 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n161)Footnote 152. S. Rep. No. 1035, 96th Cong., 2d Sess. 21 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised); *Gershkowitz v. Commissioner*, 88 T.C. 984 (1987) .

The decisions of the Sixth Circuit Court of Appeals and the Tax Court in *Babin v. Commissioner*, 23 F.3d 1032 (6th Cir. 1994) , *aff'g*, 64 T.C.M (CCH) 1357, T.C. Memo 1992-673 (1992) , create some doubt about this result under the law prior to the Bankruptcy Tax Act of 1980. In *Babin*, both the Tax Court and the Sixth Circuit concluded that, although an insolvent partner could exclude discharge of indebtedness income resulting from discharge of partnership indebtedness under the judicial insolvency exception that existed prior to the 1980 Act, the partner was not entitled to an increase in the partner's outside basis equal to the amount of discharge of indebtedness income allocated to the partner.

Both courts reasoned that a partner could increase outside basis only if the partner recognized the discharge of indebtedness income. 23 F.3d 1032, 1037, 64 T.C.M. 1357, 1367. The Sixth Circuit offered the following explanation of its decision:

[T]he amount generated from the deemed distribution of money as a result of that discharge require completely separate analysis. Thus, if petitioner were correct in arguing that he is allowed to increase the adjusted basis of his interest in the Partnership by *the discharge of indebtedness income that he was not, and never will be, required to recognize and pay tax on*, then not only will petitioner avoid the ordinary income tax on his share of the partnership's discharge of indebtedness income, but he will also avoid tax on the deemed distribution of money to him of his interest in the liabilities that he previously used to increase his adjusted basis. We refuse to sanction such a windfall to petitioner.

23 F.3d 1032, 1037, 94-1 U.S.T.C. at 83,941-83,942 (emphasis added) The Sixth Circuit's argument that Babin never would have to pay tax on his share of the discharge of indebtedness income apparently overlooks the effect of I.R.C. § 108(b), which requires a taxpayer who excludes discharge of indebtedness income under I.R.C. § 108(a) to reduce tax attributes. To the extent the taxpayer must reduce tax attributes, the exclusion granted by I.R.C. § 108(a) is really only a *deferral* of tax liability. The exclusion is a permanent exclusion *only* to the extent a taxpayer does not have enough tax attributes to cover the full amount excluded under I.R.C. § 108(a). Thus, the court's concern about a "windfall" seems, in large part, unnecessary. Although the Tax Court has cited *Babin* in dicta with approval in *Marcaccio v. Commissioner*, 69 T.C.M. 2420 (1995), the legislative history of the Bankruptcy Tax Act of 1980 makes it clear that the rationale applied in *Babin* should not apply to cases arising after the effective date of the Act. See S. Rep. No. 1035, 96th Cong., 2d Sess. 22 n.28 (1980) reprinted in Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised). See also *Tech. Adv. Mem. 9739002 (May 19, 1997)*, in which the Internal Revenue Service concluded that *Babin* does not apply to partnership transactions commencing after December 31, 1980.

(n162)Footnote 153. Rev. Rul. 92-97, 1992-2 C.B. 124.

(n163)Footnote 154. Treas. Reg. § 1.731-1(a)(1).

(n164)Footnote 155. I.R.C. § 706(a).

(n165)Footnote 156. I.R.C. § 705(a)(1)(A).

(n166)Footnote 157. I.R.C. § 731(a)(1).

(n167)Footnote 158. Rev. Rul. 92-97, 1992-2 C.B. 124.

(n168)Footnote 159. Treas. Reg. § 1.752-4(d).

(n169)Footnote 160. Treas. Reg. § 1.705-1(a)(1).

(n170)Footnote 161. Accord *Willis, Pennell & Postlewaite*, n.1 *supra*, P TX13.02[1][b]; but see *McKee, Nelson & Whitmire*, n.1 *supra*, P TX13.02[1][b]; *Rabkin & Johnson*, P TX16.02[2][3].

(n171)Footnote 162. Rev. Rul. 92-97, 1992-2 C.B. 124.

(n172)Footnote 163. For a complete discussion of Rev. Rul. 92-97, see P TX13.03[1][a][ii] *supra*.

(n173)Footnote 164. For a detailed discussion of this problem, see *Sheffield & Maynes, Selected Tax Issues in Partnership Debt Restructurings*, 68 *Taxes* 861, 862-873 ("Sheffield & Maynes") (1990).

(n174)Footnote 165. *McKee, Nelson & Whitmire*, n.1 *supra* , P TX9.02[2][a]; *Rabkin & Johnson*, P TX16.01[2][c].

(n175)Footnote 166. *McKee, Nelson & Whitmire*, n.1 *supra* , P TX9.02[2][a][ii] at 9-48 n.216; *Rabkin & Johnson*, P TX16.01[2][c], [d].

(n176)Footnote 167. *Rev. Rul. 71-301*, 1971-2 C.B. 256 .

(n177)Footnote 168. *McKee, Nelson & Whitmire*, n.1 *supra* , P TX9.02[2][a][ii]; *Rabkin & Johnson*, PP TX1.02[2], TX16.01[2].

(n178)Footnote 169. *Rev. Rul. 95-21*, 1995-11 I.R.B. 4 .

(n179)Footnote 170. *Tech. Adv. Mem. 9619002* (Jan. 31, 1996) .

(n180)Footnote 171. *69 T.C.M. (CCH) 2420* (1995) .

(n181)Footnote 172. As one commentator has noted, both the arguments of the parties and the opinion of the Tax Court leave the holding of *Marcaccio* unclear. See Cowan, *Recent Cases Reflect Continuing IRS Uncertainties About COD Income from Contingent Debt*, 84 J. Tax'n 261, 263-264 (1996).

(n182)Footnote 173. The holding of *Marcaccio* is not as clear as the IRS asserts in the Technical Advice Memorandum: One of the uncertainties in *Marcaccio* is whether the Tax Court's holding against the taxpayer was premised on the conclusion that (1) the partnership realized COD income that was allocated to the taxpayer, (2) the taxpayer recognized COD income because his liability as a guarantor had been discharged, or (3) the partnership had terminated when the foreclosure had occurred and the individual partners, as the partnership's successors-in-interest, had become the primary--and only--obligors on their respective portions of the partnership's obligation. Cowan, *Recent Cases Reflect Continuing IRS Uncertainties About COD Income from Contingent Debt*, 84 J. Tax'n 261, 264 (1996).

(n183)Footnote 174. *58 T.C.M. (CCH) 1299* (1989) .

(n184)Footnote 175. *Moore v. Commissioner*, 68 T.C.M. (CCH) 660 (1994) .

(n185)Footnote 176. P TX13.02[4][b][ii][C] *supra* .

(n186)Footnote 177. *Treas. Reg. § 1.704-2(b)(1)* defines the term "nonrecourse deductions."

(n187)Footnote 178. *Treas. Reg. § 1.704-2(f)(1)*. However, *Treas. Reg. § 1.704-2(f)(2)-(5)* enumerates exceptions to and waivers of the "minimum gain chargeback" requirement.

(n188)Footnote 179. For a discussion of the allocation of items of partnership income and gain required by the minimum gain chargeback, see P TX13.03[1][a][ii] *supra*.

(n189)Footnote 180. A's capital account would be his initial contribution of \$100,000 minus his allocable share (\$200,000) of the \$400,000 depreciation taken on the real property. B's capital account would be his initial contribution of \$50,000 minus his allocable share (\$100,000) of the \$400,000 depreciation. C's capital account would be the same as B's capital account.

(n190)Footnote 181. A's basis in his partnership interest is \$300,000 (\$100,000 cash contribution + \$400,000 share of nonrecourse debt - \$200,000 share of depreciation). B's basis in his partnership interest is \$150,000 (\$50,000 cash contribution + \$200,000 share of nonrecourse debt - \$100,000 share of depreciation). C's basis in his partnership interest would be the same as B's basis in his partnership interest.

(n191)Footnote 182. A "foreign partner" is "any partner who is not a United States person." *I.R.C. § 1446(e)*. *I.R.C. § 7701a(30)* defines "United States person" as "(A) a citizen or resident of the United States, (B) a domestic partnership, (C) a domestic corporation, (D) any estate (other than a foreign estate within the meaning of [*I.R.C. § 7701(a)(31)*]), and (E) any trust if--(i) a court within the United States is able to exercise primary supervision over the administration of the trust, and (ii) one or more United States persons have the authority to control all substantial decisions of the trust." *See also Rev. Proc. 89-31*, § 5, 1989-1 *C.B.* 895 (determination of whether a person is a "foreign partner" and certification of non-foreign status).

(n192)Footnote 183. *I.R.C. § 1446(c)* defines the term "effectively connected taxable income" as follows:

For purposes of [*I.R.C. § 1446*], the term "effectively connected taxable income" means the taxable income of the partnership which is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States computed with the following adjustments:

(1) Paragraph (1) of section 703(a) shall not apply.

(2) The partnership shall be allowed a deduction for depletion with respect to oil and gas wells but the amount of such deduction shall be determined without regard to sections 613 and 613A.

(3) There shall not be taken into account any item of income, gain, loss, or deduction to the extent allocable under section 704 to any partner who is not a foreign partner.

See also I.R.C. § 864(c) (general definition of "effectively connected income").

(n193)Footnote 184. *Rev. Proc. 89-31*, § 4.01, 1989-1 *C.B.* 895 .

(n194)Footnote 185. *I.R.C. § 1446(b)(2)(B)*.

(n195)Footnote 186. *I.R.C. § 1446(b)(2)(A)*.

(n196)Footnote 187. 88 *T.C.* 984 (1987) .

(n197)Footnote 188. 934 *F.2d* 426 (2d Cir. 1991) , *rev'g*, 59 *T.C.M. (CCH)* 543 (1990) .

(n198)Footnote 189. *I.R.C. § 733(1)*.

(n199)Footnote 190. *I.R.C. § 731(a)(1)*.

(n200)Footnote 191. *I.R.C. § 108(a)* creates exclusions for insolvent debtors, debtors in title 11 cases, and certain solvent debtors who obtain a discharge of "qualified farm indebtedness."

(n201)Footnote 192. *I.R.C. § 108(b)* provides that in exchange for the exclusions created by *I.R.C. § 108(a)*, a debtor must reduce certain "tax attributes."

(n202)Footnote 193. *I.R.C. § 108(g)* further defines the exclusion for discharges of "qualified farm indebtedness."

(n203)Footnote 194. S. Rep. No. 1035, 96th Cong., 2d Sess. 21 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n204)Footnote 195. S. Rep. No. 1035, 96th Cong., 2d Sess. 21 n.26 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n205)Footnote 196. 441 F.2d 465 (5th Cir. 1971) .

(n206)Footnote 197. *Stackhouse v. United States*, 71-1 U.S. Tax Cas. (CCH) P 9128 (W.D. Tex. 1970), rev'd, 441 F.2d 465 (5th Cir. 1971) .

(n207)Footnote 198. 441 F.2d 465, 469-70 (5th Cir. 1971) .

(n208)Footnote 199. For a discussion of *I.R.C. § 108(e)(4)* and its application to partnerships, see P TX13.03[4] *infra*.

(n209)Footnote 200. If a creditor acquires stock of the debtor corporation in exchange for the debt, *I.R.C. § 108(e)(7)* provides that the stock received will be treated as *I.R.C. § 1245* recapture property and that the amount of any bad debt deductions claimed under *I.R.C. § 166* or loss deductions claimed with respect to the stock will be treated as "depreciation" which will be recaptured as ordinary income upon the subsequent disposition of the stock. The creditor must reduce the bad debt or loss deductions by the amount, if any, included in the creditor's income as a result of the exchange of stock for debt. Thus, *I.R.C. § 108(e)(7)* prevents the creditor from getting the double benefit of an immediate ordinary loss deduction and capital gain treatment on any gain on the subsequent sale of such stock.

The following example illustrates the operation of *I.R.C. § 108(e)(7)*:

Example: Acme, Inc. made a \$1,000 short-term loan to In-Sol-Vent, Inc. in 1986 and Acme claimed an \$800 deduction for a partially worthless bad debt under Section 166(a) in 1987. In 1988, In-Sol-Vent issued its stock worth \$500 to Acme in complete satisfaction of the debt. In that exchange, Acme realized a gain of \$300 (\$500-\$200 basis in debt). If Acme later sells the In-Sol-Vent stock for \$1500, \$500 of Acme's gain will be treated as ordinary income (\$800 bad debt deduction less the \$300 gain realized on receipt of the stock). In the alternative, if Acme disposes of the stock in a tax-free transaction, the potential recapture will carry over to the stock received.

S. Rep. No. 1035, 96th Cong., 2d Sess. 18 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

If a creditor receives stock of a parent corporation of a corporate debtor, that stock will be treated as stock of the subsidiary/debtor corporation and will be subject to the recapture rules. *I.R.C. § 108(e)(7)(C)*.

(n210)Footnote 201. S. Rep. No. 1035, 96th Cong., 2d Sess. 20, *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised); *Ltr. Rul. 8617003* (Dec. 30, 1985) .

(n211)Footnote 202. See P TX13.03[3][a] *supra*.

(n212)Footnote 203. Mason, Resnick & Smith, *Restructuring of Partnership Debt Need Not Result in Income Recognition*, 74 J. Tax'n 312, 315 (1991).

(n213)Footnote 204. *Voelker*, at 352 n.76 .

(n214)Footnote 205. *Rev. Rul. 67-200, 1967-1 C.B. 15*, clarified by *Rev. Rul. 70-406, 1970-2 C.B. 16* . Although these rulings predate the Bankruptcy Tax Act of 1980 and thus no longer reflect the precise result under *I.R.C. § 108*, they reflect the proper relationship between *I.R.C. § 111* and *I.R.C. § 108*.

(n215)Footnote 206. Note, however, that *I.R.C. § 111(c)* provides that if the "recovered" deduction increased a net operating loss carryover which has not expired before the beginning of the taxable year in which the "recovery or adjustment" occurs, it is treated as an amount which reduces the tax. The following example illustrates the operation of

I.R.C. § 111(c). If an accrual basis taxpayer purchases an item of inventory and deducts, but does not pay, the cost in 1989 and the creditor forgives that obligation in 1990, the forgiveness of the inventory obligation will result in taxable income if the deduction in 1989 had either decreased the taxpayer's tax or, if the taxpayer owed no tax, increased an operating loss in 1989.

(n216)Footnote 207. The *I.R.C. § 752* regulations published on December 21, 1991 do not define "liability" for purposes of *I.R.C. § 752*. Temporary Regulations published on December 30, 1988 contained the following definition of "liability" for purposes of *I.R.C. § 752*:

Except as otherwise provided in the regulations under section 752, an obligation is a liability of the [partnership] for purposes of section 752 and the regulations thereunder to the extent, *but only to the extent*, that *incurring or holding* such obligation gives rise to--

(1) The creation of, or an increase in, the basis of property owned by the [partnership] (including cash attributable to borrowings),

(2) A deduction that is taken into account in computing the taxable income of the [partnership], or

(3) An expenditure that is not deductible in computing the obligor's taxable income and is not properly chargeable to capital.

Temp. Treas. Reg. § 1.752-1T(g) (1988) (emphasis added). The significance of Treasury's decision not to include a definition of "liability" in the final *I.R.C. § 752* regulations is not clear. See Cuff, *Allocating Partnership Liabilities*, 70 *Taxes* 303, 312 (1992).

(n217)Footnote 208. See P TX13.03[2][a][i] *supra*.

(n218)Footnote 209. 1988-2 C.B. 128 .

(n219)Footnote 210. Rev. Rul. 88-77, 1988-2 C.B. 128, 129 .

(n220)Footnote 211. *I.R.C. § 705(a)*.

(n221)Footnote 212. *I.R.C. §§ 752(a)* and 722.

(n222)Footnote 213. *I.R.C. §§ 752(b)* and 733.

(n223)Footnote 196. *United States v. Kirby Lumber Co.*, 284 U.S. 1, 52 S. Ct. 4, 76 L. Ed. 131 (1931) . For such a discussion, see P TX6.03[5][e] *supra*.

(n224)Footnote 214. 115 F.2d 656 (7th Cir. 1940) , rev'g, 41 B.T.A. 890 .

(n225)Footnote 215. 115 F.2d 656, 658 .

(n226)Footnote 216. 19 T.C. 275 (1952) . In *Edwards* the taxpayer had purchased stock using money borrowed from a third party, pledging the purchased stock as security for the loan. Subsequently, the taxpayer substituted other collateral for the pledged stock. Still later, the taxpayer compromised the loan for less than the outstanding balance. Finally, the taxpayer sold the stock to a third party. The Service argued that the taxpayer understated his gain on the sale of the stock because he had failed to reduce his basis in the stock after the compromising the loan. The court noted that, unlike the situation in *Hirsch*, the stock had no connection with the loan other than that the stock had at one time been used as collateral to secure payment of the loan.

(n227)Footnote 217. 147 F.2d 453 (2d Cir. 1944) .

(n228)Footnote 218. S. Rep. No. 1035, 96th Cong., 2d Sess. 22 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n229)Footnote 219. S. Rep. No. 1035, 96th Cong., 2d Sess. 16 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised). The Senate Finance Committee Report also provides that "if the debt has been transferred by the seller to a third party ... , *this provision does not apply to determine whether a reduction in the amount of purchase money debt should be treated as discharge income or as a true price adjustment.*" S. Rep. No. 1035, 96th Cong., 2d Sess. 16 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n230)Footnote 220. S. Rep. No. 1035, 96th Cong., 2d Sess. 20, n.24 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n231)Footnote 221. 88-1 U.S.T.C. P 9269 (Ct. Cl. 1988). In *Sutphin*, the taxpayers, who were not eligible to use I.R.C. § 108(e)(5) because the lender was not their seller, argued that the judicial purchase price reduction exception articulated in *Hirsch and Sherman v. Commissioner*, 135 F.2d 68 (6th Cir. 1943) , applied to the reduction they obtained on their residential mortgage debt. The Claims Court refused to apply the judicial purchase price reduction exception, stressing that in both *Hirsch* and *Sherman* the value of the property was less than the principal amount of the mortgage. Thus, the Claims Court concluded, the judicial purchase price reduction exception did not apply because there was no evidence that the value of the taxpayers' residence had fallen below the unpaid mortgage balance prior to the reduction. Significantly, the court did not say that enactment of I.R.C. § 108(e)(5) eliminated the judicial exception.

(n232)Footnote 222. For further discussion of the judicial exception, see P TX6.03[5][e][ii] *supra*.

(n233)Footnote 223. See also *Commissioner v. Sherman*, 135 F.2d 68 (6th Cir. 1943) (creditor who granted the reduction was not the original seller of the property). But see Rev. Rul. 92-99, 1992-46 I.R.B. 5, 6 , in which the IRS announced that it will not follow *Sherman* to the extent that it relied on *Bowers v. Kerbaugh-Empire*, 271 U.S. 170, 46 S. Ct. 449, 70 L. Ed. 886 (1926) , to permit a purchase price adjustment.

(n234)Footnote 224. See, e.g., *Commissioner v. Sherman*, 135 F.2d 68 (6th Cir. 1943) (creditor who granted the reduction was not the original seller of the property). But see Rev. Rul. 92-99, 1992-2 C.B. 35, 6 , in which the IRS announced that it will not follow *Sherman* to the extent that it relied on *Bowers v. Kerbaugh-Empire*, 271 U.S. 170, 46 S. Ct. 449, 70 L. Ed. 886 (1926) , to permit a purchase price adjustment.

(n235)Footnote 225. Rev. Rul. 92-99, 1992-2 C.B. 35 . See also Avakian-Martin, *Has the IRS Guttled a Judicial Exception to COD Income?*, 59 Tax Notes 169, 170 (1993) (quoting Richard H. Manfreda, IRS Deputy Assistant Chief Counsel, Passthroughs and Special Industries: "The IRS studied the issue of whether section 108(e)(5) preempts the common law rules of purchase price adjustment and determined that it did not ... ").

(n236)Footnote 226. Avakian-Martin, *Has the IRS Guttled a Judicial Exception to COD Income?*, 59 Tax Notes 169, 170 (1993), quoting Richard H. Manfreda, IRS Deputy Assistant Chief Counsel, Passthroughs and Special Industries:

The IRS's Richard H. Manfreda said those in the Service who have the authority to rule in this area view the purchase price adjustment exception "very narrowly," with "any change in the equation at all causing one to fall outside" the exception.

(n237)Footnote 227. Although the FACTS section of the Revenue Ruling does not disclose whether the debt was recourse or nonrecourse, both the ISSUE section and the HOLDING section of the Revenue Ruling recite that the debt

was nonrecourse debt.

(n238)Footnote 228. *Fifth Avenue-Fourteenth Street Corp.*, 147 F.2d 453, 456-57 (2d Cir. 1945) .

(n239)Footnote 229. *Rev. Rul. 92-99, 1992-2 C.B. 35* .

(n240)Footnote 230. *127 F.2d 127 (5th Cir. 1942)* .

(n241)Footnote 231. *Rev. Rul. 92-99, 1992-2 C.B. 35* .

(n242)Footnote 232. *271 U.S. 170, 46 S. Ct. 449, 70 L. Ed. 886 (1926)* .

(n243)Footnote 233. *Rev. Rul. 92-99, 1992-2 C.B. 35* . The IRS cited *Burnet v. Sanford & Brooks Co.*, 282 U.S. 359, 51 S. Ct. 150, 75 L. Ed. 383 (1931) (establishing the annual accounting period concept); *United States v. Kirby Lumber Co.*, 284 U.S. 1, 52 S. Ct. 4, 76 L. Ed. 131 (1931) (discharge of an indebtedness results in gross income); *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426, 75 S. Ct. 473, 99 L. Ed. 483 (1955) (gross income includes all accessions to wealth from whatever source); *Commissioner v. Tufts*, 461 U.S. 300, 103 S. Ct. 1826, 75 L. Ed. 2d 863 (1983) (the "amount realized" on the sale of property encumbered by a nonrecourse obligation that exceeded the fair market value of the property includes the amount of the obligation discharged); and *Vukasovich v. Commissioner*, 790 F.2d 1409 (9th Cir. 1986) (discharge of an indebtedness results in gross income, notwithstanding the loss that the taxpayer incurred on the underlying transaction).

(n244)Footnote 234. *790 F.2d 1409 (9th Cir. 1986)* .

(n245)Footnote 235. Avakian-Martin, *Has the IRS Guttled a Judicial Exception to COD Income?*, 59 *Tax Notes* 169, 169 (1993) (quoting Richard H. Manfreda, IRS Deputy Assistant Chief Counsel, Passthroughs and Special Industries). However, "the exception could probably be applied after the original purchaser merges with another entity, since the asset is still with the same entity." *Id.*

(n246)Footnote 236. *Id.* at 169-70 .

(n247)Footnote 237. For a more detailed discussion of the requirements of *I.R.C. § 108(e)(5)*, see *P TX6.03[5][e][i] supra*.

(n248)Footnote 238. *I.R.C. § 108(e)(5)(A)*.

(n249)Footnote 239. *I.R.C. § 108(e)(5)(C)*.

(n250)Footnote 240. *Cf. Juister v. Commissioner*, 53 T.C.M. (CCH) 1079, 1080 (1987) (*I.R.C. Section 108(e)(5)* held inapplicable to reduction of nonpurchase money indebtedness).

(n251)Footnote 241. Although *I.R.C. § 108(e)(5)* does not explicitly require the debtor to reduce the basis of the property by the amount of the reduction in the debt, such a basis reduction is necessary to prevent a windfall to the debtor, either in the form of overstated depreciation deductions or understated gain on disposition of the property.

(n252)Footnote 242. However, the reduction in the partnership debt would trigger a deemed distribution of money to the partners under *I.R.C. § 752(b)* with results described in *P TX13.03[2][a] supra* .

(n253)Footnote 243. *Priv. Ltr. Rul. 8429001 (March 12, 1984)* .

(n254)Footnote 244. For a discussion of *I.R.C. § 108(e)(6)*, see *P TX6.03[5][a] supra*.

(n255)Footnote 245. The tax policy justification for this preference is not clear. *I.R.C. § 108(e)(5)* serves a valid

tax policy by ensuring that a true purchase price reduction, although technically generating discharge of indebtedness income, will not fall under the rule in *Kirby Lumber*. The benefit of *I.R.C. § 108(e)(5)* should not depend on solvency. Why should insolvent taxpayers have to treat a purchase price reduction as discharge of indebtedness income with the corresponding consequences under *I.R.C. § 108* while solvent taxpayers can use *I.R.C. § 108(e)(5)*? The reason stated in the 1980 legislative history (eliminating disagreements between the Service and taxpayers over what is a true purchase price adjustment) does not help us understand why only solvent taxpayers need *I.R.C. § 108(e)(5)*.

(n256)Footnote 246. *Rev. Proc. 92-92, 1992-2 C.B. 505* .

(n257)Footnote 247. Although the Revenue Procedure provides that the transaction must qualify as a purchase price adjustment for purposes of *I.R.C. § 108(e)(5)* but for the bankruptcy or insolvency, *I.R.C. § 108(e)(5)* by its terms cannot provide support for the position the IRS has taken in this Revenue Procedure. Thus, the Revenue Procedure implicitly recognizes a nonstatutory exception to the *Kirby Lumber* doctrine for partnerships that are either insolvent or debtors in title 11 cases.

(n258)Footnote 248. *I.R.C. § 108(d)(3)*.

(n259)Footnote 249. *461 U.S. 300 (1983), reh'g denied, 463 U.S. 1215, 103 S. Ct. 3555, 77 L. Ed. 2d 1401 (1983), on remand, 712 F.2d 199 (5th Cir. 1983)* .

(n260)Footnote 250. *461 U.S. 300, 307, 103 S. Ct 1826, 1831, 75 L. Ed. 2d 863, 870 (1983)* .

(n261)Footnote 251. *Estate of Newman, 934 F.2d 426 (2d Cir. 1991)* .

(n262)Footnote 252. Frankel, *Tax Planning for Troubled Real Estate and Partnership Transactions --Part 1* , 19 *J. Real Est. Tax'n* 285, 300-301 (1992).

(n263)Footnote 253. *Commissioner v. Court Holding Co., 324 U.S. 331, 65 S. Ct. 707, 89 L. Ed. 981 (1945)* (distribution of assets to shareholders in complete liquidation of corporation, followed by sale by shareholders, held to be sale by corporation).

(n264)Footnote 254. "[I]f the property has been transferred by the buyer to a third party (whether or not related to the buyer), [*I.R.C. § 108(e)(5)*] does not apply" S. Rep. No. 1035, 96th Cong., 2d Sess. 16 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii)(Matthew Bender 15th Ed. Revised).

(n265)Footnote 255. Uniform Partnership Act § 25.

(n266)Footnote 256. *Cf. Priv. Ltr. Rul. 9037033 (June 18, 1990)* . In this ruling, the IRS concluded that *I.R.C. § 108(e)(5)* applied to a bank holding company even though the holding company was not the original purchaser of the encumbered property (bank stock). Although the precise rationale is not clear from the ruling, apparently the IRS ignored ownership prior to the bank holding company's ownership as involving an intermediate agent used solely to satisfy non-tax banking rules and regulations.

(n267)Footnote 257. *See Rev. Proc. 92-92, 1992-2 C.B. 505* , discussed in the text accompanying n.192 *supra*.

(n268)Footnote 258. *I.R.C. § 108(d)(2)*. *See Frankel, Tax Planning for Troubled Real Estate and Partnership Transactions --Part 1* , 19 *J. Real Est. Tax'n* 285, 300 n.61 (1992).

(n269)Footnote 259. *See Chapter TX8* for a discussion of the history of the stock for debt exception.

(n270)Footnote 260. Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13,226 (Aug. 10, 1993).

(n271)Footnote 261. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 896 (Oct. 22, 2004).

(n272)Footnote 261a. Section 896 of the American Jobs Creation Act of 2004, provides:

SEC. 896 RECOGNITION OF CANCELLATION OF INDEBTEDNESS INCOME REALIZED ON SATISFACTION OF DEBT WITH PARTNERSHIP INTEREST

(a) IN GENERAL Paragraph (8) of section 108(e)(relating to general rules for discharge of indebtedness (including discharges not in title 11 cases or insolvency) is amended to read as follows:

(8) INDEBTEDNESS SATISFIED BY CORPORATE STOCK OR PARTNERSHIP INTEREST For purposes of determining income of a debtor from discharge of indebtedness, if--

(A) a debtor corporation transfers stock, or

(B) a debtor partnership transfers a capital or profits interest in such partnership,

to a creditor in satisfaction of its recourse or nonrecourse indebtedness, such corporation or partnership shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock or interest. In the case of any partnership, any discharge of indebtedness income recognized under this paragraph shall be included in the distributive shares of taxpayers which were the partners in the partnership immediately before such discharge.

The American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 896(a).

(n273)Footnote 260b. Section 896(b) of the American Jobs Creation Act of 2004 provides:

(b) EFFECTIVE DATE.--The amendment made by this section shall apply with respect to cancellations of indebtedness occurring on or after the date of the enactment of this Act.

The American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 896(b). The American Jobs Creation Act of 2004 became effective on October 22, 2004.

(n274)Footnote 261c. *Prop. Treas. Reg. §§ 1.108-8 and 1.721-1(d), 73 Fed. Reg. 64,903-01 (2008)* .

(n275)Footnote 261d. *Prop. Treas. Reg. § 1.108-8(b)(1)*.

(n276)Footnote 261e. *Prop. Treas. Reg. § 1.108-8(b)(1)(i)*.

(n277)Footnote 261f. *Prop. Treas. Reg. § 1.108-8(b)(1)(ii)*.

(n278)Footnote 261g. *Prop. Treas. Reg. § 1.108-8(b)(1)(iii)*.

(n279)Footnote 261h. *Prop. Treas. Reg. § 1.108-8(b)(1)(iv)*.

(n280)Footnote 261i. *Prop. Treas. Reg. § 1.108-8(b)(1)*.

(n281)Footnote 261j. *Prop. Treas. Reg. § 1.108-8(c)*, ex.

(n282)Footnote 261k. *Prop. Treas. Reg. § 1.721-1(d)*:

(d) Debt-for-equity exchange-- (1) In general. Except as otherwise provided in section 721 and the regulations under section 721, and notwithstanding § 1.108- 8(a), section 721 applies to a contribution of a partnership's recourse or nonrecourse indebtedness by a creditor to the debtor partnership in exchange for a capital or profits interest in the partnership.

(2) Exception. Section 721 does not apply to the transfer of a partnership interest to a creditor in satisfaction of a partnership's recourse or nonrecourse indebtedness for unpaid rent, royalties, or interest on indebtedness (including accrued original issue discount). For rules applicable to a determination of whether a partnership interest transferred to a creditor is treated as payment of interest or accrued original issue discount, see §§ 1.446-2(e) and 1.1275-2(a), respectively.

(n283)Footnote 261l. 73 Fed. Reg. at 64,904 (2008) .

(n284)Footnote 261m. *Prop. Treas. Reg. § 1.721-1(d)(2)*.

(n285)Footnote 261n. *Id.*

(n286)Footnote 261o. 73 Fed. Reg. at 64,904 (2008) .

(n287)Footnote 261p. *Id.* Treasury requested comments on this conclusion and suggestions for possible alternative approaches. *Id.* See Blake D. Rubin, Andrea Macintosh Whiteway & Jon G. Finkelstein, *Creditors Beware: Proposed Partnership Debt-for-Equity Regulations Deny Your Tax Loss*, 121 *Tax Notes* 1281 (Dec. 15, 2008) (strongly criticizing the conclusion).

(n288)Footnote 261q. 73 Fed. Reg. at 64,904 (2008) .

(n289)Footnote 261r. H.R. Rep. No. 755, 108th Cong., 2d Sess. 561 (2004).

(n290)Footnote 261s. For extended discussions of these issues, see Ahrens, *Restructuring Partnership Indebtedness: The Equity-for-Debt Exception in the Partnership Arena*, 13 *Va. Tax Rev.* 329 (1993) and Burke, *Partnership Debt-Equity Exchanges: Kirby Lumber and Subchapter K*, 47 *Tax Law.* 13 (1993).

(n291)Footnote 262. To date, the IRS has refused to rule on this issue. See, e.g., *Priv. Ltr. Rul. 8444069* (July 31, 1984) (issue of whether cancellation of loan not represented by written note in exchange for partnership interest qualifies for nonrecognition under I.R.C. § 721 is under study by IRS). However, the IRS has announced that, in general, any regulations covering this issue will be prospective only. 1991-1 *C.B.* 319, *Notice 91-15* . The IRS issued the Notice to clarify a statement in the preamble to the proposed I.R.C. § 108(e)(4) regulations relating to the effective date of those proposed regulations.

(n292)Footnote 264. 47 *B.T.A.* 691 (1942) , *aff'd*, 140 *F.2d* 382 (1st Cir. 1944) , *nonacq.* 1943 *C.B.* 28 .

(n293)Footnote 265. See, e.g., *Motor Mart Trust v. Commissioner*, 4 T.C. 931 (1945), *aff'd*, 156 F.2d 122 (1st Cir. 1946), *acq.* 1947-1 C.B. 3; *Capento Securities*, 47 B.T.A. 691 (1942), *aff'd*, 140 F.2d 382 (1st Cir. 1944), *nonacq.* 1943 C.B. 28. For a discussion of the development of this judicial exception to the Kirby Lumber rule prior to the 1984 amendment adding I.R.C. § 108(e)(10), see Asofsky, *Discharge of Indebtedness in Bankruptcy After the Bankruptcy Tax Act of 1980*, 27 St. Louis U.L.J. 583, 600-08 (1983) and Note, *Debt-Equity Swaps*, 37 Tax Law. 677 (1984).

(n294)Footnote 266. See, e.g., *Motor Mart Trust v. Commissioner*, 4 T.C. 931 (1945), *aff'd*, 156 F.2d 122 (1st Cir. 1946), *acq.* 1947-1 C.B. 3; *Priv. Ltr. Rul.* 8735007 (May 28, 1987); *Priv. Ltr. Rul.* 8735006 (May 18, 1987).

(n295)Footnote 267. *Priv. Ltr. Rul.* 8837001 (May 10, 1988).

(n296)Footnote 268. Pollack & Goldring, *Can Cancellation of Indebtedness Income Be Avoided with Parent Stock?* 2 Corp. Tax'n 18-19 (Jan./Feb. 1990).

(n297)Footnote 269. 47 B.T.A. 691 (1942), *aff'd*, 140 F.2d 382 (1st Cir. 1944), *nonacq.* 1943 C.B. 28.

(n298)Footnote 270. The Board noted that the evidence did not explain why the preferred stock was worth only \$50,000 when its par value was \$500,000. *Capento Securities Corp. v. Commissioner*, 47 B.T.A. 691 (1942), *aff'd*, 140 F.2d 382 (1st Cir. 1944), *nonacq.* 1943 C.B. 28.

(n299)Footnote 271. *Capento Securities Corp. v. Commissioner*, 47 B.T.A. 691 (1942), *aff'd*, 140 F.2d 382 (1st Cir. 1944), *nonacq.* 1943 C.B.28. 47 B.T.A. 691 (1942), *aff'd*, 140 F.2d 382 (1st Cir. 1944), *nonacq.* 1943 C.B. 28.

(n300)Footnote 272. *Capento Securities Corp. v. Commissioner* 47 B.T.A. 691 (1942), *aff'd*, 140 F.2d 382 (1st Cir. 1944), *nonacq.* 1943 C.B. 28.

(n301)Footnote 273. See, e.g., *Claridge Apartments Co. v. Commissioner*, 1 T.C. 163, 173-74 (1942), *rev'd in part*, 138 F.2d 962 (7th Cir. 1943), *rev'd*, 323 U.S. 141, 65 S. Ct. 172, 89 L. Ed. 139 (1944); *Alcazar Hotel, Inc. v. Commissioner*, 1 T.C. 872, 879 (1943), *acq.*, 1947-1 C.B. 1; *Motor Mart Trust v. Commissioner*, 4 T.C. 931, 937 (1945), *aff'd*, 156 F.2d 122 (1st Cir. 1946), *acq.* 1947-1 C.B. 3; *Tower Building Corp. v. Commissioner*, 6 T.C. 125, 134-35 (1946), *acq.*, 1947-1 C.B. 4; *Woodmont Corp. v. Commissioner*, 5 T.C.M. (CCH) 291, 293 (1946).

(n302)Footnote 274. H.R. Rep. No. 833, 96th Cong., 2d Sess. 13-14 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised).

(n303)Footnote 275. H.R. Rep. No. 833, 96th Cong., 2d Sess. 15 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised).

(n304)Footnote 276. Accord Lipton, *Planning for Noncorporate Debt Workouts Outside of Bankruptcy*, 70 Taxes 275, 297 (1992); *Sheffield & Maynes*, at 875.

(n305)Footnote 277. S. Rep. No. 1035, 96th Cong., 2d Sess. 11 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n306)Footnote 278. Indeed, there is evidence that the drafters of the Bankruptcy Tax Act of 1980, working under pressure, did not have time to consider all of the issues raised by partnership workouts. *Sheffield & Maynes*, n.119 *supra*, at 876 (*citing Partner Contributions of Indebtedness: Congressional Intent or Technical Oversight?*, 28 Tax Notes 1319, 1320 (1985)).

(n307)Footnote 279. *Sheffield & Maynes*, n.119 *supra*, at 875.

(n308)Footnote 280. *McKee, Nelson & Whitmire*, at P 4.02[1].

(n309)Footnote 281. *McKee, Nelson & Whitmire*, at P 4.02[3].

(n310)Footnote 282. *McKee, Nelson & Whitmire*, at P 4.02[3].

(n311)Footnote 283. *McKee, Nelson & Whitmire*, at P 4.02[3].

(n312)Footnote 284. *Treas. Reg. § 1.704-1(b)(2)(iv)(f)(5)(i)*.

(n313)Footnote 285. *I.R.C. § 752(b)*. For a discussion of *I.R.C. § 752(b)*, see *PP TX13.02[3][d]* and *TX13.03[2][a][i]* *supra* .

(n314)Footnote 286. *I.R.C. § 733(1)*.

(n315)Footnote 287. *I.R.C. § 731(a)(1)*.

(n316)Footnote 288. Note that if Creditor receives a partnership interest greater than 10 percent, the remaining nonrecourse debt would become "partner nonrecourse debt" within the meaning of *Treas. Reg. § 1.704-2(b)(4)* because Creditor would bear the economic risk of loss on the debt. If the debt became "partner nonrecourse debt," Creditor's exchange of a portion of the nonrecourse debt for an interest in the Partnership would trigger a minimum gain chargeback to A and B. *Treas. Reg. § 1.704-2(i)(4)*. By keeping Creditor's interest in the partnership at 10 percent, the parties ensure application of the de minimis rules in *Treas. Reg. § 1.752-2(d)(1)*, thereby avoiding classification of the remaining debt as "partner nonrecourse debt."

(n317)Footnote 289. *Treas. Reg. § 1.704-1(b)(2)(iv)(f)*.

(n318)Footnote 290. *Treas. Reg. § 1.752-3(a)(2)*.

(n319)Footnote 291. *Treas. Reg. § 1.752-3(a)(3)*.

(n320)Footnote 292. See *Treas. Reg. § 1.752-2(b)(3)(i)*.

(n321)Footnote 293. For a discussion of partnership minimum gain and the minimum gain chargeback, see *PP TX13.02[4][b][ii][C]* and *TX13.03[2][a][ii]* *supra* .

(n322)Footnote 294. *Treas. Reg. § 1.704-2(d)(1)*.

(n323)Footnote 295. *Treas. Reg. § 1.704-2(d)(3)*.

(n324)Footnote 296. *Treas. Reg. § 1.704-2(f)(1)*. In this instance, neither of the exceptions established by *Treas. Reg. § 1.704-2(f)(2)* and (3) will apply. Assume the Partnership is not entitled to a waiver of the minimum gain chargeback requirement under *Treas. Reg. § 1.704-2(f)(4)*.

(n325)Footnote 297. *Treas. Reg. § 1.704-2(g)(2)*.

(n326)Footnote 298. *Treas. Reg. § 1.704-2(f)(1)*.

(n327)Footnote 299. Treasury issued proposed regulations under *I.R.C. § 108(e)(4)* on March 22, 1991. Prop. *Treas. Reg. § 1.108-2*, 56 *Fed. Reg.* 12,135 (March 22, 1991) corrected in 56 *Fed. Reg.* 28,124 (June 19, 1991) . Treasury issued these regulations in final form on December 28, 1992. For a discussion of the 1992 final regulations, see *P TX6.02[4][b][ii]* *supra*.

(n328)Footnote 300. For a discussion of *I.R.C. § 108(e)(4)*, see *P TX6.02[4][b]* *supra*.

(n329)Footnote 301. S. Rep. No. 1035, 96th Cong., 2d Sess. 19, *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised). The Senate Report uses as an example the purchase by a parent corporation of the debt of its subsidiary at a discount. *Id.* For a critical analysis of *I.R.C. Section 108(e)(4)*, see Peaslee, *Discharge of Debt Through Its Acquisition by a Person Related to the Debtor--An Analysis of Section 108(e)(4)*, 37 *Tax L. Rev.* 193 (1982).

(n330)Footnote 302. See P TX13.03[4][b][i] *infra*.

(n331)Footnote 303. The proposed regulations contained the following statement: "Although this regulation is not proposed to apply to transactions before March 21, 1991, section 108(e)(4) is effective for any transaction after December 31, 1980, subject to the rules of section 7 of the Bankruptcy Tax Act of 1980 (Pub. L. 96-589 Stat. 3339, 3411)." Prop. Treas. Reg. § 1.108-2(f), 56 *Fed. Reg.* 12135, 12140 (1991) .

(n332)Footnote 304. In contrast, *I.R.C. § 385* is not self-executing because it merely provides Treasury with the authority to issue regulations governing treatment of corporate instruments as debt or equity and does not provide any rules one could apply without regulatory guidance.

(n333)Footnote 305. For example, the Senate Finance Committee Report includes a lengthy footnote describing points Treasury should cover in the regulations. S. Rep. No. 1035, 96th Cong., 2d Sess. 19-20 n.23 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised).

(n334)Footnote 306. *I.R.C. § 108(e)(4)(A)* provides:

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.

(n335)Footnote 307. *I.R.C. § 707(b)(1)(A)*.

(n336)Footnote 308. *I.R.C. § 707(b)(1)(B)*.

(n337)Footnote 309. *I.R.C. § 267(b)(10)*.

(n338)Footnote 310. *I.R.C. § 267(c)* sets forth the constructive ownership rules. These constructive ownership rules apply for purposes of *I.R.C. § 267(b)(10)*. For purposes of both subsections (A) and (B) of *I.R.C. § 707(b)(1)*, *I.R.C. § 707(b)(3)* provides that "the ownership of a capital or profits interest in a partnership shall be determined in accordance with the rules for constructive ownership of stock provided in section 267(c) other than paragraph (3) of such section."

(n339)Footnote 311. A corporation and a partnership are "related persons" if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or the profits interest, in the partnership.

(n340)Footnote 312. Treasury issued proposed regulations under *I.R.C. § 108(e)(4)* on March 22, 1991. Prop. Treas. Reg. § 1.108-2, 56 *Fed. Reg.* 12,135 (March 22, 1991) , *corrected in* 56 *Fed. Reg.* 28,124 (June 19, 1991) . Treasury issued these regulations in final form on December 28, 1992. For a discussion of the 1992 final regulations, see P TX6.02[4][b][ii] *supra*.

(n341)Footnote 313. *Treas. Reg. § 1.108-2(a), (b) and (f).*

(n342)Footnote 314. *Treas. Reg. § 1.108-2(g)* ("correlative adjustments").

(n343)Footnote 315. *Treas. Reg. § 1.108-2(g)* ("correlative adjustments").

(n344)Footnote 316. *I.R.C. § 108(b).*

(n345)Footnote 317. *I.R.C. § 1017(b)(3)(C).*

(n346)Footnote 318. *I.R.C. § 1017(b)(3)(C).*

(n347)Footnote 319. *Treas. Reg. § 1.108-2(g)* ("correlative adjustments").

(n348)Footnote 320. *Treas. Reg. § 1.108-2(g)* ("correlative adjustments").

(n349)Footnote 321. Pub. L. No. 111-5, § 1231, 123 Stat. 115, 338-341 (2009). For a full discussion of *I.R.C. Section 108(i)* outside of the partnership context, see *P TX6.03[3][c][v] supra*.

(n350)Footnote 322. *I.R.C. § 108(i)(1).*

(n351)Footnote 323. *I.R.C. § 108(i)(5)(B)(ii)*. However, *Revenue Procedure 2009-37* provides that an election made on or before September 16, 2009 may be modified by filing an amended return on or before November 16, 2009. *Rev. Proc. 2009-37*, § 7.02, 2009- __ C.B. __, __.

(n352)Footnote 324. *I.R.C. Section 108(i)(3)(B).*

(n353)Footnote 325. See *I.R.C. § 108(i)(4)(B)*. *Rev. Proc. 2009-37* notes that

[t]he term "acquisition" also includes an indirect acquisition within the meaning of § 1.108-2(c) if a direct acquisition of the debt instrument would qualify for an election under § 108(i). For example, if a corporation acquires debt of a partnership that the partnership issued in connection with its trade or business, and the partnership and corporation become related within six months of the corporation's acquisition of the debt, the indirect acquisition is an acquisition for which an election under § 108(i) may be made.

Rev. Proc. 2009-37, 2009 - __ C.B. __ .

(n354)Footnote 326. *I.R.C. § 108(i)(2)*. There is no OID deferral if the amount of OID is less than a de minimis amount, determined under *I.R.C. Section 1273(a)(3)* and *Treas. Reg. § 1.1273-1(d)*.

(n355)Footnote 327. *Rev. Proc. 2009-37*, 2009 - __ C.B. __ .

(n356)Footnote 328. *I.R.C. § 108(i)(5)(D)(ii)*.

(n357)Footnote 329. Blake D. Rubin, Andrea Macintosh Whiteway & Jon G. Finkelstein, *Stimulus COD Income Deferral Raises Issues for Partnerships*, 2009 TNT 156-7 .

(n358)Footnote 330. *Id.*

(n359)Footnote 331.

It is unclear why the acceleration of deferred COD income that is triggered as a result of a sale or

liquidation of substantially all a taxpayer's assets under a title 11 or similar bankruptcy case is taken into account the day before the bankruptcy petition is filed as opposed to the date of the related liquidation or sale of substantially all the taxpayer's assets. The purpose of this rule may be to clarify that the accelerated COD income is a prebankruptcy petition liability that would generally receive lower priority under the Bankruptcy Code than a claim for taxes arising postpetition.

Blake D. Rubin, Andrea Macintosh Whiteway & Jon G. Finkelstein, *Stimulus COD Income Deferral Raises Issues for Partnerships*, 2009 TNT 156-7 .

(n360)Footnote 332. *See generally* Blake D. Rubin, Andrea Macintosh Whiteway & Jon G. Finkelstein, *Stimulus COD Income Deferral Raises Issues for Partnerships*, 2009 TNT 156-7 (arguing that *I.R.C. Section 108(i)(5)(D)(ii)* should be given a narrow reading and that regulations should carefully delineate the limits of the "sale or exchange or redemption" language.

(n361)Footnote 333. *Rev. Proc. 2009-37* , § 4.04, 2009- ____ C.B.____ ,____.

Thus, for example, if a taxpayer realizes \$100 of COD income from the reacquisition of an applicable debt instrument, the taxpayer may elect under § 108(i)(1) to defer only \$40 of the \$100 of COD income. The taxpayer may exclude from income the portion of COD income that the taxpayer does not elect to defer under § 108(i) (\$60 in this example) under § 108(a)(1)(A), (B), (C), or (D), if applicable.

Id.

(n362)Footnote 334. *I.R.C. § 108(i)(5)(B)(iii)*. *Revenue Procedure 2009-37* confirms that the rules governing extensions of time for making elections under *Treas. Reg. § 301.9100* will apply to an extension of time for making the *I.R.C. Section 108(i)* election. *Rev. Proc. 2009-37* , § 2.12, 2009- ____ C.B.____ ,____. Note also the *Revenue Procedure 2009-37* allows use of a protective election "if the [partnership] concludes that a particular transaction does not result in the realization of COD income, reports the transaction on its federal income tax return in a manner consistent with the [partnership's] conclusion, and would be within the scope of this revenue procedure if the [partnership's] conclusion were incorrect." *Rev. Proc. 2009-37* , § 4.11, 2009- ____ C.B.____ ,____. The *Revenue Procedure* describes the method of making the protective election. *Id.*

(n363)Footnote 335. *Rev. Proc. 2009-37* , § 4.04, 2009- ____ C.B.____ ,____.

Thus, for example, one partner's deferred amount may be zero while another partner's deferred amount may equal that partner's COD income amount (or any portion thereof). A partner may exclude from income the partner's included amount under § 108(a)(1)(A), (B), (C), or (D), if applicable.

Id. To avoid suggesting that this portion of the *Revenue Procedure* indicates that Treasury and the Service believe *I.R.C. § 704* generally requires some sort of proportionality, *Revenue Procedure 2009-37* states that "[t]he provisions of this section 4.04(3) apply for purposes of § 108(i) only and are not intended as an interpretation of or a change to existing law under § 704." *Id.*

(n364)Footnote 336. *Rev. Proc. 2009-37* , §§ 2.08 and 2.09, 2009- ____ C.B.____ ,____.

(n365)Footnote 337. *Rev. Proc. 2009-37* , § 4.05, 2009- ____ C.B.____ ,____.

(n366)Footnote 338. *Rev. Proc. 2009-37* , § 4.07, 2009- ____ C.B.____ ,____.

(n367)Footnote 339. *Rev. Proc. 2009-37* , § 4.10, 2009- ____ C.B.____ ,____.

(n368)Footnote 340. *Rev. Proc. 2009-37*, § 4.12, 2009- ____ C.B.____ ,____.



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Collier on Bankruptcy Taxation

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CHAPTER TX13 Financially Troubled Partnerships

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P TX13.04 Tax Consequences When a Partnership or a Partner Files for Relief as a Debtor Under Title 11

[1] Commencement of a Title 11 Case for a Partnership

[a] Commencement Does Not Create a Separate Taxable Entity

A partnership n1 can be a debtor in a title 11 case. n1a Prior to the Bankruptcy Tax Act of 1980, n2 commencement of a title 11 case for a partnership resulted in the creation of a new, separate taxable entity that succeeded to the assets of the debtor partnership. n3 The IRS treated the new entity as a trust for federal income tax purposes. n4 In contrast, under current law, commencement of a title 11 case for a partnership does not create a new taxable entity for federal income tax purposes. n5

Several consequences flow from this statutory rule. First, commencement of a title 11 case for a partnership does not trigger recognition of income, gain or loss by the debtor partnership. Because the commencement does not create a new taxable entity, there is no deemed transfer of partnership assets that might trigger such recognition. Second, such commencement does not trigger recapture of depreciation or tax credits and does not accelerate recognition of installment gain. Again, there is no deemed transfer of partnership assets that might trigger such recapture or acceleration. Third, the debtor partnership continues to function as a conduit, and partners or their bankruptcy estates continue to receive their distributive shares under *I.R.C. section 704*. Fourth, the debtor partnership's taxable year does not change. Fifth, the debtor partnership or trustee continues to use the employer identification number assigned to the debtor partnership. n6

Because the partnership in bankruptcy continues to function as a conduit, the partnership must file an annual information return (Form 1065) and will continue to use the same taxpayer identification number. n6a The question is who has the obligation to file that return. Prior to the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act"), n7 the Internal Revenue Manual took the position that the trustee of a partnership in bankruptcy must file a partnership return on behalf of the partnership. n8 However, as commentators pointed out, between the Bankruptcy Tax Act of 1980 and the 2005 Act, there was neither statutory nor judicial authority for the position taken in the Manual. n9 Prior to the 2005 Act, the only authority for the position taken in the Manual appeared in the legislative history of the Bankruptcy Tax Act of 1980. n10 The 2005 Act addresses two relatively limited aspects of this question. First, the 2005 Act adds newSection 1116 to the Bankruptcy Code, specifying the duties of the trustee or debtor in possession in "small business cases," n10a including the duty to "timely file tax returns." n10b Second, the 2005 Act amends *11 U.S.C. section 346(b)*, which deals with treatment of state and local taxes. Following the 2005 Act

amendments, section 346(b) provides in pertinent part:

The trustee shall make such tax returns of income of corporations and of partnerships as are required under State or local law, but with respect to partnerships, shall make such returns only to the extent such returns are also required to be made under [the Internal Revenue Code of 1986]. n10c

Note that section 346(b) applies only to *State and local* tax returns, and limits the trustee's obligation to file a *State or local* tax return based on limitations on the trustee's obligation to file corresponding *federal* tax returns. The 2005 Act does not amend *Internal Revenue Code section 6031* to clarify a trustee's obligation to file a partnership information tax return, so, as explained earlier, the question of whether a trustee has such a duty for Federal tax purposes remains open. Presumably the Internal Revenue Service will continue to assert the position currently set forth in the Internal Revenue Manual. If that position is correct, section 346(b) appears to obligate a trustee to prepare State and local partnership information tax returns in those states and localities that require such information returns.

In situations not governed by either of these 2005 statutory changes, if a partnership's bankruptcy trustee concludes that he or she does not have the authority to file an information return for the partnership, the trustee should consider the following recommendations:

[A] trustee should undertake reasonable good faith efforts to marshal information concerning prepetition transactions that she is aware of and provide that information to the partners and others as required by the Bankruptcy Code. The trustee should also cooperate with the partners to aid partners in collection of tax information. [A] trustee should provide to the managing partner, general partner, tax matters partner, or whoever is responsible for the bankruptcy, work papers providing information with respect to the estate's transactions. n10d

In addition to the question of who must file the original partnership tax return, there is a question as to who has authority to file an amended partnership tax return. *I.R.C. section 6227* provides that only a "tax matters partner" n11 or other general partner n12 may file a request for an "administrative adjustment." In the partnership context, an "administrative adjustment" is the equivalent of filing an amended tax return. Unfortunately, there is no direct statutory authority for a partnership's trustee in bankruptcy to file such a request. However, in view of its position on the trustee's obligation to file partnership returns, presumably the IRS would not object to a trustee's filing a request for an "administrative adjustment," at least if the request relates to a return filed by the trustee.

Another consequence of the fact that the partnership in bankruptcy continues to function as a conduit deserves note. To the extent that such a partnership has items of income or gain, those items pass through to the partners, who must report them on their individual tax returns. However, because the post- bankruptcy petition earnings of the partnership are property of the estate, n13 the partners may never receive any actual distributions from the partnership to help cover the tax on the income or gain passed through to them. This consequence may create hardship for some partners.

The 2005 Act amends *11 U.S.C. section 346*, which provides special rules for the treatment of state and local taxes. These amendments provide important uniformity between federal and state or local tax treatment of debtors in title 11 cases. Of importance to partnerships that are debtors in title 11 cases are amendments to section 346(b), (c) and (d):

[i] State and Local Taxation of Partnership Income, Gain, Loss, Deductions and Credits

Section 346(b), as amended by the 2005 Act, provides in pertinent part:

(b) Whenever the Internal Revenue Code of 1986 provides that no separate taxable estate shall be

created in a case concerning a debtor under [11 U.S.C.], and the income, gain, loss, deductions, and credits of an estate shall be taxed to or claimed by the debtor, such income, gain, loss, deductions, and credits shall be taxed to or claimed by the debtor under a State or local law imposing tax on or measured by income and may not be taxed to or claimed by the estate. ... The estate shall be liable for any tax imposed on such ... partnership, but not for any tax imposed on partners ... n13a

[ii] State and Local Taxation of Post-Commencement Partnership Distributions

Section 346(c) provides:

(c) With respect to a partnership or any entity treated as a partnership *under a State or local law imposing a tax on or measured by income* that is a debtor in a case under [11 U.S.C.], any gain or loss resulting from a *distribution of property from such partnership, or any distributive share of any income, gain, loss, deduction, or credit* of a partner or member *that is distributed, or considered distributed*, from such partnership, *after the commencement of the case*, is gain, loss, income, deduction, or credit, as the case may be, of the partner or member, and if such partner or member is a debtor in a case under [11 U.S.C.], shall be subject to tax in accordance with [Section 346(a)(state and local taxation when the Internal Revenue Code of 1986 provides that there is a separate taxable estate for the debtor) or section 346(b) (state and local taxation when the Internal Revenue Code of 1986 provides that there is no separate taxable estate for the debtor)]. n13b

This provision applies to distributive shares and distributions (actual or deemed) made by the partnership after commencement of the partnership's title 11 case. Note that section 346(c) only applies if state or local law treats the entity as a partnership. Thus, if an entity is treated as a partnership under *federal* income tax law, but if applicable state or local law does not treat the entity as a partnership, section 346(c) does not apply. Note also that section 346(c) applies only to a state or local tax "on or measured by income."

[iii] State and Local Taxation--Termination of Partnership Taxable Year

Section 346(d) provides:

(d) For purposes of any State or local law imposing a *tax on or measured by income*, the taxable period of a debtor in a case under [11 U.S.C.] shall terminate *only if and to the extent that the taxable period of such debtor terminates under the Internal Revenue Code of 1986*. n13c

As explained in the following section, commencement of a title 11 case by a partnership does not terminate the partnership's taxable year. n13d Thus, commencement of a title 11 case by a partnership will not cause the partnership's taxable year to close for state or local taxes on or measured by income.

[b] Commencement Does Not Terminate the Debtor Partnership

Under current law, commencement of a title 11 case for a partnership does not terminate the partnership for federal income tax purposes. n14 for federal income tax purposes, the Code treats a partnership as terminated if " *no part* of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership" n15 Since the effective date of the Bankruptcy Tax Act of 1980 (March 25, 1981), the commencement of a title 11 case for a partnership does not create a new taxable entity. Therefore, there is no deemed transfer of the partnership's assets that might trigger termination of the partnership for tax purposes. Of course, events subsequent to the commencement of a title 11 case for a partnership may cause termination of the partnership for tax purposes.

For partnership title 11 cases commenced prior to the effective date of the Bankruptcy Tax Act of 1980, the commencement of the title 11 case apparently caused the termination of the debtor partnership for federal income tax

purposes. n16 The deemed transfer of all of the partnership assets to the debtor partnership's bankruptcy estate left the debtor partnership with no assets with which to conduct its business, thus presumably triggering termination. n17

Although commencement of a title 11 case for a partnership does not terminate the debtor partnership for federal income tax purposes, what happens if the bankruptcy court consolidates several related debtor partnerships for bankruptcy purposes? In general, *I.R.C. section 708(b)(2)(A)* provides:

In the case of the merger or consolidation of two or more partnerships, the resulting partnership shall, for purposes of [section 708], be considered a continuation of any merging or consolidating partnership whose members own an interest of more than 50 percent in the capital and profits of the resulting partnership.

If one or more of the pre-merger or pre-consolidation partnerships cannot satisfy section 708(b)(2)(A), such partnerships would be deemed to have terminated. and their taxable years would terminate as of the date of the merger or consolidation under *I.R.C. section 706(c)(1)*. Would a consolidation ordered by the bankruptcy court be subject to section 708(b)(2)(A)?

In Field Service Advice issued in 1999, n17a the IRS addressed this question in the following context. A group of related tax shelter partnerships had commenced title 11 cases. One person (A) was a partner in all of these partnerships and was the Tax Matters Partner (TMP) for all these partnerships. Another person (B) was a partner in some but not all of these partnerships. The bankruptcy substantively consolidated the partnerships into a single entity for purposes of the ongoing bankruptcy proceeding. The Judgment for Substantive Consolidation in the bankruptcy proceeding provided:

7. Neither the order granting the motion for summary judgment for substantive consolidation nor this judgment shall be dispositive of the effects of this consolidation on the rights and liabilities of any partner not named as a defendant in this adversary proceeding, which rights and liabilities shall be determined later as necessary.

When A was indicted in connection with the tax shelter activity, the IRS sought to remove A as TMP. A offered to resign as TMP if B could be appointed TMP. In response to the argument that B could not be the TMP for any partnership in which he was not a member, those supporting B's appointment argued that the consolidation made B a partner in all the partnerships. The IRS rejected that argument:

The Order is clear that the Judgment for Substantive Consolidation alone does not alter the rights of the partners. Thus, though the partnerships have been consolidated for purposes of the bankruptcy proceeding, the Judgment for Substantive Consolidation, on its face, does not alter the legal structure of the partnerships. This conclusion is further strengthened when viewed in light of the state law regarding the merger or consolidation of partnerships in each of the jurisdictions in which the partnerships were formed. Under each provision, a merger or consolidation of partnerships must be approved by the partners in order for it to be effective...

In light of the foregoing, we conclude that the substantive consolidation of the partnerships for purposes of the bankruptcy proceeding did not serve to merge or consolidate the partnerships for any purpose other than the bankruptcy proceeding. Accordingly, Mr. B is not deemed to be a partner of all of the partnerships and thus may not be designated to serve as the TMP of all related partnerships that are docketed before the Tax Court.

Although the issue addressed by the FSA is the question of who could be the TMP for the consolidated partnerships, the reasoning of the FSA suggests that an administrative consolidation of the sort described in the FSA would not be a consolidation for purposes of *I.R.C. section 708(b)(2)(A)*. Whether the narrowly tailored language of the court order was essential is open to debate because the FSA distinguishes between a consensual merger or consolidation and one

ordered by a court.

[c] The I.R.C. section 1446 Withholding Tax

As discussed earlier in this chapter, n17b if the partnership has "effectively connected taxable income" n17c for any taxable year, and if any portion of the "effectively connected taxable income" is allocable to a foreign partner, n17d *I.R.C. section 1446(a)* requires the partnership to pay a withholding tax. The addition to tax imposed by *I.R.C. section 6655(a)* can apply if the partnership fails to withhold under *I.R.C. section 1446*. n17e Thus, before a partnership commences a title 11 case, it must ascertain whether any discharge of indebtedness income it will have will be "effectively connected taxable income" and if so, whether any of such income will be allocated to a foreign partner. If the partnership discovers that *I.R.C. section 1446* will apply and that its financial troubles will make payment of the *I.R.C. section 1446* withholding tax difficult, the partnership might avoid liability under *I.R.C. section 1446* if it could establish that the foreign partner would not be liable for any United States income tax. Because liability for the *I.R.C. section 1446* withholding tax can extend to partners and to the partnership's trustee in bankruptcy, it is essential that the partnership identify *I.R.C. section 1446* problems before commencing a title 11 case.

[2] Commencement of a Title 11 Case for a Partner

Although full analysis of the taxation of an "individual" in a title 11 case appears elsewhere, n18 several issues deserve attention at this point.

[a] Commencement Creates a Separate Taxable Entity

In contrast to the commencement of a title 11 case for a partnership, commencement of a title 11 case under either chapter 7 or chapter 11 of the Bankruptcy Code for a partner who is an "individual" creates a new taxpayer, the estate of the "individual" partner. n19 However, if an "individual" seeks relief under Chapter 12 of the Bankruptcy Code, dealing with "family farmers" and "family fishermen," the IRS takes the position that no new taxable entity comes into being as the result of the filing. n20 The IRS acknowledges that under *section 541(a) of the Bankruptcy Code*, a chapter 12 petition creates a bankruptcy estate consisting of all property in which the debtor has an interest on the date of filing. However, because *I.R.C. section 1398* refers only to cases under chapter 7 and chapter 11 of the Bankruptcy Code, the IRS concludes that a chapter 12 case does not create a separate taxable entity. "When [the taxpayer] filed a chapter 12 petition, an estate was created However, according to section 1399, that estate was not a separate taxable entity." n21 Thus, the problems associated with the allocation of partnership income or loss between the partner and the partner's taxable bankruptcy estate discussed below n22 do not arise when the partner is in a Chapter 12 case.

[b] Commencement Does Not Terminate the Partnership

A partner's filing for relief under the Bankruptcy Code should not cause a termination of the partnership under *I.R.C. section 708(b)(1)(b)*, which treats a partnership as terminated if "within a 12-month period there is a *sale or exchange* of 50 percent or more of the total interest in partnership capital or profits." n23 Does the creation of a separate bankruptcy estate for an "individual" partner who owns 50% or more of the total interest in a partnership's capital or profits (or the creation of separate bankruptcy estates for two or more partners who, in the aggregate, own 50% or more of the total interest in a partnership's capital or profits) cause termination of the partnership under *I.R.C. section 708(b)(1)(B)*? Prior to the Bankruptcy Tax Act of 1980, the regulations under *I.R.C. section 708* and a Revenue Ruling suggested that a partnership did not terminate for tax purposes simply because an "individual" partner had commenced a case under either chapter 7 or chapter 11. n24 The Bankruptcy Tax Act of 1980 did not directly address this question. "The implication to be drawn from this silence is that Congress did not intend to disturb the existing rule that a transfer to the bankrupt's estate is not a sale or exchange for purposes of *section 708 of the Code*." n25 *I.R.C. section 1398(f)(1)* supports this conclusion by providing that "[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." n26 The Tax Court

has properly adopted this analysis. n27

[c] Does Commencement Close the Partner's Taxable Year or the Partnership's Taxable Year?

[i] The Partner's Taxable Year

Commencement of a bankruptcy case by a partner does not automatically close the partner's taxable year. n27a However, if the debtor partner is an "individual," the partner may elect to close his or her taxable year on the date before the bankruptcy case is commenced. n27b The effect of this election is to divide the partner's taxable year into two short taxable years. For a complete discussion of this election, see *P TX2.05 supra*.

[ii] The Partnership's Taxable Year

A partnership's taxable year closes with respect to a partner who "sells or exchanges" his or her entire interest in the partnership. n28 When a partner commences a title 11 case, n29 the Internal Revenue Code treats that partner as having transferred his or her entire partnership interest to the bankruptcy estate. If this deemed transfer is a "sale or exchange" of the partner's entire interest in the partnership, the partnership's taxable year would close with respect to the partner on the date the partner commences the title 11 case. If the partnership's taxable year closes with respect to the partner, the partnership would determine the partner's distributive share of partnership income or loss for the short partnership taxable year ending on the date the partner commenced a title 11 case. n30 The partner would report that distributive share on the return for his or her taxable year that includes that date. n31

I.R.C. section 1398(f)(1) provides that "[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 [the income tax title] assigning tax consequences to a disposition ... " The tax court has properly concluded that *I.R.C. section 1398(f)(1)* governs, with the result that commencement of a title 11 case for a partner does not close the partnership's taxable year with respect to that partner. n32

[d] Allocation of Partnership Income or Loss Between Partner and Partner's Bankruptcy Estate

Although the commencement of a title 11 case by a *partner* does not cause the *partnership's* taxable year to terminate with respect to that partner, *I.R.C. section 706(d)* might have the same effect. *I.R.C. section 706(d)(1)* provides that

if during any taxable year of the partnership there is a change in any partner's interest in the partnership, each partner's distributive share ... for such taxable year shall be determined by use of any method prescribed by the Secretary by regulations which takes into account the varying interests of the partners in the partnership during such taxable year.

The question is whether the commencement of a title 11 case by a partner constitutes a "change" in that partner's interest in the partnership sufficient to trigger application of *I.R.C. section 706(d)*. The IRS has issued a Private Letter Ruling concluding that it will not treat the transfer of a debtor partner's interest in a partnership to the debtor partner's bankruptcy estate as a "change" in a partner's interest in the partnership under *I.R.C. section 706(d)*. n33 The Tax Court adopted the same position in *Gulley v. Commissioner* n34 and in *Katz v. Commissioner*. n34a Although neither the Private Letter Ruling nor *Gulley* cited authority for this conclusion, both reach the correct result, because *I.R.C. section 1398(f)(1)* overrides the "varying interests" rule embodied in *I.R.C. section 706(d)*. n35 *Katz* confirms this analysis. n35a Thus, the partnership would allocate the entire year's income or loss to the person who is the partner on the last day of the partnership's taxable year. If the debtor partner's bankruptcy estate still exists when the partnership's taxable year ends, the estate, not the debtor partner, would receive the allocation. n36 If the debtor partner elects under *I.R.C. section 1398(d)* to treat the year in which the debtor partner commences the title 11 case as two taxable years, that decision will not affect this result. n37

[e] I.R.C. section 752(b)

When a partner who is an "individual" seeks relief under chapter 7 or chapter 11 of the Bankruptcy Code, does the transfer of the partner's partnership interest to the partner's bankruptcy estate trigger a deemed distribution of cash under *I.R.C. section 752(b)*? In other words, does the transfer to the bankruptcy estate relieve the partner of his or her share of the partnership liabilities? If so, the deemed cash distribution under *I.R.C. section 752(b)* will cause the partner to recognize gain under *I.R.C. section 731* to the extent the deemed distribution exceeds the partner's basis in the partnership interest. Arguably, *I.R.C. section 1398(f)(1)* eliminates any problem under *I.R.C. section 752(b)*. *I.R.C. section 1389(f)(1)* provides that the transfer from the partner to the bankruptcy estate is not a "disposition" of the partnership interest "for purposes of any provision of [the income tax title of the Internal Revenue Code] assigning tax consequences to a disposition." Further, *I.R.C. section 1398(f)(1)* provides that the bankruptcy estate "shall be treated as the debtor would be treated with respect to" the partnership interest. "It is clear from the language and legislative history of this provision that [Congress] intended to treat, for federal income tax purposes, the transfer by the debtor of property to the estate as if the transfer had not occurred. Section 752, therefore, should have no application to such a transfer."

n38

[f] Partner's Liability for Employment Taxes

John Smith, a general partner in the four person general partnership known as Black, Green, White & Smith, commenced a title 11 case on February 4, 2000. Between 1992 and 1996, the IRS had properly assessed the partnership \$10,000 for unpaid employment taxes for which the partnership was directly liable. These taxes were unpaid as of the date on which Smith commenced his title 11 case. The IRS never assessed these taxes against Smith and the statute of limitations for making an assessment against Smith had already expired when Smith commenced his title 11 case. Shortly after Smith commenced his title 11 case, the IRS filed a proof of claim for the \$10,000 in employment taxes against Smith. Is Smith (or his bankruptcy estate) liable for the \$10,000 in employment taxes?

On essentially these facts, the United States District Court for the Central District of California in *In re Briguglio* n38a and *In re Galletti* n38b concluded that a proof of claim filed against the partner in bankruptcy was not valid because the IRS had not assessed the taxes against the partner. The court based its decision on its interpretation of *I.R.C. section 6203*, which requires a valid assessment against a taxpayer as a prerequisite for collection of taxes from the taxpayer. The court noted that *I.R.C. section 7701(a)(14)* defines the term "taxpayer" as "any person subject to any internal revenue tax." *I.R.C. section 7701(a)(1)* defines the term "person" as including "an individual, a trust, estate, partnership, association, company or corporation." Although the definitions of "taxpayer" and "person" do not specifically refer to a "partner" or "general partner," the court concluded that a general partner who is an "individual" is a "taxpayer" against whom a tax must be assessed to be collectible. The court explained that, under California law, general partners in a general partnership are liable for the debts of the partnership. However, because *I.R.C. section 6203* requires assessment of a tax against any "taxpayer" as a prerequisite to collection of the tax, the IRS should have assessed the tax against the partners in the partnership. Failure to do so within the statute of limitations period prevented the IRS from collecting the tax from the bankrupt partner or the bankrupt partner's estate.

Although the Court of Appeals for the Ninth Circuit affirmed *In re Briguglio* and *In re Galletti* in a combined opinion cited as *In re Galletti*, n38c the United States Supreme Court reversed the Ninth Circuit's decision. n38d The Court first explained that the issue was "whether the United States can collect the Partnership's unpaid employment taxes from [the individual partners] in a judicial proceeding occurring more than three years after the tax return was filed but within the 10-year extension to the 3-year limitations period that attached when the tax was timely assessed against the Partnership." n38e The Court rejected the partners' argument that a valid assessment (i.e., an assessment that would trigger the 10-year extension to the 3-year statute of limitations) must name them individually because they were primarily liable for the tax debt under *I.R.C. section 6203* and relevant California law. As to *I.R.C. section 6203*, the Court explained that the taxpayer liable for the tax was the employer, which in this case was the Partnership. As to the partners' liability under California partnership law, the Court explained that:

[U]nder California's partnership principles, a partnership and its general partners are separate entities. See *Cal. Corp. Code Ann. section 16201* (Supp. 2004). Thus [the partners] cannot argue that, for all intents and purposes, imposing a tax directly on the Partnership is equivalent to imposing a tax directly on the general partners. [The partners] must instead prove that the tax liability was imposed both on the Partnership and [the partners] as separate "employers." The fact that [the partners] are jointly and severally liable for the debts of the Partnership is irrelevant to this determination. n38f

The Court concluded:

Once a tax has been properly assessed, nothing in the Code requires the IRS to duplicate its efforts by separately assessing the same tax against individuals or entities who are not the actual taxpayers but are, by reason of state law, liable for payment of the taxpayer's debt. The consequences of the assessment--in this case the extension of the statute of limitations for collection of the debt--attach to the tax debt without reference to the special circumstances of the secondarily liable parties. n38g

To this point, we have focused on a partner's liability for a partnership's employment taxes. In *People Place Auto Hand Carwash LLC v. Commissioner*, n38h the Tax Court addressed the related question of whether the commencement of a title 11 case by the owner-operators of the LLC caused the bankruptcy automatic stay n38i to apply to collection efforts against the LLC. Husband and Wife were the only members of People Place Auto Hand Carwash LLC. The Internal Revenue Service sought to collect from the LLC employment taxes relating to several individuals who, according to the Service, were employees of the LLC. The LLC petitioned the Tax Court for a redetermination of the employment tax liability. During the pendency of the Tax Court case, Husband and Wife commenced a chapter 7 case. The LLC then argued that the automatic stay in the chapter 7 case required the Tax Court to stay the redetermination proceedings. The LLC based its argument on *11 U.S.C. section 362(a)(8)* which, prior to amendment by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, provided that the automatic stay applied to Tax Court proceedings "concerning the debtor." n38j The Service, noting that the LLC was not a debtor in a title 11 case, responded that the automatic stay in connection with the chapter 7 case had no effect on collection proceedings against the LLC.

Rejecting the LLC's argument, the Tax Court conceded that "[i]n 'unusual circumstances', a *bankruptcy court* may properly stay a proceeding against a nonbankrupt third party, if 'there is such identity between debtor and the third-party defendant that the debtor may be said to be the real party defendant and that a judgment or finding against third-party defendant will in effect be a judgment against the debtor.'" n38k However, "[a]ny such stay ... would not arise pursuant to the automatic stay provisions of *11 U.S.C. section 362(a)* but rather pursuant to the bankruptcy court's equitable power to issue an order as 'necessary or appropriate to carry out the provisions' of the Bankruptcy Code, as provided by *11 U.S.C. section 105(a) (2000)* ... [R]equests for such relief can only be presented to the bankruptcy court." n38l Despite the fact that the LLC was treated as a conduit for federal income tax purposes, "[s]uch classification for tax purposes, however, has no effect on the legal status of the ownership of LLC assets and provides no basis for disregarding [the LLC's] separate identity from the Conways'." n38m Thus, the Tax Court concluded, the automatic stay in the chapter 7 case did not require the Tax Court to stay the LLC's redetermination case.

[3] Dismissal for Failure to Timely File Tax Returns

The 2005 Act amends *11 U.S.C. section 521* by adding new subsection (j), which provides:

(j)(1) Notwithstanding any other provision of [11 U.S.C.], if the debtor fails to file a tax returns that becomes due after the commencement of the case or to properly obtain an extension of the due date for filing such return, the taxing authority *may* request that the court enter an order converting or dismissing the case.

(2) If the debtor does not file the required return or obtain the extension referred to in [Section 521(j)(1)] within 90 days after a request is filed by the taxing authority under that paragraph, the court

shall convert or dismiss the case, whichever is in the best interests of creditors and the estate. n39

Section 521(j) represents a significant change in the law. The triggering event for section 521(j) is a request from the taxing authority. The taxing authority may, but need not, make such a request. However, once the taxing authority makes the request, if the debtor fails to file the return or to obtain an extension within 90 days after the filing of the request, the bankruptcy court must either dismiss or convert the case.

[4] The Effect of Bankruptcy on Partnership Level Tax Audits

[a] Overview of the Partnership Tax Audit Rules

Prior to 1982, when the IRS audited tax items on a partnership's information tax return (Form 1065), it did so by examining those items in the individual partners' tax returns. The IRS reasoned that because a partnership is a conduit for its items of income, gain, loss, deduction and credit, it could not make adjustments for tax liability at the partnership level. n39a This approach created significant administrative problems for several reasons. First, the IRS had to locate each partner in a partnership and coordinate the audit of each partner's individual tax return to ensure a consistent audit result. Second, agreements made with one partner did not bind other partners. Third, the IRS faced significant statute of limitations problems because it had to deal with each partner and often had to request extensions of the statute of limitations from each partner. n40 To deal with these administrative problems, Congress enacted procedures regarding audits at the partnership level as part of the Tax Equity and Fiscal Responsibility Act ("TEFRA") of 1982. n41

The TEFRA legislation applies to all partnerships required to file information tax returns under *I.R.C. section 6031(a)* (which invokes the definition of "partnership" set forth in *I.R.C. section 761(a)*). n42 However, *I.R.C. section 6231(a)(1)(B)* creates an exception for partnerships "*having 10 or fewer partners each of whom is an individual (other than a nonresident alien), a C corporation, or an estate of a deceased partner.*" n43 For purposes of determining the number of partners, husbands and wives (and their estates) are considered one partner. n44 A partnership that qualifies for this exception may, however, elect to be covered by the TEFRA legislation. n45

Partnerships covered by the exception set forth in *I.R.C. section 6231(a)(1)(B)* should take care not to make an inadvertent election to be covered by the TEFRA legislation by naming a "tax matters partner" n45a on the partnership's Form 1065. n45b

Under TEFRA, the IRS determines the tax treatment of items of partnership income, gain, loss, deduction and credit at the partnership level in a unified proceeding rather than in separate proceedings with the partners. n46 To effectuate this auditing approach, the legislation provides that each partner's tax return must treat partnership items consistently with that item's treatment on the partnership tax return. n47 If a partner's reporting of any item is not consistent with the partnership's reporting of that item, and if the partner cannot take advantage of one of the statutory exceptions, n48 the IRS can, by a "computational adjustment," n49 make the partner's reporting consistent with the partnership's reporting. n50 The IRS can make a "computational adjustment" without commencing a partnership audit proceeding, n51 something that would otherwise be a precondition to an assessment. n52 If the "computational adjustment" results in additional tax, the IRS may also assert a negligence penalty based on the amount of the additional tax. n53

Outside of the exceptions noted in the preceding paragraph, *I.R.C. section 6225* requires the IRS to commence a partnership audit before making any assessments of any deficiencies attributable to any partnership item. In a partnership audit, a "tax matters partner" represents the partnership. n54 The "tax matters partner" has significant powers and corresponding responsibilities. "The [Internal Revenue] Service and the tax matters partner will determine the time and place for all administrative proceedings." n55 The "tax matters partner" has the power to extend the partnership statute of limitations, n56 institute litigation on behalf of the partnership and select the court in which to conduct the litigation, n57 and, in certain circumstances, settle partnership adjustments for all partners. n58 In addition, because the "tax matters partner" receives notices and information relating to the partnership audit from the IRS, the

"tax matters partner" has the obligation to keep the other partners informed of the status of the partnership audit. n59 Finally, when the IRS sends the partnership a notice of a partnership audit for a particular taxable year, the "tax matters partner" must furnish the IRS with the name, address, profits interest, and taxpayer identification number of each person who was a partner at any time during such taxable year. n60

When the IRS proposes a settlement to one or more partners on any partnership items in connection with a partnership audit, it must offer the same settlement to any other partners who request the settlement. n61 The consistent settlement option does not require all partners to settle on the same basis. Because the consistent settlement option applies only to "partnership items," it does not apply to penalties that may be assessed against partners. Thus, partners cannot compel a consistent settlement with regard to penalties.

[b] The Effect of Bankruptcy on Partnership Tax Audits

Suppose the IRS has instituted a partnership level audit under TEFRA, and then either the partnership, the "tax matters partner," or another partner commences a title 11 case. In each of these three situations, should the automatic stay n62 have any effect on the partnership level audit? Ordinarily, when a debtor commences a title 11 case, the automatic stay prevents (1) the IRS from assessing any additional tax, n63 (2) the debtor from commencing litigation in Tax Court, n64 and (3) the continuation of any pending litigation in Tax Court. n65 However, in the context of a partnership level audit, the effect of the automatic stay depends on who commenced the title 11 case.

[i] Partnership in Bankruptcy

If the partnership commences the title 11 case, courts have properly concluded that the automatic stay does not affect the partnership level audit. n66 The partnership as an entity has no tax liability. As explained earlier in this section, the partnership level audit is an administrative convenience designed to avoid the problems created by separate audits of individual partners. Because the partnership level audit will not produce any partnership level tax liability, there is no reason for the automatic stay to affect the partnership level audit.

[ii] Partner (Other Than "Tax Matters Partner") in Bankruptcy

If a partner other than the "tax matters partner" commences the title 11 case, one might conclude that the automatic stay would affect the conduct of the partnership level audit. An IRS determination that certain partnership items would produce tax liabilities affects the tax liability of all partners, including the partner in the title 11 case. For that reason, one might think that the automatic stay might affect the continuation of the partnership level audit. However, Congress gave the IRS the authority to treat what would otherwise be partnership items as nonpartnership items, thereby avoiding the problem. n67 Treasury has exercised this authority in *Treas. Reg. section 301.6231(c)-7(a)*:

The treatment of partnership items with respect to a debtor in a bankruptcy proceeding will interfere with the effective and efficient enforcement of the internal revenue laws. Accordingly, partnership items of such a partner arising in any partnership taxable year ending on or before the last day of the latest taxable year of the partner with respect to which the United States could file a claim for income tax due in the bankruptcy proceeding shall be treated as nonpartnership items as of the date the petition naming the partner as debtor is filed in bankruptcy. n68

Once the partnership items become nonpartnership items, the bankrupt partner is no longer involved in the partnership level audit. n69 As a result, the need to apply the automatic stay to the partnership level audit disappears.

The IRS apparently takes the position that the term "claim" as used in *Treas. Reg. section 301.6231(c)-7(a)*, quoted above, has a broad meaning:

Claim for purposes of the temporary regulation means both a proof of claim pursuant to *Bankruptcy*

Code section 501 and a request for administrative expenses pursuant to *Bankruptcy Code section 503*. Therefore, partnership items attributable to both prepetition and postpetition years can convert. Also the word "could" for purposes of Temp. Treas. Reg. section 301.623 1(c)-7T is interpreted broadly to include a potential claim. otherwise, there would be a restriction that the bankrupt debtor's taxable years must be examined on their merits to determine whether conversion occurs (i.e., to determine whether a bona fide claim exists).

Thus, items for prepetition years for which the Service can file a proof of claim will always convert. Whether or not items for postpetition years can convert is more complicated. In order to determine which partnership items convert, it is necessary to ascertain the LATEST taxable year of the partner for which the government could file a claim in bankruptcy for tax attributable to the partnership interest. In a chapter 7 or 11 case, this date will be the latest year the partnership interest is in possession of the bankruptcy estate. In a chapter 13 case, this date will generally be the latest year that the case is pending. Two questions must be answered. Has the partnership's taxable year ended on or before the last day of the latest year of the partner for which a claim could be filed? Can a claim be filed in the bankruptcy proceeding? It is this office's position that the special enforcement regulation for bankruptcy requires that the partnership's taxable year end on or before the latest year of the partner for which a claim could be filed. If the partnership's year does not end on or before such date, then regardless of whether a claim could be filed, the partnership items for that year will not convert.

For example, suppose a chapter 11 bankruptcy petition is filed on December 6, 1986, and the plan is confirmed in May 1988. After confirmation the bankruptcy estate no longer exists, and claims for administrative expenses can no longer be filed. However, by May 1988, the partnership's 1988 taxable year has not ended, so the debtor's partnership items for 1988 do not convert. Accordingly, 1988 is not the latest year for which a claim could be filed. However, the estate clearly was in existence for 1987, so any liabilities are those of the estate, and a request for payment of tax attributable to partnership items could be filed. In addition, the partnership's taxable year has ended for 1987. Therefore, 1987 is the latest year for which a claim could be filed by the government in the partner's bankruptcy proceeding. Accordingly, all partnership items for 1987 and earlier years convert. n70

[iii] "Tax Matters Partner" in Bankruptcy

If the "tax matters partner" commences a title 11 case, the Treasury Regulations provide that the partner's designation as the "tax matters partner" ends on the day when that partner's partnership items become nonpartnership items. n71 As the preceding material explains, that event occurs on the date of the commencement of the title 11 case (the filing of the petition in bankruptcy). The Tax Court has approved this result. n72 Thus, for the reasons set forth in the preceding paragraph, the bankruptcy of the "tax matters partner" does not result in the application of the automatic stay to the partnership level audit.

Terminating a debtor partner's status as "tax matters partner" may create a problem if the debtor partner is the sole general partner in the partnership. *I.R.C. section 6231(a)(7)*, which defines the term "tax matters partner," provides that, as a general rule, the "tax matters partner" must be a general partner. *I.R.C. section 6231 (a)(7)(A)* first allows the partnership to designate the "tax matters partner." Alternatively, if the partnership makes no such designation, *I.R.C. section 6231 (a)(7)(B)* provides that the general partner with the largest profits interest at the close of the taxable year at issue is the "tax matters partner," and if there is more than one such partner, the general partner whose name would appear first in an alphabetical listing is the "tax matters partner." Finally, *I.R.C. section 6231 (a)(7)* provides that, if the partnership fails to designate a "tax matters partner" and the Secretary determines that it is impracticable to apply the largest profits interest rule, the partner selected by the Secretary shall be treated as the "tax matters partner." *Treas. Reg. section 301.6231(a)(7)-1(b)(1)* provides that a person may only be designated by a partnership to be the "tax matters partner" if that person was a general partner in the partnership at some time during the taxable year for which the

designation is made, or is a general partner in the partnership as of the time the designation is made. Thus, if the sole general partner of a partnership is a debtor in a title 11 case, the partnership cannot designate a tax matters partner and the largest profits interest rule will not apply. In such an instance, there will be no "tax matters partner" until the Internal Revenue Service designates one pursuant to *I.R.C. section 6231(a)(7)*. n73

Although commencement of a title 11 case by the "tax matters partner" does not cause the automatic stay to apply to a partnership level audit, the bankruptcy of a "tax matters partner" may have ancillary effects that deserve discussion. First, suppose a partnership is involved in a partnership level audit when its "tax matters partner" commences a title 11 case. After commencing the title 11 case, the "tax matters partner" signs an extension of a statute of limitations on behalf of the partnership. Is the extension valid? If the "tax matters partner" had not commenced a title 11 case, *I.R.C. section 6229(b)(1)(B)* would apply and all partners would be bound by the extension agreement entered into between the "tax matters partner" and the IRS. However, as discussed in the preceding paragraph, when the "tax matters partner" commenced the title 11 case, that partner's status as "tax matters partner" terminated. Thus, if the extension in the hypothetical was entered into on or before August 5, 1997, the extension would not be binding on the other partners because the partner who executed the extension was not the "tax matters partner" at the time of the execution. n74 However, if the extension was entered into after August 5, 1997, *I.R.C. section 6229(b)(2)* provides that the extension will bind all partners unless the IRS has received proper notice of the title 11 case commenced by the "tax matters partner." n75

Second, because the partnership level audit will continue, the partnership must have a new "tax matters partner." Prompt action to name a new "tax matters partner" is advisable because the bankruptcy of the former "tax matters partner" does not affect statutory time limits relating to the partnership level audit. For example, the bankruptcy of the "tax matters partner" does not toll the running of the ninety day period during which the "tax matters partner" may commence litigation to contest a notice of a final partnership administrative adjustment issued by the IRS. n76 If the "tax matters partner" was the sole general partner of the partnership, note the discussion of this problem in the preceding material.

[iv] Tiered Partnerships

Although the discussion to this point has focused on a single partnership, business and investment arrangements often involve tiers of partnerships. For example, ABC Partnership is a partner in a partnership consisting of ABC Partnership and individuals D, E, and F. Practitioners refer to the ABC Partnership as an "upper tier" partnership and to the ABC-D, E & F Partnership as a "lower tier" or "subsidiary" partnership. In the context of partnership tax audits, Congress has dealt with the problem of tiered partnerships by creating the concept of the "pass-thru partner." *I.R.C. section 6231(a)(9)* defines that term as a partnership, estate, trust, S corporation, nominee, or other similar person through whom other persons hold an interest in the partnership with respect to which the Internal Revenue Service is conducting unified partnership tax audit proceedings. In the example, ABC Partnership is a "pass-thru partner" in the ABC-D, E & F Partnership. The Internal Revenue Service refers to the "pass-thru partner" as a "tier" and to the partnership in which the "pass-thru partner" holds an interest as the "source partnership." n77

For litigation purposes, the Internal Revenue Services takes the position that

the bankruptcy of a tier should generally be treated the same as the bankruptcy of a partnership. Since a partnership is separate and distinct from its partners, the indirect partners should not be affected by the bankruptcy of the tier. (The term "indirect partner" is defined in section 6231 (a)(10) as a person holding an interest in a partnership through one or more pass-thru partners.) This is supported by the fact that indirect partners are considered partners in the source partnership under section 6231(a)(2)(13), and when the indirect partners have been properly identified to the Service in accordance with section 6223(c), the Service is required to use the names, addresses and profits interests of the indirect partners in lieu of the information pertaining to the pass-thru partner. Hence, notwithstanding that a tier is a partner and the bankruptcy of a partner will normally convert the debtor's partnership items into

nonpartnership items, we believe that the tier should be ignored under these circumstances, and that the bankruptcy of a tier will not convert the partnership items of the indirect partners into nonpartnership items. *Cf. Sente Investment Club v. Commissioner*, 95 T.C. 243 (1990). Accordingly, it is the position of this office that only the occurrence of an event personal to an indirect partner will convert the indirect partner's partnership items relating to the source partnership into nonpartnership items. Therefore, the bankruptcy of a tier should not adversely affect the TEFRA partnership proceeding regarding the source partnership. n78

FOOTNOTES:

(n1)Footnote 1. For federal income tax purposes, *Treas. Reg. § 301.7701-2(c)(1)* defines the term "partnership" as "a business entity that is not a corporation under [*Treas. Reg. § 301.7701-2(b)*] and that has at least two members." The so-called "check-the-box" regulations, *Treas. Reg. § 301.7701-3*, allow business entities that are not classified as corporations under *Treas. Reg. § 301.7701-2(b)* and that have at least two members ("eligible entities") to elect to be treated as corporations for federal income tax purposes. "Eligible entities" that do not make such an election are treated as partnerships for federal income tax purposes. *Treas. Reg. § 301.7701-3(b)*. Thus, many limited liability companies (LLCs) with two or more members and limited liability partnerships (LLPs) are taxed under subchapter K of the Internal Revenue Code. Note, however, that a LLC or LLP, even if treated as partnership for federal income tax purposes, will be treated as a corporation for purposes of title 11. *11 U.S.C. § 101(9)*:

(9) The term "corporation"-

(A) includes-

(i) association having a power or privilege that a private corporation, but not an individual or a partnership, possesses;

(ii) partnership association organized under a law that makes only the capital subscribed responsible for the debts of such association;

(iii) joint-stock company;

(iv) unincorporated company or association; or

(v) business trust; but

(B) does not include limited partnership.

A corporation, like a partnership, is eligible to be a debtor in a title 11 case. *11 U.S.C. §§ 109(a)* and *101(41)*. The federal income tax treatment of a LLC or LLP in a title 11 case should be essentially the same as the treatment of a partnership in a title 11 case. One commentator has raised interesting questions about application of title 11 to "series" LLCs:

Whether a single series of a series LLC would itself constitute a corporation and hence a person for purposes of bankruptcy eligibility is a question of first impression. Bankruptcy courts likely would look first to the degree of separateness conferred on a designated series by the law of the series LLC's state of incorporation. The court may be inclined to presume rebuttably that a designated series of a series LLC is

a separate corporation for purposes of the Bankruptcy Code and may rely on the bankruptcy doctrine of substantive consolidation if necessary to remedy abuse. Substantive consolidation is the equitable doctrine whereby corporate entities are disregarded to create a single pool of assets and a single body of creditors when related but ostensibly separate affiliates have been operated as a single entity.

Michael E. Mooney, *Series LLC's: The Loaves and Fishes of Subchapter K*, 116 *Tax Notes* 663, 664 n.6 (Aug. 20, 2007). "[A] series LLC is a special form of LLC that provides for the establishment of designated series within the LLC applicable to specified assets or operations, each with a separate business purpose or investment objective. In a series LLC, the debts, liabilities, and obligations relating to one series are enforceable only against the assets of that series and not against the assets of the LLC generally or the assets of any other series." *Id.* at 664.

(n2)Footnote 1a. 11 U.S.C. § 109(a) (any "person" who resides in the United States or has a domicile, a place of business, or property in the United States can be a debtor in a title 11 case) and 11 U.S.C. § 101(41) (the term "person" includes a partnership). However, a partnership may not always be eligible for relief under chapter 11 of title 11. Compare *In re C-TC 9[th] Ave. Partnership*, 113 F.3d 1304 (2d Cir. 1997) (a partnership that had dissolved and continued under applicable state law only for the limited purpose of winding up its affairs and had only a single general partner was not eligible for relief under chapter 11) with *In re Shea & Gould*, 38 C.B.C.2d 1453, 214 B.R. 739 (Bankr. S.D.N.Y. 1997) (a partnership in dissolution was eligible to liquidate under chapter 11). See also 2 *Collier on Bankruptcy* P 109.02[1][b] (Matthew Bender 15[th] Ed. Revised).

(n3)Footnote 2. Pub. L. No. 96-589, 94 Stat. 3389 (1980), reprinted in Vol. E *Collier on Bankruptcy*, App. Pt. 5(a) (Matthew Bender 15th Ed. Revised).

(n4)Footnote 3. *Rev. Rul. 68-48, 1968-1 C.B. 301*. See also *G.C.M. 24617, 1945 C.B. 235* (same result under the 1939 Internal Revenue Code).

(n5)Footnote 4. *Rev. Rul. 68-48, 1968-1 C.B. 301, 302*.

(n6)Footnote 5. I.R.C. §§ 1398(a), (b)(2) and 1399, added by the Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 3(a)(1), 94 Stat. 3389, 3397-3401 (1980), reprinted in Vol. E *Collier on Bankruptcy*, App. Pt. 5(a) (Matthew Bender 15th Ed. Revised), applicable to title 11 cases commencing on or after March 25, 1981. I.R.C. § 1399 provides that "[e]xcept 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." I.R.C. § 1398(a) provides that I.R.C. § 1398 applies only to title 11 cases in which the debtor is an "individual." I.R.C. § 1398(b)(2) provides that "[f]or purposes of [I.R.C. § 1398(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 [I.R.C. § 1398] in the same manner as any other interest of the debtor."

(n7)Footnote 6. *Rev. Proc. 89-37, 1989-1 C.B. 919, 920*.

(n8)Footnote 6a. *Rev. Proc. 89-37, 1989-1 C.B. 919*.

(n9)Footnote 7. Pub. L. No. 109-8, 119 Stat. 23 (2005), enacted on April 20, 2005, and generally effective for cases filed on or after October 17, 2005, reprinted in Vol. E-2 *Collier on Bankruptcy*, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n10)Footnote 8. II Int. Rev. Man. (Audit) (CCH) § 4583.21(14).

(n11)Footnote 9. Shepard & Williams, *The Duty of a Bankruptcy Trustee to File Federal Information Returns on Behalf of a Debtor-Partnership*, 3 *Am. Bankr. Inst. L. Rev.* 295 (1995).

(n12)Footnote 10. See S. Rep. No. 96-1035, 96th Cong., 2d Sess. 26 (1980), reprinted in Vol. E *Collier on*

Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th Ed. Revised), and H.R. Rep. No. 96-833, 96th Cong., 2d Sess. 21 (1980), *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised) (indicating that under a trustee of a partnership in bankruptcy would have an obligation under *I.R.C. § 6031* to file annual information returns).

(n13)Footnote 10a. *11 U.S.C. § 101(51C) (2005)* provides that a " 'small business' case means a case filed under chapter 11 of [11 U.S.C.] in which the debtor is a small business debtor." *11 U.S.C. § 101(51D) (2005)* defines the term "small business debtor" as:

(A) ... a person engaged in commercial or business activities (including any affiliate of such person that is also a debtor under [11 U.S.C.] and excluding a person whose primary activity is the business of owning or operating real property or activities incidental thereto) that has aggregate noncontingent liquidated secured and unsecured debts as of the date of the petition or the date for the order for relief in an amount not more than \$2,000,000 (excluding debts owned to 1 or more affiliates or insiders) for a case in which the United States trustee has not appointed under section 1102(a)(1) a committee of unsecured creditors or where the court has determined that the committee of unsecured creditors is not sufficiently active and representative to provide effective oversight of the debtor; and

(B) does not include any member of a group of affiliated debtors that has aggregate noncontingent liquidated secured and unsecured debts in an amount greater than \$2,000,000 (excluding debt owed to 1 or more affiliates or insiders).

(n14)Footnote 10b. *11 U.S.C. § 1116(6)(A)*, added by Pub. L. No. 109-8, § 436, 119 Stat. 23 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n15)Footnote 10c. *11 U.S.C. § 346(b)*, as amended by Pub. L. No. 109-8, § 719, 119 Stat. 23 (2005) (emphasis added), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n16)Footnote 10d. Shepard & Williams, *The Duty of a Bankruptcy Trustee to File Federal Information Returns on Behalf of a Debtor-Partnership*, 3 *Am. Bankr. Inst. L. Rev.* 295, 327-328 (1995) (citations omitted).

(n17)Footnote 11. *I.R.C. § 6227(b)*. See also *Treas. Reg. § 301.6231(a)(7)-1* and *Treas. Reg. § 301.6231(a)(7)-2* (rules for determining the "tax matters partner" of a partnership or limited liability company treated as a partnership for federal income tax purposes).

(n18)Footnote 12. *I.R.C. § 6227(c)*.

(n19)Footnote 13. *11 U.S.C. § 541(a)(6)*.

(n20)Footnote 13a. *11 U.S.C. § 346(b)*, as amended by Pub. L. No. 109-8, § 719(a), 119 Stat. 23 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n21)Footnote 13b. *11 U.S.C. § 346(c) (2005)*, as amended by Pub. L. No. 109-8, § 719(a), 119 Stat. 23 (2005) (emphasis added), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n22)Footnote 13c. *11 U.S.C. § 346(d) (2005)*, as amended by Pub. L. No. 109-8, § 719(a), 119 Stat. 23 (2005) (emphasis added).

(n23)Footnote 13d. See P 13.04[1][b], *infra*.

(n24)Footnote 14. W. McKee, W. Nelson & R. Whitmire, *Federal Taxation of Partnerships and Partners*, P 12.02 (WGL 3d ed. 1997) ("it is now clear that a bankrupt partnership is not terminated for tax purposes" by commencement

of a title 11 case). Further, a large body of judicial decisions predating the Bankruptcy Tax Act of 1980 supports the general proposition that a partnership does not terminate under *I.R.C. § 708(b)(1)(A)* if the partnership retains some assets. *See, e.g., Estate of Levine v. Commissioner*, 72 T.C. 780 (1979), *aff'd*, 634 F.2d 12 (2d Cir. 1980); *Baker Commodities, Inc. v. Commissioner*, 48 T.C. 374 (1967), *aff'd*, 415 F.2d 519 (9th Cir. 1969); *Foxman v. Commissioner*, 41 T.C. 535 (1964), *aff'd*, 352 F.2d 466 (3d Cir. 1965).

(n25)Footnote 15. *I.R.C. § 708(b)(1)(A)* (emphasis added).

(n26)Footnote 16. W. McKee, W. Nelson & R. Whitmire, *Federal Taxation of Partnerships and Partners* P 12.02 (WGL 3d ed. 1997).

(n27)Footnote 17. *I.R.C. § 708(b)(1)(A)*.

(n28)Footnote 17a. FSA 1999-52-016 (Sept. 24, 1999).

(n29)Footnote 17b. *See* P 13.03[2][c] *supra*.

(n30)Footnote 17c. *I.R.C. § 1446(c)* provides:

For purposes of this section, the term "effectively connected taxable income" means the taxable income of the partnership which is effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States computed with the following adjustments:

(1) Paragraph (1) of section 703(a) shall not apply.

(2) The partnership shall be allowed a deduction for depletion with respect to oil and gas wells but the amount of such deduction shall be determined without regard to sections 613 and 613A.

(3) There shall not be taken into account any item of income, gain, loss, or deduction to the extent allocable under section 704 to any partner who is not a foreign partner.

(n31)Footnote 17d. *I.R.C. § 1446(e)* provides that "[f]or purposes of this section, the term 'foreign partner' means any partner who is not a United States person."

(n32)Footnote 17e. *I.R.C. § 1446(f)(2)* authorizes Treasury to write regulations treating *I.R.C. § 6655(a)* as applicable. *See Treas. Reg. § 1.1446-3(b)*.

(n33)Footnote 18. *See* chapters TX2 and TX12 *supra*.

(n34)Footnote 19. *I.R.C. § 1398*.

(n35)Footnote 20. Priv. Ltr. Rul. 89-28-012 (April 7, 1989).

(n36)Footnote 21. *Priv. Ltr. Rul. 8928012 (April 7, 1989)*. This conclusion is clearly correct as a matter of statutory interpretation. However, several commentators have pointed out possible problems for a Chapter 12 debtor because there is no taxable entity. *See, e.g.,* Neil E. Harl, 5 Agricultural Law § 39.04[2][b][i] (noting, among other things, that although the taxable bankruptcy estate in Chapter 7 and Chapter 11 cases shields debtors from most tax consequences of asset liquidation during the bankruptcy proceeding, Chapter 12 debtors remain liable for taxes incurred as assets are liquidated). *But see* Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, § 1003, 119 Stat. 23 (2005) (taxes owed to "governmental units" generated by sales of farm assets used in farming operations treated as dischargeable unsecured claims provided the debtor receives a Chapter 12 discharge).

(n37)Footnote 22. See *P TX13.04[2][d] infra*.

(n38)Footnote 23. *I.R.C. § 708(b)(1)(B)* (emphasis added).

(n39)Footnote 24. The regulations explain that "a disposition of a partnership interest by gift (including assignment to a successor in interest) ... is not a sale or exchange for purposes of [*I.R.C. § 708(a)(1)(B)*]." *Treas. Reg. § 1.708-1(b)(1)(ii)* (emphasis added). *Rev. Rul. 68-48, 1968-1 C.B. 301* provides that a debtor's bankruptcy estate takes a carryover basis in the debtor's assets and can "tack" the debtor's holding period in those assets, thus suggesting that the estate is a successor in interest within the meaning of *Treas. Reg. § 1.708-1(b)(1)(ii)*. See also Thompson & Tenney, *Partnership Bankruptcy--The New Entity and Individual Tax Consequences*, 35 *Tax Law.* 89, 93 (1981) (arguing for this result but acknowledging that there was no statutory authority for the result).

(n40)Footnote 25. Thompson & Tenney, *Partnership Bankruptcy--The New Entity and Individual Tax Consequences*, 35 *Tax Law.* 89, 93 (1981).

(n41)Footnote 26. Unfortunately, the legislative history of *I.R.C. § 1398(f)(1)* does not specifically address the *I.R.C. § 708(b)(1)(B)* issue. Both the House and Senate Committee Reports provide the same example of a transfer covered by *I.R.C. § 1398(f)(1)*. The transfer (other than by sale or exchange) of an installment obligation from the debt to the debtor's bankruptcy estate is not a "disposition" of the obligation that would trigger acceleration of gain. H.R. Rep. No. 833, 96th Cong., 2d Sess. 26 (1980), *reprinted in* Vol. Collier on Bankruptcy, App. Pt. 5(b)(i) (Matthew Bender 15th Ed. Revised); S. Rep. No. 1035, 96th Cong., 2d Sess. 31 (1980), *reprinted in* Vol. Collier on Bankruptcy, App. Pt. 5(b)(ii) (Matthew Bender 15th ed.).

(n42)Footnote 27. *Gulley v. Commissioner*, 79 *T.C.M. (CCH)* 2171, *T.C. Memo* 2000-190 (2000) . The Tax Court also addressed the question of whether the partnership in *Gulley* was terminated under *I.R.C. Section 708(b)(1)(A)*, which provides:

Termination.--(1) General rule. For purposes of subsection (a), a partnership shall be considered as terminated only if--

(A) no part of any business, financial operation, or venture of the partnership continues to be carried on by any of its partners in a partnership,...

For purposes of *I.R.C. Section 708(b)(1)(A)*, the date of termination is the date on which the partnership completes the winding up of its affairs. *Treas. Reg. § 1.708-1(b)(1)(iii)(a)*. Neither the Code nor the Regulations define the term "winding up." The taxpayer in *Gulley* argued that the partnership agreement provided that the partnership terminated upon the bankruptcy of the general partner. The taxpayer also argued that, under Texas law, a person ceases to be a general partner in a limited partnership when he or she files a voluntary petition in bankruptcy. *Tex. Rev. Civ. Stat. Ann. art. 6132a-1, § 4.02(a)(4)(B)* (1999). Thus, the taxpayer argued, the taxpayer ceased being the general partner of the partnership and the partnership dissolved, when taxpayer filed the petition in bankruptcy on July 11, 1991. However, the Tax Court rejected both arguments. Neither the partnership provision stating that the partnership terminated upon the bankruptcy of its general partner, nor the Texas statute could cause the partnership to terminate on July 11, 1991, because federal law, not state law, controls when a partnership terminates for federal tax purposes. *Fuchs v. Commissioner*, 80 *T.C.* 506, 510 (1983) (state law dissolution does not cause a partnership to terminate for federal tax purposes); *Estate of Skaggs v. Commissioner*, 75 *T.C.* 191, 198 (1980) , *aff'd*, 672 *F.2d* 756 (9th Cir. 1982) . The Tax Court concluded that the partnership continued to exist for tax purposes until it settled pending litigation in September 1992.

(n43)Footnote 27a. *I.R.C. § 1398(d)(1)*.

(n44)Footnote 27b. *I.R.C. § 1398(d)(2)(A)*.

(n45)Footnote 28. *I.R.C. § 706(c)(2)(A)*

(n46)Footnote 29. As noted at *P TX13.04[2][a] supra*, commencement of a case under chapter 12 of the Bankruptcy Code does not result in creation of a separate taxable bankruptcy estate. Thus, commencement of a chapter 12 case does not cause a deemed transfer of the partner's interest in the partnership.

(n47)Footnote 30. The regulations under *I.R.C. § 706* would govern the allocation of partnership income or loss between the transferor and the transferee. *See P TX13.04[2][d] infra*.

(n48)Footnote 31. *I.R.C. § 706(a)*. *See P TX13.04[2][e] infra*.

(n49)Footnote 32. *Gulley v. Commissioner*, 79 T.C.M. (CCH) 2171, T.C. Memo 2000-190 (2000). *See also* Rubin, *Tax Planning for the Debtor in Bankruptcy*, 19 J. Real Est. Tax'n 322, 328 (1992).

(n50)Footnote 33. *Priv. Ltr. Rul. 9304008* (Oct. 27, 1992).

(n51)Footnote 34. *Gulley v. Commissioner*, 79 T.C.M. (CCH) 2171, T.C. Memo 2000-190 (2000). At issue in *Gulley* was a net operating loss. Because the Tax Court concluded that the portion of the net operating loss attributable to the taxpayer's partnership interest passed to the taxpayer's bankruptcy estate, that net operating loss was a tax attribute of the bankruptcy estate. As such, the net operating loss was subject to reduction under *I.R.C. Section 108(b)*, and the taxpayer was entitled only to the unused portion, if any, of the net operating loss when the bankruptcy case ended.

(n52)Footnote 34a. 116 T.C. 5 (2001).

(n53)Footnote 35. *See P TX2.04[4][b] supra*. *Report of the Section 108 Real Estate and Partnership Task Force (Part II)*, 46 Tax Law. 397, 448-49 (1993) ("Section 108 Task Force Report (Part II)") (concluding that the transfer of the debtor partner's interest in the partnership to the debtor partner's bankruptcy estate is not treated as a change in a partner's interest in the partnership under *I.R.C. § 706(d)*). *Cf.* Rubin, *Tax Planning for the Debtor in Bankruptcy*, 19 J. Real Est. Tax'n 322, 329 (1992) (concluding that *I.R.C. § 706(d)* applies).

(n54)Footnote 35a. 116 T.C. at 15-21 (citing *P TX13.04[2][d]*).

(n55)Footnote 36. *Priv. Ltr. Rul. 9304008* (Oct. 27, 1992) ("Therefore, all items of income, gain, loss, deduction or credit of [the partnership] for the calendar year including [the date on which the debtor partner commenced his title 11 case] are allocable to the bankruptcy estate."). The discussion assumes that the partnership has not terminated within the meaning of *I.R.C. § 708* by reason of events occurring prior to debtor partner's commencement of the title 11 case. *Section 108 Task Force Report (Part II)*, n.35 *supra*, at 448.

(n56)Footnote 37. *Section 108 Task Force Report (Part II)*, n.35 *supra*, at 449.

(n57)Footnote 38. Thompson & Tenney, *Partnership Bankruptcy--The New Entity and Individual Tax Consequences*, 35 Tax Law. 89, 94 (1981).

(n58)Footnote 38a. 87 A.F.T.R.2d 1639 USTC P 50,360 (C.D. Cal. 2001).

(n59)Footnote 38b. 88 A.F.T.R.2d 2001-5580, 2001-1 USTC P 50,434 (C.D. Cal. 2001).

(n60)Footnote 38c. *In re Galletti*, 298 F.3d 1107 (9th Cir.), *amended*, 314 F.3d 336 (9th Cir. 2002).

(n61)Footnote 38d. *U.S. v. Galletti*, 541 U.S. 114, 124 S. Ct. 1548, 158 L. Ed. 2d 279, 51 C.B.C.2d 121 (2004).

(n62)Footnote 38e. 541 U.S. at 118, 124 S. Ct. at 1552, 158 L. Ed. 2d at 287, 51 C.B.C.2d at 123. In note 1, the

Court added:

Because the Government is attempting to enforce the Partnership's tax liabilities against respondents in a judicial proceeding, we do not address whether an assessment only against the Partnership is sufficient for the IRS to commence administrative collection of the Partnership's tax debts by lien or levy against respondents' property. We also decline to address whether an assessment against the partnership suffices to trigger liability against the partners for interest and penalties without separate notice and demand to them.

(n63)Footnote 38f. 541 U.S. at 121, 124 S. Ct. at 1553, 158 L. Ed. 2d at 288, 51 C.B.C.2d at 124 .

(n64)Footnote 38g. 541 U.S. at 122, 124 S. Ct. at 1554, 158 L. Ed. 2d at 289, 51 C.B.C.2d at 125 .

(n65)Footnote 38h. 126 T.C. 359, 126 T.C. No. 19 (2006) .

(n66)Footnote 38i. 11 U.S.C. § 362(a).

(n67)Footnote 38j. The 2005 amendment changed the phrase "concerning a debtor" to "concerning the tax liability of a debtor."

(n68)Footnote 38k. 126 T.C. at _____, citing *A.H. Robins Co. v. Piccinin*, 788 F.2d 994, 999 (4th Cir.1986) , *Amedisys, Inc. v. Nat'l Century Fin. Enters. (In re Nat'l Century Fin. Enters.)*, 423 F.3d 567, 577 (6th Cir.2005) , and *Patton v. Bearden*, 8 F.3d 343, 349 (6th Cir.1993) (emphasis added).

(n69)Footnote 38l. 126 T.C. at _____.

(n70)Footnote 38m. 126 T.C. at _____.

(n71)Footnote 39. 11 U.S.C. § 521(j), as added by Pub. L. No. 109-8, § 720, 119 Stat. 23 (2005) (emphasis added), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n72)Footnote 39a. H.R. Rep. 97-760, 97th Cong., 2d Sess. 599 (1982).

(n73)Footnote 40. H.R. Rep. 97-760, 97th Cong., 2d Sess. 599 (1982).

(n74)Footnote 41. Pub. L. No. 97-248, §§ 401-407, 96 Stat. 648-671 (1982) *codified in* 26 U.S.C. §§ 6221 through 6232. The partnership audit provisions now appear in 26 U.S.C. §§ 6221 through 6234.

(n75)Footnote 42. *I.R.C. § 761(a)* provides that "the term 'partnership' includes a syndicate, group, pool, joint venture or other unincorporated organization through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title [sic], a corporation or a trust or estate."

(n76)Footnote 43. *I.R.C. § 6231(a)(1)(B)(i)* (emphasis added). Prior to amendment by Section 1234(a) of the Taxpayer Relief Act of 1997, Pub. L. No. 105-34, 111 Stat. 788, 1024 (1997), *I.R.C. § 6231(a)(1)(B)(i)* denied a partnership this exception if either the partnership had a C corporation as a partner or the partnership made special allocations of any partnership items. The 1997 amendments are effective for partnership taxable years ending after August 5, 1997. Pub. L. No. 105-34, § 1234(b), 111 Stat. 1024 (1997).

In January 1999, Treasury published temporary and proposed regulations under *I.R.C. Section 6231(a)*. The temporary and proposed Regulations provided that "the 10 or fewer limitation [set forth in *I.R.C. § 6231(a)(1)(B)(i)*] ... is applied to the number of natural persons (other than nonresident aliens) ..." *T.D. 8965* Fed. Reg. 50,541 (2001), which finalized the 1999 proposed regulations, Treasury noted:

Some practitioners have read this provision to mean that a nonresident alien can be a partner in a small partnership that is not subject to the unified partnership audit rules, but that such partners are not counted toward the 10 partner limitation. To clarify that a partnership that has a nonresident alien partner cannot qualify for the small partnership exception of section 6231(a)(1)(B)(i), this parenthetical has been removed in § 301.6231(a)(1)-1(a)(1) of the final regulations.

66 *Fed. Reg.* 50,542-50,543 .

(n77)Footnote 44. *I.R.C.* § 6231(a)(1)(B)(i) (last sentence).

(n78)Footnote 45. *I.R.C.* § 6231(a)(1)(B)(ii).

(n79)Footnote 45a. For a discussion of the concept of the "tax matters partner," see the text beginning at n.54, *infra*.

(n80)Footnote 45b. See Burgess J. W. Raby & William L. Raby, Consistent Settlements and "Partnership Items," 91 *Tax Notes* 799, 802 (2001) ("Given the instructions to the Form 1065 [partnership may designate a "tax matters partner" "[i]f the partnership is subject to the rules for consolidated audit proceedings in sections 6221 through 6233"], the designation of a ["tax matters partner"] could be viewed as a representation that the partnership is subject to the partnership-level rules." *Id.*)

(n81)Footnote 46. *I.R.C.* § 6221.

(n82)Footnote 47. *I.R.C.* § 6222(a).

(n83)Footnote 48. *I.R.C.* § 6222(b) creates three exceptions to the consistency requirement. First, if the partnership has not filed a return, there is technically an "inconsistency" because the partnership has not reported any items of income, gain, loss, deduction or credit, yet the partner has reported such items. Nevertheless, *I.R.C.* § 6222(b)(1)(A)(ii) makes it clear that such an "inconsistency" does not create a problem, provided the partner notifies the IRS of the "inconsistency" that exists because the partnership has not filed a tax return. Second, *I.R.C.* § 6222(b)(1) provides that if a partner treats any item in a way that "is (or may be) inconsistent with the treatment of the item on the partnership return," the partner must notify the IRS. The IRS requires use of Form 8082 (Notice of Inconsistent Treatment or Amended Return) to provide such notification. Compliance with this requirement permits the partner to avoid the "computational adjustment" described in the text following this footnote. However, the IRS may make adjustments after *either* commencing a partnership audit proceeding or converting all of the partner's partnership items to nonpartnership items. Third, *I.R.C.* § 6222(b)(2) creates an exception if a partner can establish that the treatment of an item in the partner's tax return was consistent with the treatment of the item in an erroneous Schedule K-1 provided by the partnership.

(n84)Footnote 49. *I.R.C.* 6231(a)(6) defines the term "computational adjustment" as "the change in tax liability of a partner which properly reflects the treatment under this subchapter of a partnership item."

(n85)Footnote 50. *I.R.C.* § 6222(c)(2).

(n86)Footnote 51. *I.R.C.* § 6222(c)(2).

(n87)Footnote 52. *I.R.C.* § 6225(a)

(n88)Footnote 53. *I.R.C.* § 6222(d).

(n89)Footnote 54. The regulations issued under the authority of *I.R.C.* § 6231(a)(7) create the following order of priority for selecting a "tax matters partner":

(1) A general partner designated by the partnership in the manner provided in *Treas. Reg. § 301.6231(a)(7)-1(b)* through (l);

(2) If there has been no valid designation under (1), the "tax matters partner" will be the general partner with the largest profits interest at the close of the taxable year involved (or if there is more than one such partner, the one of such partners whose name would appear first in an alphabetical listing) [*Treas. Reg. § 301.6231(a)(7)-1(m)(2)*];

(3) If there has been no valid designation under either (1) or (2), the IRS will select a "tax matters partner" following the criteria set forth in *Treas. Reg. § 301.6231(a)(7)-1(q)*.

Note that, under certain circumstances, the Tax Court may appoint the "tax matters partner" for purposes of the litigation. *See, e.g., Computer Programs Lambda, Ltd v. Commissioner, 90 T.C. 1124 (1988)* (adversarial nature of relationship between partnership and IRS demanded that court, not IRS, appoint "tax matters partner" for litigation).

(n90)Footnote 55. *Treas. Reg. § 301.6224(a)-1*.

(n91)Footnote 56. *I.R.C. § 6229(b)(1)(B)*.

In Field Service Advice 2001-22-023 (June 1, 2001), the Internal Revenue Service Chief Counsel's Office noted that, when the "tax matters partner" of a TEFRA partnership is a subsidiary of a consolidated group, "we recommend that the consent be signed by an officer of the parent corporation on behalf of the subsidiary and by an officer of the TMP subsidiary. Accordingly, we recommend that the following signatures be obtained."

The signature block for the common parent should appear as follows on the Form 872-P:

[Name of common parent], common parent of [name of consolidated group], by [name of authorized representative, title], on behalf of [name of subsidiary], Tax Matters Partner of [name of TEFRA partnership].

The signature block for the TMP-subsidary should appear as follows on the Form 872-P:

[Name of TMP subsidiary], by [name of authorized representative, title], Tax Matters Partner of [name of TEFRA partnership].

(n92)Footnote 57. *I.R.C. § 6226(a)*.

(n93)Footnote 58. *I.R.C. § 6224(c)(3)*.

(n94)Footnote 59. *I.R.C. § 6223(g)* provides that "[t]o the extent and in the manner provided by regulations, the tax matters partner of a partnership shall keep each partner informed of all administrative and judicial proceedings for the adjustment at the partnership level of partnership items." Temp. *Treas. Reg. § 301.6223(g)* implements *I.R.C. § 6223(g)* by detailing the responsibilities of the "tax matters partner" for providing information to the other partners in connection with a partnership audit.

(n95)Footnote 60. *I.R.C. § 6230(e)*.

(n96)Footnote 61. *I.R.C. § 6224(c)(2)*.

(n97)Footnote 62. 11 U.S.C. § 362.

(n98)Footnote 63. 11 U.S.C. § 362(a)(4) & (6). 11 U.S.C. § 362(b)(9) provides that the automatic stay does not prevent the IRS from issuing a debtor a "notice of tax deficiency" because such a notice is not an "assessment" of the tax within the meaning of 11 U.S.C. § 362(a)(6) or an "act to create, perfect, or enforce any lien" against the property of the debtor's estate within the meaning of 11 U.S.C. § 362(a)(4).

(n99)Footnote 64. 11 U.S.C. § 362(8).

(n100)Footnote 65. 11 U.S.C. § 362(8).

(n101)Footnote 66. See, e.g., 1983 *Western Reserve Oil and Gas Co. v. Commissioner*, 95 T.C. 51 (1990), *aff'd in unpublished opinion*, 995 F.2d 235 (9th Cir. 1993); *Chef's Choice Produce Ltd. v. Commissioner*, 95 T.C. 388 (1990). Litigation Guide Memorandum LGM TL-73/GL-42, § B, 2000 Tax Notes Today 101-40 (May 24, 2000), prepared by the Internal Revenue Service Assistant Chief Counsel (Litigation) and the Assistant Chief Counsel (Field Service), concurs with the position taken by the courts.

(n102)Footnote 67. I.R.C. § 6231(c)(1)(E), (c)(2) & (c)(3). For an interesting discussion of how this rule applies in connection with a title 11 case of a corporation that is a member of a consolidated group and owns a separate interest in a partnership, see FSA 2002-03-007 (September 28, 2001):

The bankruptcy of a corporation holding a separate interest in a partnership will convert its partnership items to nonpartnership items. After these items convert to nonpartnership items, the other members of the consolidated filing group who are severally liable for these items will no longer have their tax liability determined by reference to these items as "partnership items." Thus, the other members of the consolidated group will no longer be considered "partners" under § 6231(a)(2)(B) with respect to the bankrupt corporation's separately held items.

(n103)Footnote 68. *Treas. Reg. § 301.6231(c)-7(a)*, applicable to partnership taxable years beginning on or after October 4, 2001. For years beginning prior to October 4, 2001, see *Temp. Treas. Reg. § 301.6231(c)-7T(a)*, which had identical wording.

(n104)Footnote 69. I.R.C. § 6229(f)(1) provides that for partnership items that convert to non-partnership items, the period for assessing tax with respect to those items shall not expire before the date which is one year after the date the items become nonpartnership items. I.R.C. § 6229(h), added by Section 1233(b) of the Taxpayer Relief Act of 1997, provides that, when a partner is a debtor in a title 11 case, the I.R.C. § 6229(f)(1) limitations period is suspended for the entire period during which the IRS is prohibited from making an assessment against that partner and for sixty days thereafter. Prior to the 1997 amendment, it was not clear whether the partner's bankruptcy suspended the running of the I.R.C. § 6229(f)(1) limitations period. H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 680 (1997). The legislative history of the 1997 amendment recites that the Congress did not intend the amendment to create any inference as to the proper interpretation of the pre-amendment law. *Id.* at 681.

(n105)Footnote 70. Litigation Guideline Memorandum LGM TL-73/GL-42, § C.1.a., 2000 Tax Notes Today 101-40 (May 24, 2000) (footnotes omitted). LGM TL-73/GL-42 also provides information on the Internal Revenue Service's litigating position on (1) conversion of a nondebtor spouse's partnership items, (2) the statute of limitations for converted partnership items, (3) suspension of the running of the statute of limitations period, and (4) notice of deficiency for converted partnership items. Although the Litigation Guideline Memorandum refers to former *Temp. Treas. Reg. § 301.6231(c)-7T(a)*, which was removed by *T.D. 8965*, 66 Fed. Reg. 50,542, 50,561 (2001), effective for partnership taxable years beginning on or after October 4, 2001, the wording of *Temp. Treas. Reg. § 301.6231(c)-7T(a)* is identical to the wording of *Treas. Reg. § 301.6231(c)-7(a)*. Presumably, promulgation of the final regulations did not change the IRS position on the broad meaning of the word "claim".

(n106)Footnote 71. *Treas. Reg. § 301.6231(a)(7)-1(l)(1)(iv)*.

In Field Service Advice 2001-22-023 (June 1, 2001), the Internal Revenue Service Chief Counsel's Office considered whether the bankruptcy of a consolidated group's parent corporation terminated the subsidiary's status as "tax matters partner" of a TEFRA partnership in which the subsidiary was one of the general partners. The Field Service Advice described the following fact pattern:

Parent is the common parent of a consolidated group (the "P group"). Subsidiary is a subsidiary of Parent and a member of the P group. Subsidiary is a general partner and the "tax matters partner" of Partnership, a TEFRA partnership. Corporation X, an unrelated corporation, is the only other partner of Partnership. Parent filed a petition in bankruptcy but Subsidiary did not file a petition in bankruptcy.

The issue addressed in the Field Service Advice was whether Parent's bankruptcy converted Subsidiary's partnership items to nonpartnership items pursuant to Temp. Treas. Reg. § 301.6231(c)-7T(a), thereby terminating Subsidiary's status as "tax matters partner" pursuant to *Treas. Reg. § 301.6231(a)(7)-1(l)(1)(iv)*. The Field Service Advice concluded that Parent's bankruptcy did not convert Subsidiary's partnership items to nonpartnership items and did not terminate Subsidiary's status as "tax matters partner."

The Field Service Advice based its conclusion on an analogy to *Callaway v. Commissioner*, 231 F.3d 106 (2d Cir. 2000) and *Dubin v. Commissioner*, 99 T.C. 325 (1992), two cases involving husbands and wives who each owned partnership interests. Both cases treat such spouses as separate, with the result that a conversion event affecting one spouse does not convert the partnership items of the other spouse. The Field Service Advice stressed that Parent, not Subsidiary, filed for bankruptcy, and that Subsidiary, not Parent, owned the partnership interest.

Although the Field Service Advice refers to former Temp. Treas. Reg. § 301.6231(c)-7T(a), which was removed by T.D. 8965, 66 Fed. Reg. 50,542, 50,561 (2001), effective for partnership taxable years beginning on or after October 4, 2001, the wording of Temp. Treas. Reg. § 301.6231(c)-7T(a) is identical to the wording of *Treas. Reg. § 301.6231(c)-7(a)*. Presumably, promulgation of the final regulations did not change the IRS conclusion in the Field Service Advice.

(n107)Footnote 72. *Computer Programs Lambda, Ltd. v. Commissioner*, 89 T.C. 198, 206 (1987).

(n108)Footnote 73. The Internal Revenue Service takes the position that the trustee for the former "tax matters partner" cannot automatically become the "tax matters partner" ("TMP"):

The Tax Court in *1983 Western Reserve Oil and Gas Co., Ltd. v. Commissioner*, 95 T.C. 51(1990), held that a receiver pendente lite could not file a petition as TMP. The Tax Court found that the district court's order appointing the receiver to be the tax matters partner did not empower the receiver to file a petition in Tax Court. The order empowered the receiver to perform the duties of TMP for the partnerships only in proceedings before the Internal Revenue Service, or other tax or administrative agencies. The Tax Court in finding the receiver was not the TMP, noted that the Tax Court is a judicial body, not a tax agency or administrative agency, therefore, the receiver did not have authority to file a petition. Nor was the receiver otherwise qualified by statute to file a petition. The receiver does not fall under the statutory provisions for determining a TMP. See *I.R.C. section 6231 (a)(7)*. The receiver was never a partner in the partnerships. The court specifically noted that it was not deciding the issue of whether a court had the power to appoint a nonpartner as TMP for purposes of a partnership proceeding.

It is also questionable whether a trustee in bankruptcy can be the TMP based upon the Court's holding in *1983 Western Reserve Oil & Gas, supra* at 61, 62. If the partnership itself is in bankruptcy, then the trustee for the debtor partnership cannot be the TMP, since the trustee is not a partner in the

partnership. If a general partner files a bankruptcy petition, and that partner's partnership interest is part of the bankruptcy estate, it is questionable whether the trustee can be considered a partner in the partnership. There is an argument that can be made that the trustee is a partner since the bankruptcy estate holds the partnership interest of the debtor partner, and the trustee is the representative of the bankruptcy estate. Despite the question of whether the trustee could be considered a partner, it is unlikely that the trustee could be the TMP since the trustee would be in the same position as that of the debtor partner. That is the partnership items for the debtor partner have converted and the debtor partner's status as TMP has terminated (if debtor partner was the TMP), therefore, the same is true for the bankruptcy estate. Litigation Guideline Memorandum LGM TL-73/GL-42, § D.4., 2000 Tax Notes Today 101-40 (May 24, 2000) (footnote omitted).

(n109)Footnote 74. *Barbados # 7 Ltd. v. Commissioner*, 92 T.C. 804 (1989) . The legislative history of the Taxpayer Relief Act of 1997 states, cryptically, that the amendment to *I.R.C. § 6229* changing this result "is not intended to create an inference as to the proper interpretation of present law." H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 681 (1997). This statement is odd in light of the Conference Reports' earlier unequivocal statement of the status of the pre-amendment law: "As a result, if a consent to extend the statute of limitations is signed by a person who would be the ["tax matters partner"] but for the fact that at the time the agreement is executed the person was a debtor in a bankruptcy proceeding, *the consent would not be binding on the other partners because the person signing the agreement was no longer the ["tax matters partner"] at the time that the agreement was executed.*" H.R. Conf. Rep. No. 220, 105th Cong., 1st Sess. 681 (1997) (emphasis added).

(n110)Footnote 75. *I.R.C. § 6229(b)(2)*, added by Section 1233(c) of the Taxpayer Relief Act of 1997, applicable to agreements entered into after August 5, 1997.

(n111)Footnote 76. *See, e.g., 1983 Western Reserve Oil and Gas Co. v. Commissioner*, 95 T.C. 51 (1990) , *aff'd in unpublished opinion*, 995 F.2d 235 (9th Cir. 1993) .

(n112)Footnote 77. Litigation Guideline Memorandum LGM TL-73/GL-42, § 2000 Tax Notes Today 101-40 (May 24, 2000) .

(n113)Footnote 78. *Id.*



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CHAPTER TX14 Tax Consequences of Disputed Claims Reserves and Creditors' Trusts

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CHAPTER TX14 Tax Consequences of Disputed Claims Reserves and Creditors' Trusts

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P TX14.01 Introduction

Almost every significant chapter 11 reorganization plan will provide some arrangement to resolve disputed creditor claimsⁿ¹ and interests.ⁿ² This arrangement will include provisions for the delayed distribution of consideration under the plan of reorganization to persons whose disputed rights become allowed claims or interestsⁿ³ after the initial distribution following the effective date of the plan. Because such unsettled rights most often are creditor claims this discussion will refer to them as disputed claims.

A typical plan of reorganization provides for the *pro rata* distribution of a fixed amount of plan consideration to creditors of a particular class. Such a plan will provide for an initial distribution to creditors with allowed claims. This initial distribution will be calculated on the assumption that disputed claims will eventually become allowed claims and that such disputed claimants eventually will receive the same *pro rata* share of the plan consideration as the creditors with the initially allowed claims. Pending resolution of the disputed claims, the plan consideration is "held in trust" pursuant to the plan in a disputed claims reserve by a disbursing agent, frequently the reorganized company. To the extent that some disputed claims are resolved adversely to the claimants, the plan consideration reserved for such claimants will be distributed by the disbursing agent *pro rata* to the holders of allowed claims, including the claimants whose disputed claims become allowed claims.

These disputed claims reserve arrangements generally provide that upon the delayed distribution to the holders of allowed claims, the claimants will receive earnings and distributions on the consideration held as part of the disputed claims reserve. Thus, for instance, to the extent the plan consideration consists of notes of the reorganized debtor, the disbursing agent will distribute the *pro rata* share of the notes, and generally the interest earned on such *pro rata* share of the notes, to the holder of the subsequently allowed claim. Such arrangements will hereinafter be referred to as disputed claims reserve arrangements.

For tax purposes, disputed claims reserve arrangements are distinguished from situations in which, at the end of the disputed claims resolution process, the reorganized company and not the holders of allowed claims, will receive the plan consideration held to satisfy the disputed claims resolved unfavorably to the claimants. In cases where the reorganized company (or another participant in the plan) will receive the remaining undistributed plan consideration, such person generally is treated as owning the plan consideration held for payment to the disputed claimants. Such funds are treated as discharging an obligation of the reorganized debtor (or other plan participant). As the owner of the funds, the reorganized company (or other plan participant) is currently taxable on the income earned by such plan

consideration.

Depending on the nature of the claims being satisfied by the disputed claims reserve and the mechanics by which it is created and administered, a disputed claims reserve might or might not be a designated settlement fund as defined in *I.R.C. § 468B(d)* or a qualified settlement fund as defined in regulations issued under *I.R.C. § 468B(g)*. n4

Disputed claims arrangements are also to be distinguished from arrangements where substantially all of the assets in the estate of a corporate or individual debtor are transferred to a trustee to liquidate for the benefit of creditors. These trusts are referred to herein as creditors' trusts. Creditors' trusts hold assets on behalf of creditors for the purpose of liquidating and distributing the assets. n5 The Supreme Court in *Holywell Corp. v. Smith*, n6 held that the trustee of the creditors' trust was the trustee of a liquidating trust and was bound to file tax returns attributable to the assets being liquidated for the creditors. n7

With respect to the disputed claims reserve arrangements, from an income tax perspective, the principal issue presented is whether and how such arrangements should be taxed. Who must pay the taxes on the current income earned while the disbursing agent holds the plan consideration pending disbursement to the creditors ultimately determined to be entitled to the funds? In addition, how do the tax consequences of the delayed distributions differ, if at all, from the consequences of the initial distributions following the plan effective date? Finally, do the answers to these questions affect the reorganized debtor and its reorganization tax planning?

FOOTNOTES:

(n1)Footnote 1. *11 U.S.C. § 101* defines a "claim."

(n2)Footnote 2. An equity security is defined in *11 U.S.C. § 101* and such a holder may file a proof of interest.

(n3)Footnote 3. *11 U.S.C. § 502* provides for the allowance of prepetition claims or interests.

(n4)Footnote 4. *See P TX14.02 infra*.

(n5)Footnote 5. *See Treas. Reg. § 301.7701-4(d)* (definition of liquidating trust), *Treas. Reg. § 301.7701-2(a)* (definition of business entity), and *1994-2 C.B. 684, Rev. Proc. 94-45* (checklist for ruling on status of entity as liquidating trust). *See Priv. Ltr. Rul. 9752039* (September 25, 1997). Note that liquidating trusts need not succeed to substantially all of the assets of the transferor. *See Priv. Ltr. Rul. 9528017* (April 14, 1995).

(n6)Footnote 6. *Holywell Corp. v. Smith*, 503 U.S. 47, 112 S. Ct. 1021, 117 L. Ed. 2d 196, 26 C.B.C.2d 1 (1992), on remand. 965 F.2d 994 (11th Cir. 1992), on remand. 161 B.R. 302 (Bankr. S.D. Fla. 1993), *aff'd*, 177 B.R. 991 (S.D. Fla. 1995), *aff'd*, 95 F.3d 57 (11th Cir. 1996).

(n7)Footnote 7. *See P TX14.05 infra*. *See also* chapter TX3 *supra*.



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CHAPTER TX14 Tax Consequences of Disputed Claims Reserves and Creditors' Trusts

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P TX14.02 Regulations Concerning Designated and Qualified Settlement Funds

[1] Introduction

The Service, on February 14, 1992, proposed regulations to provide a single set of operative rules for the taxation of designated settlement funds as defined in *I.R.C. § 468B(d)(2)* and qualified settlement funds as defined in the Proposed Regulations. n1 Final regulations were issued on December 23, 1992. n2 These Regulations apply to income of qualified settlement funds after December 31, 1992, subject to certain transition rules. In general the Regulations reconfirm that *I.R.C. § 468B(g)* is effective for funds established after August 16, 1986, and requires that the income of the fund be reported currently under a reasonable, consistently applied method. n3

The IRS takes the position that *I.R.C. § 468B(g)* was enacted to eliminate the "homeless income" problem that arose when defendants deposited amounts into a settlement fund to pay a claim and to reverse the holding of *Rev. Rul. 71-119*, n4 to the effect that a settlement fund is not a trust and that the court administering the fund is not a fiduciary. n5 A qualified settlement fund as defined in the Regulations must be a trust under applicable state law, or its assets must otherwise be segregated from other assets of the transferor (and related persons). n6 Among the liabilities for which a qualified settlement fund may be established are CERCLA environmental liabilities, n7 tort, breach of contract or violation of law liabilities and other liabilities designated by the Service. n8 In order to be a qualified settlement fund the governmental authority must have continuing jurisdiction over the fund although it need not have continuing "supervision."

[2] Description of Designated and Qualified Settlement Funds

A designated settlement fund is, generally speaking, a court ordered fund to which property (other than stock or indebtedness of the taxpayer) is transferred to satisfy liabilities for personal injury, death or property damage and which is administered by a majority of independent persons. A qualified settlement fund, as defined in the Regulations, is a fund, account or trust that is established pursuant to governmental authority; that is established to resolve certain enumerated liabilities; and that is a trust under state law or the assets of which are segregated from other assets of the transferor. n9 Unlike status as a designated settlement fund, which is elective, funds that meet the requirements of a qualified settlement fund are taxed as such even if they otherwise would be classified as an association taxable as a corporation or a contested liability account established under *Treas. Reg. § 1.461-2(c)(1)*. n10

Treas. Reg. § 1.468B reconciles the term "qualified settlement fund" in the Regulations with the term "designated

settlement fund" in the Internal Revenue Code. The Regulations state that a designated settlement fund, as defined in *I.R.C. § 468B(d)(2)*, is taxed in the manner described in *Treas. Reg. § 1.468B-2*. The rules for transferors to a qualified settlement fund described in *Treas. Reg. § 1.468B-3* apply to transferors to a designated settlement fund. Similarly, the rules for claimants of a qualified settlement fund described in *Treas. Reg. § 1.468B-4* apply to claimants of a designated settlement fund. A fund, account, or trust that does not qualify as a designated settlement fund is, however, a qualified settlement fund if it meets the requirements of a qualified settlement fund described in *Treas. Reg. § 1.468B-1*. n11

[3] Application to Title 11 Cases

In certain cases under title 11 of the *Bankruptcy Code*, particularly a case in which the debtor's problems result from massive tort liability, a fund, disputed claims reserve or creditors' trust created under the plan of reorganization could satisfy the definitional requirements for a designated settlement fund or a qualified settlement fund. n12 In general, the final regulations specifically exclude from the liabilities giving rise to qualified settlement fund status the claims of general trade creditors and debt holders in a title 11 case. n13 Under the final regulations, a fund established to satisfy qualified liabilities, as well as excluded liabilities arising from the same event or related series of events, may be a qualified settlement fund. n14

Based on the IRS' position in *2001 IRS CCA Lexis 312*, n15 it appears that the IRS does not think that governing criteria for a qualified settlement fund need to be in place in the confirmed plan in order to satisfy the requirement that the fund be established to resolve or satisfy the liability. In the case at issue, the trust was established pursuant to the bankruptcy court order almost a year before a plan would be confirmed, when the debtors were still working on determining the assets and liabilities at issue and on establishing the criteria and procedures to guide how much of the settlement fund proceeds would be paid to whom, and when such payments would be made. Nevertheless, the IRS stated that "[u]nlike under the statutory designated settlement fund, there is no need for the transfer to a qualified settlement fund to extinguish or fully resolve or satisfy the transferor's liability. Although the regulations are not explicit on this issue, it is the IRS's position that a pro tanto resolution or satisfaction meets the regulation standards for a qualified settlement fund." The IRS further stated that the qualified settlement fund rules should be distinguished from the designated settlement fund rules that appear in *I.R.C. § 468B(a)-(f)*, which require that the fund extinguish completely the transferor's liability. According to the IRS, the qualified settlement fund rules were designed to provide more flexibility and "[t]hus, it is sufficient that the fund was established for the purpose of paying the claimants, even if there has not yet been a confirmed plan of reorganization directing the claimants to look to the fund." The Court of Appeals for the Tenth Circuit similarly held that the qualified settlement fund regulations "do not create a complete-extinguishment requirement. Thus, the Estate can still be the qualified settlement fund even though the victims will not be completely compensated for their injuries and their claims may therefore survive." n16

[a] Single Shared Fund to Satisfy CERCLA or Securities Claims

To the extent that a single disputed claims reserve is established as a single shared fund to satisfy CERCLA or Securities Act claims that constitute qualified liabilities, the fund could be a qualified settlement fund under the regulations notwithstanding the fact that it is established in a bankruptcy context so long as the excluded liabilities arose out of the same event or related series of events. In a private letter ruling, the Service held that general unsecured claims and the damage claims of a debtor consisting of workers' compensation claims and claims for personal injury and property damage allegedly caused by the tortious acts of the Company did not arise out of the same event or related series of events under *Treas. Reg. § 1.468B-1(h)(2)* and therefore the fund was not a qualified settlement fund. n17 The implication of the ruling is that the economic performance under *I.R.C. § 461(h)* had not occurred, and the debtor could not deduct its payments on account of the damage claims, until payments were made from the trust to the creditors. The taxation of payments for the trade creditors depends upon whether the economic performance and all events tests can be satisfied. A debtor may wish to create separate disputed claims reserves to avoid the impact of this IRS position.

[b] Fund Treatment Would Defer Some Types of Deduction; Appraisal Requirement

One possible drawback of the application of the qualified settlement fund Regulations to title 11 cases is that in the event that debt of the transferor (or a related party) is transferred to a qualified settlement fund, economic performance under *I.R.C. § 461(h)* does not occur earlier than principal payments are made on the debt. n18 If the debtor, under general tax principles, would be entitled to a deduction at the time of transfer of its debt to a disputed claims reserve, the treatment of the disputed claims reserve as a qualified settlement fund would change the result. Qualified settlement fund treatment would defer deduction by the debtor of amounts not previously accrued by the debtor that are satisfied by new indebtedness paid to trade creditors under the plan through the mechanism of a qualified settlement fund. It is unclear how the cash treatment of debt for economic accrual purposes would mesh with the original issue discount rules. While not clear, the rules on economic accrual suggest that the debtor might be required to defer original issue discount deductions on the debt until principal or interest payments have been made. This might not result in deferral of original discount income to the holder of the debt, which would be the qualified settlement fund. Likewise, the fund might be required to accrue interest income on the indebtedness in advance of payment. n19

It should be noted that the final regulations treat stock and partnership interests of the debtor or a related party transferred to the fund to satisfy liabilities like other property, but require an appraisal attached to the return for nonpublic stock and interests. n20

[c] Transfer to Provide for Satisfaction of Asserted Liability

On November 21, 2003, the IRS issued Proposed and Temporary Reg. § 1.461-2T(c)(1) to replace and restate *Treas. Reg. § 1.461-2(c)(1)* to clarify when a transfer for the satisfaction of an asserted liability is a transfer of money or property beyond the taxpayer's control. n21 For example, for a transfer to qualify as a transfer of money or property beyond the taxpayer's control the transfer should be to (1) person asserting the liability, (2) an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) providing that the money or other property be delivered in accordance with the settlement of the contest, (3) an escrowee or trustee pursuant to an order of a court or government entity providing that the money or other property be delivered in accordance with the settlement of the contest; or (4) a court with jurisdiction over the contest.

On July 20, 2004, the regulation proposed on November 21, 2003 was adopted without change as final. n22

On December 8, 2003, the IRS issued *Notice 2003-77* n23 in which the IRS alerted taxpayers to certain transactions that use contested liability trusts improperly to attempt to accelerate deductions for contested liabilities under *I.R.C. § 461(f)*. The Notice warns that a transaction in which a taxpayer transfers stock issued by the taxpayer, or indebtedness or stock issued by a party related to the taxpayer (as defined in *I.R.C. § 267(b)*) on or after November 19, 2003, to other than the person asserting the liability (e.g., a trust purported to be established under *I.R.C. § 461(f)* to provide for the satisfaction of any asserted liability) is now a "listed transaction" for purposes of *Treas. Reg. § 1.6011-4(b)(2)*. Transactions identified as "listed transactions" are subject to disclosure requirements as well as penalties.

[4] Taxation of Qualified Settlement Funds

Qualified settlement funds are treated as separate taxable entities and the tax treatment of the parties flows from that characterization. Thus, the transferor recognizes gain or loss on the transfer of property to a qualified settlement fund. The fund is treated as a person subject to tax on its modified gross income at the highest rate in effect under *I.R.C. § 1(e)*. n24 The amounts transferred to the qualified settlement fund are excluded from its income. n25 For purposes of tax administration and procedure, including filing a tax return, reporting its income and payment of estimated tax, a fund is treated as a corporation. n26 It is an accrual basis taxpayer with a calendar year. n27 The plan of reorganization should, therefore, consider the sources of cash a disputed claims reserve arrangement treated as a qualified settlement fund will have available to make such tax payments.

The regulations specify who will be the person treated as the administrator of the fund and consequently responsible for filing the tax returns and information statements, such as Forms 1099 and W-2 (in the same manner as if the transferor had made the payment to the claimant). n28 The administrator is, in order of priority: the person designated by the creating or approving governmental authority; the person designated in the agreement governing the fund; the escrow agent, custodian, or other person in possession and control of the fund's assets; or the transferor (or in the case of multiple transferors the transferor designated as the administrator in an agreement signed by all transferors). n29

The fund is entitled to deductions for its administrative expenses and other incidental expenses that would be allowed to a corporation. n30 Such expenses include state and local taxes, legal, accounting and actuarial fees, and other expenses of operating the fund, including the notification of claimants and the processing of their claims. Deductible expenses do not include the legal fees of the claimants, which are treated as their expenses and, if paid by the fund, are treated as the payment of distributions to such claimants. Thus, the legal fees incurred by the fund to resolve disputed claims would appear to be deductible. Losses on fund property are deductible, as are net operating losses, in the same manner as in the case of a corporation, although the fund is not subject to *I.R.C. § 382*. Amounts distributed to claimants are not deductible. n31

The most significant element of taxation of qualified settlement funds under the Regulations is that a fund is taxable under *I.R.C. § 1001(a)* on gains or losses on property distributed to the claimants based on the appreciation or depreciation in the value of the property since the date of transfer to the fund. This treatment seems particularly inappropriate to the taxation of disputed claims reserves created under a chapter 11 plan of reorganization. When the property to be distributed to the holder of an allowed claim (such as a *pro rata* share of fixed principal amount of debt and shares of the reorganized debtor) has appreciated in value, the application of the Regulations would transfer the tax burden to the claimants whose claims are resolved in the future. This is because assets remaining to be distributed to the holders of such later resolved claims will have been diminished by the taxes on the gain inherent in the property distributed in kind to the creditors whose claims were resolved favorably early in the disputed claims process.

The recipient of a distribution from a qualified settlement fund must treat the payment as taxable or excludable from income in the same manner as would have been the case if the payment had been received directly from the transferor. n32 Thus, if the payment to the claimant would have been wages if paid by the transferor, the fund must withhold as if it is paying wages. The fund must provide the claimant with a Form W-2 covering the wages and the creditor must report the receipt of the total value of the distribution as compensation income. n33

On February 7, 2006, the IRS issued final Treasury regulations relating to the taxation and reporting of income earned on funds held by a qualified settlement fund. n33a The effective date of the Treasury regulations is February 3, 2006. Under final *Treas. Reg. § 1.468B-1(k)*, if there is only one transferor to a qualified settlement fund, the transferor may make an election to treat the qualified settlement fund as a grantor trust, all of which is treated as owned by the transferor (a "grantor trust election"). The election (other than during the transition period) must be made in the first taxable year when the qualified settlement fund is established and may be revoked only for compelling circumstances upon consent of the Commissioner by private letter ruling. Commentators on the proposed *Treas. Reg. § 1.468-1(k)* asked the IRS to expand the "grantor trust election" to permit election by multiple-transferor trusts or in a taxpayer year other than the first taxable year of the trust. The IRS rejected both comments because they would result in undue complexity.

[5] Effective Dates

The regulations assert that *I.R.C. § 468B*, as well as *I.R.C. § 468B(g)* are effective as provided in the Tax Reform Act of 1986 and TAMRA. n34 In general, the provisions of the Regulations are effective on January 1, 1993 and apply to income of a qualified settlement fund earned after December 31, 1992 and distributions from a qualified settlement fund after December 31, 1992. Existing funds established after August 16, 1986, may for periods prior to January 1, 1993, employ a reasonable method, consistently applied, that results in current taxation of the income. n35 Depending on the

facts and circumstances, reasonable methods include grantor trust treatment by the transferors, complex trust treatment with the transferors as the grantors or taxation as a designated settlement fund.

[6] Implications of the Qualified Settlement Fund Tax Regime

It is imperative that a plan proponent, as well as creditors, consider and deal with the implications of the qualified settlement fund tax regime in the Regulations on the administration and operation of a disputed claims reserve. Such a reserve could be treated as a qualified settlement fund even if there was no intention to create a qualified settlement fund at the time of plan confirmation. n36 As noted above, if a disputed claims reserve provides for both trade and debt holder claims *plus* tort liabilities (e.g., CERCLA or Securities Act) it may be a qualified settlement fund under the final Regulations. Problems also could be encountered in the administration and operation of a creditors' trust created under a plan of reorganization if it meets the definition of a qualified settlement fund. Likewise, a plan proponent, as well as creditors, should consider the implications of the proposed regulations dealing with disputed ownership funds discussed in the next section.

[7] Disputed Ownership Funds

On February 1, 1999, the Service proposed regulations dealing with escrow funds and similar funds that had not been dealt with in the regulations concerning designated settlement funds and qualified settlement funds. n37 The proposed regulations would affect qualified settlement funds, qualified escrow accounts and qualified trusts established in connection with deferred like-kind exchanges; escrow accounts established in connection with sales of property; disputed ownership funds; and parties to these escrow accounts, trusts, and funds. n38

A disputed ownership fund is an escrow account, trust, or fund that is not a qualified settlement fund and is established to hold money or property subject to conflicting claims, is subject to continuing jurisdiction of a court, and the money or property of which cannot be paid or distributed to the claimants or transferor without the approval of the court. n39

In general, a disputed ownership fund is treated as the owner of the assets it holds. It is taxed as a qualified settlement fund under *Treas. Reg. § 1.468B-2*, if all of the assets transferred to the fund by or on behalf of the transferors are passive assets, such as cash or cash equivalents, stock, or debt obligations. It is taxed as a C Corporation in all other cases (for example, where the transferred assets are real estate or business assets). Alternatively, the proposed regulations permit the claimants to the fund to submit a private letter ruling request proposing an alternative method of tax treatment if it is more appropriate. Generally, the money or property that is transferred to the disputed claims fund is not taxable income to the fund. An exception is made for payments made on account of late or delayed payments, dividends of the transferor or a related person, and interest on debt obligations of a transferor or related person. Likewise, a distribution to a claimant is not a taxable event to the disputed claims fund and the fund is not allowed a deduction for the distribution. Finally, if the fund has a net operating loss, the claimants succeed to the losses. n40

Property received by the disputed claims fund from the transferor takes a fair market value basis unless the transferor claims ownership of the property or the transferor is a fiduciary for a person claiming ownership of the property before and after the transfer of the property. When the property takes a fair market value basis, the transferor treats the transfer of the property as a sale or exchange. Generally, economic performance under *I.R.C. § 461(h)* takes place when the transferor makes a transfer to the fund, but only if the transferor (or a related person) is not a claimant to the fund and has no right to receive payments or distributions from the fund. When the transferred property is a debt of the transferor or a related person, economic performance takes place when principal payments are made on the debt. The same rules apply to obligations of the transferor to make future transfers to the fund. n41

The proposed regulations are effective for most purposes on or after the publication of final regulations. However, the proposed regulations also provide that, with respect to a disputed ownership fund established after August 16, 1986, but before the publication of final regulations, the Service will not challenge a reasonable, consistently applied method of

taxation for income earned by the fund, transfers to the fund, and distributions made by the fund. n42

On February 7, 2006, the IRS issued final Treasury regulations relating to the taxation and reporting of income earned on certain other escrow accounts, trusts, and funds. n42a Proposed Treas. Reg. § 1.468B-9, relating to disputed ownership funds, has been adopted with a few substantive changes. The final Treasury Regulations clarified that an escrow account, trust, or fund that is a qualified settlement fund under *Treas. Reg. § 1.468B-1*, or a bankruptcy estate (or part thereof) resulting from the commencement of a case under title 11 of the U.S. Code, or a liquidating trust under *Treas. Reg. § 301.7701-4(d)* (except as provided below in the immediately following sentence) do not qualify for treatment as a disputed ownership fund. Final *Treas. Reg. § 1.468B-9*, however, allows a trustee of a liquidating trust established pursuant to a plan confirmed by the court in a case under title 11 of the U.S. Code to elect, in its first taxable year, to treat an escrow account, trust, or fund that holds assets of the liquidating trust that are subject to disputed claims as a disputed ownership fund. Pursuant to this election, creditors holding disputed claims are not treated as a transferors of the money or property transferred to the disputed ownership fund. The election may be revoked only upon consent of the Commissioner by private letter ruling.

FOOTNOTES:

(n1)Footnote 1. IA-54-90. Prop. Treas. Reg. § 1.468B-0 *et seq.*, 57 Fed. Reg. 5399(2/14/92) ,(respecting designated and qualified settlement funds). *See also* 1993-2 C.B. 470, Rev. Proc. 93-34 (respecting when a designated or qualified settlement fund will be considered "a party to the suit or agreement" for purposes of I.R.C. § 130).

(n2)Footnote 2. *Treas. Reg. § 1.468B-0, et seq.*, 57 Fed. Reg. 60983 (Dec. 23, 1992); corrected 58 Fed. Reg. 7865 (Feb. 10, 1993).

(n3)Footnote 3. *See Treas. Reg. § 1.468B-5* and *Priv. Ltr. Rul. 9310023 (Dec. 14,1992)* (complex trust treatment deemed reasonable).

(n4)Footnote 4. 1971-1 C.B. 163 (obsoleted by 1992-2 C.B. 102, Rev. Rul. 92-51).

(n5)Footnote 5. *Priv. Ltr. Rul. 200216013 (Jan. 16, 2002)* (citing H.R. Conf. Rep. No. 841, 99th Cong., 2nd Sess. (1986), 1986-3 (Vol. 4) C.B. 844-845).

(n6)Footnote 6. *Treas. Reg. § 1.468B-1(c)(3)*.

(n7)Footnote 7. Comprehensive Environmental Response, Compensation and Liabilities Act, 42 U.S.C. § 9601 *et seq.* *See also* T. Yancey and N. Finston, *Qualified Settlement Funds and Their Use in Funding Environmental Cleanups*, 1992 Toxics L. Rep. (May 13, 1992). *See generally* E. Slavitt, *An Overview of the Tax Implications of Environmental Litigation*, 20 Env'tl. L. Rep. 10547 (Env'tl. L. Inst. December 1990).

(n8)Footnote 8. *Treas. Reg. § 1.468B-1(c)(2)*. *See* Priv. Ltr. Ruls. 2000-06-029 (Nov.10, 1999) and 95-52-009 (Sept. 25, 1995) (trust created pursuant to bankruptcy plan is a qualified settlement fund); *Priv. Ltr. Rul. 9503022 (Oct. 26, 1994)* (IRS rejects state and county government contentions that trust fund is not a qualified settlement fund).

(n9)Footnote 9. *Treas. Reg. § 1.468B-1(c)*; *compare* FSA 1999-736 (May 1, 1992) (ruling that Disputed Claims Reserve did not constitute separate taxable entity, where escrow agent had very limited investment and other authority, no separate document apart from the Plan of Reorganization purported to establish an entity under state law with authority over the reserve, and taxpayer retained certain rights and control over the reserve).

(n10)Footnote 10. *Treas. Reg. § 1.468B-1(b)*.

(n11)Footnote 11. *Priv. Ltr. Rul. 200329045 (March 21, 2003)* .

(n12)Footnote 12. The Bankruptcy Reform Act of 1994, Pub. L. No. 103-394, *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(a) (Matthew Bender 15th Ed. Revised), added subsection (g) to *section 524 of the Bankruptcy Code* to establish a procedure for dealing with future personal injury claims based on exposure to asbestos in a claims reserve trust. In "Bankruptcy Reform Act of 1994, a Section-by-Section Description," *reprinted in* Vol. E Collier on Bankruptcy, App. Pt. 9(b)(Matthew Bender 15th Ed. Revised), the Committee of the Judiciary states "How the new statutory mechanism works in the asbestos area may help the Committee judge whether the concept should be extended into other areas." *See Priv. Ltr. Rul. 9534031 (June 2, 1995)* (portion of trust that is the designated settlement fund entitled to benefits of special transition rule in the Tax Reform Act of 1986).

(n13)Footnote 13. *Treas. Reg. § 1.468B-1(g)(3)*.

(n14)Footnote 14. *Treas. Reg. § 1.468B-1(h)(2)*. *See Priv. Ltr. Rul. 9542008 (July 18, 1995)* (trust under bankruptcy plan to hold fraud claims is a qualified settlement fund).

(n15)Footnote 15. Issued Dec. 17, 2001, in which the IRS cited *Priv. Ltr. Rul. 9949008 (Sep. 3, 1999)* (Payments that company may have to make subsequent to bankruptcy plan confirmation, but prior to the bankruptcy plan effective date, to a trust will be deductible under § 162 at the time the payment is made to the trust, pursuant to *I.R.C. § 461(f)* and *Treas. Reg. § 1.468B-1(c)(2)*), and *Priv. Ltr. Rul. 9839027 (June 29, 1998)*). (On Date 1, court preliminarily approved a settlement agreement; on Date 2, a fund was established with an initial payment to the committee (with the funds being segregated); on Date 3, the court entered its final order approving the settlement; on Date 4, the fund was formally established as a trust under state law; on Date 5, the court's order became final. Held that the fund constituted a qualified settlement fund since Date 2, and the initial payment made on Date 2 was deductible when made).

(n16)Footnote 16. *United States v. Brown, 348 F.3d 1200, 1211 (10th Cir. 2003)* .

(n17)Footnote 17. *Priv. Ltr. Rul. 9549026 (Sept. 8, 1995)* (trust under bankruptcy plan for both general unsecured claims and "damage" claims is not a qualified settlement fund).

(n18)Footnote 18. *Treas. Reg. § 1.468B-3(c)(3)* and *Priv. Ltr. Ruls. 95-52-009 (Sep. 25, 1995), 97-33-019 (May 19, 1997)* (transferor is entitled to deduct the amount of principal payments on debt at the time transferor makes such principal payments to the qualified settlement fund). *See also Priv. Ltr. Ruls. 2000-06-029 (Nov. 10, 1999)* (debtor is entitled to deduct the amounts transferred to a qualified settlement trust consisting of income of the debtor, less a sufficient amount of capital to maintain business operations); *see Priv. Ltr. Rul. 200216013 (Jan. 16, 2002)* (debtor is entitled to value and to deduct fair market value of stock on date when stock transferred to intended recipients); *93-17-006 (Jan. 15, 1993)* (debtor entitled to deduct amount of cash and fair market value of property transferred to qualified settlement fund) and *Priv. Ltr. Rul. 9338032 (Jun. 28, 1993)* (amounts received by reorganized debtor from settlement of an insurance claim transferred to a qualified settlement fund not deductible unless included in reorganized corporation's gross income). *See also Prop. Treas. Reg. § 1.468B-9(f)(2)(ii)* (involving disputed ownership funds). Disputed ownership funds are discussed below at P TX 14.02[7].

(n19)Footnote 19. It is unclear whether the economic performance rules invoked by the *Treas. Reg. § 1.468B* should be at all applicable to situations involving breach of contract when the claimant has performed its part of the contract. *See Maxus Energy Corp. v. U.S., 31 F.3d 1135 (Fed. Cir. 1994)* .

(n20)Footnote 20. *See Treas. Reg. § 1.468B-3(a) and (b)*. *See Priv. Ltr. Rul. 9733019 (May 22, 1997)* .

(n21)Footnote 21. *T.D. 9095, 68 F.R. 65634 (Nov. 21, 2003)*.

(n22)Footnote 22. *T.D. 9140, 69 F.R. 43302* .

(n23)Footnote 23. *2003-49 I.R.B. 1182* .

(n24)Footnote 24. *Treas. Reg. § 1.468B-2. See generally Priv. Ltr. Rul. 9507035 (Nov.21, 1994) ; Priv. Ltr. Rul. 9503022 (Oct. 26, 1994) (trust treated as a qualified settlement fund despite taxpayer arguments to the contrary); Priv. Ltr. Rul. 9416032 (Jan. 24, 1994) ; Priv. Ltr. Rul.9424008 (March 14, 1994) ; Priv. Ltr. Rul. 9344031 (Aug. 10, 1993) ; Priv. Ltr. Rul. 9340046(Jul. 9, 1993) .*

(n25)Footnote 25. *See Treas. Reg. 1.468B-2(b)(1); Priv. Ltr. Rul. 200242035 (July 22, 2002) ; Priv. Ltr. Rul. 9552009 (Sep. 25, 1995), Priv. Ltr. Rul. 9416032 (Jan. 24, 1994).*

(n26)Footnote 26. *Treas. Reg. § 1.468B-2(k).*

(n27)Footnote 27. *Treas. Reg. § 1.468B-2(j).* Where the company that established the fund filed a tax return and paid the tax on the fund's taxable income, the IRS ruled the company would be credited with overpayments made on behalf of the qualified settlement fund making a back year election. *Priv. Ltr. Rul. 9340055 (Jul. 12, 1993) .*

(n28)Footnote 28. *Treas. Reg. § 1.468B-2(k)(3).*

(n29)Footnote 29. *Treas. Reg. § 1.468B-2(k)(3); IRS CCA 200104030 (Jan. 26, 2001) ("adminstrator" is a court appointed receiver to whom all property of debtor was turned over by the court).*

(n30)Footnote 30. *Treas. Reg. § 1.468B-2(b)(2); Priv. Ltr. Rul. 200243034 (July 26, 2002) ; Priv. Ltr. Rul. 200106021 (Nov. 21, 2001), Priv. Ltr. Rul. 200025023 (March 22, 2000).*

(n31)Footnote 31. *Treas. Reg. § 1.468B-2(b); Priv. Ltr. Rul. 200006029 (Nov. 10, 1999) .*

(n32)Footnote 32. *Treas. Reg. § 1.468B-4; Priv. Ltr. Rul. 200222001 (Feb. 28, 2002) (trust does not need to withhold tax from reimbursed medical payments that are excluded from taxable income of payee under I.R.C. § 104). But see Priv. Ltr. Rul. 9437033 (June 20, 1994) .*

(n33)Footnote 33. *Treas. Reg. § 1.468B-2(l).*

(n34)Footnote 33a. *71 F.R. 6197, T.D. 9249 .*

(n35)Footnote 34. *Treas. Reg. § 1.468B-5; Priv. Ltr. Rul. 200106021 (Nov. 7, 2000) (fund is subject to the information reporting requirements of I.R.C. § 6041 for payments to a class member of amounts that are allocable to interest).*

(n36)Footnote 35. *Treas. Reg. § 1.468B-5(b). See Priv. Ltr. Rul. 9310023 (Dec. 14,1992) (complex trust treatment). See also Priv. Ltr. Rul. 9309030 (Dec. 4, 1992) (treatment as a qualified settlement fund effective January 1, 1992).*

(n37)Footnote 36. *See O'Cheskey v. U.S., 2001 U.S. Dist. LEXIS 21370, 2002-1 Tax. Cas. (CCH) P 50,197 (N.D. Tex. Dec. 21, 2001).*

(n38)Footnote 37. *See P TX14.02[1] supra.*

(n39)Footnote 38. *See Prop. Treas. Reg. §§ 1.468B-0 through 1.468B-9, 64 Fed. Reg. 4801 (Feb. 1, 1999) .*

(n40)Footnote 39. *Prop. Treas. Reg. § 1.468B-9(a).*

(n41)Footnote 40. *Prop. Treas. Reg. § 1.468B-9(c).*

(n42)Footnote 41. *Prop. Treas. Reg. §§ 1.468B-9(d) and (f).*

(n43)Footnote 42. *Prop. Treas. Reg. § 1.468B-9(h).*

(n44)Footnote 42a. 71 F.R. 6197, T.D. 9249 .



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Collier on Bankruptcy Taxation

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CHAPTER TX14 Tax Consequences of Disputed Claims Reserves and Creditors' Trusts

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P TX14.03 Alternative Methods of Taxing Disputed Claims Reserves

[1] Introduction

Under the existing authorities there appear to be four analogies for taxing a disputed claims reserve arrangement created under a chapter 11 plan of reorganization that does not constitute a designated or qualified settlement fund: n1

- the arrangement could be taxed similarly to a grantor trust of the debtor; n2
- the arrangement could be taxed as if it were a grantor trust established by the creditors to resolve their conflicting claims to the plan consideration;
- the arrangement could be taxed as if it were a separate entity trust similar to a bankruptcy estate; or
- the arrangement could be treated as a separate taxable entity similar to the treatment of a disputed ownership fund under the regulations dealing with taxation of disputed ownership funds. n3

If a disputed claims reserve is to be treated as a trust, it must be determined how this trust-like entity is to be taxed under Subchapter J of the Internal Revenue Code.

The legislative history of *I.R.C. § 468B(g)* could be read to require a disputed claims reserve arrangement to be treated similarly to a grantor trust owned by the debtor. n4 While this tax treatment may have been contemplated by the drafters of the original provision when the predecessor of *I.R.C. § 468B(g)* was enacted in 1986, subsequent amendments seem to have softened the original directive language of the statute and tied the tax treatment of such funds to future regulations. n5 This suggests that at some point Congress recognized that settlement funds can vary in their economic arrangements and the tax treatment of such settlement funds is more complex than a simple resort to the grantor trust rules can accommodate.

[2] Analysis of the Economic Effect of the Deposit

If settlement funds are not automatically to be taxed as grantor trusts, it seems pertinent to question whether grantor trust tax treatment is appropriate for disputed claims reserve arrangements. Debtor grantor trust treatment seems to be grounded on the principle that the depositor into the fund is settling its liabilities with future income earned by the fund.

This is not the case with the typical disputed claims reserve arrangement. The debtor has been discharged from its past liabilities by the plan of reorganization. The deposit of the plan consideration into the disputed claims reserve arrangement as required by the plan serves primarily to determine which of the debtor's creditors will receive the plan consideration.

Such arrangement also will lead to a determination of how much of the plan consideration each of the claimants will be treated as receiving on account of such claimant's allowed claim. This determination is obviously important for certain tax purposes, such as for purposes of calculating the amount of the cancellation of indebtedness. It is not, as an economic matter, relevant to the reorganized debtor since it has "paid" its liabilities--allowed and disputed--by virtue of the plan consideration that it agreed to distribute to creditors in the plan of reorganization. From an economic point of view, the reorganized debtor is indifferent as to whether the plan consideration in the reserve is ultimately distributed to one creditor or to another.

It may not even make much difference to the reorganized debtor from a tax viewpoint whether the plan consideration is distributed to satisfy the claims of the holders of allowed claims or disputed claims. To the extent that the creditors' claims are for ordinary and necessary business expenses under *I.R.C. § 162*, the debtor is entitled to a deduction on account of the payment. It is likely that prior to the deposit of the plan consideration into the disputed claims reserve on the effective date, the disputed claims have not been deducted because "all of the events" necessary to determine the debtor's liability have not occurred.

Under *I.R.C. § 461(f)*, the creation of the disputed claims reserve arrangement on the effective date of the plan may give rise to an immediate deduction for such ordinary and necessary business expenses. *I.R.C. § 461(f)* permits a taxpayer continuing to contest a liability to take a current deduction, though the contest continues, if the taxpayer transfers money or property beyond his control to satisfy the liability. n6 The transfer of property to segregated accounts for the benefit of creditors as a disputed claims reserve arrangement to satisfy creditor claims pursuant to a confirmed plan of reorganization seems to satisfy these requirements. n7

The post effective date proceedings to resolve the disputed claims should satisfy the statutory requirement that the contest continue after the transfer. However, because under *11 U.S.C. § 1141* the confirmation of a plan would ordinarily discharge the debtor from continuing liability on a disputed claim, it is at least arguable that there is no continuing contest. It is unclear whether the economic performance rules invoked by *Treas. Reg. § 1.468B-3(c)(3)* should be at all applicable to situations involving breach of contract when the claimant has performed its part of the contract. n8 This would be an unduly restrictive reading in light of the fact that a contest continues on the underlying claim as to whether the holder of the disputed claim is entitled to an allowed claim and to participate with the holders of other allowed claims in receiving the consideration provided for allowed claims under the plan. Assuming all creditor claims were for deductible expenses, this analysis supports the current deduction by the debtor of the entire plan consideration, including the amounts deposited into the disputed claims reserve arrangement, at the effective date of the plan of reorganization, independently of the benefits of *I.R.C. § 461(f)*. n9

Since the administration of the disputed claims reserve by the reorganized debtor is subject to the supervision of the bankruptcy court and the property held subject to the reserve would not be subject to the claims of new creditors of the reorganized company in the event of a subsequent title 11 case, administration of the reserve by the reorganized debtor ought to satisfy the requirement that the property be placed beyond the control of the taxpayer. n10 Nevertheless, in order to avoid challenges by the Service on this point, in the absence of clear authority it would be prudent to appoint an entity other than the taxpayer as the administrator of the disputed claims reserve arrangement.

If *I.R.C. § 461(f)* is not applicable to the creation of the disputed claims reserve arrangement, at the least the debtor will be entitled to a deduction when each disputed claim is resolved unfavorably to the debtor. Other claimants with previously allowed claims will consequently receive less consideration under the plan of reorganization than they otherwise would have received. This is because the total amount to be distributed to claimants under the plan is fixed.

As a result the allowed claims for expenses previously accrued by the debtor or for capital items will be satisfied at greater discounts from the amounts accrued as liabilities on the books of the debtor. This in turn likely will give rise to larger cancellation of indebtedness. But these amounts will often be offset by the newly accrued deductions on account of the distributions of plan consideration to the former disputed claimants. n11

[3] Grantor Trust Treatment

[a] Debtor Grantor Trust

Despite the legislative history of *I.R.C. § 468B(g)*, debtor grantor trust treatment of the disputed claims reserve arrangements does not appear to be appropriate. The reorganized debtor typically does not retain a substantial residual interest in the reserve. Sometimes the plan of reorganization will provide that the debtor succeeds to the remaining funds in the disputed claims reserve as a matter of administrative convenience. This occurs if the remaining amount is considered too small to be feasibly distributed to a large number of claimants. In addition, the plan often will provide that the expenses of the administration of the disputed claims reserve will be deducted from the amount distributable to holders of allowed claims. The reorganized debtor often performs the functions of disbursing agent (sometimes after the initial distributions are made by a third party disbursing agent) and is entitled to reimbursement or payment for its expenses. Under such circumstances, it is doubtful that one could say that the reorganized debtor had an interest of more than 5% of the value of the disputed claims reserve as required by the grantor trust rules of *I.R.C. § 673*.

While in a literal sense the reorganized debtor may be satisfying with the plan consideration in the disputed claims reserve the liabilities to disputed claimants that subsequently have their claims allowed, the current earnings on the plan consideration (and possible appreciation thereof) generally are not intended to be the economic source of payment of such liabilities. Rather, to the extent they are distributed to the successful claimants, they roughly compensate such creditors for the delay in the distribution of the plan consideration and place such creditors in the same position as the creditors with allowed claims at the effective date of the plan of reorganization receiving the initial distribution. To the extent the earnings are added to the amounts held in the disputed claims reserve and distributed to the creditors at the termination of the arrangement, the earnings do provide additional consideration to creditors with allowed claims previously discharged by the plan. The current earnings on the assets in the disputed claims reserve do not discharge the reorganized debtor's liabilities. The current earnings belong to the claimants whose claims are ultimately allowed and whose claims have been discharged by the plan.

[i] Tax Consequences of Debtor Grantor Trust Treatment

Ignoring the tax existence of the disputed claims reserve arrangement or treating it as a debtor grantor trust creates the anomalous situation that there is unlikely to be significant current taxable income. This is because the cash component of the plan consideration distributable to creditors under a plan of reorganization is generally modest and the most significant element of current income in the disputed claims reserve is likely to be original issue discount and interest on debt securities of the reorganized company. These items of income would not give rise to current income because the putative grantor cannot be taxable on the original issue discount and interest of its own indebtedness which it would be treated as owning under this theory of taxation of disputed claims reserve arrangements.

Payments of stated interest and dividends, if any, on the plan securities paid into the disputed claims reserve would be treated as additional cash payments by the reorganized debtor to the creditors when distributed from the reserve to the holders of allowed claims. n12 The tax treatment of such payments would depend on the nature of the claim and the creditor's circumstances. Consider, for instance, the resolution of a disputed claim for wages in favor of an employee of the debtor. Payments to such creditor under the debtor grantor trust arrangement should result in the entire payment, including interest and dividends on plan securities, at the time of distribution being treated as a payment of wages subject to withholding and other employment related taxes. n13

When the instruments in the disputed claims reserve are released to the creditors with allowed claims, they may have very different tax attributes and values than the instruments issued on the plan effective date. This is because under the grantor trust analogy to taxation of disputed claims reserves the instruments would be deemed to be issued at the later date when the subsequent distribution is made. At such time the conditions affecting the tax attributes of the instrument may have changed substantially. For instance, a debt obligation may not be traded on an established securities market when it is first issued at the effective date of the plan of reorganization. Consequently, if there is adequate interest under *I.R.C. § 1274*, and the other conditions respecting qualified periodic interest payments are met, the debt may not be treated as issued at a discount. However, a few years later the other debt of the same series originally issued to creditors may be publicly trading at a sharp discount. In such case, the issue price of the instrument distributed from the disputed claims reserve would be determined under *I.R.C. § 1273(b)(3)* by reference to such later trading value with the consequence that such debt would be treated for tax purposes as if it had been issued at an original issue discount. In addition to varying the expected tax consequences to the creditors and the debtor, such varying tax attributes could cause practical problems in terms of trading in the market.

Similarly, if the disputed claims reserve arrangement is treated as a grantor trust, the distributions from the disputed claims reserve may be subject to the imputed interest rules of *I.R.C. § 483*.ⁿ¹⁴ In general, that section provides for the treatment of a portion of deferred payments under a contract for the sale or exchange of property as interest under calculations similar to those involved in determining original issue discount under *I.R.C. § 1272(a)*. The plan of reorganization is likely a contract for these purposes. Certainly the claims of creditors holding indebtedness of the debtor are property, as may be the claims of other claimants such as wage claimants for these purposes.ⁿ¹⁵ The rule does not apply if payments are not due more than one year after the sale or exchange, if the sales price is \$3,000 or less,ⁿ¹⁶ or to certain transfers of patent rights.

Another consequence of the debtor grantor trust analogy to taxation of disputed claims reserves relates to the measurement of stock ownership under *I.R.C. § 382* and related provisions respecting use of net operating losses and other tax attributes following certain changes in stock ownership.ⁿ¹⁷

In a private letter ruling applying *I.R.C. § 382(1)(5)(A)(ii)*, the Service considered whether a qualified settlement fund that was funded with all of the stock of a debtor is a qualified creditor of the debtor. The Service concluded that the fund will be treated as the owner of the debtor's stock issued to it under the reorganization plan and that the fund will be considered as having received the stock because of its relationship with its beneficiaries, the holders of claims in the bankruptcy proceedings. The fund therefore received the stock through a "qualified transfer" within the meaning of *Treas. Reg. § 1.382-9(d)(5)(ii)*. The fund thus was permitted to tack the holding periods of the beneficiaries for purposes of satisfying the "qualified creditor" test of *Treas. Reg. § 1.382-9(d)(1)*.ⁿ¹⁸ On the other hand, if the stock held in the disputed claims reserve to be distributed in the future to creditors is not treated as issued and outstanding for tax purposes, the calculation of the owner shifts for purposes of *I.R.C. § 382* may be different. For example, the stock in the reserve may be treated as subject to an option. Such stock would not be seasoned with the passage of time and would be subject to a full three year testing period under *I.R.C. § 382(i)* commencing on the date it was actually distributed to creditors from the disputed claims reserve. Moreover, the failure to count such stock as issued to creditors may adversely affect calculations of the stock ownership of the "old and cold" shareholders and creditors for purposes of determining an ownership change or qualifying for the special bankruptcy exception of *I.R.C. § 382(l)(5)*.ⁿ¹⁹ In a private letter ruling applying *I.R.C. § 108(e)(8)* to a situation involving a disputed claims reserve, the Service took a practical approach and ruled that the determinations would be based on the "projected" distributions to creditors and no redeterminations would be made based on actual distributions to creditors from the disputed claims reserves.ⁿ²⁰ Likewise, in a private letter ruling applying *I.R.C. § 382(1)(5)*, the Service held that distributions of the debtor's stock from a qualified settlement fund to the beneficiaries would not be treated as owner shifts because beneficiaries of the qualified settlement fund, rather than the fund itself, will be considered to own the stock in the debtor in proportion to their respective interests in the settlement fund on the original date of the transfer of stock by the debtor to the fund.ⁿ²¹

[ii] IRS Position on Debtor Grantor Trust Treatment

Despite the obvious problems with debtor grantor trust treatment of disputed claims reserve arrangements, to the extent that one can draw conclusions from limited examinations of taxpayers, the Service currently appears to favor debtor grantor trust treatment. This position may have been ameliorated by the tax treatment of disputed ownership funds advanced in Treas. Reg. § 1.468B-9. n22

[b] Creditor Grantor Trust

A disputed claims reserve arrangement could be treated as a grantor trust owned by the creditors. This treatment would analogize the reserve to a stakeholder for the creditors with claims against the reserve who are engaged in a kind of interpleader action to determine their respective rightful interests in the reserve. The disputed claims agent would be the fiduciary for the creditors and would file a grantor trust tax return indicating that the disputed claims reserve was held for the creditors as their interest would appear. n23

This treatment makes the most sense logically, but it seems administratively difficult in light of the purpose of *I.R.C. § 468B(g)* currently to tax the income earned by settlement funds. It is difficult to allocate properly the current income each year to the respective creditors prior to the resolution of all of the disputed claims. As a practical matter, when filing the trust tax returns, how would the fiduciary determine how much income to allocate on Schedules K-1 to individual creditors with interests in the reserve? A reasonable method would be to report the income to creditors with allowed claims. The alternative is to report the income to all creditors--those holding disputed claims as well as allowed claims. The first alternative would overstate the income to creditors with allowed claims, assuming some disputed claims become allowed claims. n24 The second alternative would have the effect of causing some creditors who will never receive the plan consideration to be treated as if they had received the distributions of the plan consideration on the same basis on which the deposits were allocated to the disputed claims reserve on account of their disputed claims. The disputed claimants would have the reportable income, but, unlike the holders of allowed claims, would not have any of the plan consideration to finance the payment of the taxes. At some point claimants under either alternative would recognize a loss on the phantom plan distributions on account of their claims. The inability to allocate fairly the current earnings on the assets in the disputed claims reserve casts doubt on the viability of this approach.

Moreover, if the distributions were not allocated to all creditors currently, it is unclear how the creditors would report the income when distributions actually were made from the reserve. They could report the income in the year of receipt. This in effect would be a return to the cash basis tax regime under *Rev. Rul. 70-567* and *Rev. Rul. 71-119*. Given the legislative history disapproving of the Service's rulings position, as well as the Service pronouncement in *Rev. Rul. 92-51* declaring the rulings to be obsolete, this appears to be a doubtful approach, especially for accrual basis taxpayers. Alternatively, the creditors could file amended returns for the years when the income was earned. This again seems to be an administratively unworkable alternative. It would result in underreported income by the creditors in the prior years and could subject them to penalties and nondeductible interest charges on late paid taxes.

[4] Separate Entity Trust Treatment

[a] Taxable Trust Similar to a Bankruptcy Estate

A disputed claims reserve arrangement could be treated as a separate entity trust for the benefit of the creditors similar to the bankruptcy estate. This entity trust treatment is also the treatment suggested in a private letter ruling. n25 In the ruling, the IRS stated that a fund consisting of a pool of assets created pursuant to the chapter 11 plans of three companies was held to be a trust subject to certain of the provisions of Subchapter J. The IRS reasoned that the fund functioned much like the separate bankruptcy estate of an individual, including the right to pursue causes of action under the Bankruptcy Code. In another ruling, the IRS stated that a fund created pursuant to a chapter 11 plan should be treated as a trust subject to certain of the provisions of Subchapter J because the powers of the disbursing agent, including the power to bring suit to avoid transfers and pursue other causes of action, were held to be consistent with the

duties of a trustee. n26

[b] Obligations to File Tax Returns

The Service made similar arguments in *Holywell Corp. v. Smith* n27 with respect to the obligations to file tax returns of the trustees of creditors' trusts created under a plan of reorganization to liquidate properties for the creditors. The Supreme Court in *Holywell* did not reach this issue as to the corporate debtors since the parties contended that the results in that case would be the same as on the grounds the Court decided the taxation of the creditors' trust of the corporations. n28 However, with respect to an individual debtor, the Court rejected the Service's contention that the trustee of a creditors' trust of the individual debtor was required to file tax returns under *I.R.C. § 6012(b)(4)* as the substitute fiduciary of the individual debtor's bankruptcy estate. Rather, the Court held that under the facts of that case, the trustee had an obligation to file returns as the trustee of a liquidating trust. n29

Treatment of a disputed claims reserve arrangement as a continuation of a bankruptcy estate makes no sense in the case of a corporate chapter 11 plan when there is no separate taxable bankruptcy estate created by the filing of the petition and when the disbursing agent has limited powers unlike the broad powers of a debtor in possession. Further, there are no provisions of Subchapter J of the I.R.C. that currently describe the taxation of any such special trust.

[c] Complex Trust with Separate Shares

The disputed claims reserve arrangement could be treated similarly to a complex trust with separate shares for the benefit of the creditors as described in *I.R.C. § 663(c)* and *Treas. Reg. § 1.663(c)-1*. This analogy makes the most sense in the case of a disputed claims reserve established pursuant to a corporate chapter 11 plan where the disbursing agent has limited powers unlike the broad powers of a debtor in possession. n30

In general, complex trust treatment results in current taxation of the income earned postconfirmation by the reserve, as well as the inclusion of the income by the creditors ultimately determined to be entitled to such income in the year in which they receive their distributions. There is no double taxation of the current income and this arrangement approaches that of the creditor grantor trust analogy. It generally matches any current income earned on the cash, notes and stock in the reserve to the creditors who receive such consideration under the plan, although the complexity of the trust throw-back rules makes it complicated to administer. It avoids the complications of valuing stock or securities transferred to the reserve and of applying the time value of money rules of *I.R.C. § 1272 et. seq.* to the deferred payments to creditors under the plan.

By contrast, complex trust treatment without separate shares would be even more difficult to administer fairly and is likely to result in even greater mismatch of income. Some creditors would be treated as receiving excessive distributions of current or accumulated income that was earned on the assets held by the reserve. Other similarly situated creditors could be treated as receiving distributions of trust principal or corpus and little or no income.

Under the analogy to complex trust-separate share treatment, the income should be matched to each creditor in accordance with his or her ultimate share of the cash and property distributions under the plan and such creditor should receive the appropriate credit for the taxes paid by the trust on the current and accumulated income of the fund ultimately distributed to the creditor. n31

[5] Current Service Position with Respect to I.R.C. Section 468B(g)

There are several published private letter rulings that provide conflicting insight into the IRS National Office thinking with respect to *I.R.C. § 468B(g)*. A private letter ruling n32 held that a settlement fund established by the parties to benefit ratepayers of a utility company was taxable as a trust under Subchapter J, even though not a technical trust. Because it was represented that the current expenses of the fund would exceed the interest currently earned on the fund

assets, the IRS ruled that so long as the expenses exceed the current income, the fiduciary would not be required to provide a Form K-1 to the ratepayers. To the contrary, *Priv. Ltr. Rul. 8924090 (March 23, 1989)* held that a settlement receivership was not taxable as a trust since the receiver did not have broad powers of administration and management. There was no discussion of the applicability of *I.R.C. § 468B(g)*. In *Priv. Ltr. Rul. 9243033 (July 24, 1992)*, assuming but not deciding the applicability of *I.R.C. § 468B(g)*, the Service ruled that a fund established in connection with an illegally collected use tax was a grantor trust of the governmental entities owned by them in proportion to their contributions to the fund.ⁿ³³ In the mid-1990's, in the case of disputed claims reserves created under title 11 cases, the Service contended that disputed claims reserve arrangements are not separate tax entities or trusts and thus the current income of such a disputed claims reserves are taxable to the reorganized company as if the reserves were grantor trusts. Finally, *Treas. Reg. § 1.468B-9* suggests that the Service now believes that the taxation of disputed ownership funds should in most cases follow the general procedures for taxing qualified settlement funds. It is likely that in most chapter 11 cases, a disputed claims reserve can be structured to meet the requirements of a disputed ownership fund under the Treasury regulations.

[6] Sample Disclosure Statement Language

Taxation of Certain Reserves. Section 468B(g) of the Internal Revenue Code provides that escrow accounts, settlement funds or similar funds are subject to current taxation. It also provides that the Service shall prescribe regulations for the taxation of any such account or fund, whether as a grantor trust or otherwise. The Service issued final regulations regarding qualified settlement funds on December 18, 1992. However, such regulations specifically reserve the tax treatment of funds established to resolve certain types of claims, including (i) claims of a debtor's general trade creditors or debtholders that relate to a title 11 or similar case, or a workout, or (ii) claims that arise under a workers' compensation act or a self-insured health plan ("Excluded Claims") if such Excluded Claims do not arise out of the same event or series of events as certain qualified claims. Under § 1.468B-2 of the final regulations, a qualified settlement fund is taxable on its modified gross income at a rate equal to the maximum federal income tax rate for trusts. In general, the modified income of a qualified settlement fund should not include amounts transferred by a debtor to the qualified settlement fund to resolve or satisfy a liability for which the trust was established. The tax basis in the property transferred to the qualified settlement fund by the debtor would be equal to the fair market value of such property, and the qualified settlement fund would be taxed on gains and losses on the property when sold or distributed in kind to creditors based on the appreciation or depreciation in the value of such property since the date of receipt. For purposes of filing federal income tax returns, information reporting and withholding requirements, payments by or to the qualified settlement fund should be treated as payments to a corporation.

On February 7, 2006, the Service issued final regulations respecting disputed ownership funds. A disputed ownership fund under the Treasury regulations is an escrow, fund or that (i) is established to hold money or property subject to conflicting claims of ownership, (ii) is subject to continuing jurisdiction of a court, and (iii) the money or property of which cannot be paid to or on behalf of a claimant without the approval of the court. A disputed ownership fund is taxable as if it were a qualified settlement fund, as such term is defined in the *Treas. Reg. § 1.468B-1(c)*, if all assets transferred to the fund are passive investment assets, such as cash, cash equivalents, stock, and debt obligations. A disputed ownership fund is taxable as if it were a C corporation in all other cases.

Thus, there is some uncertainty as to who is responsible for reporting income generated by the funds in the Unpaid Claims Reserve/Disputed Claims Reserve formed pursuant to the Plan. If an analogy to the treatment of such reserves in the Treasury regulations is used, the fund will be taxed as a separate taxpayer similar to a qualified settlement fund or a C corporation. It is also possible that the Unpaid Claims Reserve/Disputed Claims Reserve could be treated as a grantor trust of which the holders of Allowed Claims as beneficiaries are treated as the grantors. As such, the holders of Allowed Claims and Disputed Claims would be subject to current taxation on the income generated by the Unpaid Claims Reserve/Disputed Claims Reserve. In such event, the manner of allocating the income of the trust among the holders of such Allowed Claims and Disputed Claims is unclear. Since the Debtor does not have a residual interest in the Unpaid Claims Reserve/Disputed Claims Reserve, it is doubtful the fund would be treated as a grantor trust of the

Debtor. The Plan and related documents will authorize and obligate the administrators responsible for administering the Unpaid Claims Reserve/Disputed Claims Reserve to file appropriate income tax returns and pay any tax due out of funds in the Unpaid Claims Reserve/Disputed Claims Reserve as a result of any taxable income earned in the Unpaid Claims Reserve/Disputed Claims Reserve.

FOOTNOTES:

(n1)Footnote 1. *See P TX14.02 supra*.

(n2)Footnote 2. This is the treatment that may have been contemplated when the uncodified provision was first enacted in 1986.

(n3)Footnote 3. *See P TX14.02[7] supra*. Treas. Reg. § 1.468B-9.

(n4)Footnote 4. *See P TX14.06[2] infra*.

(n5)Footnote 5. *See P TX14.06[2] infra*. *See also United States v. Brown*, 2001 U.S. Dist. LEXIS 8064, 2001-2 U.S. Tax. Cas. (CCH) P 50,519 (D. Utah May 23, 2001) (the court noted that, while the Treasury has "virtually unbridled authority [under § 468B(g)] to prescribe regulations for the taxation of escrow accounts, settlement funds, and similar funds through the promulgation of suitable regulations, whether as trusts or otherwise," such authority has not yet been exercised fully, and, because the Service had asserted liability only on the theory that the receivership estate in question was a qualified settlement fund, the estate avoided current taxation). The District Court's decision that the estate was not a qualified settlement fund was reversed and the proceeding was remanded to determine the amount of income tax owed by the estate as a qualified settlement fund. *United States v. Brown*, 348 F.3d 1200 (10th Cir. 2003).

(n6)Footnote 6. *See Treas. Reg. § 1.461-2*. *See also 2000 FSA Lexis 216* (discussion of necessary elements for deductions under § 461(f)).

(n7)Footnote 7. 11 U.S.C. § 1141(a). *See Varied Investments, Inc. v. U.S.*, 31 F.3d 651 (8th Cir. 1994). *But see Treas. Regs. § 1.461-2(c)(1)* (clarifying that a transfer of money or property shall be treated as a transfer beyond the taxpayer's control only if such transfer is to (1) person asserting the liability, (2) an escrowee or trustee pursuant to a written agreement (among the escrowee or trustee, the taxpayer, and the person who is asserting the liability) providing that the money or other property be delivered in accordance with the settlement of the contest, (3) an escrowee or trustee pursuant to an order of a court or government entity providing that the money or other property be delivered in accordance with the settlement of the contest; or (4) a court with jurisdiction over the contest) Also, a transfer of stock of the debtor or a transfer of stock or any debt instrument issued by a party related to the debtor, on or after November 19, 2003, to other than the person asserting the liability (e.g., a trust purported to be established under I.R.C. § 461(f) to provide for the satisfaction of any asserted liability) is now a "listed transaction" for purposes of *Treas. Reg. § 1.6011-4(b)(2)*. 2003-49 I.R.B. 1182, Notice 2003-77.

(n8)Footnote 8. *See Maxus Energy Corp. v. U.S.*, 31 F.3d 1135 (Fed. Cir. 1994).

(n9)Footnote 9. *Compare Priv. Ltr. Rul. 9424018 (March 14, 1994)* (time of accrual of deduction for transfer to qualified settlement fund).

(n10)Footnote 10. 11 U.S.C. §§ 1142; 541(d).

(n11)Footnote 11. Assuming all creditor claims were for deductible expenses, this analysis supports the current deduction by the debtor of the entire plan consideration, including the amounts deposited into the disputed claims reserve arrangement, at the effective date of the plan of reorganization, independently of the benefits of I.R.C. § 461(f). *See Priv. Ltr. Rul. 9424018 (March 14, 1994)* (time of accrual of deduction for transfer to qualified settlement fund).

(n12)Footnote 12. See *Priv. Ltr. Rul. 9241011 (July 7, 1992)* ("interest" treated as additional settlement payment).

(n13)Footnote 13. This would be the result under the qualified settlement fund Regulations. See *P TX14.02[4] infra*. The same would be true under the regulations dealing with disputed ownership funds. See *P TX14.02[7] supra*. See *Treas. Reg. § 1.468B-9*.

(n14)Footnote 14. *Rev. Rul. 70120, 1970-1 C.B. 124*, the Service held that *I.R.C. § 483* did not apply when stock was issued in the name of the transferee but was placed in an escrow to be returned to the issuer under certain conditions. The transferee was entitled to dividends and to vote the stock. See also *AOD 1981-137 (1981 AOD Lexis 53)*. This authority would not seem to apply since its underlying rationale is that the stock was immediately transferred to the transferee. In the debtor grantor trust situation, the opposite conclusion is being advanced.

(n15)Footnote 15. See, e.g., *Duncan v. Commissioner, 9 T.C. 468 (1947) , acq., 1948-2 C.B. 2 ; 1977-1 C.B. 97, Rev. Rul. 77-81 ; but see I.R.C. § 351(d)* (stock issued for indebtedness of the transferee which is not evidenced by security shall not be considered as issued in return for property).

(n16)Footnote 16. However, payments may be aggregated to prevent avoidance of the provision. *Treas. Reg. § 1.483-1(e)*.

(n17)Footnote 17. See chapter TX11 *supra*.

(n18)Footnote 18. *Priv. Ltr. Rul. 9733019 (May 22, 1997) .*

(n19)Footnote 19. See *P TX11.04[6] supra*.

(n20)Footnote 20. *Priv. Ltr. Rul. 9516025 (Jan. 18, 1995) .*

(n21)Footnote 21. *Priv. Ltr. Ruls. 96-19-051 (Feb. 8, 1996)*, revoking *Priv. Ltr. Rul. 9603006 (Oct. 10, 1995) .*

(n22)Footnote 22. See *P TX14.03[5] infra*.

(n23)Footnote 23. See *Priv. Ltr. Rul. 9752039 (Sep. 25, 1997)* (IRS's treatment of an arrangement as a liquidating trust under *Treas. Reg. § 301.7701-4(d)* and the creditors as the owners of such liquidating trust under *I.R.C. §§ 671 and 677*).

(n24)Footnote 24. Some support for this alternative may be found in *Arrowsmith v. Commissioner, 344 U.S. 6, 73 S. Ct. 71, 97 L. Ed. 6 , reh'g denied, 344 U.S. 900 , S. Ct. 273, 97 L. Ed. 696 (1952) .*

(n25)Footnote 25. *Priv. Ltr. Rul. 8848019 (Aug. 31, 1988) .*

(n26)Footnote 26. *Priv. Ltr. Rul. 8524052 (March 19, 1985) (GCM 39368)*; compare *1992 FSA Lexis 257* (distinguishing *GCM 39368* and ruling that in the absence of such powers, the reserve will not be regarded as a separate taxable entity).

(n27)Footnote 27. *Holywell Corp. v. Smith, 503 U.S. 47, 112 S. Ct. 1021, 117 L. Ed. 2d 196, 26 C.B.C.2d 1 , on remand, 965 F.2d 994 (11th Cir. 1992) , on remand, 161 B.R. 302 (Bankr. S.D. Fla. 1993) , aff'd, 177 B.R. 991 (S.D. Fla. 1995) , aff'd without opinion, 95 F.3d 57(11th Cir. 1996) .*

(n28)Footnote 28. See *P TX14.05 infra*.

(n29)Footnote 29. See *P TX14.05 infra*.

(n30)Footnote 30. See *Priv. Ltr. Ruls. 94-28-039, 94-28-040, 94-28-041 (April 21, 1994)* (accounts to hold

qualified settlement payments treated as trusts pending resolution of interpleader actions).

(n31)Footnote 31. It is interesting that the Service finds acceptable complex trust treatment for the transition period prior to the January 1, 1993, effective date of the proposed qualified settlement fund rules. *See P TX14.03[5] infra*.

(n32)Footnote 32. *Priv. Ltr. Rul. 8916030 (Jan. 19, 1989)*

(n33)Footnote 33. *But see Priv. Ltr. Rul. 9241011 (July 7, 1992)* (fund established to settle Securities Acts litigation stated to be a "taxable entity").



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Collier on Bankruptcy Taxation

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CHAPTER TX14 Tax Consequences of Disputed Claims Reserves and Creditors' Trusts

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P TX14.04 Administration of Disputed Claims Reserves in the Absence of Authoritative Regulations

As a practical matter, taxpayers will have to make a decision on the method of applying *I.R.C. § 468B(g)*. The various parties concerned with the implementation of a plan of reorganization will have different interests to serve. Agreement on the issues may avoid the unfortunate problems that occurred in *Holywell*.

[1] Conflicting Interests of the Parties

The fiduciary responsible for the administration of the disputed claims reserve--whether the reorganized company or a bank or other custodian--will wish to be sure that there is authority under the disputed claims reserve arrangement to retain cash from the disputed claims reserve or otherwise raise cash to satisfy any tax liabilities that may be imposed upon the fiduciary on behalf of the disputed claims reserve arrangement if it is treated as a separate taxable entity. The creditors may wish to have the disputed claims reserve arrangement treated as a debtor grantor trust. This will reduce the income taxable to the creditors--whether currently or upon distribution. For instance, original issue discount under the original debt instruments should be eliminated, although it may reappear in the guise of original issue discount or imputed interest on the deferred payments under the plan. As to income earned from sources other than the reorganized debtor, debtor grantor trust treatment allows the creditors to avail themselves of the debtor's net operating loss carryovers. Future distributions may be a return of capital to the creditors.

The debtor will have to weigh the value of the loss of current original issue discount and interest deductions on plan consideration consisting of its indebtedness. The use of net operating loss carryovers to shelter the income otherwise covered by the original issue discount and interest deductions may not change the taxpayer's regular income tax. It is likely to increase its alternative minimum taxable income ("AMTI") since for AMTI purposes only 90% of net operating losses may be used. In addition the debtor will have reduced future availability of its net operating losses, as well as the possibility that future events may result in limitations on its ability to use such losses to offset income earned by the reserve. The effect of treating the plan distributions as made in the future tax years rather than at the effective date of the plan of reorganization also must be weighed.

Even if the debtor is willing so to accommodate the creditors and use its net operating losses, the disbursing agent will nevertheless be reluctant to subject itself to possible future tax liability if the disputed claims reserve arrangement is held to be a separate entity trust. This will usually entail an indemnification agreement from the reorganized company.

The position of reorganized debtors and disbursing agents with respect to the many existing disputed claims reserves that have not yet made final distributions to the creditors and to date have reported on the basis of *Rev. Rul. 70-567* and *Rev. Rul. 71-119* differs from that of a debtor with an as yet unconfirmed plan of reorganization.

[2] Closing Agreement with the I.R.S. and Other Options

The only method of ascertaining with any certainty the taxation of a disputed claims reserve arrangement in the absence of final regulations implementing *I.R.C. § 468B(g)* applicable to bankruptcy reorganizations is to enter into a closing agreement with the IRS. n2 Since the IRS is often a party to the reorganization of a debtor because of federal tax liabilities, inclusion of such a closing agreement in the IRS claims resolution process can be beneficial to all parties and preclude future uncertainties over the administration of the disputed claims reserve arrangement.

In the absence of such an agreement, the debtor and disbursing agent should consider structuring the disputed claims arrangement so that the fiduciary can report its current income and pay taxes thereon in accordance with complex trust treatment or in accordance with the rules under *Treas. Reg. § 1.468B-9* for taxing disputed ownership funds. In that way, the disbursing agent will be protected from the possibility that future regulations or judicial interpretations will find that the fiduciary owes substantial federal taxes but has no fund from which to pay such taxes. The debtor can take the position on its tax return that the current income of the disputed claims reserve is not includable in its income as a debtor grantor trust because the income is taxable to the disbursing agent under the complex trust analysis or as a separate taxable entity by analogy to the proposed regulations. As a practical matter, in the typical case, there is unlikely to be any great incentive for the Service to attack separate entity treatment of a disputed claims reserve where taxes have been paid on the earnings of the disputed claims reserve at a high tax rate.

The tax treatment issue might be precipitated by the fiduciary filing a trust tax return on the basis of a complex trust or separate entity and then filing a claim for refund with the IRS. In this manner the issue may be determined before the final distributions from the disputed claims reserve. The issue also may be determined in connection with the examination of the debtor's returns to the extent that the reorganized debtor's income is not sheltered by its net operating losses or it has AMTI.

FOOTNOTES:

(n1)Footnote 1. For disclosure statement language respecting the tax consequences of a disputed claims reserve arrangement, see the sample at *P TX14.03[6] supra* .

(n2)Footnote 2. See *I.R.C. § 7121*. See also *P TX5.13[6][b] supra*.



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CHAPTER TX14 Tax Consequences of Disputed Claims Reserves and Creditors' Trusts

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P TX14.05 Taxation of Creditors' Trusts

[1] *Holywell Corp. v. Smith*

In *Holywell Corp. v. Smith*,ⁿ¹ the Supreme Court was faced with a situation involving a number of related corporate debtors and an individual debtor, a trustee under a liquidating trust for the benefit of creditors created under a consolidated plan and holding substantially all of the debtors' properties, and the question of who had the responsibility to file returns and pay the taxes on post confirmation earnings of the trust. The trustee did not want to file the returns and pay the taxes and neither did the debtors. Since the trustee was the deep pocket, the Service argued that the trustee was required to file the returns and pay the taxes under the provisions of *I.R.C. § 6012(b)(3)* which provides:

Receivers, trustees and assignees for corporations -- In a case where a receiver, trustee in a case under title 11 of the United States Code, or assignee, by order of a court of competent jurisdiction, by operation of law or otherwise, has possession of or holds title to all or substantially all of the property or business of a corporation, whether or not such property or business is being operated, such receiver, trustee, or assignee shall make the return of income for such corporation in the same manner and form as corporations are required to make such returns.

In *Holywell*, the Court unanimously held that the trustee was an assignee of substantially all of the properties of the corporations and therefore required to file returns and pay the taxes. It did not discuss the issue of whether the trustee met any other criteria. As to the individual debtor, the Court could not rely on the assignment language because it is applicable only to corporations.ⁿ²

The Court rejected the Service's argument that the trustee was a fiduciary of the individual debtor's estate. While not ruling out the possibility that the trustee under a similar trust arrangement for creditors could in another fact situation be a substitute for the fiduciary of the estate during the chapter 11 case, the Court ruled that substitution had not occurred in this case. That is because the plan "created a separate and distinct trust holding the property of the estate and gave the trustee control of this property."ⁿ³ Nevertheless, the trustee was obligated to file a tax return and pay the tax on an express trust, a liquidating trust under *Treas. Reg. § 301.7701-4(d)*. The Court rejected the argument that the trust was a grantor trust of the individual debtor.ⁿ⁴ Likewise it rejected the contention that the trustee did not act as a fiduciary because he had almost no discretion in performing his duties under the plan.

[2] Implications of *Holywell*

The Supreme Court's opinion in *Holywell* leaves many unanswered questions. While it is clear that the trustee of the liquidating trust must file tax returns and pay tax, the Court does not provide guidance concerning the calculation of the income that the trustee is required to report. n5 No clear distinction is drawn between tax events occurring on or before the effective date of the plan of reorganization when the trustee received the assets from the debtors. The Court fails to specify the tax basis that the trustee takes in the assets received from the debtors pursuant to the plan or whether tax attributes are inherited from the corporate debtors. n6 These are among the issues that are left to be resolved by future decisions.

In the *Holywell* decision, the Court assumed that every tax return is a "return of tax" that requires the person making the return to pay the tax, citing *I.R.C. § 6151(a)*. It first decided that the trustee had to file tax returns that the corporate assignors would have had to file and pay taxes because the trustee was the assignee of the corporate debtors. n7 The Court does not explain the details of the reporting obligation of the trustee as assignee of the corporations. The Court's language to the effect that "the trustee must file the returns that the corporate debtors would have filed," n8 suggests that the trustee files corporate tax returns incorporating all of the tax attributes of the assigning corporations, including tax basis and net operating losses. This would be the equivalent of debtor grantor trust arrangements but with the trustee (rather than the corporations) obligated to file the tax returns and pay the taxes. In effect the assignment would be ignored for tax purposes (no gain or loss recognized), just as the creation of a corporate debtor bankruptcy estate is ignored. n9

[a] Court Did not Treat Creditor as Purchaser for Value

The Court did not explain why it treated the trustee as the assignee of the assets of the corporate debtors rather than the purchaser of the assets on behalf of the creditors, assuming there is a difference. Surely every purchaser of assets for value (receiving an assignment of the assets it purchases) does not assume the transferor corporation's obligation to file tax returns. An explanation might be that in this title 11 context the Court did not treat the creditors as purchasing the properties for value when the only thing the debtor received was a mechanism for paying liabilities from which the debtor apparently did not even receive a discharge. n10 The Court then decided that the trustee would be required to file a tax return and thus pay tax on the income of the liquidating trust in respect of the individual debtor. Presumably this trust would be a complex trust. While the Court addressed the problem as if there were two trusts, one for the assets of the corporations and another for those of the individual, it appears that there was in fact only one trust created under the consolidated plans. If the trust for the individual debtor was a liquidating trust, there is no reason why the arrangement for the corporations was not also a liquidating trust. The Court apparently ignored the implication of its decision that two different tax returns had to be filed by the single liquidating trust performing a single function for the creditors.

[b] Liquidating Trustee was Grantor Trustee

The Court's conclusion that the trustee had to file tax returns and thus pay tax was not a necessary conclusion. A second alternative was that the liquidating trust created under the plan was a grantor trust owned by the creditors as to both the corporate and the individual debtors. Under this characterization of the transaction, the property would be treated as if it had been transferred (sold) to the creditors in satisfaction of their claims under the plan and the creditors would be treated as owning the property deposited with the trustee in order to effect the orderly liquidation of the property. The creditors would be liable for reporting taxable income subsequent to the transfer of the properties to the trustee and the corporations' and individual's bankruptcy estates would be liable for the income taxes applicable to the gain realized on the sale of the assets to the creditors' trust.

The Service should have objected to the plan on the grounds that activities of the bankruptcy estates prior to the transfer and gain, if any, on the sale of the property by the bankruptcy estates to the trustee produced taxable income. This taxable income gave rise to an administrative tax expense that was not adequately provided for under the plan because the debtors apparently did not have the assets to pay such taxes. n11 Then the Service should have pursued the

creditor-beneficiaries of the liquidating trust for the taxes on post effective date income accruing on the assets transferred to the trust pursuant to the confirmed plan. There is nothing in *Treas. Reg. § 301.7701-4* that is inconsistent with this treatment. If the trust is a creditor-owned grantor trust, the trustee would file a tax return reporting the income and give each of the creditor beneficiaries a Schedule K-1 indicating the creditor beneficiary's share of the income of the liquidating trust. The I.R.S. would then collect taxes on the post effective date income of the trust from the creditor beneficiaries.

[c] Trustee as Assignee to File Tax Return

A third possible analysis of the *Holywell* Court's language respecting the obligation of the trustee to file tax returns for corporate debtors might be to require the trustee as assignee to file a tax return for the corporations reporting the transfer of the assets (and any gain or loss of the corporations on the transfer) to the trustee on the effective date of the plan of reorganization.ⁿ¹² The open question is what does the trustee do thereafter? The trustee could file a tax return for the liquidating trust (either a complex trust return or a creditor-owned grantor trust return) using fair market value purchase tax accounting for purposes of determining the tax basis of the assets. Under this analysis the trustee never succeeds to the tax attributes of the corporate debtors, only the obligation to file the tax returns and pay the taxes the debtors would have paid if they had properly reported all of the tax events of their final year, including the sale of the assets to the trustee.

It does not appear that any of the parties to *Holywell* presented taxable sale treatment to the Court; it should not be foreclosed in a case properly presenting the issue. This is especially true in the situation where the property transferred to the creditors' trust does not constitute substantially all of the properties of a corporate debtor and the corporate debtor continues in business as a viable entity following the consummation of the plan.

The Court's opinion is equally unclear as to the tax consequences of the transfer by the individual debtor to the trustee. It is accepted that the trustee has to file a tax return for the liquidating trust, which must either be treated as a creditor-owned grantor trust or a complex trust. The question is whether the trustee has to file a return reflecting any gain on the transfer by the individual debtor's estate of the assets to the trust. Put another way, does the trustee's obligation to file returns and pay taxes commence with the receipt of the assets which take a fair market value tax basis in the trustee's hands? Alternatively, does the trustee take a carryover tax basis in the assets from the individual debtor's estate so that any gain on the assets is preserved until subsequent sale by the trustee? The Court's opinion does not answer these questions. The better answer would seem to be that the trustee is treated as the purchaser of the assets, acquiring a fair market value tax basis therein, and that the trust is treated as a creditor-owned grantor trust. A cautious trustee, however, will provide for the most adverse possible tax consequences under these circumstance until these issues are clarified by subsequent court opinions.ⁿ¹³

FOOTNOTES:

(n1)Footnote 1. 503 U.S. 47, 112 S. Ct. 1021, 117 L. Ed. 2d 196, 26 C.B.C.2d 1 (1992) , on remand 965 F.2d 994 (11th Cir. 1992) , on remand, 161 B.R. 302 (Bankr. S.D. Fla.1993) , *aff'd*, 177 B.R. 991 (S.D. Fla. 1995) . For a further discussion of the duty to file tax returns and the *Holywell* decision, see chapter TX3 *supra*. See also 7 Collier on Bankruptcy, P 1106.03 (Matthew Bender 15th Ed. Revised).

(n2)Footnote 2. As to an individual, I.R.C. § 6012(b)(4) provides: (4) Returns of estates and trusts. 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.

(n3)Footnote 3. *Holywell Corp v. Smith* 503 U.S. 47, 55, 112 S. Ct. 1021, 1026, 117 L. Ed. 2d 196, 205-06,26 C.B.C.2d 1, 6-7(1992) . See *In re Lindsey*, 142 B.R. 447 (Bankr. W.D. Okla. 1992) (chapter 12 trustee not liable for

taxes since no separate liquidating trust).

(n4)Footnote 4. The Court distinguished *In re Sonner*, 53 B.R. 859 (Bankr. E.D. Va. 1985) , without expressing an opinion on the merits of that decision because the debtor there was revested in the property and only placed some of the property in the trust. A more significant distinction in *Sonner* was the fact that the individual debtor had a continuing obligation to the creditors that was to be satisfied out of assets of the creditors' trust and that he was entitled to any surplus over the amount of the obligation to the creditors.

(n5)Footnote 5. It was subsequently held that the trustee was not personally liable for the taxes, which were satisfied from the assets held in trust. *In re Holywell Corp.*, 177 B.R. 991 (S.D. Fla. 1995) .

(n6)Footnote 6. See *Priv. Ltr. Rul. 9528017* (April 14, 1994) (liquidating trust for limited partners of limited partnership in bankruptcy takes carryover tax basis of limited partners); 1994-2 C.B. 684, Rev. Proc. 94-45 (procedures for obtaining a ruling that an entity created under a bankruptcy plan is a liquidating trust).

(n7)Footnote 7. See *P TX3.02 supra*. Alternatively, the liquidating trust might be viewed as a business trust taxable as a corporation, see *Treas. Reg. § 301.7701-4(b)*, which holds the assets with a carryover tax basis. Under either approach the liquidating trust would seem to get the benefit of the net operating losses of the corporations, if they are not otherwise limited. See generally chapter TX11 *supra*.

(n8)Footnote 8. 503 U.S. 47, 54, 112 S. Ct. 1021, 1025, 117 L. Ed. 2d 196, 204, 26 C.B.C.2d 1, 5 (1992) .

(n9)Footnote 9. This is the tax treatment associated with a receiver and a trustee in a cases under title 11, the other two categories in *I.R.C. § 6012(b)(3)*.

(n10)Footnote 10. See 11 U.S.C. §§ 727(a)(1); 1141(d)(3)(c) (denying a discharge to corporate debtors in liquidations and liquidating chapter 11 proceedings). It is hard to imagine that the results would have been the same if the transfer to the trustee had been in exchange for the payment of \$20 million cash to the corporate debtors rather than merely satisfaction of indebtedness that had no independent value to the corporate debtors.

(n11)Footnote 11. The opinion implies that the Service was seeking to recover from the trustee taxes on income that was realized by the corporations prior to the trustee's appointment. See *In re Swann*, 149 B.R. 137 (Bankr. D.S.D. 1993) .

(n12)Footnote 12. This analysis would produce a difference in the tax treatment of an assignee of a corporate debtor (and presumably the duties respecting the corporate tax return) since the transfer under *I.R.C. § 6012(b)(3)* to a receiver or a bankruptcy trustee would not be a taxable event or give rise to a separate taxable entity. The Court seemed to assume that the tax treatment of all three characterizations under *I.R.C. § 6012(b)(3)* of the status of the trustee in *Holywell* would be the same because the parties did not argue that the trustee's duties would be different under either of the two classifications other than "assignee."

(n13)Footnote 13. In the *Holywell* case, the taxing authorities were eventually paid after the assets were sold. Subsequently, the trustee successfully sued the creditor that had proposed the plan of reorganization for indemnification and negligent misrepresentation because the plan and the disclosure statement failed to make any provision for the payment of taxes. *Smith v. Bank of New York*, 161 B.R.302 (Bankr. S.D. Fla. 1993) , subsequent appeal, *Holywell Corp. v. Bank of New York*, 177 B.R. 991 (S.D. Fla. 1995) .



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CHAPTER TX14 Tax Consequences of Disputed Claims Reserves and Creditors' Trusts

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P TX14.06 Legislative Changes in Taxation of Disputed Claims Reserves

Historically, as described below, disputed claims reserve arrangements generally have not been treated as separate taxable entities.

[1] Prior Administrative Practice

Historically, the administrator or fiduciary did not have to file fiduciary tax returns or entity tax returns. Rather, these arrangements were generally administered on a cash basis. No tax was paid on the current earnings on the plan consideration held subject to the disputed claims reserve. When a determination was made as to the amount a creditor was entitled to receive as a distribution from the reserve, such creditor would be treated as receiving the consideration specified by the plan and the accumulated taxable income in respect of such plan consideration in the year the creditor received the distribution.

This treatment was in accordance with *Rev. Rul. 70-567* n1 and *Rev. Rul. 71-119* . n2 *Rev. Rul. 70-567* it was held that interest earned on money held by a bank in a court ordered escrow account was not to be reported on a fiduciary tax return under *I.R.C. § 461(a)*. The ruling further held that the accumulated interest was taxable to the distributees in the year they were determined to be entitled to the funds. *Rev. Rul. 71-119* it was held that money deposited by a corporation with a district court to settle Securities Act litigation was not property held in trust within the meaning of *I.R.C. § 641(a)* and that neither the court nor the master appointed to administer the fund was a fiduciary required to file a Form 1041. In each case the Service ruled that the potential fiduciary did not have the powers of conserving and protecting the corpus ordinarily associated with a trustee. n3 An exception to this non-entity treatment was made where the administrator or some other entity (such as the creditors' committee) retained substantial discretionary authority and power respecting the fund. In such instances, the fund was held to be a separate taxable entity, but the theory of taxation of such entities advanced by the Service was not consistent or well articulated. n4

In *Rev. Rul. 70-567* and *Rev. Rul. 71-119* were declared to be obsolete in light of the enactment of *I.R.C. § 468B(g)* for funds or accounts established after August 16, 1986. n5 This belated action by the Service reinforces the conclusion that the cash basis treatment of disputed claims reserve arrangements under plans of reorganization now appears to be precluded by *I.R.C. § 468B(g)* dealing with escrow accounts, settlement or similar funds. n6

[2] Legislative History of I.R.C. Section 468B(g)

I.R.C. § 468B(g) provides that:

nothing ... shall be construed as providing that an escrow account, settlement fund, or similar fund is not subject to current taxation. The Secretary shall prescribe regulations providing for the taxation of any such account or fund as a grantor trust or otherwise.

Regulations dealing with some, but not all, of the implications of *I.R.C. § 468B(g)* were proposed on February 14, 1992 and finalized on December 23, 1992. n7 Additional regulations dealing with disputed ownership funds were proposed on February 1, 1999. n8

I.R.C. § 468B(g) derives from an uncodified statute entitled "Clarification of Law With Respect to Certain Funds." It was adopted in 1986 as part of the technical corrections to the Deficit Reduction Act of 1984, when *I.R.C. § 468B* relating to designated settlement funds (generally tort-related) was enacted. The uncodified provision was § 1807(a)(7)(A) of the Tax Reform Act of 1986 and it directed that if the payor's contribution to the fund is not deductible, such "fund shall be taxed as a grantor trust." The legislative history indicated that the provision was intended to reverse the holding in *Rev. Rul. 71-119*. n9

A grantor trust is a trust that for tax purposes generally has no separate tax existence because the grantor of the trust has such control over the trust corpus and income, including a significant revisionary interest in the corpus or income, that it is appropriate to ignore the trust. n10 The income of such a trust is currently taxable to the grantor.

The uncodified settlement fund provision was further amended in 1988 and incorporated into the Internal Revenue Code as *I.R.C. § 468B(g)* by § 1018(f) of the Tax and Miscellaneous Revenue Act of 1988 ("TAMRA"), retroactive for funds established after August 16, 1986. The legislative history of TAMRA sets forth certain provisions that are "anticipated" to be included in the regulations. Among these is a provision that if the funds are transferred "pursuant to an arrangement that constitutes a trust, [thus begging the question decided in *Rev. Rul. 70-567*] then the income earned by the amounts transferred will be currently taxed under Subchapter J of the [Internal Revenue] Code." n11 Further, if the income may be used to discharge a legal obligation of the transferor (economically not the case with a disputed claims reserve set up primarily to determine the relative rights to the reserved funds of creditors with disputed claims that have already been discharged by the plan), then the fund is taxed as a grantor trust. n12

Section 468B(g) remedies situations where the income earned by the fund might escape taxation altogether. This occurred when the depositor of the funds satisfied a personal injury tort liability, the fund earned income pending identification of and distribution to the claimants and the amounts distributed to the distributees were tax free (both principal and interest) because excludable from income as a personal injury under *I.R.C. Section 104*. It appears from this legislative history that the drafters of the TAMRA amendment contemplated that arrangements would either be bilateral escrow type situations (taxable to either the depositor or the recipient of the funds) or be trusts. If trusts, the income would be taxable to the trusts or the beneficiaries under the general Internal Revenue Code Subchapter J trust taxation rules or to the grantors under the grantor trust rules. There is no guidance in the legislative history as to the method for identifying the person subject to current taxation and of taxing arrangements that are not "trusts." Non-trust arrangements seem to fit into the category of accounts or funds as to which the Secretary is to provide for taxation "otherwise" than as a grantor trust. n13

Finally in 1990, Congress passed § 11702(e)(1) of The Omnibus Budget Reconciliation Act of 1989 ("OBRA") as a technical amendment to *I.R.C. § 468B(e)*. The OBRA amendment seems to foreclose arguments that *I.R.C. § 468B(g)* does not apply to disputed claims reserves constituting *I.R.C. § 461(f)* funds created to satisfy contested liabilities pending their resolution.

FOOTNOTES:

(n1)Footnote 1. 1970-2 C.B. 133 . I.R.C. § 468B(g) renders this Revenue Ruling obsolete. *See discussion infra; see also 1992-2 C.B. 102, Rev. Rul. 92-51 .*

(n2)Footnote 2. 1971-1 C.B. 163 . I.R.C. § 468B(g) renders this Revenue Ruling obsolete. *See discussion infra; see also 1992-2 C.B. 102, Rev. Rul. 92-51 . See In re Alan Wood Steel Co., 7 B.R. 697 (Bankr. E.D. Pa. 1980) .*

(n3)Footnote 3. *See also Priv. Ltr. Rul. 9252024 and Priv. Ltr. Rul. 9252021 (Sept. 28, 1992) (Securities Acts settlements); Priv. Ltr. Rul. 9228020 (April 20, 1992) (SEC insider trading settlement); Priv. Ltr. Rul. 9129018 (April 19, 1991) (Securities Act claims); Priv. Ltr. Rul. 8443113 (July 27, 1984) (Bankruptcy Act § 77 claims reserve); Priv. Ltr. Rul. 8012024 (Dec. 26, 1979) (Ch. XI disputed claims reserve).*

(n4)Footnote 4. *Compare 1969-1 C.B. 167, Rev. Rul. 69-300 (a bank appointed by court order with substantial discretionary powers of administration and management with respect to property held to be a fiduciary required to file a Form 1041); Priv. Ltr. Rul. 8848019 (Aug. 31, 1988) (a fund consisting of a pool of assets created pursuant to the chapter 11 plans of three companies held to be a trust subject to certain of the provisions of Subchapter J because it functioned much like the bankruptcy estate by analogy to the separate bankruptcy estate of an individual, including the right to pursue causes of action under the Bankruptcy Code); Priv. Ltr. Rul. 9428039 (April 21, 1994) (account for beneficiaries of interpleader action held to be a trust); and Priv. Ltr. Rul. 8524052 (March 19, 1985) (discussed in Gen. Couns. Mem. 39368 (June 3, 1985) (fund created pursuant to a chapter 11 plan held to be a trust subject to certain of the provisions of Subchapter J because the powers of the disbursing agent, including the power to bring suit to avoid transfers and pursue other causes of action, were held to be consistent with the duties of a trustee) with 1982-2 C.B. 365, Rev. Rul. 82-177 (bank which held money for an estate subject to a will contest, but performed no administrative duties for the estate, held not to be a fiduciary required to file a tax return) and IR 90-79 (May 16, 1990) (interest earned on the Agent Orange fund created in 1984 held not to be taxable to the fund or the distributees).*

(n5)Footnote 5. 1992-2 C.B. 102, Rev. Rul. 92-51 . Rev. Rul. 92-51 also declared 1964-1 C.B. 485, Rev. Rul. 64-131 , *obsolete in part and modified in part*, 1982-2 C.B. 365, Rev. Rul. 82-177 and 1976-1 C.B. 378, Rev. Rul. 76-50 to delete references to the obsolete rulings.

(n6)Footnote 6. *See, e.g., Priv. Ltr. Rul. 9252024 (Sept. 28, 1992) ; Priv. Ltr. Rul. 9252021 (Sept. 28, 1992) ; Priv. Ltr. Rul. 9228020 (April 20, 1992) (settlement escrows not subject to I.R.C. § 468B(g) because they were established prior to the August 1986 effective date). See also Tech. Adv. Mem. 9037004 (June 5, 1990) .*

(n7)Footnote 7. IA-54-90. Prop. Treas. Reg. § 1.468B, *et seq.*, 57 Fed. Reg. 5399(1992) ; Treas. Reg. § 1.468B-0, 57 Fed. Reg. 60983 (1992) , respecting designated and qualified settlement funds. *See P TX14.03 supra.*

(n8)Footnote 8. *See P TX14.02[6] supra.*

(n9)Footnote 9. H.R. No. 99-841, 99th Cong., 2nd Sess., 3838 (Sept. 18, 1986) (corrections to Pub. L. No. 99-514); Pub. L. No. 99-514, Title XVIII of H.R. 3838, 99th Cong.

(n10)Footnote 10. I.R.C. §§ 671-681.

(n11)Footnote 11. Joint Committee on Taxation, Description of the Technical Corrections Act of 1988 at 390(March 31, 1988).

(n12)Footnote 12. Joint Committee on Taxation, Description of the Technical Conventions Act of 1988 at 390(March 31, 1988).

(n13)Footnote 13. *See United States v. Brown, 2001 U.S. Dist. LEXIS 8064, 2001 -U.S. Tax Cas. (CCH) P50, 519 (D. Utah May 23, 2001) (where IRS asserted liability only on the basis that a receivership estate was a qualified*

settlement fund, the court denied IRS's attempt to impose entity level tax on the estate because it was not a qualified settlement fund, noting that the estate was more aptly described by the proposed disputed ownership fund regulations.) The court in this case stated "that the QSF regulations are of limited scope; that the Treasury has the power and the apparent will to extend the reach of its regulations under § 468B(g); and ... in the future, the Treasury may reach homeless income that may be escaping taxation in unusual situations like the present one, but it has yet to promulgate regulations which do so." *Id.* at *49-*50 .



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CHAPTER TX15 Miscellaneous Tax Issues

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CHAPTER TX15 Miscellaneous Tax Issues

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P TX15.01 Introduction

This volume is devoted to the identification and explanation of the major substantive and procedural tax issues arising in cases under title 11. In addition to those major issues that merit an entire chapter, there are certain other issues that are encountered with sufficient regularity to justify inclusion in this work. In this chapter, these miscellaneous issues will be considered and, where appropriate, practical suggestions will be made.

Section 6672 of the Internal Revenue Code provides that persons responsible for withholding various federal taxes and paying them to the Internal Revenue Service may be liable for a penalty equal to 100 percent of the taxes if they willfully fail to do so. In P TX15.02, the elements of responsibility and willfulness are explained, along with certain defenses often asserted by persons against whom this "100 percent penalty" has been assessed. After an examination of the substantive law relevant to this issue, the focus will shift to the additional unique problems that occur in cases under title 11 with respect both to the corporation that did not withhold and pay the taxes in the first place and to the responsible person who subsequently becomes the subject of a "100 percent penalty."

Since the liability of individuals responsible under section 6672 for assuring that taxes withheld by such a corporation are remitted to the IRS is derivative of the initial corporate liability, a question may arise with respect to the designation of any payments to be made from either a corporation's or an individual's case under title 11. Payments received from the corporation may be applied to the liability for the withheld taxes or any additional taxes it owes such as the employer contribution to FICA taxes, but payments from an individual responsible person may only be applied to the withholding tax liability. Accordingly, the designation of such payments is occasionally a contentious issue. The ramifications of this issue are *considered in P TX15.03*. Additional designation questions arising when the IRS has claims for different tax liabilities in a single case, *i.e.*, claims for different years or claims that are secured, unsecured priority and general unsecured are also discussed.

The tremendous growth in the amounts paid to the various professionals rendering services to the debtor and to committees in chapter 11 cases has prompted renewed interest in the possibility of reducing the debtor's administrative tax liability by deducting these fees as ordinary and necessary business expenses. Prior to the enactment of the Bankruptcy Code, it was fairly clear that the expenses of professionals could be deducted to the extent that they related to the usual business operations of the debtor and would have been required if a case under title 11 had not been filed. The expenses of professionals related to the administration of the case under title 11 itself and the development and confirmation of a plan of reorganization were capital in nature and could not be deducted. The only court thus far to

have considered this issue in a case under the Bankruptcy Code has reached essentially the same result, rejecting the argument that the nature of chapter 11 cases has so changed that all of the professional fees should be deductible. In P TX15.04, this decision and the lingering question of how to develop a plausible method for allocating between the two categories of professional expenses are considered.

Taxpayers confronting the likelihood of insolvency or initiation of a case under title 11 face an interesting question if they use the accrual basis of accounting: May they continue to deduct interest they owe on debts as it accrues even though it is unlikely that the interest will actually be paid? The answers of the several courts that have addressed this question are examined in P TX15.05.

During the first years after confirmation of a chapter 11 plan, the reorganized debtor may encounter serious problems with respect to the determination and payment of the tax liabilities for those years. These concerns have led to questions about the jurisdiction of the bankruptcy courts over these postconfirmation tax disputes. Variations on these questions have included cases in which a confirmed plan purported to grant the bankruptcy court jurisdiction over those disputes, presenting res judicata issues, and cases in which the confirmed plan purported to determine what tax attributes, such as net operating loss deductions, would be available for use in future tax periods. In P TX15.06, the conclusions which the courts have reached in these situations are examined.



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CHAPTER TX15 Miscellaneous Tax Issues

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P TX15.02 Trust Fund Tax Liabilities

[1] Introduction

One of the common signs that a business is experiencing financial difficulties is its failure to collect, account for and pay over certain withheld tax monies as required by law. These "trust fund" tax liabilities n1 may include, for example, social security and income taxes withheld from the paychecks of employees, federal and local excise taxes required to be withheld at the source of some sales, or state and local sales taxes n2 required to be withheld at the source of a sale. These tax liabilities are often the cause of the filing of a title 11 petition by the employer entity or the underlying individuals who may bear personal liability for the withheld taxes. The most prominent of the collection statutes is *I.R.C. section 6672*, which provides:

SEC. 6672 FAILURE TO COLLECT AND PAY OVER TAX, OR ATTEMPT TO EVADE OR DEFEAT TAX

...

General Rule --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. n3

The proper representation of a debtor or the shareholders, directors, and officers of a debtor requires an understanding of the application of *I.R.C. section 6672*. n4

Both the responsible person and willfulness tests must be satisfied before *I.R.C. section 6672* liability will accrue against a taxpayer. n5 Whether a person related to a debtor is a "responsible person" who "willfully" failed to collect, account for, and pay over a withheld "trust fund" tax liability pursuant to *I.R.C. section 6672* is a factual determination. n5a Although no bright line test of liability versus non-liability will be applicable to every case, certain criteria or "indicia" for determining liability under *I.R.C. section 6672* have been developed. The key to the responsible person test is generally to identify those persons who had the status, duty, power and/or authority to ensure the trust fund taxes were paid to the IRS. The willfulness standard under *I.R.C. section 6672* can be met in several ways. If a responsible person has actual knowledge that other creditors are being paid before a trust fund tax liability is paid, the willfulness

test is satisfied. If a person pays "net payrolls" or generally places the business's assets at risk with respect to their availability to pay the tax liability, then the willfulness test will also be satisfied.

Another recurring issue raised in bankruptcy cases related to trust fund tax liabilities of corporate officers is whether corporate payments will be applied by the governmental agency to the non-trust fund tax liabilities first or to the trust fund portions of the corporate tax liability. The Supreme Court in *United States v. Energy Resources Co.* n6 confirmed the authority of bankruptcy courts to allocate tax payments as required in a chapter 11 reorganization plan if that allocation is necessary for a successful reorganization. n7 The scope of the *Energy Resources* opinion is, however, unclear because the Court requires bankruptcy courts to balance the interests of the IRS and the corporate debtor before they decide whether a designated payment is necessary for the successful completion of the plan of reorganization.

Although the relationship between business entities and individuals with respect to taxes due on the wages paid to employees of the business usually presents an issue concerning the individuals' potential liability for the trust fund portion of the taxes that should have been paid by a corporate employer, other situations occur. When the employer is a partnership instead of a corporation, then the individual partners may face liability for the entire amount of the taxes due on wages paid to employees, *e.g.*, both the trust fund taxes to be withheld from the wages and the additional employers' nontrust taxes due on the same wages. A question arises when the individual partners later file title 11 petitions and the IRS asserts this tax liability against them based solely upon an assessment against the partnership without separately assessing each partner individually. The Supreme Court, reversing all three courts below, held that it is not necessary for the IRS to assess the individual partners separately since there is a single tax debt involved. Once it has been properly assessed, limitations on the period to collect that tax from the individual partners is extended without a separate assessment of the same debt against each one of them. n7a

[2] Responsible Person Status Under I.R.C. Section 6672

[a] Introduction

The Internal Revenue Code requires certain persons to withhold taxes from the proceeds of various transactions. The most common example of this obligation is the withholding of an employee's share of Federal Insurance Contribution Act ("FICA") taxes and income taxes from the wages of employees. n8

The money withheld from each employee's wages is held by an employer in trust for the benefit of the United States. n9 These trust fund monies do not belong to the employer and cannot to be used by the business to fund its operations. n10 If an employer withholds trust fund taxes and fails to pay them to the United States, the employee is nevertheless given full credit for paying the taxes, and the IRS may not require any additional payment from the employee. Thus, unless the IRS can collect the trust fund taxes from the employer or the persons responsible for the collection and nonpayment of the taxes, the trust fund tax revenues are lost to the United States. n11

To protect against this revenue loss, *I.R.C. section 6672(a)* was enacted.

Although *I.R.C. section 6672* is labeled as a "penalty," an assessment under *I.R.C. section 6672* is more accurately described as a collection tool to shift the tax liability of a defaulting corporation to those responsible for the nonpayment. n12

The first predicate to liability under *I.R.C. section 6672* is that a person must be characterized as a "person required to collect, truthfully account for, and pay over any tax." n13 If a court finds an individual is not a "responsible person" within the meaning of this provision, the second issue of willfulness need not be addressed. n14

[b] Who is a "Responsible Person" for Purposes of section 6672?

The term "person" in *I.R.C. section 6672* includes any person so connected or associated with a corporate employer that he or she has the duty, power, status and authority (i) to make sure trust fund taxes are paid, (ii) to make or participate in the making of decisions concerning the disbursement of funds of the corporation, or (iii) to determine which corporate creditors are paid and when they are paid. n15 Responsibility is determined by status, duty or authority, not by knowledge. n16 *I.R.C. section 6671(b)* defines "person," as used in section 6672, to mean:

The term "person," as used in this subchapter, *includes* an officer or employee of a corporation, or a member or employee of a partnership, who as such officer, employee, or member is under a duty to perform the act in respect of which the violation occurs.

[i] Look to Degree of Connection to and Control of the Corporation

This definition is not exclusive and that "responsible person" status is not determined solely by official title n17 but rather by the degree of connection to the corporation and the amount of control over the corporate duty involved. n18 Thus, the Court of Appeals for the Ninth Circuit in *United States v. Graham* n19 rejected a director's argument that, because the director was not an officer or employee and was therefore not involved in the day-to-day operational business management, he was not a "responsible person":

This is too narrow a reading of this section. The term "person" does include officer and employee, but certainly does not exclude all others [T]he section must be construed to include all those so connected with a corporation as to be responsible for the performance of the act in respect of which the violation occurred. n20

[ii] Bookkeeper, Accountant or Controller Could be a "Responsible Person"

"Responsible person" status can extend beyond the officers, directors and shareholders of an entity as long as the persons in question had the effective power or authority to determine how the entity's funds would be disbursed. Thus, bookkeepers, accountants, and controllers could, under the right circumstances, be classified as responsible persons for *I.R.C. section 6672* purposes. n21 Similarly, an individual need not be the disbursing or payment officer, nor even authorized to draw checks on corporate accounts, in order to be classified as a responsible person, as long as he or she has the power to decide who will receive those checks. n22 Responsible party status is thus not limited to the people who perform the mechanical jobs of collection and payment of corporate funds when those functions are simply performed in accordance with the executive judgment of other individuals whose duty it is to make corporate financial decisions. n23

[iii] Sureties or Financial Institutions Could be Assessed Penalties Under *I.R.C. section 6672*

In addition, sureties, financial institutions, and other third parties can also be assessed the 100 percent penalty of *I.R.C. section 6672*. Such an assessment is justified when the degree of management influence or control asserted by such an outsider rises to the level that the third party can be functionally described as the person or entity who determined how the debtor's funds would be spent. n24

[iv] Need of Significant Control Over Disbursements

A "responsible person" under section 6672 need only possess significant, but not necessarily exclusive, control over disbursements. n25 It is generally sufficient for the purposes of section 6672 that an individual have the ability to exercise control over the process by which corporate funds are disbursed even if that control is not, in fact, exercised. n26

[v] Characteristics of a "Responsible Person"

The determination of responsible person status is a subjective inquiry dependent on the facts of each case. n27 Many courts have offered lists of the indicia used to decide if a person is a responsible person, including such characteristics as:

- status as an officer, shareholder or director;
- authority to sign checks;
- authority to prepare the corporate tax returns;
- authority to hire and fire employees;
- authority to control the financial affairs of the corporation; and
- entrepreneurial stake in the corporation. n28

However, the subjective nature of the inquiry, including a court's discretion to review different criteria, has led to varying degrees of expansiveness in the decisions of different circuits. At any stage along the process by which a payment is made to the IRS, many people may be involved. One or more members of upper management may possess the authority, albeit unexercised, to direct that tax liabilities be paid, but another level of management may in fact be in charge of the physical process by which the IRS is paid. If the intent of *I.R.C. section 6672* is applied broadly, then multiple levels of the management and employee groups of an entity could be exposed to *I.R.C. section 6672* liability. Thus, the decisions by the Court of Appeals for the Fifth Circuit in *Howard v. United States* n29 and *Mazo v. United States* n30 broadly interpret the term responsible person to include all levels of management and employees to ensure collection of the misappropriated trust fund tax liability. A similarly broad reading by the Court of Appeals for the Ninth Circuit in *Pacific National Ins. v. United States* n31 interprets section 6672 to apply to a surety of the employers that exercise the requisite control.

[vi] Some Courts Apply a Functional Test

In contrast, other courts have applied a narrower functional test, recognizing divisions of authority and business functions between the officers and employees and limiting "responsible person" status to those persons who controlled which creditors would be paid and when. In *Godfrey v. United States*, n32 the taxpayer was chairman of the board of directors. He elected officers, hired or approved the hiring of consultants, delegated authority to open bank accounts, authorized borrowing of money, approved loan agreements, approved lawsuit settlements, and participated in the formation of corporate policy. However, the court held that the taxpayer was not a responsible person because he was an outside director who neither signed nor had authority to sign checks, who did not participate in the day-to-day financial management of the corporation, who did not control payroll, and who did not determine which creditors would be paid and which would not. n33

[vii] Defenses to the "Responsible Person Liability" of I.R.C. section 6672

Various defenses may be raised to the "responsible person" element of liability under *I.R.C. section 6672*, with varying results depending on the circumstances of the case and the expansiveness of the court's interpretation.

In several cases, potential "responsible persons" have attempted to argue that they functioned "basically as a puppet who, in order to maintain his job, had to listen to the dictates" of upper management. n34 Some courts have rejected this defense, holding, for example, that:

[t]he fact that [the supervisor] might well have fired [the employee assessed under section 6672] had

he disobeyed ... instructions and paid the taxes does not make[the employee] any less responsible for their payment. ... We cannot condone his abdication of the responsibility imposed upon him by law. n35

Other courts have, however, held that the law does not require a person to disregard check writing instructions from a superior in order to avoid liability under *I.R.C. section 6672*. n36 In other cases, individuals have claimed that, although they may ordinarily qualify as "responsible parties," they delegated that authority in the instance in dispute and therefore cannot be held liable under section 6672. The status, duty, power and authority referred to in decisions applying *I.R.C. section 6672* are similar to the fiduciary obligations imposed upon the trustee of a trust. n37

The delegation of the *I.R.C. section 6672* responsibility to another person will not absolve an officer, director, shareholder, or other person for his or her failure or another person's failure to collect, account for, or pay over trust fund taxes. n38 In *In re Vaglica*, n39 the court held that although the president and sole shareholder delegated the collection and disbursement of employment taxes to accountants and office personnel, this did not excuse him from the ultimate responsibility for payment of the trust fund taxes; any other finding under the facts of this case would have thwarted the clear intent of *I.R.C. section 6672*. Thus, a bookkeeper, accountant, or controller may also, on the same facts, be liable under *I.R.C. section 6672*. Their job designation and the delegation of authority does not absolve members of upper management from liability when to do so would defeat the purpose of *I.R.C. section 6672* to collect the misappropriated trust fund taxes from persons who could have insured their payment to the IRS. In another instance, a debtor had entered into an arrangement prior to filing his case under title 11 in which his company "leased" back its employees from a company that undertook to withhold and pay their income taxes. The debtor's company nevertheless continued to satisfy the legal definition of "employer," and the individual debtor was held liable as a responsible person for the failure to withhold and pay the taxes. Status as a responsible person could not be delegated away. n40 Similarly, delegation of check signing and responsibilities for the clerical and administrative operations of the corporation to another person will not constitute reasonable cause for the failure to collect, account for, and pay over withholding taxes. n41

Finally, a taxpayer may contend that there are other individuals who are equally, or more responsible, for the collection, accounting for and paying over of trust fund taxes. This defense is contrary to long-standing precedent that there may be more than one responsible person:

The IRS is not obligated to pursue every person with responsibility for paying taxes of this sort, and did not abuse its discretion in assessing the penalty against Howard, and not Jameson. The fact that there may be other fiscally "responsible persons" does not relieve Howard of his duty to pay taxes as a "responsible person." n42

There is always at least one responsible person, but the existence of other persons bearing the same responsibility to collect, account for, and pay over the trust fund taxes does not absolve or excuse a responsible person against whom the assessment has been made. n43

In cases where there are multiple responsible persons and one pays the trust fund liability, a question may arise about that person's ability to recover some or all of the payment from the corporate employer or from another responsible person. Typically, the IRS would not be pursuing payment from the responsible persons if the corporate employer were in a position to pay the taxes. However, in a case where two responsible persons paid a portion of the trust fund taxes, a bankruptcy court held that they were entitled to be subrogated to the IRS claim in the corporation's chapter 7 proceeding, but it gave them general unsecured claims for the amount of their payments. n43a When a claim for subrogation was made by one responsible person against another responsible person, a different bankruptcy court denied it because the first person had only discharged a claim for which he (like the other person) was primarily responsible. n43b The distinction between the two situations is that corporate employer has primary responsibility to pay the taxes and the responsible persons are secondarily liable if it fails to pay; but, as between responsible persons, they are all equally liable.

[3] Willful Failure to Collect, Account for or Pay Over Trust Fund Monies

Liability attaches to a "responsible person" under *I.R.C. section 6672* only upon his or her "willful" failure to collect, account for, or pay over the employment taxes. n43c Willfulness for *I.R.C. section 6672* purposes can be defined and proved in several different ways.

[a] Definition of "Willfulness"

Willfulness is generally defined as the voluntary, conscious, and intentional act to prefer other creditors over the United States. n44 Many courts have confirmed that the determination of willfulness is a subjective inquiry based upon the actual knowledge of the taxpayer at the time payments are made to a creditor other than the United States. n45

The issue of willfulness is necessarily directed to the state of the responsible person's mind, a subjective determination. This determination is usually factual ... evidence that the responsible person had knowledge of payment to other creditors after he was aware of the failure to pay withholding tax is sufficient for summary judgment on the question of willfulness.

[i] "Willfulness" Does Not Indicate Criminal Intent

"Willfulness" for *I.R.C. section 6672* purposes is not, however, equivalent to criminal intent. n46 All that is necessary for a finding of willful conduct for purposes of *I.R.C. section 6672* is that there be a considered decision not to fulfill one's obligation to pay the taxes owed, evidenced by payments made to other creditors in the knowledge that the taxes are due. n47

The predicate of willfulness for *I.R.C. section 6672* can be met in several other ways based upon the nature of the actions, or inaction, of the responsible person involved.

[b] The Risk of Corporate Funds

Liability under *I.R.C. section 6672* can be based upon the use of withheld trust fund tax monies for other corporate purposes *before* the date on which the taxpayer is required to deposit the funds with the United States. n48 This is because a Form 941, Quarterly Payroll Tax Return, is due and the tax reflected thereon finally payable at least by the last day of the month following the end of a quarter. Some taxpayers may be required to make payroll tax deposits within three banking days of the end of each week. n49 If a corporation accrued but did not pay withholding tax liabilities during any month during a quarter, those trust fund monies would continue to be placed at risk in the operation of the business until they were paid to the IRS. n50 Even the subsequent bankruptcy of the corporation is no defense against willfulness for an individual responsible for ensuring that the withheld taxes were paid over to the IRS. n50a

This "risk" theory of willfulness assumes that a responsible person is voluntarily and consciously paying other debts before the withholding liabilities are paid to the IRS. The risking of those monies in the operations of a failing or struggling business is also a separate form of willfulness:

The responsible officer's actions before the due date for payment of the withheld taxes satisfies the "willfulness" requirement under section 6672: when the responsible officer (as defined by section 6671(b)) knows that the withheld funds are being used for other corporate purposes, regardless of his expectation that sufficient funds will be on hand on the due date for payment over to the government. Of course, the officer is only liable under section 6672 if the corporation does not pay over the withheld taxes at the date prescribed in the regulations. However, he subjects himself to liability under section 6672 when he voluntarily and consciously "risks" the withheld taxes in the operation of the corporation, and subsequently the corporation is unable to remit the withheld taxes. n51

[c] Willfulness Based on Reckless Disregard

A responsible person also acts willfully for *I.R.C. section 6672* purposes if that person acts with a reckless disregard of whether the withheld trust fund taxes will be paid to the United States. n52 Application of this willfulness test involves a review of the business judgment of the persons operating a business to determine whether they acted with the normal prudence of the average, reasonable businessperson who has knowledge of financial problems. Thus, if a person acts or fails to act in the face of known facts or risks that would inform a reasonable businessperson that trust fund tax liabilities might not be paid, a finding of willfulness under *I.R.C. section 6672* will be appropriate. n53

[i] I.R.S. Will Assert a Continuing Obligation to Pay Delinquent Taxes

After a person has received notice that a trust fund tax liability has not been paid in preceding quarters, the IRS will expand this reckless disregard argument to assert a continuing obligation on the responsible person to make sure all delinquent trust fund tax liabilities are paid before any other debts or expenses are paid. A responsible person may argue that he or she cannot be willful if, by the time he or she became aware of the unpaid trust fund liabilities, there were no funds available to satisfy the tax liability. In *Garsky v. United States*, n54 this was the argument proposed by the parties. The court concluded that when a person is a responsible person throughout the period the withholding tax liability accrued and thereafter, that person has a continuing obligation to pay all after-acquired funds to the United States to satisfy the unpaid trust fund liability. n54a This is an independent basis for the finding of willfulness.

Assume, for example, that one or more members of the board of directors of an insolvent, financially struggling corporation had actual knowledge that the chief financial officer and the controller failed to pay over trust fund tax liabilities to the IRS for the first month during the first quarter of 1992. During this period the business had barely enough cash flow to cover net payroll and basic operating expenses. After the board members obtained actual knowledge of the failure of their corporation to pay trust fund taxes to the IRS, they confronted the chief financial officer and the controller, made sure the delinquent taxes were paid, and ordered the employees never to let such a default occur in future months. Notwithstanding this admonition, the board members failed to take any action to ensure that the chief financial officer and the controller paid subsequent tax liabilities during the quarter. Additionally, the board members did not invoke any new accounting or reporting procedures to ensure that such a tax payment default will not happen again. Assuming that the IRS is able to establish that the board members are responsible persons, their omissions may be found to be willful under *I.R.C. section 6672* because they had prior knowledge of defaults in the payment of taxes, there was a grave risk that future taxes would not be paid due to the insolvency of the business, and the board members were in a position to easily determine if the employees in charge of the financial functions for the business were collecting, accounting for, and paying over the trust fund taxes as required by the Internal Revenue Code.

Willfulness based upon "reckless disregard" does not require a high degree of recklessness. A "high degree" standard would thwart the purpose of *I.R.C. section 6672* to collect the misapplied trust fund taxes from the persons who could have ensured their payment. Responsible persons are guilty of reckless disregard and thereby act willfully under *I.R.C. section 6672* if they are found to be "grossly negligent." n55 The gross negligence that results in a finding of reckless disregard and willfulness occurs when the responsible person:

- should have known
- there was a grave risk the trust fund taxes were not being paid, and
- he or she was in a position to ascertain easily whether payment was made n56

Thus, if a responsible officer knows the corporation has incurred a payroll tax delinquency, and is aware of the deteriorating financial affairs of the corporation, the officer runs the risk of being assessed a tax liability under *I.R.C. section 6672* for the unpaid trust fund taxes if he or she fails to take steps to ascertain the state of the trust fund tax

liabilities or to institute effective financial controls to guard against nonpayment. n57

[d] Willfulness Based Upon the Payment of Net Wages

The willfulness test under *I.R.C. section 6672* is strict in its application. None of the taxpayer's creditors, including its employees, can be paid before the IRS is paid, or the willfulness test of *I.R.C. section 6672* will be satisfied. This prohibition includes the payment of wages to employees when there is an outstanding trust fund liability owed to the IRS, including the taxes which should be withheld for the current payroll. n58

[e] Willfulness Based Upon Consumption of Available After-acquired Funds

If a person is characterized as a responsible person before and after he or she became aware of the trust fund tax deficiency, that responsible person has a duty to use all after-acquired funds to satisfy the trust fund tax obligation. n59 The failure to pay all available corporate funds, even those that are not subject to the trust imposed by *I.R.C. section 7501*, to the IRS to repay the trust fund taxes when the responsible person is aware of the existence of the trust fund tax liability satisfies the willfulness test of *I.R.C. section 6672*.

This test for willfulness is a combination of the actual knowledge test, the reckless disregard test, and the risk of corporate assets test. It is, however, broader in its potential scope because a responsible person who had no actual knowledge of a prior period's withholding tax liability can nevertheless become liable for both pre-notice and post-notice liabilities to the extent of subsequently acquired unencumbered funds held by the taxpayer. n60

Assume, for example that the chairperson of the board of directors of a corporation is a responsible person for purposes of *I.R.C. section 6672* during each month of 1992. During the first two quarters of 1992, the corporation incurred over \$250,000 of unpaid payroll trust fund tax liabilities. Prior to June 30, 1992, however, the chairperson had no knowledge that the controller of the corporation had not paid trust fund tax liabilities to the IRS, and he or she cannot otherwise be said to have acted willfully under any of the other forms of willfulness described in this discussion. If the chairperson obtains actual knowledge of the unpaid tax liabilities on July 1, 1992, he or she must ensure that all available corporate funds received after July 1, 1992 are used to pay the delinquent trust fund taxes payable to the IRS. This result follows because of the chairperson's status as a responsible person before and after the July 1, 1992 notice date. n61

[4] Injunctive Relief Against the Internal Revenue Service With Respect to Collection of the section 6672 Penalty

Corporate debtors have attempted, in the bankruptcy court, to enjoin the collection of the *I.R.C. section 6672* liability asserted against one or more of their officers, directors, or shareholders. These efforts have been predicated on an extension of the section 362(a) automatic stay to the nondebtor officers or, in most cases, by the suggested exercise of the bankruptcy court's injunctive powers under *section 105(a) of the Bankruptcy Code*. n62 The United States has successfully objected to attempts to obtain injunctive relief on several grounds.

A corporate debtor may request a bankruptcy court to enjoin the IRS's collection of the *I.R.C. section 6672* penalty against the officers, directors, and employees of the corporation. n63 This injunction issue can also arise, however, in the case of a husband and wife when only one of the debtors is liable for a particular tax but the government is attempting to collect the tax from the exempt assets owned by both of the debtors. n64

[a] Defenses to Request for Injunctive Relief

The United States asserts many defenses to these requests for injunctive relief. Courts have accepted many of these defenses, and the weight of authority favors the United States even though some courts have allowed the injunctive relief under particular factual circumstances. In *United States v. Energy Resources Co.*, n65 the Supreme Court allowed the allocation of involuntary payments to the trust fund tax liabilities if the possibility for a successful reorganization

would be increased. The same argument can be made in support of the bankruptcy court's injunctive relief against collection of the *I.R.C. section 6672* penalty if that relief will increase the possibility for the confirmation of a successful plan. After the Supreme Court's opinion in *Energy Resources*, a theoretical question arose regarding whether it made possible an extension of equitable relief in these types of injunction proceedings. One court of appeals has answered that question in the negative. The Fifth Circuit, in *United States v. Prescription Home Health Care, Inc.*, n65a has held that nothing in *Energy Resources* diminishes the authority of cases like *United States v. Huckabee Auto Co.*, n65b holding that bankruptcy courts do not have authority to enjoin tax collection from non-debtors. The court in *Prescription Home Health Care* also rejected an attempt to justify the injunction on the basis of the bankruptcy court's "related to" jurisdiction. The question of whether a bankruptcy court has authority to enjoin collection from non-debtors is discussed in *P TX5.04[5] supra*.

[b] The United States' Defenses

The United States asserts many defenses to attempts to enjoin the collection of the *I.R.C. section 6672* penalty including

- the debtor corporation's lack of standing to request the injunctive relief;
- the lack of subject matter jurisdiction over the United States as a result of its defense of sovereign immunity;
- the general lack of subject matter jurisdiction over the adversary proceeding because the targeted responsible person is not a debtor within the jurisdiction of the bankruptcy court; and
- the Internal Revenue Code's Anti-Injunction Act n66 bar to the requested relief.

[i] Lack of Standing

The jurisdiction of the federal courts is limited by Article III of the United States Constitution to deciding only "cases or controversies." n67 This jurisdictional requirement includes the requirement that the plaintiff or movant have standing to bring the action. The tax liability asserted against a responsible person under *I.R.C. section 6672* is a separate and distinct tax liability from any tax liability owed by the debtor corporation or any other responsible person. n68 Because the *I.R.C. section 6672* penalty is a separate and distinct tax liability, the IRS is authorized and required to collect that tax liability from the responsible persons regardless of the fact that full payment of the tax liability may ultimately be made by the corporation through a confirmed plan. n69 As a result, a corporation's attempt to enjoin the collection of a responsible person's separate and distinct tax liability would require the corporation to litigate that tax liability on behalf of another taxpayer. The litigation of a tax liability by one taxpayer on behalf of another is barred as a matter of law. n70

[ii] The Sovereign Immunity Defense

There may be a waiver of the United States' sovereign immunity in *Bankruptcy Code section 106(a)*, which provides that sovereign immunity is waived with respect to certain claims against governmental units if the claims are "property of the estate." n71 Amended section 106 waives sovereign immunity of the federal and state governments for the recovery of money judgments. The IRS may, however, assert that claims for injunctive relief are not property of the estate and the "claim" in issue is in fact a claim owned by the nondebtor responsible officer. This argument may have some validity because of the separate and distinct status of the *I.R.C. section 6672* tax liability of the responsible officer from the tax liability of the corporate debtor. n72

[iii] Absence of Subject Matter Jurisdiction

The United States may also assert that the bankruptcy court does not have subject matter jurisdiction to consider the request for injunctive relief because the responsible person is not a "debtor" n73 and because the Anti-Injunction Act, *I.R.C. section 7421(a)*, bars the requested relief.

This statute generally prohibits any attempt, in any court, to restrain the assessment or collection of any tax.

[iv] Exceptions to the Anti-Injunction Act

The Anti-Injunction Act is read in a strict manner in favor of the United States, n74 but there are two judicially recognized exceptions to the prohibition contained in the statute. n75 When a corporate debtor is attempting to enjoin the collection of the *I.R.C. section 6672* penalty, the complaint is usually filed to stop collection of the liability without any challenge to the validity of the underlying tax assessment. n76

Many taxpayers who have requested injunctive relief against the *I.R.C. section 6672* penalty have based their argument on an opinion from the Court of Appeals for the Eighth Circuit that enjoined the IRS from collecting a tax liability from the debtor because collection might interfere with the successful reorganization and confirmation of the plan. n77 In *Bostwick v. United States* n78, the debtor was attempting to obtain injunctive relief with respect to one of its own tax liabilities. This is the factual distinction raised by the United States when taxpayers raise the *Bostwick* opinion as support for requests for injunctive relief. In most attempts to obtain injunctive relief, the debtor is attempting to obtain that remedy for the benefit of a nondebtor, third party. Therefore, the *Bostwick* opinion is, in the IRS's view, distinguishable on its facts. n79

Therefore, in most cases, the Anti-Injunction Act has resulted in the rejection of the requested injunctive relief. n80 On the other hand, some courts have granted injunctive relief when that injunction is necessary to ensure the successful reorganization or rehabilitation of the debtor. n81

[c] Some I.R.S. Districts will Agree to Stay Collection Efforts

The practical problem addressed by the debtor corporation and its officers, shareholders, directors and employees is that the unpaid trust fund liability may be paid through the confirmed title 11 plan and they do not want two forms of collection to occur at the same time. As a practical resolution, some IRS districts will agree to execute a collection stay agreement that generally provides that:

- (i) all *I.R.C. section 6672* responsible parties will stipulate, for *res judicata* purposes, that they are liable for the *I.R.C. section 6672* tax liability;
- (ii) all *I.R.C. section 6672* responsible parties and the debtor corporation agree to cure all tax delinquencies, file and pay all unfiled tax returns, file all future tax returns timely, and pay all future tax liabilities timely;
- (iii) all *I.R.C. section 6672* responsible parties consent to the recording of tax liens and agree to execute a waiver of the statute of limitations on collection of the *I.R.C. section 6672* liability;
- (iv) the *I.R.C. section 6672* parties agree that the United States will not waive its statutory right of setoff per *I.R.C.*

section 6402 to claim any refunds payable to the responsible parties; and

(v) the United States will agree not to actively collect the *I.R.C. section 6672* liability if the corporate chapter 11 plan payments remain current and all other terms of the agreement are met. n82

FOOTNOTES:

(n1)Footnote 1. "Trust fund" tax liabilities generally include monies withheld by a business or tax liabilities collected by the business for a governmental agency upon the occurrence of some transaction. *See, e.g., I.R.C. § 7501*:

Whenever any person [as defined at *I.R.C. § 6671(b)*] is required to collect or withhold any internal revenue tax from any other person and to pay over such tax to the United States, the amount of such tax so collected or withheld shall be held to be a special trust fund in trust for the United States

In a novel case, the trustee of an insolvent railroad which had sought reorganization under the Bankruptcy Act reduced the wages of the railroad's employees following appointment. Subsequently, the trustee paid them a portion of the amounts by which their wages had been reduced and withheld and paid to the IRS the taxes which were due on these payments. Still later, the trustee sought a refund of the remittances made to the IRS contending that these payments to the employees did not constitute "compensation" paid by an "employer," and, therefore, that the statute requiring taxes to be withheld did not apply. The Court of Federal Claims rejected this theory and was affirmed. *Chicago Milwaukee Corp. v. United States*, 141 F.3d 1112 (*Fed. Cir.* 1998) .

(n2)Footnote 2. Although cases involving social security and income taxes are by far the most common, other types of taxes subject to withholding are occasionally the subject of litigation. *See, e.g., Bergt v. United States (In re Bergt)*, 97-1 U.S. Tax Cas. (CCH) P 50461 (Bankr. D. Ala. 1997) (air transportation excise tax). Sales taxes are specifically discussed in chapter TX11 *supra*.

(n3)Footnote 3. *I.R.C. § 6672(a)*, as amended by Sec. 9(a), Act of November 10, 1978, Pub. L. No. 95-628, 92 Stat. 3627. Although the tax liability imposed upon individuals by this statute is sometimes referred to as the "100 percent penalty," it is, in fact, not a "penalty" as that term is normally used in either the Internal Revenue Code or the Bankruptcy Code. The confusion arises because the statute imposes a liability on the individual equal to 100 percent of the amount of the trust fund taxes that the corporation should have paid over to the Internal Revenue Service. Notwithstanding these references to the "100 percent penalty," it is clear that the liability is entitled to priority status in Title 11 cases. *See, e.g., In re Boehm*, 255 B.R. 686 (*Bankr. E.D. Ky* 2001) .

(n4)Footnote 4. Reference should also be made to state statutes that enforce trust fund liabilities, for example sales tax and employment tax statutes.

(n5)Footnote 5. *See P TX15.02[2] and [3] infra* for detailed examinations of the responsible person test and the willfulness test, respectively.

(n6)Footnote 5a. A factor that sometimes arises in disputes under section 6672 is the IRS's inability to link an individual debtor to its investigation of corporation that has not paid taxes withheld from its employees in time to file a claim in the individual case before the bar date. *Seivers v. United States (In re Seivers)*, 378 B.R. 473 (*Bankr. W.D. Pa.* 2007).

(n7)Footnote 6. *United States v. Energy Resources Co.*, 495 U.S. 545, 110 S. Ct. 2139, 109 L. Ed. 2d 580, 22 C.B.C.2d 1093 (1990) . *See P TX15.03 infra* for a more detailed discussion of the designation issue.

(n8)Footnote 7. *But see In re Deer Park, Inc.*, 136 B.R. 815 (B.A.P. 9th Cir. 1992) , discussed at P TX15.03 *infra*.

(n9)Footnote 7a. *United States v. Galletti*, 541 U.S. 114, 124 S. Ct. 1548, 158 L. Ed. 2d 279 (2004) .

(n10)Footnote 8. *See I.R.C. §§ 3102(a) and 3402(a)*. Employers are also required to pay over or deposit these withheld taxes to the United States at quarterly intervals. Treas. Reg. § 31.6071-1.

Although 26 U.S.C. § 6672 provides a mechanism by which the Internal Revenue Service can collect the "trust fund" portion of taxes that should have been paid by corporate employers from responsible persons, as discussed below, it is not the only remedy available to the Internal Revenue Service. Section 6672 does not preempt other vehicles available, such as asserting that a partner is liable for the withholding taxes due on wages paid to partnership employees. *See Remington v. United States*, 210 F.3d 281 (5th Cir. 2000) .

(n11)Footnote 9. *I.R.C. § 7501(a)*; *see, e.g., Slodov v. United States*, 436 U.S. 238, 243, 98 S. Ct. 1778, 1783, 56 L. Ed. 2d 251, 259 (1978) ; *Howard v. United States*, 711 F.2d 729, 733 (5th Cir. 1983) ; *Mazo v. United States*, 591 F.2d 1151, 1153 (5th Cir.) , *cert. denied sub nom. Lattimore v. United States*, 444 U.S. 842, 100 S. Ct. 82, 62 L. Ed. 2d 54 (1979) ; *Newsome v. United States*, 431 F.2d 742, 745 (5th Cir.1970) . However, the responsible persons cannot be held liable on the same theory for the unpaid employer's share of FICA payments. *See, e.g., Wood v. United States*, 808 F.2d 411 (5th Cir. 1987) ; *Muntwyler v. United States*, 703 F.2d 1030 (7th Cir. 1983) .

(n12)Footnote 10. *See Howard v. United States*, 711 F.2d 729, 733 (5th Cir.1983) *Kinnie v. United States*, 771 F. Supp. 842 (E.D. Mich.1991) . The United States can be expected to argue in title 11 cases (as it does in non-title 11 cases) that it should not be forced to finance the operations of the debtor and thereby become an unwilling creditor. The IRS will therefore resist any attempt to limit its collection sources for the trust fund tax liability. *See P TX15.02[4] infra*.

(n13)Footnote 11. *See Howard v. United States*, 711 F.2d 729, 733 (5th Cir.1983) ; *Mazo v. United States*, 591 F.2d 1151, 1153 (5th Cir.) , *cert. denied sub nom. Lattimore v. United States*, 444 U.S. 842, 100 S. Ct. 82, 62 L. Ed. 2d 54 (1979) .

(n14)Footnote 12. *See Newsome v. United States*, 431 F.2d 742, 745 (5th Cir.1970) ; *Monday v. United States*, 421 F.2d 1210 (7th Cir.) , *cert. denied*, 400 U.S. 821, 91 S. Ct. 38, 27 L. Ed. 2d 48 (1970) ; *Botta v. Scanlon*, 314 F.2d 392 (2d Cir. 1963) . The I.R.C. § 6672 assessment is often referred to as the "100 percent penalty" because it is intended to collect 100 percent of the trust fund taxes not paid over to the IRS. Some individuals assessed an I.R.C. § 6672 liability have asserted the assessment is a "penalty" dischargeable under 11 U.S.C. § 507(a)(8)(G) rather than a withheld tax which is never dischargeable under 11 U.S.C. § 507(a)(8)(D). *See chapter TX18 supra* for a discussion of the dischargeability of tax liabilities. This dischargeable penalty argument has been rejected many times because the I.R.C. § 6672 liability is not a punitive penalty. I.R.C. § 6672 is a separate and distinct tax liability of each responsible person which is assessed to ensure the collection of the trust fund monies the taxpayer failed to collect, account for, and pay over to the United States. *See, e.g., United States v. Sotelo*, 436 U.S. 268, 98 S. Ct. 1795, 56 L. Ed. 2d 275 (1978) . Accordingly, this "penalty" is compensatory and not punitive in nature. *See also In re Mosbrucker*, 227 B.R. 434 (B.A.P. 8th Cir. 1998) ; *In re Thomas*, 40 C.B.C.2d 464, 222 B.R. 742 (Bank. E.D. Pa. 1998) .

(n15)Footnote 13. *I.R.C. § 6672*.

(n16)Footnote 14. *See Howard v. United States*, 711 F.2d 729, 733 (5th Cir.1983) .

(n17)Footnote 15. *See Commonwealth National Bank of Dallas v. United States*, 665 F.2d 743, 748 (5th Cir. 1982) . Although I.R.C. Section 6672 itself lists these duties in the conjunctive ("to collect, truthfully account for, and pay over") (italics added), case law has established that a responsible person need only have a duty to perform one, not all three, of these duties. *See, e.g., Slodov v. United States*, 436 U.S. 238, 247, 98 S. Ct.1778, 1785, 56 L. Ed. 2d 251, 261 (1978) . The term "person" also includes corporations, partnerships and other business entities. *Pacific National*

Insurance Company v. United States, 422 F.2d 26, 30 (9th Cir.) , cert. denied, 398 U.S. 937, 90 S. Ct. 1838, 26 L. Ed. 2d 269 (1970) . A debtor who was a partner in a partnership which was determined to be a responsible person for several corporations was held liable for unpaid withholding taxes in her individual title 11 case. See *Elms v. United States (In re Elms)*, 156 B.R. 519 (Bankr. E.D. La. 1993) . Although another partner was found to have "ultimate authority" to act for the partnership, he was acting on behalf of the partnership, thereby making all of the partners liable. Accordingly, the debtor-partner's liability for the partnership withholding tax obligation was not precluded, and she was also liable.

(n18)Footnote 16. See *Mazo v. United States*, 591 F.2d 1151, 1153 (5th Cir.) , cert. denied sub nom. *Lattimore v. United States*, 444 U.S. 842, S. Ct. 82, 62 L. Ed. 2d 54 (1979) . Whether the targeted officer had notice of the nonpayment of the trust fund liability is thus irrelevant to a determination of responsibility.

(n19)Footnote 17. Clear titular authority is, however, generally sufficient. *United States v. Burger*, 717 F. Supp. 245, 248 (S.D.N.Y. 1989) .

(n20)Footnote 18. See *Pacific National Insurance Company v. United States*, 422 F.2d 26, 30 (9th Cir.) , cert. denied, 398 U.S. 937, 90 S. Ct. 1838, 26 L. Ed. 2d 269(1970) ; *Commonwealth National Bank of Dallas v. United States*, 665 F.2d 743, 748 (5th Cir. 1982) .

(n21)Footnote 19. *United States v. Graham* 309 F.2d 210 (9th Cir. 1962) .

(n22)Footnote 20. *United States v. Graham* 309 F.2d 210, 212 (9th Cir. 1962) .

(n23)Footnote 21. In *Neckles v. United States*, 579 F.2d 938 (5th Cir. 1978) , Section 6672 liability was assessed against an individual who was neither a corporate officer nor a shareholder, but who possessed authority to sign on all three of the corporate accounts. The Court of Appeals for the Fifth Circuit affirmed the lower court's finding that the individual was a responsible person:

It thus appears that appellant was acting as a *de facto* officer or employee The fact that he received no remuneration and held no official position, while important, is not conclusive as to his liabilities under section 6672. Whatever his motives and official position, the appellant had the power and authority to pay creditors, did so, and ignored the taxes collected and held in trust for the government. ... The appellant's knowledge of these arrears, plus his duty and authority to remedy them, made him a responsible person under section 6672.

579 F.2d 938, 940 (5th Cir. 1978) .

(n24)Footnote 22. See *Genins v. United States*, 489 F.2d 95, 96 (5th Cir.1974) ; *Liddon v. United States*, 448 F.2d 509, 512 (5th Cir.1971) ; *Monday v. United States*, 421 F.2d 1210, 1214 (7th Cir.) , cert. denied, 400 U.S. 821, 91 S. Ct. 38, 27 L. Ed. 2d 48 (1970) ; *In re Sheppard*, 253 B.R. 397 (Bankr. D.S.C. 2000) .

(n25)Footnote 23. *Commonwealth National Bank of Dallas v. United States*, 665 F.2d 743, 752 (5th Cir. 1982) (quoting *Liddon v. United States*, 448 F.2d 509, 512(5th Cir. 1971) .

(n26)Footnote 24. See, e.g., *Commonwealth National Bank of Dallas v. United States*, 665 F.2d 743, 748 (5th Cir. 1982) .

(n27)Footnote 25. See, e.g., *Adams v. United States*, 504 F.2d 73 (7th Cir. 1974) , cert. denied sub nom. *Estate of Klein v. Commissioner*, 421 U.S. 991, 95 S. Ct. 1998, 44 L. Ed. 2d 482, 186 U.S.P.Q. 1 (1975) ; *Dudley v. United States*, 428 F.2d 1196 (9th Cir.1970) ; *Gephart v. United States*, 818 F.2d 469 (6th Cir. 1987) ; *United States v. Burger*, 717 F. Supp. 245, 248 (S.D.N.Y. 1989) ; *In re Vaglica*, 112 B.R. 17 (Bankr. E.D. Tex. 1990) ; *In re Quattrone*

Accountants, Inc., 88 B.R. 713 (Bankr. W.D. Pa. 1988), *aff'd*, 895 F.2d 921, 22 C.B.C.2d 427 (3d Cir. 1990).

An attempt by an attorney to avoid status as a responsible person by having each of his employees incorporate and characterizing them as independent contractors was rejected by a bankruptcy court. (The court also refused to accept his characterizations of payments he made to himself as loans instead of wages.) *Smith v. United States (In re Smith)*, 99-1 U.S. Tax Cas. (CCH) P 50,278 (Bankr. D. Haw. 1999).

A corporate treasurer who was also a 40 to 45 percent shareholder in the parent corporation, had authority to hire and fire employees, and was the primary provider of capital was a "responsible person." *In re Hayes*, 240 B.R. 457 (Bankr. D. Mass. 1999).

After *Hayes* was decided, the First Circuit radically changed its interpretation of who could be a responsible person by making it much easier for a subordinate employee to shift sole responsibility to the "boss." *Vinick v. United States*, 205 F.3d 1 (1st Cir.2000). A bankruptcy court in that circuit subsequently applied *Vinick* to hold that a corporate treasurer who had check-signing authority and was aware of the unpaid trust fund taxes was not a responsible person, because the corporate president had refused to allow the treasurer to pay the taxes. *In re Aboody*, 250 B.R. 1 (Bankr. D. Mass. 2000).

(n28)Footnote 26. For example, in *Mazo v. United States*, 591 F.2d 1151, 1153 (5th Cir.), *cert. denied sub nom. Lattimore v. United States*, 444 U.S. 842 (1979) *Lattimore v. United States*, 62 L. Ed. 2d 54 the plaintiffs were officers, directors, and the general manager of a country club. Although each plaintiff asserted that he held a title and a position in the corporation that did not carry genuine authority, the Court of Appeals for the Fifth Circuit affirmed the trial court's finding that each plaintiff was a responsible person. The Fifth Circuit found support for its conclusion in its decision in *Liddon v. United States*, 448 F.2d 509, 512 (5th Cir.1971):

[W]e there held that evidence that a director was the only person at the company's home office who was permitted to sign checks supported a finding that he was a responsible person, even though the right-hand man did most of the check signing and supervised the clerical operations of the company.

591 F.2d 1151, 1156 (5th Cir.). Thus, if a person is in a position to exercise authority over a corporation that could lead to the payment of the trust fund taxes to the IRS (the effective power to pay), that person may be a responsible person even if that authority is not exercised, was shared with others, or was delegated to other employees.

(n29)Footnote 27. See, e.g., *Neckles v. United States*, 579 F.2d 938 (5th Cir. 1978). After reviewing "unbelievable" and "incredible" testimony, a bankruptcy court held that the former treasurer and bookkeeper of a series of businesses she operated with her husband was not a mere employee of a similar business founded by her 19-year old son immediately prior to the filing of her Chapter 13 proceeding. The court determined that she was a responsible person who willfully failed to see that trust fund taxes were paid to the IRS and, because of a continuing pattern of abuse, dismissed her case. *In re Wigley*, 333 B.R. 768 (Bankr. N.D. Tex. 2005).

(n30)Footnote 28. See, e.g., *Williams v. United States*, 931 F.2d 805 (11th Cir. 1991); *Thomsen v. United States*, 887 F.2d 12 (1st Cir. 1989); *Thibodeau v. United States*, 828 F.2d 1499 (11th Cir. 1987); *George v. United States*, 819 F.2d 1008 (11th Cir. 1987); *Silberberg v. United States*, 524 F. Supp. 744 (E.D.N.Y. 1981); *In re Green*, 89 B.R. 466 (Bankr. E.D. Pa. 1988); *In re Quattrone Accountants, Inc.*, 88 B.R. 713 (Bankr. W.D. Pa. 1988), *aff'd*, 895 F.2d 921, 22 C.B.C.2d 427 (3d Cir. 1990); *In re Clate*, 69 B.R. 506 (Bankr. W.D. Pa. 1987); *In re Thompson*, 37 B.R. 211 (Bankr. M.D. Fla. 1983).

After reviewing a list of "recognized indicia of responsible person status," a bankruptcy court explained: "Neither any particular indicia nor any particular combination of indicia is required for a finding of responsibility. As the Fifth Circuit has explained, it 'cannot allow [an individual] to disqualify himself from responsible person status simply

because he does not fit into every category ever listed.' *Raba v. United States*, 977 F.2d 941, 944 (5th Cir. 1992) ." *In re Chabrand*, 301 B.R. 468, 478 (Bankr. S.D. Tex. 2003) . The contention by the founder, former president, and "animating force" behind a corporation who subsequently installed a former maintenance man as president and then contended that he no longer controlled the affairs of the corporation and could not be a responsible person was rejected as "utterly unconvincing" and "lacking credibility." *In re Casini*, 2008 Bankr. LEXIS 1972 (Bankr. D.N.J. June 2, 2008).

(n31)Footnote 29. *Howard v. United States*, 711 F.2d 729 (5th Cir. 1983) . In *Howard*, an employee who, the court acknowledged, might well have been fired for paying trust fund taxes against the orders of his supervisor, was held to be a responsible person because he had the "effective power to pay." The court relied on the fact that the employee had in the past issued small checks without his supervisor's approval. *Howard v. United States*, 711 F.2d 729, 734 (5th Cir.1983) . The bankruptcy court in *Gongaware v. United States (In re Gongaware)*, 207 B.R. 95 (Bankr. W.D. Pa. 1997) followed *Howard*. See also *In re Treacy*, 45 C.B.C.2d 120, 255 B.R. 656 (Bankr. E.D. Pa. 2000) .

(n32)Footnote 30. *Mazo v. United States*, 591 F.2d 1151, 1153 (5th Cir.) , cert. denied sub nom. *Lattimore v. United States*, 444 U.S. 842, 100 S. Ct. 82, 62 L. Ed. 2d 54 (1979) . In *Mazo*, corporate officials, though not active in business affairs, nevertheless possessed the power and authority to ensure the trust fund taxes were paid. Even though that authority was exercised by others, the plaintiffs in *Mazo* were held to be responsible persons.

(n33)Footnote 31. *Pacific National Ins. v. United States*, 422 F.2d 26, 30 (9th Cir.) , cert. denied, 398 U.S. 937, 90 S. Ct. 1838, 26 L. Ed. 2d 269 (1970) .

(n34)Footnote 32. See, e.g., *Godfrey v. United States*, 748 F.2d 1568 (Fed. Cir.1984) ; *In re Derickson*, 104 B.R. 346 (Bankr. D. Or.1989) . See also *In re Brady*, 110 B.R. 16 (Bankr. D. Nev. 1990) (holding that only the owner with responsibility for the financial management of the company was a "responsible person" under the statute).

(n35)Footnote 33. See, e.g., *Godfrey v. United States*, 748 F.2d 1568 (D.C. Cir. 1984) .

(n36)Footnote 34. See, e.g., *In re Green*, 89 B.R. 466, 475 (Bankr. E.D. Pa.1988) .

(n37)Footnote 35. *Howard v. United States*, 711 F.2d 729, 734 (5th Cir. 1983) ; *Freeman v. United States*, 603 F. Supp. 272 (D. Ariz. 1985) , aff'd per curiam, 817 F.2d 106 (9th Cir. 1987) ; *Fontenot v. United States*, 547 F. Supp. 496 (M.D. La. 1942) ; *In re Hanshaw*, 94 B.R. 753 (Bankr. M.D. Fla. 1988) . See also *Roth v. United States*, 779 F.2d 1567(11th Cir. 1986) .

A corporate officer who possessed check-writing authority, knew the payroll taxes were not being paid, and paid other creditors instead of the IRS was a responsible person in spite of the fact that the corporation's sole shareholder could have fired him. *Sheppard v. United States (In re Sheppard)*, 253 B.R. 397 (Bankr. D.S.C. 2000) . A debtor who was the nominal president of a corporation and did not exercise active control of its affairs could not avoid liability based upon "the 'Nuremberg defense' that she was just following orders." *United States v. Marino (In re Marino)*, 311 B.R. 111, 115-16 (M.D. Fla.2004) .

(n38)Footnote 36. See, e.g., *Graunke v. United States*, 711 F. Supp. 388 (N.D. Ill.1989) . The *Graunke* decision, however, emphasized that the individual's liability had not been established as a matter of law and remanded the case. The court did not disagree with *Howard* and similar cases, but distinguished them, finding that while the individual to be held responsible in *Graunke* had authority to write checks, he did not have authority to decide whom to pay. See also *In re Tripplett*, 23 C.B.C.2d 413, 115 B.R. 955(Bankr. N.D. Ill. 1990) (following *Graunke*).

(n39)Footnote 37. See *Hornsby v. Internal Revenue Service*, 588 F.2d 952, 953 (5th Cir. 1979) . In an unusual decision, a bankruptcy court found that the president and 50 percent shareholder of a corporation who had signed checks and fired an employee was, nevertheless, not a responsible person. *Barnett v. United States (In re Barnett)*, 387 B.R. 698 (Bankr. W.D. Va. 2008) . However, in a case involving a less sympathetic debtor, a different bankruptcy court

rejected many of the same defenses and held the debtor was a responsible person. *In re Norohna*, 382 B.R. 363 (Bankr. W. D. Ky. 2007) .

(n40)Footnote 38. *Thomsen v. United States*, 887 F.2d 12 (1st Cir. 1989) ; *Mazo v. United States*, 591 F.2d 1151, 1155 (5th Cir.) , cert. denied sub nom. *Lattimore v. United States*, 444 U.S. 842, 100 S. Ct. 82, 62 L. Ed. 2d 54 (1979) .

(n41)Footnote 39. 112 B.R. 17 (Bankr. E.D. Tex. 1990) .

(n42)Footnote 40. *United States v. Garami*, 184 B.R. 834 (M.D. Fla. 1995) . *Garami* was followed by the district court in *United States v. Total Employment Company, Inc.*, 305 B.R. 333 (M.D. Fla. 2004) .

(n43)Footnote 41. *Liddon v. United States*, 448 F.2d 509, 512 (5th Cir. 1971) .

(n44)Footnote 42. See *Howard v. United States*, 711 F.2d 729, 735 (5th Cir.1983) . See also *Commonwealth National Bank of Dallas v. United States*, 665 F.2d 743, 748 (5th Cir. 1982) ; *George v. United States*, 819 F.2d 1008 (11th Cir. 1987) .

(n45)Footnote 43. The IRS may collect the full amount of the liability from each allegedly "responsible party," but may retain only the amount necessary to satisfy the liability. *U.S. Life Title Insurance Company of Dallas v. Harbison*, 784 F.2d 1238, 1243-44 (5th Cir. 1986) . The IRS may continue to collect from allegedly responsible parties until the statute of limitations for a refund of those collected taxes has expired and the IRS's satisfaction of the amount due has been assured. *U.S. Life Title Insurance Company of Dallas v. Harbison* 784 F.2d 1238,1243-44 (5th Cir. 1986) .

(n46)Footnote 43a. *In re Fiesole Trading Corp.*, 315 B.R. 198 (Bankr. D. Mass.2004) .

(n47)Footnote 43b. *Patterson v. Yeargin (In re Yeargin)*, 116 B.R. 621 (Bankr. M.D. Tenn. 1990) .

(n48)Footnote 43c. Once it is established that an individual is a responsible person, the burden of proving a lack of willfulness falls on that individual. *Paris v. United States (In re Paris)*, 355 B.R. 860 (Bankr. M.D. Fla. 2006) , *aff'd*, 355 B.R. 867 (M.D. Fla. 2006) .

(n49)Footnote 44. *Thomsen v. United States*, 887 F.2d 12 (1st Cir. 1989) ; *Barnett v. United States*, 594 F.2d 219 (9th Cir. 1979) ; *Monday v. United States*, 421 F.2d 1210 (7th Cir.) , cert. denied, 400 U.S. 821,91 S. Ct. 38, 27 L. Ed. 2d 48 (1970) ; *In re Quattrone Accountants, Inc.*, 88 B.R. 713 (Bankr. W.D. Pa. 1988) , *aff'd*, 895 F.2d 921, 22 C.B.C.2d 427 (3d Cir. 1990) .

(n50)Footnote 45. See, e.g., *Howard v. United States*, 711 F.2d 729, 735 (5th Cir.1983) (quoting *Mazo v. United States*, 591 F.2d 1151, 1157 (5th Cir.) , cert. denied sub nom. *Lattimore v. United States*, 444 U.S. 842 (1979) ; *Kalb v. United States*, 505 F.2d 506, 511 (2d Cir. 1974) , cert. denied, 421 U.S. 979, 95 S. Ct. 1981, 44 L. Ed. 2d 471(1975) ; *Moore v. United States*, 465 F.2d 514, 516 (5th Cir. 1972) , cert. denied, 409 U.S. 1108, 93 S. Ct. 907, 34 L. Ed. 2d 688 (1973) . Once it has been established that a party is a responsible person, the burden is on that party to disprove willfulness. *United States v. Macagnone (In re Macagnone)*, 240 B.R. 444 (M.D. Fla. 1999) , *rev'g*, 228 B.R. 784 (Bankr. M.D. Fla. 1998) .

(n51)Footnote 46. *Frazier v. United States*, 304 F.2d 528 (5th Cir. 1962) .

(n52)Footnote 47. *Howard v. United States*, 711 F.2d 729, 736 (5th Cir. 1983) . Explaining that willfulness does not require a showing of fraud or bad motive, a district court held a bankruptcy court was clearly erroneous when it accepted a defense to willfulness predicated upon the debtor's full and open cooperation with the IRS once it began attempts to collect the taxes the corporate employer was failing to pay. *United States v. Beltran*, 316 B.R. 371 (S.D. Fla. 2004) .

(n53)Footnote 48. *Bowen v. United States*, 836 F.2d 965, 966-67 (5th Cir. 1988) .

(n54)Footnote 49. *Treas. Reg. § 31.6011(a)-1(a)(1)*.

(n55)Footnote 50. *See Treas. Reg. § 31.6302(c)-1(a)(1)(ii)(b)*.

(n56)Footnote 50a. A responsible person should realize the possibility that the corporation may file bankruptcy without having paid the withheld taxes. *Ferguson v. United States*, 317 F. Supp. 2d 945 (S.D. Iowa 2004) , quoting *Thibodeau v. United States*, 828 F.2d 1499, 1506 (11th Cir. 1987) ("[i]t is also irrelevant that the corporation declared bankruptcy before the taxes were actually due for either quarter.").

(n57)Footnote 51. *Newsome v. United States*, 431 F.2d 742, 746 (5th Cir. 1970) ; *see also Howard v. United States*, 711 F.2d 729, 736 (5th Cir.1983) .

(n58)Footnote 52. *See, e.g., In re Summers*, 32 B.R. 861 (Bankr. N.D. Ohio 1983) (the willfulness test will be met even if a person does not have actual notice of unpaid trust fund taxes but nevertheless is aware of management problems and prior failures to pay trust fund taxes; a responsible person must investigate and take action to correct mismanagement and ensure the trust fund tax default does not recur).

"A responsible person with knowledge of a corporation's financial problems may not immunize himself of the consequences of his actions by wearing blinders which will shut out all knowledge of the liability for and the nonpayment of its withholding taxes. Such actions constitute a deliberate or reckless disregard of the facts and constitute willfulness. *Bolding v. United States*, 565 F.2d 663, 674 (Ct. Cl. 1977) ; *Calderone v. United States*, 799 F.2d 254,259-260 (6th Cir. 1986) ." *In re Chabrand*, 301 B.R. 468, 479-80 (Bankr. S.D Tex. 2003) An individual with knowledge of payroll tax obligations based upon prior employment, who was aware of the business' cash flow problems, but who lacked specific knowledge of the unpaid taxes was not in reckless disregard until began signing checks for the business. *Thatcher v. United States (In re Thatcher)*, 334 B.R. 732 (Bankr. M.D. Pa. 2006) .

(n59)Footnote 53. *See, e.g., United States v. Vespe*, 868 F.2d 1328 (3d Cir.1989) ; *Godfrey v. United States*, 748 F.2d 1568 (D.C. Cir.1984) ; *Teel v. United States*, 529 F.2d 903 (9th Cir. 1976) ; *Monday v. United States*, 421 F.2d 1210 (7th Cir.) , *cert. denied*, 400 U.S. 821,91 S. Ct. 38, 27 L. Ed. 2d 48 (1970) ; *Guito v. United States*, 764 F. Supp. 1445 (M.D. Fla. 1991) ; *In re Vaglica*, 112 B.R. 17 (Bankr. E.D. Tex. 1990) (the debtor's failure to recover misappropriated monies resulting from an auction was reckless in light of his knowledge of the existence of employment tax delinquencies). *See P TX15.02[3][e] infra*. A district court affirmed a bankruptcy court's rejection of a debtor's claim that her Indian culture permitted her to rely upon her husband to be sure the taxes were paid and its finding that she acted with reckless disregard since she was aware of the accruing unpaid taxes. *Noronha v. Internal Revenue Service*, 2008 U.S. Dist. LEXIS 69843 (W.D. Ky. Sept. 11, 2008).

(n60)Footnote 54. *Garsky v. United States*, 600 F.2d 86 (7th Cir. 1979) .

(n61)Footnote 54a. A similar conclusion was reached in *In re Hawley*, 98-1 U.S. Tax Cas. (CCH)P 50,439 (Bankr. E.D. Wash. 1998).

(n62)Footnote 55. *Wright v. United States*, 809 F.2d 425, 427 (7th Cir. 1987) .

(n63)Footnote 56. *Wright v. United States*, 809 F.2d 425, 427 (7th Cir. 1987) . A corporate officer acted willfully when he displayed a reckless disregard by failing to investigate the uncertainty of the company's payment of trust fund taxes to the IRS. *Rutherford*, 178 B.R. 716 (Bankr. S.D. Ohio 1995) .

(n64)Footnote 57. *Wright v. United States*, 809 F.2d 425, 428 (7th Cir. 1987) .

(n65)Footnote 58. *See, e.g., Sorenson v. United States*, 521 F.2d 325, 328-29 (9th Cir. 1975) , in which the court

considered the willfulness issue and stated:

We hold that the payment of net wages in circumstances where there are no available funds in excess of net wages from which to make withholding is a willful failure to collect and pay over under Section 6672.

* * * * *

The unmistakable consequence of our holding, therefore, is to require the employer to prefer the United States over his workers. While to some this may appear oppressive, we see no escape from this position so long as § 6672 remains in its present form. As written, there is no authority for the employer to prefer any creditors over the United States.

(n66)Footnote 59. *United States v. Vespe*, 868 F.2d 1328 (3d Cir. 1989) ; *Garsky v. United States*, 600 F.2d 86 (7th Cir. 1979) ; *Mazo v. United States*, 591 F.2d 1151, 1153 (5th Cir.) , cert. denied sub nom. *Lattimore v. United States*, 444 U.S. 842, 100 S. Ct. 82, 62 L. Ed. 2d 54 (1979) ; *State of Alabama and United States v. King*, 95-1 U.S. Tax Cas. (CCH)P 50,241 (N.D. Ala. 1995) *Grillo v. Corigliano (In re Grillo)*, 331 B.R. 614 (Bankr. D.N.J. 2005) .

(n67)Footnote 60. See *Kizzier v. United States*, 598 F.2d 1128, 1134 (8th Cir.1979) (the court followed the holding in *Mazo v. United States*, 591 F.2d 1151, 1153 (5th Cir.) , cert. denied sub nom. *Lattimore v. United States*, 444 U.S. 842, 100 S. Ct. 82, 62 L. Ed. 2d 54 (1979) holding that in 1974 when a responsible person became aware of unpaid withholding taxes from 1973, and that person was a responsible person during both 1973 and 1974, his responsibility to pay the corporation's withheld employment taxes extended to unencumbered funds received by the corporation after he learned of the company's tax delinquency whether or not those funds were trust funds within the meaning of I.R.C. § 7501). A bankruptcy court's decision that a responsible officer would be relieved of liability for periods before he had actual knowledge that the taxes were not being paid by limiting his liability to only \$5,000 on some equitable basis was reversed on appeal in *Alabama v. King*, 95-1 U.S. Tax Cas. (CCH) P 50,241 (N.D. Ala. 1995). The district court, quoting from *Williams v. United States*, 931 F.2d 805 (11th Cir. 1991) , stated that "[t]he seeds of common sense compassion sown by the jury find scant hospitality on this rock hard legal landscape."

(n68)Footnote 61. The attempt of a responsible person to avoid liability by claiming that he reasonably relied upon some other corporate officer has not usually succeeded. See, e.g., *Stevens v. Internal Revenue Serv. (In re Ray Stevens Paving Co., Inc.)*, 93-2 U.S. Tax Cas.(CCH) P 50,539 (Bankr. D. Ariz. 1993) (rejecting a "reasonable cause" defense based on reliance upon an allegedly dishonest comptroller and the assertion that the corporation's assets were "tied up").

(n69)Footnote 62. 11 U.S.C. § 105(a) provides:

(a) The court may issue any order, process, or judgment that is necessary or appropriate to carry out the provision of this title. No provision of this title providing for the raising of an issue by a party in interest shall be construed to preclude the court from, sua sponte, taking any action or making any determination necessary or appropriate to enforce or implement court orders or rules, or to prevent an abuse of process.

(n70)Footnote 63. See, e.g., *In re Original Wild West Foods, Inc.*, 11 C.B.C.2d 1447, 45 B.R. 202 (Bankr. W.D. Tex. 1985) (bankruptcy court enjoined the collection of the I.R.C. § 6672 penalty because it was necessary to enable the corporate debtor to successfully reorganize). Compare this result to *Bowen Industries, Inc. v. United States*, 61 B.R. 61 (W.D. Tex. 1986) , an identical case subsequently decided by the Chief Judge for the same district, which rejected the request for injunctive relief. These conflicting cases from the same judicial district illustrate the conflict over the ability of bankruptcy courts to prevent the IRS from pressing the collection of tax liabilities that can be paid through a confirmed plan of the corporate employer. With the passage of time, most bankruptcy courts have held that the

Anti-Injunction Act, 26 U.S.C. § 7421, prohibits them from enjoining collection from the individuals responsible for the corporate debtor's failure to pay the taxes. *See, e.g.,* *Hirshfield v. United States* (*In re Mednet Ambulance Service, Inc.*), 2002-2 U.S. Tax Cas. (CCH) P50,786 (Bankr. D.N.M. 2002).

(n71)Footnote 64. *See, e.g., In re Pennington*, 88-2 U.S.T.C.P 9479 (Bankr. N.D. Tex. 1988); *In re Schmick*, 87 B.R. 55 (Bankr. C.D. Ill. 1988); *In re Pressimone*, 11 C.B.C.2d 1059, 39 B.R. 240 (N.D.N.Y. 1984).

(n72)Footnote 65. *United States v. Energy Resources Co.*, 495 U.S. 545, 110 S. Ct. 2193, 109 L. Ed. 2d 580, 22 C.B.C.2d 1093 (1990).

(n73)Footnote 65a. *United States v. Prescription Home Health Care, Inc. (In the Matter of Prescription Home Health Care, Inc.)*, 316 F.3d 542 (5th Cir. 2002).

(n74)Footnote 65b. 783 F.2d 1546 (11th Cir. 1986).

(n75)Footnote 66. I.R.C. § 7421(a).

(n76)Footnote 67. *See, e.g., Baker v. Carr*, 369 U.S. 186, 82 S. Ct. 691, 7 L. Ed.2d 663 (1962).

(n77)Footnote 68. *See, e.g., United States v. Huckabee Auto Co.*, 783 F.2d 1546, 14 C.B.C.2d 483 (11th Cir. 1986); *Howard v. United States*, 711 F.2d 729 (5th Cir. 1983); *Datlof v. United States*, 252 F. Supp. 11 (E.D. Pa.1966), *aff'd*, 370 F.2d 655 (3d Cir. 1966), *cert. denied*, 387 U.S. 906, 87 S. Ct. 1688, 18 L. Ed. 2d 624 (1967); *Bloom v. United States*, 272 F.2d 215 (9th Cir. 1959), *cert. denied*, 363 U.S. 803, 80 S. Ct. 1236, 4 L. Ed. 2d 1146 (1960); *Bernardi v. United States*, 74-1 U.S.T.C. P 9170 (N.D. Ill. 1973), *aff'd*, 507 F.2d 682 (7th Cir. 1974); *In re Cadillac Recreation, Inc.*, 153 B.R. 824 (Bankr. C.D. Ill.), *aff'd*, 159 B.R. 244 (C.D. Ill. 1993).

Because the individual's liability is separate and distinct from the corporation's, bankruptcy courts lack "related to" jurisdiction to determine the tax liability of non-debtors. Sovereign immunity considerations also require this result. *United States v. Zellers (In re CNS, Inc.)*, 255 B.R. 198 (N.D. Ohio 2000).

(n78)Footnote 69. *Hornsby v. United States*, 588 F.2d 952 (5th Cir. 1979); *Kelly v. Lethert*, 362 F.2d 629 (8th Cir. 1966); *Datlof v. United States*, 370 F.2d 655 (3d Cir. 1966), *cert. denied*, 387 U.S. 906, 87 S. Ct. 1688, 18 L. Ed. 2d 624 (1967); *Cash v. Campbell*, 346 F.2d 670 (5th Cir. 1965).

(n79)Footnote 70. *See Simon v. Eastern Kentucky Welfare Rights Organization*, 426 U.S. 26, 96 S. Ct. 1917, 48 L. Ed. 2d 450 (1976); *Bowen Industries, Inc. v. United States*, 61 B.R. 61 (W.D. Tex. 1986); *In re Booth Tow Services, Inc.*, 53 B.R. 1014 (Bankr. W.D. Mo. 1985); *In re Arrow Transfer & Storage Co.*, 50 B.R. 726 (Bankr. E.D. Tenn. 1985) (rights of employees could not be asserted through the corporate bankruptcy case); *United States v. Rayson Sports, Inc.*, 44 B.R. 280 (Bankr. N.D. Ill. 1984); *In re Driscoll's Towing Service, Inc.*, 51 B.R. 990 (Bankr. S.D. Fla. 1985); *Pierce Coal and Construction, Inc. v. United States*, 49 B.R. 779 (Bankr. N.D. W. Va. 1985).

(n80)Footnote 71. Section 106 was amended by the Bankruptcy Reform Act of 1994, Pub. L. No. 103-394 effective as of the date of enactment, October 22, 1994. For a more complete discussion of the sovereign immunity defense in the context of bankruptcy court litigation against the United States, *see* chapter TX12 *supra*.

(n81)Footnote 72. *See In re American Bicycle Ass'n*, 895 F.2d 1277 (9th Cir. 1990); *In re LaSalle Rolling Mills, Inc.*, 832 F.2d 390, 17 C.B.C.2d 650 (7th Cir. 1987); *In re Becker's Motor Transp., Inc.*, 632 F.2d 242, 2 C.B.C.2d 1078 (3d Cir. 1980), *cert. denied*, 450 U.S. 916, 101 S. Ct. 1358, 67 L. Ed. 2d 341 (1981); *In re Condel, Inc.*, 19 C.B.C.2d 864, 91 B.R. 79 (B.A.P. 9th Cir. 1988); *In re John Renton Young, Ltd.*, 19 C.B.C.2d 238, 87 B.R. 635 (Bankr. D. Nev. 1988); *In re Success Tool and Mfg. Co.*, 62 B.R. 221 (Bankr. N.D. Ill. 1986); *Cambridge Machined Products Corp.*, 58 B.R. 22 (Bankr. D. Mass. 1985), *aff'd*, 87-2 U.S.T.C. (CCH) P 9649 (D. Mass. 1987); *In re Driscoll's Towing Service, Inc.*, 51 B.R. 990 (Bankr. S.D. Fla. 1985); *In re Arrow Transfer and Storage Co.*, 50 B.R.

726 (Bankr. E.D. Tenn. 1985) ; *In re Steel Products, Inc.*, 13 C.B.C.2d 1208, 53 B.R. 999 (Bankr. W.D. Wash.1984) .

(n82)Footnote 73. 11 U.S.C. § 101 provides that a "debtor" means any person or municipality concerning which a case under title 11 has been commenced.

(n83)Footnote 74. *See, e.g., Bob Jones University v. Simon*, 416 U.S. 725, 94 S. Ct.2038, 40 L. Ed. 2d 496 (1974)

(n84)Footnote 75. In *Enochs v. Williams Packing & Navigation Co.*, 370 U.S. 1, 82 S. Ct. 1125, 8 L. Ed. 2d 292 (1962) , the Court held that a taxpayer may obtain an injunction against tax collection only upon a showing that (i) under the most liberal view of the facts and law, the government cannot prevail on the issue of tax liability, or (ii) there exists an independent basis for equitable jurisdiction as a result of irreparable harm to the plaintiff and the inadequacy of any legal remedy. *Compare South Carolina v. Regan*, 465 U.S. 367, 104 S. Ct.1107, 79 L. Ed. 2d 372 (1984) (injunctive relief, under the right factual and legal circumstances, might be proper if there is no alternative means to challenge the tax liability).

(n85)Footnote 76. One court has held that as a result of this strategy, the two exceptions of the Supreme Court's opinion in *Enochs v. Williams Packing & Navigation Co.* are inapplicable. *See In re Pressimone*, 11 C.B.C.2d 1059, 39 B.R. 240(N.D.N.Y. 1984) .

(n86)Footnote 77. *See Bostwick v. United States*, 521 F.2d 741 (8th Cir.1975) .

(n87)Footnote 78. 521 F.2d 741 (8th Cir. 1975) .

(n88)Footnote 79. The Court of Appeals for the Eighth Circuit subsequently distinguished its holding in *Bostwick* from the case in which a nondebtor is the person being protected by the injunctive relief requested. *See A to Z Welding & Mfg. Co. v. United States*,803 F.2d 932 (8th Cir. 1986) .

(n89)Footnote 80. *See, e.g., In re American Bicycle Ass'n*, 895 F.2d 1277 (9th Cir.1990) ; *In re LaSalle Rolling Mills, Inc.*, 832 F.2d 390, 17 C.B.C.2d 650 (7th Cir. 1987) ; *In re Becker's Motor Transp., Inc.*, 632 F.2d 242, 2 C.B.C.2d 1078 (3d Cir. 1980) , *cert. denied*, 450 U.S. 916, 101 S. Ct.1358, 67 L. Ed. 2d 341 (1981) ; *In re Condel, Inc.*, 19 C.B.C.2d 864, 91 B.R. 79 (B.A.P. 9th Cir. 1988) ; *In re John Renton Young, Ltd.*, 19 C.B.C.2d 238, 87 B.R. 635 (Bankr. D. Nev. 1988) ; *In re Success Tool and Mfg. Co.*, 62 B.R. 221 (Bankr. N.D. Ill. 1986) ; *Cambridge Machined Products Corp.*, 58 B.R. 22 (Bankr. D. Mass. 1985) , *aff'd*, 87-2 U.S.T.C. (CCH) P 9649 (D. Mass. 1987); *In re Driscoll's Towing Service, Inc.*, 51 B.R. 990 (Bankr. S.D. Fla. 1985) ; *In re Arrow Transfer and Storage Co.*, 50 B.R. 726 (Bankr. E.D. Tenn. 1985) ; *In re Steel Products, Inc.*, 13 C.B.C.2d 1208, 53 B.R. 999 (Bankr. W.D. Wash.1984) .

(n90)Footnote 81. *See, e.g., In re William Netherly, Inc.*, 53 B.R. 856 (Bankr. M.D. Fla. 1985) ; *In re J.K. Printing Services, Inc.*, 49 B.R. 798 (Bankr. W.D. Va. 1985) ; *In re Datair Systems Corporation*, 42 B.R. 241(Bankr. N.D. Ill. 1984) ; *In re Major Dynamics, Inc.*, 5 C.B.C.2d 511, 14 B.R. 969 (Bankr. S.D. Cal. 1981) .

(n91)Footnote 82. For an example of such an agreement, *see P TX15.50 infra*.



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Collier on Bankruptcy Taxation

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CHAPTER TX15 Miscellaneous Tax Issues

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P TX15.03 Designation of Tax Payments in Cases Under Title 11

When payments are made by a trustee or other fiduciary pursuant to a confirmed plan under title 11, the issue raised is whether any payment made as a result of a legal proceeding in which the United States is seeking to collect delinquent taxes can be designated by the debtor in possession or the trustee when there is no collection activity by the IRS that converts the payment to an otherwise involuntary payment. Some courts have held that any payments made to the IRS pursuant to a case under title 11 are involuntary. n1 Other courts, however, have rejected this *per se* rule that the filing of a title 11 petition followed by the confirmation of a plan eliminates the possibility for the designation of voluntary payments to the IRS. n2

Prior to 1990, a conflict existed as to whether a debtor or a party connected to a debtor could designate how payments to the IRS would be applied to outstanding payroll tax liabilities. As an example, a debtor corporation may wish to designate its payments by directing the IRS to apply any payments first to the trust fund tax liability, which can also be collected for the "responsible persons" under *I.R.C. section 6672*, and then to the employer's matching FICA tax liability, which can only be collected from the corporate debtor. n2a This designation strategy has the benefit of liquidating the trust fund liability first resulting in a contemporaneous benefit to the responsible persons, usually members of the debtor's management, whose *I.R.C. section 6672* trust fund tax liability is simultaneously paid. n3

The IRS will only collect the unpaid trust fund tax liabilities one time. The designated payment of the trust fund tax liabilities through the employer's plan reduces the trust fund liability faster and thereby reduces the number of collection sources available to the IRS. The IRS will therefore oppose the designation of tax payments in title 11 cases to pay trust fund taxes first because the plan could be the method by which the employer's non-trust fund tax liabilities are paid. The responsible persons could then remain as alternative sources for the collection of the unpaid trust fund tax liabilities. This scenario maximizes the IRS's ability to collect all of the misappropriated trust fund tax liability and is motivated by the IRS's realization in many cases that confirmed plans fail, thus making it impossible to collect the nontrust fund tax liabilities. The IRS's concerns about failed plans leaving it with no opportunity to collect the nontrust fund taxes were ameliorated to some extent by the amendment of section 1129(a)(9)(C) in 2005 n3a to provide that deferred payments of priority claims could only be extended over a period of five years from the date the order for relief was entered. Previously, a period of six years from the date of assessment resulted in a longer period for the IRS to worry over the fate of the chapter 11 plan.

The dispute over the ability to designate tax payments to the IRS generally focused on two issues: (i) whether the

payment was voluntary or involuntary n4 and (ii) whether bankruptcy courts have the authority to order the IRS to apply payments received from a debtor in possession in a manner that is contrary to the IRS's procedures.

[1] *United States v. Energy Resources Co.*

The designated payment issue was resolved in 1990 by the Supreme Court in *United States v. Energy Resources Co.* n5 The Court held that payments made to the IRS by a debtor pursuant to a confirmed chapter 11 plan were involuntary payments. n6 The Court also held that a bankruptcy court has the authority to order the IRS to apply tax payments made by a chapter 11 debtor to offset trust fund obligations if the court finds the designation is necessary for a reorganization's success:

whether or not the payments at issue are rightfully considered to be involuntary, the bankruptcy court has the authority to order the IRS to apply the payments to trust fund liabilities if the bankruptcy court determines that this designation is necessary to the success of a reorganization plan. n7 This conclusion was based on the bankruptcy court's authority to rearrange debtor-creditor relationships pursuant to the broad equitable powers inherent in *Bankruptcy Code sections 105 and 1129(a)*. n8

[a] Court Must Decide if the Designation Provisions of a Plan are Necessary to a Successful Reorganization

To the extent the bankruptcy court must balance the interests of the debtor and the IRS, litigation will continue to be necessary to decide if the designation provisions of a plan are necessary to the successful reorganization of the debtor. n9 The debtor will be required to establish the designated payment to the trust fund liability is essential or necessary to the successful reorganization of the debtor.

[b] I.R.S. May Argue that Debtor's Plan is Not Feasible

The IRS will probably respond to a plan's designated payment provisions by arguing the plan is not feasible, *i.e.*, if the designation is necessary for plan success, then the debtor's financial health is too unstable to justify confirmation. n9a Additionally, the IRS may argue that the true motivation for a designation provision is the benefit derived to the debtor's officers, directors, and employees who have been assessed the 100% penalty pursuant to *I.R.C. section 6672*. n9b Similarly, attempts to obtain designation benefits by a nondebtor will continue to be opposed by the IRS. n10

The designation of tax payments in chapter 7 cases or in chapter 11 liquidating plans has generally been rejected by courts because the reorganization effort referred to by the court in *Energy Resources* cannot be enhanced by such a designation; at least one court of appeals has, however, allowed the designation of payments to the IRS in a chapter 11 liquidating plan. n11

However, in *In re Deer Park, Inc.*, n12 the court held that the "fact that Deer Park's chapter 11 plan was a liquidating plan does not abrogate the applicability of the holding in *Energy Resources*." The court allowed designation in a liquidating chapter 11 case and rejected the United States' view that a liquidating plan was not a reorganization:

Such a broad statement fails to recognize that a debtor's continuing participation in a planned, orderly liquidation may in fact be necessary to bring about the maximum recovery for the creditors, as opposed to the amount realized from a forced sale. The Bankruptcy Code recognizes this in section 1129(a)(11), by providing that liquidation may be contemplated in a valid chapter 11 plan of reorganization, despite the label "reorganization." Although the word "reorganization" might commonly bring to mind ongoing operations, Congress explicitly placed language providing for liquidation within chapter 11, which is titled "Reorganization." Had Congress not intended to include liquidation as an acceptable type of reorganization plan, then presumably all provisions dealing with liquidation would fall within chapter 7, which is specifically titled "Liquidation." We must therefore assume Congress placed this provision in chapter 11 intentionally. Liquidation under a chapter 11 plan is not the same as a

chapter 7 liquidation. A liquidation under chapter 11 allows the debtor in possession, one who is presumably more familiar with the assets of the debtor's organization and its respective values, the ability to plan for an orderly divestiture of the assets over time as opposed to a chapter 7 trustee, who is generally less familiar with the debtor's assets. A chapter 11 plan, even though a liquidating plan, must still conform to the same statutory requirements of any other chapter 11 reorganization. A liquidating plan is desirable when the debtor in possession can bring about a greater recovery for the creditors than would a straight liquidation under chapter 7. n13

The Bankruptcy Appellate Panel also concluded the designation of payment was necessary for the success of the liquidating plan. The fact the plan called for liquidation did not *per se* mean that the designation was not also necessary. The bankruptcy court found that the services of a former corporate officer were needed to ensure the officer's continued assistance with the liquidation of the debtor's assets. n14

[c] Designation of Payments Question Not Usually Present in Chapter 12 or 13 Cases

The designation of tax payments to liquidate a trust fund tax liability will generally not be present in a chapter 12 n14a or 13 case because there is no corporate debtor and the individual debtor is usually liable for all of the tax liability and not just the trust fund portion. n15 Nevertheless, a designation of how payments are to be paid in chapter 13 and other cases may be beneficial to a debtor for other reasons.

The designation of payments to the IRS pursuant to a confirmed chapter 11 or 13 plan of an individual can be beneficial to a taxpayer if the payments are applied only to the secured or nondischargeable portion of a tax liability. n16 If the IRS asserts a claim in a title 11 case which is only partially secured, the IRS will want to apply any payments received under a plan to the unsecured portion of the claim and any portion of the claim which is potentially dischargeable.

[i] Courts Hold that Payments Made Pursuant to Chapter 13 Plan are Involuntary

Courts that have discussed these issues have generally held that payments made pursuant to a chapter 13 plan are involuntary payments and can be allocated by the IRS to its claims that are not entitled to priority. n17 A few courts have specifically addressed a debtor's attempt to allocate the value of the IRS's collateral among the components of the IRS claim to convert penalties to general, unsecured claims. n18

[ii] "First In, First Out" Basis

In *United States v. Specialty Cartage, Inc.*, n19 the bankruptcy and district courts both held that the secured tax status of each year's tax liability, including interest and penalties, would be determined on a "first in, first out" basis. n20 The bankruptcy court looked at each year's assessment date, observed that each year's tax liability was a separate secured claim for all of the tax, interest and penalties, and then allocated all of the IRS's collateral to the earliest tax liability. n21 Any remaining collateral value was allocated to the tax, interest, and penalty liabilities (in that order) for later periods to the extent of the value of the remaining collateral. As a result, the taxpayer was unable to designate payments to the IRS and thereby convert otherwise secured penalty claims into general unsecured penalty claims. n22 In another situation, a debtor attempted to compel the IRS to apply an overpayment of income taxes to a prior year's liabilities which were nondischargeable instead of a still earlier year which was dischargeable. A court of appeals held that the voluntary payment rule permitting a taxpayer to designate payments did not apply to the application of overpayments. n23

FOOTNOTES:

(n1)Footnote 1. See, e.g., *In re Ribs-R-Us, Inc.*, 828 F.2d 199, 17 C.B.C.2d 1098 (3d Cir. 1987) ; *In re DuCharmes*

& Co., 852 F.2d 194, 19 C.B.C.2d 588 (6th Cir. 1988) ; *In re Technical Knockout Graphics*, 833 F.2d 797, 17 C.B.C.2d 1246 (9th Cir. 1987) ; *In re Avildsen Tools & Machines, Inc.*, 40 B.R. 253 (Bankr. N.D. Ill. 1984) , modified and *aff'd*, 794 F.2d 1248 (7th Cir. 1986) ; *In re Mr. Marvin, Inc.*, 48 B.R. 279 (Bankr. E.D. Mich. 1984) ; *In re Frost*, 12 C.B.C.2d 990, 42 B.R. 961 (D. Kan. 1985) .

(n2)Footnote 2. See, e.g., *A&B Heating and Air Conditioning, Inc.*, 823 F.2d 462, 17 C.B.C.2d 409 (11th Cir. 1987) , vacated and remanded for consideration of mootness, 486 U.S. 1002, 108 S. Ct. 1724, 100 L. Ed. 2d 189 (1988) ; *In re Frank Meador Buick*, 85 B.R. 392 (Bankr. W.D. Va. 1988) , rev'd, 123 B.R. 213 (Bankr. W.D. Va. 1989) , *aff'd per curiam*, 946 F.2d 885 (4th Cir. 1991) ; *In re B&P Enterprises, Inc.*, 67 B.R. 179 (Bankr. W.D. Tenn. 1986) . As discussed *infra*, however, the issue of voluntary versus involuntary payment status in the context of the bankruptcy issues raised in the *United States v. Energy Resources Co.*, 495 U.S. 545, 110 S. Ct. 2139, 109 L. Ed. 2d 580, 22 C.B.C.2d 1093 (1990) . The *Energy Resources* opinion, n.5 *infra*, was not ultimately determinative of the designation issue by the Supreme Court.

(n3)Footnote 2a. *Stevenson v. Internal Revenue Service (In re Diamond Dismantling Inc.)*, 305 B.R. 453 (Bankr. E.D. Mich. 2003) (if no designation is provided when the payment is made, the IRS may apply the payment in a manner serving its best interests).

(n4)Footnote 3. See *United States v. Sotelo*, 436 U.S. 268, 279 n.12, 98 S. Ct. 1795, 1802 n.12, 56 L. Ed. 2d 275, 285 n.12 (1978) .

(n5)Footnote 3a. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n6)Footnote 4. Outside of a title 11 case, only a "voluntary payment" can be designated by a taxpayer to be applied to a particular tax liability. See, e.g., *United States v. Transamerica*, 357 F. Supp. 743 (E.D. Va. 1973) ; *O'Dell v. United States*, 326 F.2d 451 (10th Cir. 1964) . Involuntary payments can be applied by the IRS according to its existing policies and procedures. *Liddon v. United States*, 448 F.2d 509, 513 (5th Cir. 1971) , cert. denied, 406 U.S. 918, 92 S. Ct. 1769, 32 L. Ed. 2d 117 (1972) ; *United States v. De Beradinis*, 395 F. Supp. 944, 952 (D. Conn. 1975) , *aff'd per curiam*, 538 F.2d 315 (2d Cir. 1976) ; *Rev. Rul. 79-284*, 1979-2 C.B. 83 , modifying, *Rev. Rul. 73-305*, 1973-2 C.B. 43 . In order to preserve its ability to collect the trust fund tax liabilities from the responsible persons if the corporation is unable to pay them, it is the policy of the IRS to apply a partial payment to satisfy nontrust fund tax liabilities first if no designation instructions accompany a payment. Policy Statement P-5-60, *Rev. Rul. 79-284*, 1979-2 C.B. 83 , modifying *Rev. Rul. 73-305*, 1973-2 C.B. 43 , superseding *Rev. Rul. 58-239*, 1958-1 C.B. 94 . An involuntary payment includes any payment received by the IRS as a result of distraint or levy or from a legal proceeding in which the United States is seeking to collect delinquent taxes or file a claim therefor. *Amos v. Commissioner*, 47 T.C. 65, 69 (1966) . Note: The rule permitting a taxpayer to designate how a voluntary payment will be applied does not extend to designating the application of overpayments of income taxes for one year to other liabilities. *In re Ryan*, 64 F.3d 1516 (11th Cir. 1995) ; *Kiesner v. Internal Revenue Service (In re Kiesner)*, 194 B.R. 452 (Bankr. E.D. Wis. 1996) .

(n7)Footnote 5. *United States v. Energy Resources Co.*, 495 U.S. 545, 110 S. Ct. 2139, 109 L. Ed. 2d 580, 22 C.B.C.2d 1093 (1990) . *Energy Resources* involved two chapter 11 cases from the First Circuit: *In re Energy Resources, Inc.*, 59 B.R. 702 (Bankr. D. Mass. 1986) , *aff'd*, 871 F.2d 223 (1st Cir. 1989) , and *In re Newport Offshore, Ltd.* 75 B.R. 919 (Bankr. D.R.I. 1987) , *aff'd*, 871 F.2d 223 (1st Cir. 1989) . In *Energy Resources*, the confirmed plan did not provide for the designation of payments to be made to the IRS. After tax payments had been made to the IRS, the trustee under the confirmed plan asked the court to compel the IRS to allocate the payments and apply them to the trust fund tax liability. In *Newport Offshore, Ltd.*, the plan specifically provided for the application of all postconfirmation tax payments to the trust fund tax liability until that liability was paid.

(n8)Footnote 6. See, e.g., *Internal Revenue Service v. Energy Resources Co., Inc. (In re Energy Resources Co.)*,

Inc.), 871 F.2d 223, 230, 20 C.B.C.2d 1552 (1st Cir.1989) and the cases discussed therein. This portion of the First Circuit's opinion was affirmed by the Supreme Court.

(n9)Footnote 7. *United States v. Energy Resources Co.*, 495 U.S. 545, 548-49, 110 S. Ct.2139, 2141-42, 109 L. Ed. 2d 580, 585-86, 22 C.B.C.2d 1093, 1095-96 (1990) .

(n10)Footnote 8. *United States v. Energy Resources Co.*, 495 U.S. 545, 548-49, 110 S. Ct.2139, 2141-42, 109 L. Ed. 2d 580, 585-86, 22 C.B.C.2d 1093, 1095-96 (1990) . The limits of that authority were considered by the *Court of Appeals for the Third Circuit in IRS v. Kaplan (In re Kaplan)*, 104 F.3d 589, 37 C.B.C.2d 421 (3d Cir. 1997) . In *Kaplan*, two brothers filed chapter 11 cases which were consolidated. They asked the bankruptcy court to order the IRS to allocate previously undesignated payments made while they were in chapter 11 to the trust fund portion of their corporation's liability. The bankruptcy court agreed, but the district court reversed. The brothers then had their corporation file a chapter 11 case and immediately asked for an allocation of the payments they had previously made to the trust fund taxes. Once again, they succeeded in the bankruptcy court but failed in the district court. Their appeals from both of the district court orders were consolidated in the Third Circuit which affirmed the district court in both cases. The court of appeals held that the brothers' individual cases did not provide the bankruptcy court with authority to order an allocation to trust fund taxes pursuant to *Energy Resources* since they were not the taxpayer. Section 105 did not create substantive rights and was not availing. As for the corporate case, the payments had been made prepetition and could not be reallocated retroactively. The court also noted that the request for a reallocation in the corporate case was made before a plan of reorganization had even been proposed.

(n11)Footnote 9. The Working Group on Taxes and Employee Benefits to the National Bankruptcy Conference has recommended that the Bankruptcy Code be amended to address the designation issue raised in *Energy Resources*. That Group's proposals would include: (i) the amendment of 11 U.S.C. § 505(a) to empower bankruptcy courts to enjoin the IRS's efforts to collect trust fund taxes from responsible persons when doing so enhances the debtor's successful reorganization and (ii) the amendment of 11 U.S.C. § 505 to add a provision which permits the debtor to allocate payments made to the IRS in a title 11 plan unless the bankruptcy court, for equitable reasons, determines that such designation is inappropriate. For another critical discussion of *Energy Resources*, see Bernsley, *Energy Resources and Tax Payment Allocation: The Continuing Need to Correct the Analytical Failures of Recent Precedent*, 21 Cal. Bankr. J. 101 (1993). A particularly thorough consideration of the issues raised when a request of an *Energy Resources* allocation of plan payments is made can be found in the district court's opinion in *In re F.G. Metals, Inc.*, 2008 U.S. Dist. LEXIS 111451 (M.D. Fla. Sept. 4, 2008).

(n12)Footnote 9a. *Haas v. United States (In re Haas)*, 162 F.3d 1087 (11th Cir.1998) .

(n13)Footnote 9b. *In re Laminating, Inc.*, 148 B.R. 259 (Bankr. S.D. Tex.1992) .

(n14)Footnote 10. See, e.g., *In re Leonard*, 132 B.R. 226 (Bankr. D. Conn.1991) (a nondebtor was jointly liable with the debtor for an I.R.C. § 6672 liability requested the bankruptcy court to allocate the distributions from the debtor's estate to the trust fund tax liability first; the bankruptcy court refused to grant the requested designation because the court did not have the authority under title 11 to allocate distributions in a manner which would benefit a nondebtor). Accord *In re Sotir*, 978 F.2d 29 (1st Cir. 1992) .

(n15)Footnote 11. See, e.g., the following cases holding that designation is not appropriate in liquidation cases; *In re Kare Kemical, Inc.*, 935 F.2d 243 (11th Cir. 1991) ; *In re Equipment Fabricators, Inc.*, 127 B.R. 854 (D. Ariz. 1991) ; *In re Arie Enterprises, Inc.*, 116 B.R. 641 (Bankr. N.D. Ill. 1990) ; *In re Poleshuk*, 115 B.R. 716 (Bankr. N.D. Fla. 1990) ; and *In re Looking Glass, Ltd.*, 113 B.R. 463 (Bankr. D. Ill. 1990) ; *In re Tillery Mechanical Contractors, Inc.*, 319 B.R. 695 (Bankr. S.D. Ala. 2004) ; *United States v. BTJ, Inc.*, 99 A.F.T.R.2d 2006-7172 (S.D. Fla. 2006) .

(n16)Footnote 12. 136 B.R. 815 (B.A.P. 9th Cir. 1992) , *aff'd*, 10 F.3d 1478(9th Cir. 1993) .

(n17)Footnote 13. *In re Deer Park, Inc.*, 136 B.R. 815, 818 (B.A.P. 9th Cir. 1992) , *aff'd*, 10 F.3d 1478 (9th Cir.

1993).

(n18)Footnote 14. A bankruptcy court reached a similar result in the case of *In re 20th Century Enterprises, Inc.*, 94-2 U.S. Tax Cas. (CCH) P 50,561 (Bankr. N.D. Miss.1994). Subsequently, the Third Circuit concluded that the "vast majority" of courts that have addressed the issue of the scope of the *Energy Resources* decision have declined to extend its application beyond the chapter 11 reorganization context. *United States v. Pepperman*, 976 F.2d 123 (3d Cir. 1992). The Tenth Circuit has also taken a narrow view of *Small Business Admin. v. Preferred Door Co. (In re Preferred Door Co.)*, 990 F.2d 547 (10th Cir. 1993). *Preferred Door* was later relied upon by the Eleventh Circuit. *Haas v. United States (In re Haas)*, 162 F.3d 1087 (11th Cir. 1998). Another court denied a request by a corporate debtor to designate payments to satisfy its trust fund tax liability first in a liquidating plan because such an allocation would merely reduce the responsible persons' liability and would be of no benefit to the debtor. *In the Matter of Visiting Nurse Association of Tampa Bay, Inc.*, 128 B.R. 835 (Bankr. M.D. Fla. 1992). A bankruptcy court's decision to compel allocation of payments to trust fund taxes first was reversed in the case of *In re Suburban Motor Freight, Inc.*, 94-1 U.S. Tax Cas. (CCH)P 50,054 (S.D. Ohio 1993). Bankruptcy courts have relied upon *Energy Resources* in compelling designation of payments for postpetition taxes to be applied to trust fund taxes first in the context of a liquidating plan. See, e.g., *Compass Marine Services, Inc. v. United States (In re Compass Marine Services, Inc.)*, 276 B.R. 765 (Bankr. E.D. La. 2002) (the president of a chapter 7 debtor corporation could not compel the IRS to use payments from the debtor to satisfy trust fund taxes first); *In re Poydras Manor, Inc.*, 242 B.R. 603 (Bankr. E.D. La. 2000); *In re Flo-Lizer, Inc.*, 164 BR. 749 (Bankr. S.D. Ohio 1993), *aff'd*, 94-1 U.S. Tax Cas.(CCH) P 50,154 (S.D. Ohio 1994); *Venettis v. United States*, 132 B.R. 720 (E.D. Mich. 1991).

(n19)Footnote 14a. Chapter 12, which expired on January 1, 2004, was extended until July 1, 2005 by Pub. L. No. 108-369, *reprinted in* Vol. F Collier on Bankruptcy, App. Pt. 41(u)(ii) (Matthew Bender 15th Ed. Revised).

(n20)Footnote 15. The chapter 13 debtors could not require that payments made to the IRS in a related corporation's chapter 7 case be applied first to trust fund taxes. *In re Simms*, 177 B.R. 537 (Bankr. N.D. Ohio 1995).

(n21)Footnote 16. See, e.g., *Neier v. United States*, 127 B.R. 669 (D. Kan.1991) (IRS could allocate payments received under a confirmed corporate plan to penalties and interest thereby leaving the trust fund liability fully collectible from the responsible persons of the corporation). See also *In re Ramos*, 93-1 U.S.T.C. (CCH) P 50,069 (Bankr. M.D. Fla. 1992).

(n22)Footnote 17. See, e.g., *In re Mikrut*, 79 B.R. 404, 407 (Bankr. W.D. Wis.1987); *In re Junes*, 17 C.B.C.2d 1243, 76 B.R. 795 (Bankr. D. Or. 1987), *aff'd*, 99 B.R. 978 (B.A.P. 9th Cir. 1989).

(n23)Footnote 18. See, e.g., *In re Divine*, 127 B.R. 625 (Bankr. D. Minn.1991); *United States v. Specialty Cartage, Inc.*, 113 B.R. 484 (N.D. Ind.1990). The designation of tax payments issue was not the contested problem in these cases, but the issue is important because the manner in which the components of an IRS claim are allocated, if possible, between secured and unsecured claims will control the manner in which payments under a plan will be applied. The debtor in *Specialty Cartage* requested the court to allocate the IRS's secured status first to the principal and interest liabilities for each tax period and only thereafter to any accrued penalties for each year. This argument, if accepted by the court, would have reduced the secured claims the debtor was required to include in the plan, and it increased the general unsecured claims that would only be partially paid and then discharged. See also *Bates v. United States (In re Bates)*, 974 F.2d 1234 (10th Cir. 1992).

(n24)Footnote 19. *United States v. Specialty Cartage, Inc.*, 113 B.R. 484 (N.D. Ind.1990).

(n25)Footnote 20. The importance of this "first in, first out" classification is important. Dischargeable income tax liabilities secured by a recorded tax lien may be dischargeable, but the tax lien will not be dischargeable. See chapter TX11 *supra*. Thus, a debtor may argue that it is in the best interests of the estate, creditors, and the confirmation of the plan that the collateral value of assets be allocated in a manner that will reclassify the dischargeable debts, at least the

penalty portion thereof, to general unsecured status. This argument is based upon the holding in *United States v. Energy Resources Co.*, 495 U.S. 545, 110 S. Ct. 2139, 109 L. Ed. 2d 580, 22 C.B.C.2d 1093(1990) , and cases in which courts have approved the subordination of tax penalties. See, e.g., *In re Virtual Network Services, Corp.*, 902 F.2d 1246, 22 C.B.C.2d 1667 (7th Cir. 1990) , and *Schultz Broadway Inn v. United States*, 912 F.2d 230 (8th Cir. 1990) . Compare, however, *In re Burden*, 917 F.2d 115, 24 C.B.C.2d 187 (3d Cir. 1990) . See chapter TX5 *supra* for a discussion of tax claim subordination.

(n26)Footnote 21. *United States v. Specialty Cartage, Inc*, 115 B.R. 164 (Bankr. N.D. Ind.1989) .

(n27)Footnote 22. See also *In re Seneca Balance, Inc.*, 114 B.R. 378 (Bankr. W.D.N.Y. 1990) which followed the decision in *Specialty Cartage*.

(n28)Footnote 23. *In re Ryan*, 64 F.3d 1516 (11th Cir. 1995) .



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CHAPTER TX15 Miscellaneous Tax Issues

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P TX15.04 Deductibility of Professional Fees by Chapter 11 Debtors

Cases under chapter 11 of the Bankruptcy Code frequently involve a number of professionals who may be paid from the bankruptcy estate. The large number of professionals often encountered in these cases is in part a function of the purpose of chapter 11 to allow a business to continue operating while an acceptable plan of reorganization is formulated to provide for the payment of its debts. Debtors seeking reorganization under the provisions of chapter 11 may, with permission of the bankruptcy court and pursuant to *section 327 of the Code*, employ one or more attorneys, accountants, appraisers, investment bankers, or other professional persons. Pursuant to section 330, subject to approval by the bankruptcy court, the professionals representing the debtor may be compensated by the bankruptcy estate.

Unlike other types of cases under title 11, in reorganization cases under the provisions of chapter 11, a bankruptcy court may authorize the appointment of committees to represent the interests of creditors and equity security holders, in addition to the committee of unsecured creditors required to be appointed pursuant to section 1102. The Bankruptcy Code permits the appointment of multiple committees; however, many bankruptcy courts have become cautious about the number of committees which will be allowed in a case because of concerns about the additional expenses entailed. Section 1102 also includes an expedited procedure for the reorganization of small businesses. Section 1102(a)(3) states that "on request of a party in interest" in such a case, "the court may order that a committee of creditors not be appointed."

The Bankruptcy Code permits committees to play a large number of roles in the administration of a case under chapter 11. Pursuant to *section 1103(a), of the Code*, a committee in a case under chapter 11 may:

- (1) consult with the trustee or debtor in possession concerning the administration of the case;
- (2) investigate the acts, conduct, assets, liabilities, and financial condition of the debtor, the operation of the debtor's business and the desirability of the continuance of such business, and any other matter relevant to the case or to the formulation of a plan;
- (3) participate in the formulation of a plan, advise those represented by such committee of such committee's determinations as to any plan formulated, and collect and file with the court acceptances or rejections of a plan;
- (4) request the appointment of a trustee or examiner under section 1104 of this title; and

(5) perform such other services as are in the interest of those represented. n2 These committees, with bankruptcy court approval, may also employ various professionals to represent them.

[1] If Professional Fees Not Deductible, They Must be Capitalized

Obviously, the larger the number of professionals a bankruptcy court authorizes to be retained to represent the debtor and any committees, the larger the expense of these professionals that must be paid by the bankruptcy estate. If these expenses may be deducted as ordinary and necessary business expenses, the tax savings which result would alleviate some of the drain on the bankruptcy estate. n3 On the other hand, if these expenses do not qualify for deduction, then they must be capitalized. n4

Prior to the enactment of the Bankruptcy Code, it was clear that the professional fees incurred by a debtor with respect to the institution and administration of a reorganization proceeding were not deductible and had to be capitalized. n5 Nevertheless, the broader question of when expenses might be deducted as ordinary and necessary business expenses and when they had to be capitalized had been a fertile ground for litigation for many years. n6 With the enactment of the Bankruptcy Code, some debtors were prompted to assert that the nature of reorganizations under the new chapter 11 provisions had so fundamentally changed that all of the fees paid to their professionals qualified for a deduction. n7

[2] Bankruptcy Court Held Professional Fees Generally Not Deductible

After analyzing the requirements imposed by the Internal Revenue Code for deducting ordinary and necessary business expenses, the bankruptcy court in the case of *In re Placid Oil Co.* n8 rejected the debtor's argument that chapter 11 had become a common business practice. The bankruptcy court also rejected the contention that the debtor had to experience a reorganization as defined by *I.R.C. section 368* before capitalization was required. n9 Having held that professional fees and expenses related to the administration of the case under title 11 could not be deducted, the bankruptcy court in *Placid Oil* turned to another question. Were some of the professional fees and expenses paid by the bankruptcy estate ones which would have been incurred by the debtor irrespective of its case under title 11, such as fees for the litigation of state court cases and general accounting services like an annual audit? The government had not disputed the availability of a deduction for operations expenses. n10 The dispute was over the allocation of expenses to deductible and nondeductible categories. In this particular case, however, the bankruptcy court concluded that the debtor was unable to provide a plausible basis for allocating between fees and expenses which had to be capitalized and those available for deduction; consequently no deduction was allowed. n11

[3] Fifth Circuit Held I.R.S. Had Burden of Proving Nondeductibility

It is significant that the bankruptcy court explicitly denied any deduction for the fees paid to the professionals employed to represent the unsecured creditors' committee or fees paid to the United States trustee since they were principally related to the bankruptcy restructuring and were therefore capital expenses. n12 However, the Court of Appeals for the Fifth Circuit subsequently reversed and remanded. n13 The court of appeals viewed the issue primarily as one relating to the burden of proof, and concluded that the courts below had erred in holding that the debtor had failed to rebut the *prima facie* case established by the IRS's proof of claim. When the Court of Appeals for the Fifth Circuit reached its decision in 1993, the issue of which party had the burden of proof in tax disputes litigated in a bankruptcy court was unclear, although that court had previously held that the burden would be placed upon a state tax authority. Thus, applying the established Fifth Circuit view, n14 the court held that the bankruptcy court should require the IRS to prove which portions of the fees paid by the debtor did not qualify for deduction or for amortization. n15 The court of appeals noted in its opinion that the debtor had admitted that it was unable to establish the precise amounts of the fees it sought to deduct.

[4] Subsequent Supreme Court Decision on Burden of Proof Invalidates Fifth Circuit View

In wake of the Fifth Circuit's disposition of the deductibility of professional fees by placing the burden of proof on the

IRS, considerable uncertainty existed, although another bankruptcy court has resolved a virtually identical issue in favor of the Internal Revenue Service. n16

Seven years after the Fifth Circuit's decision in *Placid Oil*, a unanimous Supreme Court resolved the issue of which party had the burden of proof when a tax controversy was litigated in a bankruptcy court by holding that it would be placed upon the debtor or the trustee. n17 Accordingly, the rationale for the Fifth Circuit's disposition of the matter is no longer viable. In any event, in order to substantiate which fees do qualify for deduction as being unrelated to the administration of the case under title 11, the prudent debtor will insist upon sufficient detail in the invoices from all of the professionals whose fees it must pay to identify the deductible portions of those fees. n18

FOOTNOTES:

(n1)Footnote 1. The affairs of a debtor in a case under chapter 11 may be conducted by a trustee or by the debtor itself as a "debtor in possession." *See 11 U.S.C. §§ 1101(1), 1107.* Unless otherwise indicated by the text, for present purposes the term "debtor" will be understood to include either a debtor being operated by a trustee or by a debtor in possession.

(n2)Footnote 2. *11 U.S.C. § 1103(c).* In addition, § 1109(b) includes committees among the parties granted a "right to be heard" on "any issue in a case under this chapter."

(n3)Footnote 3. A taxpayer is permitted to take a current deduction for ordinary and necessary business expenses by *I.R.C. § 162(a).*

(n4)Footnote 4. *See generally I.R.C. § 263.*

(n5)Footnote 5. *International Bldg. Co. v. United States*, 97 F. Supp. 595 (E.D. Mo. 1951) , *aff'd in part, reversed in part*, 199 F.2d 12 (8th Cir. 1952) , *rev'd on other grounds*, 345 U.S. 502, 73 S. Ct. 807, 97 L. Ed. 1182 (1953) ; *Denver & Rio Grande Western Railroad Co. v. Commissioner*, 38 T.C. 557 acq. (1962); *Bush Terminal Building Company v. Commissioner*, 7 T.C. 793 , acq., *Rev. Rul. 77-204*, 1977-1 C.B. 40 .

(n6)Footnote 6. *See, e.g., Welch v. Helvering*, 290 U.S. 111, 54 S. Ct. 8, 78 L. Ed. 212 (1933) ; *Deputy v. du Pont*, 308 U.S. 488, 60 S. Ct. 363, 84 L. Ed. 416 (1940) ; *Commissioner v. Lincoln Savings & Loan Ass'n*, 403 U.S. 345, 91 S. Ct.1893, 29 L. Ed. 2d 519 (1971) .

(n7)Footnote 7. *See In re Placid Oil Company*, 140 B.R. 122 (Bankr. N.D. Tex. 1990) , *aff'd*, 148 B.R. 464 (N.D. Tex. 1991) , *rev'd and remanded*, 988 F.2d 554 (5th Cir. 1993) .

In a unique case, a corporation capitalized a number of professional fees incurred in a Chapter 11 proceeding. Subsequently, it ceased operations, filed a second bankruptcy proceeding, and liquidated. The formerly capitalized professional fees became deductible, but the net operating loss the deduction produced could not be carried back to a year in which it would generate a refund under the usual three-year rule. *26 U.S.C. § 172(b)(1)(A).* A ten-year carry back period was permitted for certain "specified liability losses." *26 U.S.C. § 172(b)1(C).* It was held that professional fees incurred by the debtor and a creditors' committee in the Chapter 11 proceeding did not qualify as a specified liability loss because--at the time the services were rendered--the fees remained subject to review and approval by the bankruptcy court. *Standard Brands Liquidating Creditor Trust v. United States*, 53 Fed. Cl. 25 (2002) .

(n8)Footnote 8. *See In re Placid Oil Company*, 140 B.R. 122 (Bankr. N.D. Tex. 1990) , *aff'd*, 148 B.R. 464 (N.D. Tex. 1991) , *rev'd and remanded*, 988 F.2d 554 (5th Cir. 1993) .

(n9)Footnote 9. *See In re Placid Oil Company*, 140 B.R. 122 (Bankr. N.D. Tex.1990) , *aff'd*, 148 B.R. 464 (N.D.

Tex. 1991), *rev'd and remanded*, 988 F.2d 554 (5th Cir. 1993). In concluding that a debtor was not required to undergo a reorganization as defined by I.R.C. § 368 before capitalization of its chapter 11 professional expenses was required, the bankruptcy court relied in part upon *National Starch & Chemical Corp. v. Commissioner*, 93 T.C. 67 (1989). On appeal, the Tax Court's decision was affirmed. See *National Starch & Chemical Corp. v. Commissioner*, 918 F.2d 426 (3d Cir. 1990), *aff'd sub. nom. Indopco Inc. v. Commissioner*, 503 U.S. 79, 112 S. Ct. 1039, 117 L. Ed. 2d 226 (1992).

(n10)Footnote 10. See *Rev. Rul. 77-204, 1977-1 C.B. 40*. After the decision by the bankruptcy court in *Placid*, the Internal Revenue Service issued Technical Advice Memorandum 92-04-001 (May 13, 1991) which expressly allowed a debtor to deduct professional fees which were not related to the administration of the case under title 11. Some years after *Placid* and *INDOPCO* were decided, the Service issued a regulation explaining which types of expenses incurred during a Chapter 11 proceeding had to be capitalized and which ones could be deducted. Expenses related to instituting and administering the Chapter 11 case must be capitalized; expenses related to the resolution of claims that would have been incurred outside of the bankruptcy and those related to running the business itself may be deducted. 26 C.F.R. § 1.263(a)-5(c)(4).

(n11)Footnote 11. *In re Placid Oil Company*, 140 B.R. 122, 127 (Bankr. N.D. Tex.1990), *aff'd*, 148 B.R. 464 (N.D. Tex. 1991), *rev'd and remanded*, 988 F.2d 554 (5th Cir. 1993). For cases holding that a taxpayer must bear the burden of allocating which portions of expenses are capital and which portions are deductible or lose the deduction entirely, see *Frankford-Quaker Grocery Co. v. United States*, 353 F. Supp. 93(E.D. Pa. 1972); *Suckow Borax Mines Consol. v. Commissioner*, 12 T.C.M. (CCH) 786 (1953) T.C.M. (P-H) P 53,244 (1953); *Peaslee-Gaulbert Co. v. Commissioner*, 14 B.T.A. 769 (1928).

(n12)Footnote 12. See *In re Placid Oil Company*, 140 B.R. 122 (Bankr. N.D. Tex.1990), *aff'd*, 148 B.R. 464 (N.D. Tex. 1991), *rev'd and remanded*, 988 F.2d 554 (5th Cir. 1993). The Fifth Circuit did not address the issue of whether a debtor should be permitted to deduct the fees paid to professionals representing the unsecured creditors.

(n13)Footnote 13. See *In re Placid Oil Company*, 140 B.R. 122 (Bankr. N.D. Tex. 1990), *aff'd*, 148 B.R. 464 (N.D. Tex. 1991), *rev'd and remanded*, 988 F.2d 554 (5th Cir. 1993).

(n14)Footnote 14. See P TX5.03[5] *supra*. In *Placid Oil*, the Court of Appeals for the Fifth Circuit simply relied upon its earlier decision in the case of *In re Fidelity Holding Co., Ltd.*, 837 F.2d 696 (5th Cir. 1988), and did not discuss the contrary views of three other circuits.

(n15)Footnote 15. The issue of whether some portion of the fees paid by the debtor was a capital expenditure which might be amortized had not been raised when the bankruptcy court reached its decision, although that court did reject the debtor's attempt to raise it subsequently. Even though the Court of Appeals for the Fifth Circuit stated that some portion of the professional fees might be subject to amortization, it offered no guidance with respect to such things as the period of amortization. It should also be noted that the professional fees in dispute in *Placid Oil* were incurred during years prior to confirmation of the plan of reorganization. The Fifth Circuit did not explain how expenses paid before any restructuring of the debt had been accomplished through confirmation of the plan could be amortized in those preconfirmation years.

(n16)Footnote 16. The government requested a rehearing *en banc* by the Fifth Circuit in *Placid Oil* which was denied. *In re Placid Oil Co.*, 4 F.3d 992 (5th Cir.1993). Six years later, a bankruptcy court ruled that similar expenses were capital in nature and could not be deducted. Curiously, *Placid* was never mentioned in the opinion, perhaps because the allocation of expenses between capital and deductible portions does not appear to have been an issue. *Hillsborough Holdings Corporation v. United States (In re Hillsborough Holdings Corporation)*, 1999 Bankr. LEXIS 445 (April 7, 1999). In a subsequent opinion, the bankruptcy court amplified its earlier decision and held that the fees incurred by a creditors' committee were essentially unique to the bankruptcy process and were not deductible. It then differentiated between fees that the debtor itself would have incurred in normal operations which were deductible and

those unique to the bankruptcy proceeding which had to be capitalized. *Hillsborough Holdings Corporation v. United States (In re Hillsborough Holdings Corporation)*, 295 B.R. 679 (Bankr. M.D. Fla. 2003) .

(n17)Footnote 17. *Raleigh v. Illinois Department of Revenue*, 530 U.S. 15, 120 S. Ct. 1951, 147 L. Ed.2d 13, 43 C.B.C.2d 861 (2000) .The details of the burden of proof issue in a claims objection and in a determination of tax liability by a bankruptcy court are discussed at PPTX5.03[5] and TX5.04[6] *supra* .

(n18)Footnote 18. On January 30, 1996, the Executive Office for United States Trustees issued "Revised Guidelines for Reviewing Applications for Compensation and Reimbursement of Expenses Filed Under 11 U.S.C. § 330." These Guidelines were adopted pursuant to 28 U.S.C. § 586(a)(3)(A), as amended by the Bankruptcy Reform Act of 1994. The 1994 Act directed the United States Trustees to review, whenever they consider it appropriate, applications filed for compensation and reimbursement under section 330 in accordance with procedural guidelines. The Guidelines will be uniformly applied by all United States Trustee personnel unless the United States Trustee determines that circumstances warrant different treatment. This proposal includes "Project Categories" which would require professionals to delineate the purposes for which certain types of services were rendered. To the extent this proposal becomes effective, it may result in greater specificity and make proper allocation between capital and deductible fees an easier task.



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CHAPTER TX15 Miscellaneous Tax Issues

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P TX15.05 Tax Accrual of Postpetition Interest

[1] Taxes Accrue on Debts Even if Ultimate Payment in Question

The continued accrual for tax deduction purposes of postpetition interest on prepetition indebtedness is supported by judicial authority. Several cases hold that deductible interest properly accrues on debt even though ultimate payment may be in question due to the taxpayer's poor financial condition. The accrual of deductible interest must be distinguished from the payment of interest and the classification of creditors' rights to distributions under the Bankruptcy Code.

[2] Authorities Addressing Deductibility When Payment Is Uncertain

[a] Eighth Circuit Allows Deductibility

The leading case on the issue of the accrual and deduction of interest by financially troubled companies is *Zimmerman Steel Co. v. Commissioner*.ⁿ¹ The Court of Appeals for the Eighth Circuit, reversing the Board of Tax Appeals, held that a taxpayer who is on the verge of bankruptcy may accrue and deduct interest accumulated on outstanding debt regardless of doubts that such interest would ever be paid due to the taxpayer's financial condition. The court of appeals in *Zimmerman Steel* stated the rule concerning the accrual and deduction of interest as follows:

[W]here interest actually accrues on a debt of a taxpayer in a tax year the statute plainly says he may deduct it. That he has no intention or expectation of paying it, but must go into bankruptcy as this taxpayer was obliged to do, can not of itself justify denial of deduction in computing the taxpayer's net income.ⁿ²

[b] Tax Court Standards are More Restrictive

The standards applied by the Tax Court for determining when interest is to be accrued appear to be more restrictive, however, than the *Zimmerman Steel* rule. In *Cohen v. Commissioner*,ⁿ³ the Tax Court summarized the rule as follows:

[D]eductions for accrued interest are proper where it can not be "categorically said at the time these deductions are claimed that the interest would not be paid, even though the course of conduct of the parties indicated that the likelihood of payment of any part of the disallowed portion was extremely

doubtful." n4

The determination of the appropriateness of the interest deduction, therefore, depends on the extent to which there is a reasonable expectation that the payments will be made and thus cannot be made without an analysis of the particular taxpayer's circumstances. n5

[c] Fifth Circuit Also Allows Deductibility

The deduction of interest accruing after the filing of a case under title 11 was specifically addressed by the Court of Appeals for the Fifth Circuit in *Fahs v. Martin* n6 and decided in the taxpayer's favor. The Internal Revenue Service in *Rev. Rul.70-367* n7 permitted accrual and deduction of interest notwithstanding doubt as to its payment since that doubt constituted a contingency that did not suspend accrual of the obligation to pay the interest. n8

[d] One District Court Disallows Such Deduction

In re Continental Vending Machine Corp. n9 represents the contrary judicial authority. In that case, the district court held that postpetition interest was not properly deductible by a corporation in a proceeding under Chapter X of the Bankruptcy Act. The district court concluded that the debtor was hopelessly insolvent and that the payment of interest was therefore contingent. *Continental Vending* should be viewed as a case in which it had been determined that the postpetition interest would not be paid as a result of the operation of the Bankruptcy Act. The same court that would make that bankruptcy law decision (*i.e.*, whether postpetition interest would be deductible) rendered the reported decision on the claim for tax accrual of postpetition interest, and the proposed plan, although not confirmed, did not provide for satisfaction of postpetition interest. The *probability* of payment was so slight that perhaps, even under the Tax Court's view of *Zimmerman Steel*, the interest expense was not accruable.

Continental Vending should be viewed, together with the authority in the Tax Court, as establishing the rule that, in cases in which payment of an obligation is improbable (bordering on impossible) due to either insolvency or bankruptcy of the obligor, deduction of accrued interest is not permitted. n9a However, *Fahs* and *Zimmerman Steel* stand for the proposition that such improbability does not prevent accrual. n10

[3] Applicability of Bankruptcy Code section 502(b)(2)

Section 502(b)(2) of the Bankruptcy Code is often cited for the proposition that postpetition interest is not allowed in bankruptcy. n11 However, this is too simplistic a statement of the general rule.

[a] Interplay of section 726(a)(5) and Distribution Under section 1129(a)(7)(A)(ii)

The general rule is a rule of distribution requiring that unsecured prepetition claims be paid before the accrued postpetition interest. Section 1129(a)(7)(A)(ii) is one of the enumerated requirements in the Bankruptcy Code that must be met in order for the bankruptcy court to confirm a plan of reorganization. In general, it requires that each impaired creditor receive under the plan on account of its claim property of a value that is not less than the creditor would have received if the debtor were liquidated under chapter 7. Thus, in the case of a solvent debtor, under the "best interest of creditors test" reflected in *section 1129(a)(7)(A)(ii) of the Bankruptcy Code*, the provisions of *section 726(a)(5) of the Bankruptcy Code* (which provides that in a liquidation under chapter 7, the fifth priority of distribution is interest at the legal rate from the filing of the petition on any creditor claims) take precedence. n11a This principle was recognized by the courts prior to the enactment of the Bankruptcy Code in 1978, n12 and remains unchanged under section 726(a)(5). Since the enactment of the Bankruptcy Code, the principle has been recognized by the Supreme Court in *United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd*, n13 in which the Supreme Court stated that "[i]n the (admittedly rare) case when the debtor proves solvent ... 11 U.S.C. section 726(a)(5) provides that postpetition interest is allowed on unsecured claims." n13a

Even in cases in which there is no finding of insolvency with respect to the debtor, postpetition interest may be provided in a plan of reorganization. n14

[b] Tax Accrual Concepts and Payment Differ

Moreover, care must be taken not to confuse tax accrual concepts and payment in a title 11 context. *Section 502(b)(2) of the Bankruptcy Code* prescribes the grounds for objecting to claims in a title 11 case. By itself, it does not change the legal rights of the holder of an obligation against the debtor. There is no discharge. n14a Put another way, the general rule in title 11 cases that there is no accrual of postpetition interest is a rule of convenience governing *distributions* to creditors. n14b It is not a rule of substantive law that converts an interest-bearing indebtedness to a nonenforceable, non-interest-bearing indebtedness. Even *In re Continental Vending Machine Corp.*, n15 which is often cited for its position against tax accrual of postpetition interest, states unequivocally:

A bankruptcy proceeding, whether straight or a corporate reorganization,... suspends or postpones the accrual of interest even though the "claim has not lost its interest-bearing quality." n16

It was for this reason that the bankruptcy court in *In re Dow Corning Corp.* n16a allowed the debtor a tax deduction for postpetition interest on prepetition debt with contractual rights to stated interest, but not trade debt. n16b

[4] Conclusion

In today's business environment, when resort is made to title 11 cases for many reasons other than balance sheet insolvency, the factual circumstances justifying tax accrual of postpetition interest should be carefully considered by the debtor. It should also be recognized that tax accrual by itself does not provide the debtor with substantial tax benefits if the increased indebtedness represented by the accrued interest is not paid or otherwise satisfied (such as by utilizing the stock for debt exception) n17 and is simply canceled pursuant to the plan of reorganization. n18

FOOTNOTES:

(n1)Footnote 1. *Zimmerman Steel Co. v. Commissioner*, 130 F.2d 1011 (8th Cir.1942) . The Court of Appeals for the Eighth Circuit followed its decision in *Zimmerman Steel* nine years later in *Keebey's Inc. v. Paschal*, 188 F.2d 113 (8th Cir.1951) . In that case, the government prevailed and an accrual-basis taxpayer was denied a deduction in a later year because the court held the interest was properly accrued in earlier years by a corporation bordering on insolvency.

(n2)Footnote 2. *Zimmerman Steel Co. v. Commissioner*, 130 F.2d 1011, 1012 (8th Cir.1942) .

(n3)Footnote 3. *Cohen v. Commissioner*, 21 T.C. 855 (1954) .

(n4)Footnote 4. *Cohen v. Commissioner*, 21 T.C. 855, 857 (1954) , quoting *Jorden v. Commissioner*, 11 T.C. 914, 925 (1948) .

(n5)Footnote 5. See *Millar Brainard v. Commissioner*, 7 T.C. 1180, 1184(1946) .

(n6)Footnote 6. *Fahs v. Martin*, 224 F.2d 387 (5th Cir. 1955) . While this case involved mortgage bonds, the analysis should be the same for general unsecured debt since, to the extent that the security of a secured obligation is insufficient to satisfy the secured claim, the creditor has a general unsecured claim. See 11 U.S.C. § 506(a).

(n7)Footnote 7. 1970-2 C.B. 37 , restating I.T. 3635, 1944 C.B. 101 .

(n8)Footnote 8. Thirty-eight years after *Fahs v. Martin* was decided, a bankruptcy court refused to apply that opinion or *Revenue Ruling 70-367* and denied a chapter 7 trustee's attempt to accrue and deduct postpetition interest on

prepetition claims without stated interest where it determined that the legal obligation to pay such interest was so contingent that the "all events test" was not satisfied. *Kellogg v. United States (In re West Texas Marketing Corp.)*, 155 B.R. 399 (Bankr. N.D. Tex. 1993). The decision was affirmed on appeal. See 54 F.3d 1194 (5th Cir. 1995), reh'g denied, 66 F.3d 324 (5th Cir. 1995), cert. denied, .

(n9)Footnote 9. Continental Vending Machine Corp., 77-1 U.S.T.C. P 9121 at 86,093 (E.D.N.Y.1976) .

(n10)Footnote 9a. In an unpublished decision, the Ninth Circuit indicated that it, too, would apply a "reasonable expectation of payment" requirement, stating that "it has long been established in this circuit that an obligation, even though fixed and unconditional, cannot be accrued for tax purposes absent a reasonable expectancy" that the payment will be made. McDonald v. Commissioner, No. 96-70333 (May 23, 1997) (unpublished memorandum decision), 997 U.S.T.C. (CCH) P 50,497.

(n11)Footnote 10. See F.S.A. 1999-16-005, 1998 FSA LEXIS 23 (April 23, 1999) (noting that the Fifth and Eighth Circuits hold that doubt as to the collectibility does not prevent accrual of interest while the Tax Court has not allowed deductions where non-payment becomes certain during the taxable year). But see *Kellogg v. United States (In re West Texas Marketing Corp.)*, 155 B.R. 399 (Bankr. N.D. Tex. 1993), aff'd, 54 F.3d 1194 (5th Cir. 1995), reh. denied, 66 F.3d 324 (5th Cir. 1995), cert. denied, 516 U.S. 991, 116 S. Ct.523, 113 L. Ed. 2d 430 (1996), with regard to the precedential limitations of *Fahs*. In another case, a bankruptcy court's refusal to allow a chapter 7 trustee to deduct a liability to the Department of Energy which the court found would not be paid was affirmed by a district court, which remarked that "*Fahs*' precedential value has been undermined by subsequent Fifth Circuit caselaw." *Kellogg v. United States (In re Southwestern States Marketing Corp.)*, 179 B.R. 813 (N.D. Tex. 1994), aff'd without op., 82 F.3d 413 (5th Cir. 1996), citing *Burlington-Rock Island R. R. Co. v. United States*, 321 F.2d 817 (5th Cir.1963), cert. denied, 377 U.S. 943, 84 S. Ct. 1349, 12 L. Ed. 2d 306 (1964) and *Tampa & Gulf Coast R. R. Co. v. Commissioner*, 469 F.2d 263 (5th Cir.1972). Note: The *Kellogg* case involved the same trustee as did *West Texas Marketing*, raising a similar argument in a different factual setting.

(n12)Footnote 11. See, e.g., *Taxel v. California Employment Dept.*, 116 B.R. 734 (Bankr. S.D. Cal.1990), aff'd mem., 130 B.R. 362 (B.A.P. 9th Cir. 1991), aff'd, 998 F.2d 756(9th Cir. 1993); *In the Matter of Baldwin United Corp.*, 13 C.B.C.2d 1369, 55 B.R. 885 (Bankr. S.D. Ohio 1985). Section 502 provides:

(a) A claim or interest, proof of which is filed under section 501 of this title, is deemed allowed, unless a party in interest, including a creditor of a general partner in a partnership that is a debtor in a case under chapter 7 of this title, objects.

(b) Except as provided in subsections (e)(2), (f), (g), (h) and (i) of this section, if such objection to a claim is made, the court, after notice and a hearing, shall determine the amount of such claim in lawful currency of the United States as of the date of the filing of the petition, and shall allow such claim in such amount, except to the extent that--

* * *

(2) such claim is for unmatured interest.

(n13)Footnote 11a. See, e.g., *In re Calypso Zamas L.P.*, 293 B.R. 668, 678-79 (Bankr. W.D. Pa. 2003); *In re El Paso Refinery*, 244 B.R. 613, 619-21 (Bankr. W.D. Tex. 2000) (discussion of the Section 726 distribution and the award of post-petition interest to creditors).

(n14)Footnote 12. See, e.g., *Vanston Bondholders Protective Comm. v. Green*, 329 U.S. 156, 67 S. Ct. 237, 91 L. Ed. 162 (1946) ; *Matter of Beverly Hills Bancorp*, 752 F.2d 1334 (9th Cir. 1984) . For a discussion of the historical roots of the award of postpetition interest in bankruptcy, see *In re Marfin Ready Mix Corp.*, 220 B.R. 148, 159-63 (Bankr. E.D.N.Y. 1998) .

(n15)Footnote 13. *United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 108 S. Ct. 626, 98 L. Ed. 2d 740, 17 C.B.C.2d 1368 (1988) .

(n16)Footnote 13a. *United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 379, 108 S. Ct. 626, 634, 98 L. Ed. 2d 740, 753, 17 C.B.C.2d 1368, 1376(1988) .

(n17)Footnote 14. See *In re Public Service Co. of New Hampshire*, 114 B.R.800, 803 n.5 (Bankr. D. Vt. 1990) .

(n18)Footnote 14a. See, e.g., *Louisiana Public Service Commission v. Mabey (In re Cajun Elec. Power Coop., Inc.)*, 185 F.3d 446, 455 (5th Cir. 1999) .

(n19)Footnote 14b. See *In re Dow Corning Corp.*, 270 B.R. 393, 404 (Bankr. E.D. Mich. 2001) (chapter 11 debtor's section 726(a)(5)-based obligation to pay postpetition interest cannot become fixed until confirmation of plan of reorganization; accordingly, debtor was not entitled to deduction for postpetition interest).

(n20)Footnote 15. *Continental Vending Machine Corp.*, 77-1 U.S.T.C. P 9121 at 86,093 (E.D.N.Y. 1976).

(n21)Footnote 16. *In re Continental Vending Machine Corp* 77-1 U.S.T.C. P 9121 at 86,097 (E.D.N.Y. 1976) , quoting 6A *Collier on Bankruptcy* P 9.08, at 194 (14th ed.). The Internal Revenue Service has indicated its support for the proposition that "any contingency that results from the effect of 11 U.S.C. § 502(b)(2) is not a contingency preventing accrual," thus upholding the deductibility of postpetition interest. CCA 2008-01-039 (Sept. 24, 2007). However, the Internal Revenue Service further reasoned that "[u]nder the tax benefit rule, a taxpayer using an accrual method of accounting must recognize income if the taxpayer accrues and deducts an expense in a taxable year before it becomes payable and eventually does not have to pay the liability." CCA 2008-01-039 (Sept. 24, 2007) . Thus, in the Internal Revenue Service's view, the taxpayer must include an offsetting amount to the extent the taxpayer receives the benefit of a deduction for interest expense that the taxpayer eventually does not have to pay. See Deanna Walton Harris and Mark Hoffenberg, "Postpetition Interest: The IRS Gets One Right (And One Wrong)," 120 *Tax Notes* 51 (2008). See also discussion of interest on tax claims at P TX4.05 *supra* .

(n22)Footnote 16a. 270 B.R. 393, 416 (Bankr. E.D. Mich. 2001) .

(n23)Footnote 16b. In partially granting the debtor's motion for summary judgement, the court limited the debtor's interest deduction to the federal judgement rate because of evidence the debtor disputed its stated interest obligations in excess of that amount.

(n24)Footnote 17. But note that the stock for debt exception has been repealed by the Omnibus Budget Reconciliation Act of 1993 (Pub. L. No. 103-66). The repeal of this exception took place in two stages, becoming fully effective for stock transfers after January 1, 1995. See chapter TX8 *supra*.

(n25)Footnote 18. See chapter TX13 *supra*.



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CHAPTER TX15 Miscellaneous Tax Issues

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P TX15.06 Jurisdiction over Disputes for Tax Periods After Confirmation of a Chapter 11 Plan of Reorganization

The tax liabilities of a reorganized debtor in the years immediately following the confirmation of chapter 11 plan and the ability to pay them will frequently have a profound impact on the success or failure of the reorganization. From time to time, a question arises concerning the jurisdiction of a bankruptcy court to adjudicate disputes for taxable periods occurring after a chapter 11 plan has been confirmed. A variation on the same fundamental issue may present itself if a bankruptcy court is asked to determine the tax consequences of a particular transaction or the availability of tax attributes such as net operating loss ("NOL") deductions for future years as part of the confirmation process. Answering these questions may become more complicated if a plan of reorganization purporting to grant such jurisdiction to the bankruptcy court has been confirmed without an objection to that provision.

Postconfirmation tax disputes should be distinguished from those which arise with respect to tax periods occurring before a title 11 petition was filed or during the time that a debtor was in a chapter 11 proceeding. The authority of a bankruptcy court to adjudicate either prepetition or postpetition tax disputes, even after a chapter 11 plan has been confirmed, is unclear. Some courts, such as the Seventh Circuit, would not find jurisdiction. n1 Other courts might hold that there is jurisdiction. n1a It is, however, clear that a chapter 11 plan may retain the bankruptcy court's jurisdiction over questions regarding the interpretation or administration of the plan. n1b Although the argument has been made that retained jurisdiction provisions should be very broadly interpreted, n2 most courts have taken a more restrictive view. n3

[1] Bankruptcy Court Lacks Jurisdiction Over Postconfirmation Tax Liability in Chapter 11 Cases

When the postconfirmation dispute concerns taxes, it has usually been held that taxable periods which close after a chapter 11 plan has been confirmed are beyond the bankruptcy court's reach. n4 It has also been held that a retained jurisdiction provision does not authorize a bankruptcy court to determine postconfirmation tax liabilities. n5 The courts analyzing this issue have often explained their conclusions by reference to the well established principle of tax law that each taxable period is separate and distinct and, therefore, constitutes a new cause of action between the taxpayer and the government. n6 One court has refused to determine a tax liability for a period for which returns have not yet been filed based upon its application of the doctrine of ripeness. n6a

In 2005, section 1231(b) was amended to authorize bankruptcy courts to determine the tax effects of chapter 12 plans

with regard to "any governmental unit"--not just State or local governments. n6b The court may make such a determination after the governmental unit responds to the request or, if no response is made, 270 days from the date of the request have elapsed. Note, however, that since Congress expressly added the federal tax effects of chapter 12 plans to those subject to the bankruptcy courts' jurisdiction, the lack of a similar provision for chapter 11 cases creates a compelling inference that none was intended.

[a] Bankruptcy Court Jurisdiction Over Disputes Concerning Taxes During the Year Plan is Confirmed

This principle is fairly straightforward when a plan is confirmed in one year and a bankruptcy court is asked to adjudicate a tax dispute regarding the next year. What about a dispute arising over the tax liability for the year in which the plan is confirmed? Since the taxable year will not be closed until after the plan is confirmed, it would constitute a "post-confirmation year," and the bankruptcy court would not have jurisdiction over it.

The Internal Revenue Code provides that the "general rule" is that a taxable year in which a petition under Title 11 is filed is a postpetition year. n7 This provision does, however, make an explicit exception for chapter 7 and chapter 11 debtors to split what would otherwise have been a postpetition year into pre- and postpetition years, thereby creating two taxable years in a single twelve month period. Certain restrictions on the use of this exception are also imposed by the statute. Although it is possible to make an analogy to splitting a twelve-month period into pre-and postconfirmation taxable years, in the absence of any statutory provision creating an additional exception to the general rule, there is no legal basis for such treatment.

[b] Declaratory Judgement Act Excludes Tax Controversies

This point is also relevant when a bankruptcy court is asked to determine the tax consequences of a particular transaction, *i.e.*, a transfer of property, or the future availability of tax attributes such as NOL's as part of the plan confirmation process. As a general proposition, the Declaratory Judgment Act excludes tax controversies. n8 Although this Act was amended to make exceptions for sections 505 and 1146 of Title 11, it has been held that neither of those statutory exceptions apply to postconfirmation periods when federal taxes are concerned. n9 If certainty regarding the tax consequences of a transaction contemplated by the plan or the future availability of tax attributes is needed, then it may be worthwhile to consider negotiating a Closing Agreement with the IRS. n10

[c] Chapter 11 Plan with Authorization for Bankruptcy Court Jurisdiction

An additional issue is raised when a chapter 11 plan is confirmed which includes a specific authorization for the bankruptcy court to determine postconfirmation tax disputes or a determination of the tax consequences of a particular transaction or the future availability of tax attributes. If the plan is confirmed without an objection to such provision, the argument can be made that the doctrine of *res judicata* precludes a subsequent attack on the postconfirmation jurisdiction over a tax dispute. n11 The counter-argument, and the one which should prevail after the Supreme Court's decision in *Holywell Corp. v. Smith*, is that a confirmed plan cannot bind the United States with respect to taxes which become due after confirmation. n12

FOOTNOTES:

(n1)Footnote 1. See *In re Zurn*, 290 F.3d 861 (7th Cir. 2002) .

(n2)Footnote 1a. See *Gordon Sel-Way, Inc. v. United States*, 270 F.3d 280 (6th Cir. 2001) .

(n3)Footnote 1b. See, *e.g.*, *In re Hartman Material Handling Systems, Inc.*, 141 B.R. 802 (Bankr. S.D.N.Y. 1992) . In an unusual case, a proposed chapter 11 plan provided for a sale after confirmation that would have created a capital gains tax liability and imposed serious limitations on the I.R.S.'s ability to collect it. The proponents argued that the tax

liability was not an administrative expense since it would arise postconfirmation. The bankruptcy court, however, denied confirmation since the plan violated the prohibition of 11 U.S.C. § 1129(d) against plans whose principal purpose was tax avoidance. *In re Scott Cable Communications, Inc.*, 227 B.R. 596 (Bankr. D. Conn. 1998). Subsequently, the district court rejected an attempt to give res judicata effect to the plan in a prior Chapter 11 case filed by the same debtor, noting that the Internal Revenue Service's review of that plan was probably shaped by the knowledge that the Declaratory Judgment Act specifically excluded future tax disputes from the scope of bankruptcy jurisdiction. *United States v. State Street Bank & Trust (In re Scott Cable Communications, Inc.)*, 259 B.R. 536 (D. Conn. 2001), rev'g, 41 C.B.C.2d 1602, 232 B.R. 558 (Bankr. D. Conn. 1999).

(n4)Footnote 2. *In re Insulfoams, Inc.*, 184 B.R. 694 (Bankr. W.D. Pa.1995) (court held it had jurisdiction if the outcome to the dispute could conceivably have an effect on the estate being administered.); *In re Refrigerant Reclamation Corporation of America*, 186 B.R. 78 (Bankr. M.D. Tenn. 1995).

(n5)Footnote 3. See, e.g., *Scotland Guard Services, Inc. v. Autoridad de Energia Electrica (In re Scotland)*, 179 B.R.764 (Bankr. D.P.R. 1993). One court held that it lacked jurisdiction over a postconfirmation dispute even if the parties had agreed to it. *In re Toro*, 185 B.R. 673(Bankr. R.I. 1995). Another bankruptcy court refused to exercise jurisdiction over a postconfirmation dispute between the reorganized debtor and the Government over a contract. *In re A.R.E. Manufacturing Co., Inc.*, 138 B.R. 996 (Bankr. M.D. Fla.1992). The bankruptcy court *Zahn Associates. v. Leeds Building Products (In re Leeds Bldg. Prods.)*, 160 B.R. 689 (Bankr. N.D. Ga. 1993), held that its postconfirmation jurisdiction was limited to matters involving the execution, implementation, or interpretation of the plan and to disputes requiring the application of bankruptcy law. A similarly narrow view was taken by the Fifth and Seventh Circuits in *In re Zurn*, 290 F.3d 861 (7th Cir. 2002) and *Bank of Louisiana v. Craig's Stores of Texas, Inc. (In re Craig's Stores of Texas, Inc.)*, 266 F.3d 388 (5th Cir. 2001).

(n6)Footnote 4. A thorough discussion of this issue may be found in Judge Lifland's opinion in the case of *In re Hartman Material Handling Systems, Inc.*, 141 B.R. 802 (Bankr. S.D. N.Y. 1992). The court concluded that even the broad language of 11 U.S.C. § 505(a) to determine " 'Any tax' does not any tax of any entity at any time." *In re Hartman Material Handling Systems, Inc.*, 141 B.R. 802, 812 (Bankr. S.D.N.Y. 1992). After another thorough discussion of the reach of a bankruptcy court's jurisdiction that included consideration of *Hartman Material Handling Systems*, a bankruptcy court held that it lacked jurisdiction to determine the postconfirmation tax effects of a proposed plan of reorganization. *In re UAL Corporation*, 336 B.R. 370 (Bankr. N.D. Ill. 2006).

(n7)Footnote 5. *In re Maley*, 152 B.R. 789 (Bankr. W.D. N.Y. 1992). See also *In re Stayner*, 185 B.R. 557 (Bankr. N.D. Ill. 1995), a case involving state taxes which collects a number of the prior opinions on this subject

(n8)Footnote 6. *Commissioner v. Sunnen*, 333 U.S. 591, 68 S. Ct. 715, 92 L. Ed. 898 (1948). In *Holywell Corp. v. Smith*, 503 U.S. 47, 112 S. Ct. 1021, 117 L. Ed. 2d 196, 25 C.B.C.2d 1 (1992), the Court held "No tax liability becomes due under [26 U.S.C.] § 6151 until the time required for making those returns."

(n9)Footnote 6a. *In re Indian Motorcycle Litigation*, 307 B.R. 7 (D. Mass.2004).

(n10)Footnote 6b. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, reprinted in Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n11)Footnote 7. 26 U.S.C. § 1398.

(n12)Footnote 8. 28 U.S.C. § 2201.

(n13)Footnote 9. *In re Hartman Material Handling Systems, Inc.*, 141 B.R. 802 (Bankr. E.D.N.Y. 1992); *Dycoal, Inc. v. Internal Revenue Service (In re Dycoal, Inc.)*, 327 B.R. 220 (Bankr. W.D. Pa. 2005). Note that the answer may be different if state or local taxes are involved because of Section 1146. *State of Maryland v. Antonelli Creditors Liquidating Trust*, 191 B.R. 642 (D. Md. 1995).

(n14)Footnote 10. See P TX5.13[6], *supra*.

(n15)Footnote 11. In *Republic Supply Company v. Shoaf*, 815 F.2d 1046 (5th Cir.1987) , the Court of Appeals for the Fifth Circuit held that a party's failure to object to a plan provision discharging a third-party guarantor precluded a subsequent attack on the provision because of the doctrine of *res judicata*. Later the Fifth Circuit clarified this ruling in *Matter of Pavlovich*, 952 F.2d 114 (5th Cir. 1992) "Creditors whose claims arise from and after confirmation are not barred by the event of confirmation from asserting such claims, except to the extent they arise from preconfirmation acts.' *Matter of Pavlovich*, 952 F.2d 114, 119 (5th Cir. 1992) . Still later, the same court held in the context of a tax dispute that a plan confirmed without objection could not discharge a tax liability which the Bankruptcy Code specifically made nondischargeable. *Fein v. United States*, 22 F.3d 631 (5th Cir.1994) . Accordingly, it would appear that an attempt to grant a bankruptcy court postconfirmation jurisdiction which does not exist by including the grant in a plan of reorganization should be unsuccessful. A district court has so held and reversed a bankruptcy court which had relied heavily on the Fifth Circuit's *res judicata* analysis in *Shoaf*. *In re Davis Broadcasting, Inc.*, 176 B.R. 290 (M.D. Ga. 1994) , *rev'g*, 169 B.R. 229 (Bankr. M.D. Ga.1994) .

(n16)Footnote 12. *Holywell Corp. v. Smith*, 503 U.S. 47, 112 S. Ct. 1021, 117 L. Ed. 2d 196, 25 C.B.C.2d 1 (1992) . *Holywell* was held to prevent a trustee from asserting that section 1141(a) bound the IRS when its claim did not arise until after entry of the confirmation order. *United States v. State Street Bank & Trust Co.*, 303 B.R. 35 (Bankr. D. Del. 2003) (this is another decision in the dispute over post-confirmation taxes that was the subject of *In re Scott Cable Communications, Inc.*, see P TX15.06[1] n1b. *supra*)



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P TX15.07 Recent Internal Revenue Policies/Pronouncements

[1] Pension Obligations

Internal Revenue has advised that taxes for pension under funding n1 which occur postpetition are treated as administrative expenses and entitled to priority. n2 The Internal Revenue position is asserted even though the penalty provided for pension payment under funding does not relate to a tax. n3

Pension contributions made by a debtor corporation, before the filing of its bankruptcy, to its pension plan which were the result of a settlement with the Pension Benefit and Guaranty Corporation were denied loss carry back benefits. n4 The issue regarding the treatment of pension fund contributions arose when the debtor corporation's liquidating trustee filed for a tax refund under *Bankruptcy Code section 505*. n5

[2] Revenue Procedure For Prompt Determination of Estate's Unpaid Tax Liabilities

Internal Revenue Service has published the procedural steps a bankruptcy trustee or a debtor in possession must follow to obtain a prompt determination of unpaid tax liability of a bankruptcy estate for tax incurred during the bankruptcy estate's administration. n6

A written Request For Prompt Determination must be filed, in duplicate, along with a copy or copies of the tax return filed by the trustee or debtor in possession with the Internal Revenue Service. n7 The written request must contain certain information, as prescribed by Internal Revenue Service, as follows:

1. Statement indicating it is a request for prompt determination of tax liability;
2. Statement specifically identifying the type of tax return and the tax period for each tax return;
3. The name and location of the tax office where the return was filed;
4. The name of the debtor;
5. The debtor's social security number, tax identification number and/or entity identification number;

6. The description of the bankruptcy estate, that is what type Chapter 7, 11, 12, or 13, and the case number; and

7. The bankruptcy court where the case pends.

After the request is received the Internal Revenue Service will notify the requesting party whether the tax return is selected for examination or whether it is accepted as filed. If the tax return is to be examined, the examination is to be expedited and the requesting party is to be notified within 180 days after the request has been received of any tax due.

[3] Credit Counseling Agencies

Internal Revenue Service has the responsibility for determining the tax exempt status of credit counseling agencies. This examination is conducted by the Tax Exempt and Government Entities Division. n6 Guidance on legal standards for granting tax exempt status to credit counseling agencies has recently been issued by Internal Revenue Service. n7 A credit counseling agency which is approved by the Internal Revenue Service will receive a written communication advising that their activities are consistent with their tax exempt status.

[4] Procedures for Requesting a Determination of the Tax Consequences of a Chapter 12 Plan

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 amended *11 U.S.C. section 1231(b)* to permit bankruptcy courts to authorize proponents of Chapter 12 plans to seek determinations of their tax consequences. The IRS has issued guidance on how these requests should be submitted after they have been authorized by the court. n8 Requests must include a copy of the proposed plan, the order authorizing the debtor to make the request, and be signed under penalty of perjury. They should be submitted to the Centralized Insolvency Operation. n9 Once a determination is made, the IRS will follow it in a subsequent examination of the taxpayer's return if

1. A copy of the determination is attached to the tax return to which it relates;
2. The determination is properly reflected in the return;
3. The representations upon which the determination was made reflected an accurate statement of the controlling facts;
4. The proposed transactions were carried out substantially as proposed; and
5. There has been no change in the law that applies to the period during which the transactions were consummated.

FOOTNOTES:

(n1)Footnote 1. I.R.C. §§ 4871 (a) and (b) govern the taxation of pension plan deficiencies. In Section 4971(a) a 10% tax is imposed on the amount of pension plan funding deficiency for each year of the plan. Section 4971(b) provides for a 100% tax of the accumulated deficiency which remains unpaid.

(n2)Footnote 2. *11 U.S.C. § 503(b)(1)(A)* provides for administrative priority for post petition obligations.

(n3)Footnote 3. *11 U.S.C. § 503(b)(1)(C)*.

(n4)Footnote 4. *IRS v. Harvard Secured Creditors Liquidating Trust*, 2005 U.S. Dist. LEXIS 22460 (D.N.J. 2005) .

(n5)Footnote 5. The pension plan settlement payments were not deemed specified liability losses which could have been carried back 10 years under *I.R.C. § 172*.

(n6)Footnote 6. *11 U.S.C. § 503(b)(1)(C)*.

(n7)Footnote 7. There is a questionnaire that each credit counseling organization should obtain and complete. It is Form 13769 and is available at the Tax Exempt and Government Entities Division of the Internal Revenue Service. Specific documents to be used by IRS agents indicate that agents must determine whether the agency educates clients and helps the client chose financial alternatives. Review Chief Counsel Advice Memo 2006-2001 which sets forth the factors which a credit counseling agency requires to qualify for tax exemption.

(n8)Footnote 6. *Revenue Procedure 2006-24* , published in IRS Bulletin No. 2006-22.

(n9)Footnote 7. The Request must be mailed to Centralized Insolvency Operation; P.O. Box 21126; Philadelphia, Pa. 19114.

(n10)Footnote 8. *Revenue Procedure 2006-52* ; 2006 Internal Revenue Service Bulletin 995.

(n11)Footnote 9. *See note 7, supra*.



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CHAPTER TX15 Miscellaneous Tax Issues

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P TX15.50 Form: Agreement for Suspension of Collection of I.R.C. section 6672 Liability

AGREEMENT FOR SUSPENSION OF COLLECTION OF I.R.C. section 6672 LIABILITY

The Internal Revenue Service agrees to suspend the collection of the *I.R.C. section 6672* liability assessed against

....., (SSN:.....), a
(Responsible Person)

responsible person of, as defined by I.R.C.
(Debtor)

Section 6672, for withheld and unpaid taxes for the period(s) ending, if, and only if, ... and
..... (Responsible Person) (Debtor)

agree to the following terms and conditions:

1. hereinafter referred to
(Responsible Person)

as the responsible person, agrees that he/she is a "responsible person" of
..... within the meaning
(Debtor)
of *I.R.C. section 6672*.

2. All payments required by the confirmed chapter 11 plan of reorganization of hereinafter
(Debtor)

referred to as the debtor, will be made timely and in the amount specified by the plan.

3. Notices of federal tax lien can and will be filed against the responsible person for the *I.R.C. section 6672* liabilities

described above or subsequently assessed.

4. On or before the tenth calendar day following his/her execution of this agreement, the responsible officer will:

- a. pay any and all of his/her personal outstanding federal tax liabilities except the *I.R.C. section 6672* liabilities, and
- b. file any and all of his/her unfiled and delinquent federal tax returns, and pay in full the tax (plus applicable interest and penalties) shown thereon.

5. The responsible person will timely file (including extensions) all of his/her current and future tax returns and pay in full the tax shown thereon.

6. Any and all additional tax, interest and penalties assessed against the responsible person at any time during the pendency of this agreement, including any assessment of *I.R.C. section 6672* liabilities not related to the debtor, will be paid in full within ten days after notice and demand. This provision, however, shall not apply to any subsequent assessments of *I.R.C. section 6672* liabilities related to the debtor and shall not in any way alter the responsible person's rights to contest in the U.S. Tax Court any deficiencies in income tax and additions to tax proposed by the Commissioner of Internal Revenue.

7. With respect to each of the *I.R.C. section 6672* liabilities described above the responsible person will execute a collection extension waiver extending the statutory period for collection for a period of time equal to the current period of time remaining on the collection statute added to the period of time remaining for the completion of the debtor's confirmed chapter 11 plan of reorganization.

8. The debtor shall timely file all of its postpetition federal tax returns and shall timely pay all of its postpetition federal tax liabilities, including the making of timely federal tax deposits. 9. All future federal income tax refunds of the responsible person will be applied to the *I.R.C. section 6672* liabilities described above. Should the debtor successfully complete its chapter 11 plan of reorganization said refunds will be refunded to the responsible person to the extent permitted by the Internal Revenue Code. 10. If the responsible person's *I.R.C. section 6672* liabilities are paid in full before the debtor completes its plan of reorganization, he/she may

- a. sign a closing agreement and have the debtor's liabilities reduced by the amount paid; or
- b. have the monies he/she paid with respect to the *I.R.C. section 6672* liabilities refunded upon the successful completion of the debtor's plan, to the extent permitted by the Internal Revenue Code.

9. Should any of the terms and conditions set forth in paragraphs 1 through 8, inclusive, above, not be met, the Internal Revenue Service shall provide written notification of the default to both the responsible person and the debtor, and the responsible person and/or the debtor shall have ten calendar days to cure said default. The maximum number of defaults permitted during the life of this agreement is three. Upon the failure of the responsible person and/or the debtor to fully cure any default within ten calendar days, or immediately upon the fourth such default, this agreement shall be null and void and the Internal Revenue Service may take enforced collection action against the responsible person with respect to his/her *I.R.C. section 6672* liabilities.



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CHAPTER TX16 Tax Disclosure in a Bankruptcy Disclosure Statement

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CHAPTER TX16 Tax Disclosure in a Bankruptcy Disclosure Statement

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P TX16.01 Introduction

Section 1125 of the Bankruptcy Code requires that a disclosure statement be filed in conjunction with a chapter 11 plan of reorganization. Section 1125 requires that the disclosure statement contain "adequate information." n1 The definition of "adequate information" in section 1125(a) was amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") n2 to require "a discussion of the material Federal tax consequences of the plan to the debtor, any successor to the debtor and a hypothetical investor typical of the holders of claims or interests in the case." n3 This requirement has been interpreted to mean that the disclosure statement must contain the information that is material, important, and necessary for creditors and shareholders to properly evaluate and make a reasonably informed decision regarding the proposed plan of reorganization. n4

The amount of disclosure of tax issues and facts that is appropriate or required in a chapter 11 disclosure statement has not been clearly defined and the recent legislative change does not provide any meaningful guidance. There is little helpful guidance from the case law, and it is a subject that has evoked little interest in the academic world. Clearly, the standard does not appear to require the detailed analysis that would be customary in a securities registration statement accompanying the merger of two large publicly traded corporations. Moreover, logic would dictate that the degree of disclosure would differ for a chapter 11 plan for an individual, which is essentially a liquidating plan, as compared to a chapter 11 plan calling for the reorganization of a large corporation, where creditors have a choice of receiving cash, debt instruments, or equity interests in the reorganized debtor. In general, where the creditors do not retain an ongoing interest in the debtor, the tax consequences to the debtor, no matter how complex or dire, are not particularly relevant to the creditors in deciding how to vote. n4a On the other hand, if the creditors become shareholders or debenture shareholders of the reorganized debtor, they clearly have a legitimate interest in the projected economic growth of the reorganized debtor. Under section 1129(a), the bankruptcy court has a mandatory duty to determine whether a plan of reorganization meets all of the requirements for confirmation. One such requirement involves the determination of the financial feasibility of a nonliquidating plan of reorganization. n5 Clearly, the availability of favorable tax attributes would affect the financial feasibility determination. Moreover, if the tax consequences of the plan to the creditors themselves may be material, such as where the creditors may or may not be entitled to claim losses with respect to their claims depending on the tax characterization of the instruments they receive under the plan, the disclosure statement should address the likelihood of the varying tax treatments. Finally, if the creditors receive an interest in an entity created pursuant to the plan, such as a liquidating trust or a designated settlement fund, the tax consequences of such new entity, as well as the tax consequences of the interest acquired by the creditors in such entity, would seem material. n5a

FOOTNOTES:

(n1)Footnote 1. 11 U.S.C. § 1125(a)(1); see generally *Collier on Bankruptcy*, P 1125.02 (Matthew Bender 15th Ed. Revised).

(n2)Footnote 2. Pub. L. No. 109-8 (2005), effective for cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 *Collier on Bankruptcy*, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n3)Footnote 3. Pub. L. No. 109-8, § 717, "Standards for Tax Disclosure" (2005), effective for cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 *Collier on Bankruptcy*, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n4)Footnote 4. *In re William F. Gable Co.*, 10 B.R. 248, 249 (Bankr. N.D. W. Va. 1981) .

(n5)Footnote 4a. Of course, where the actual distribution might be impacted by taxes the answer is different. For example, in an individual Chapter 7 or Chapter 11 proceeding, a plan to have the bankruptcy estate sell tax--burdened assets as opposed to abandoning them to the debtor would require disclosure for a proper vote. Similarly, where an S corporation is in a bankruptcy proceeding, a plan to terminate the S status could adversely impact the distribution.

(n6)Footnote 5. 11 U.S.C. § 1129(a)(11). *In re Tavern Motor, Inc.*, 14 C.B.C.2d 366, 373, 56 B.R. 449, 454 (Bankr. D. Vt. 1985) .

(n7)Footnote 5a. See *Smith v. Bank of New York* discussed at P TX 16.03[2], n.5 *infra*, where a trustee's failure to insure an appropriate disclosure of tax consequences resulted in personal liability for the resulting taxes.



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CHAPTER TX16 Tax Disclosure in a Bankruptcy Disclosure Statement

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P TX16.02 The Disclosure Statement

[1] Legislative History of section 1125

Until the enactment in 1933 and 1934 of sections 77 n1 and 77B n2 of the Bankruptcy Act of 1898, no statutory machinery was generally available to facilitate the reorganization of insolvent corporations. The Bankruptcy Act of 1898 concerned itself almost entirely with the liquidation of the debtor's assets and the distribution of the proceeds among the creditors.

In 1938, section 77B was superseded by Chapter X, which was added to the Bankruptcy Act of 1898. n3 Generally, Chapter X was a restatement and clarification of section 77B, and a codification of much of the case law that developed under that section. n4 Although Chapter X provided numerous investor protection features designed to promote informed participation in the reorganization process, nothing comparable to a disclosure statement existed under the former Bankruptcy Act of 1898. n5

In 1977, during the first session of the 95th Congress, three new bankruptcy reform bills were introduced. n6 These legislative proposals each provided for a single reorganization chapter, now identified as chapter 11, and introduced the concept of a disclosure statement.

The premise underlying chapter 11 is disclosure rather than the judicial paternalism which characterized Chapter X. n7 The disclosure statement was intended by Congress to be the primary source of information upon which creditors and shareholders would make an informed judgment about a proposed plan of reorganization. n8 The requirement of a disclosure statement applies to all types of chapter 11 cases and all types of debtors, whether large or small and with many or few creditors or classes. n9

While section 1125 requires that the disclosure statement contain "adequate information," the legislative history of section 1125 clearly evidences Congressional intent to let bankruptcy courts decide on a case-by-case basis what constitutes "adequate information." n10 Moreover, in amending section 1125(a)(1) in 2005 to require a discussion of tax consequences, Congress also required the court to balance the benefit of the tax disclosure with the cost of supplying it. n10a In any event, there are yet to be reported any cases suggesting a new or more stringent standard since the 2005 legislature change.

[2] Postpetition Disclosure and Solicitation

The language of *Federal Rule of Bankruptcy Procedure 3016(c)* seems to mandate a disclosure statement in all instances. n11 Similarly, under *Federal Rule of Bankruptcy Procedure 3017(a)*, a hearing on the adequacy of the disclosure statement is mandatory. n12 Congress intended for the hearing on the adequacy of a disclosure statement to "be one of, if not the major procedural hearing in a reorganization case." n13 Postpetition disclosure is specifically governed by section 1125(a). n14

In short, the disclosure statement should be a document that is sufficiently complete and intelligible so as to allow a "typical" investor to make an informed determination as to the adoption of a proposed plan of reorganization. n15 Neither the court nor creditors should have to "perform acrobatic feats of financial analysis" in order to make an informed judgment concerning a proposed plan of reorganization. n16 Furthermore, a creditor should not have to wait until an evidentiary hearing to learn that statements or objectives in a proposed plan of reorganization are predicated on information that is either too simplistic or incorrectly stated. n17

[3] Purpose of a Disclosure Statement

The purpose of a disclosure statement is to inform equity holders and claimants, as fully as possible, about the potential financial results of either acceptance or rejection of a particular plan of reorganization. n18 Thus, interested parties must be provided with information that is comprised of all factors presently known to the proponent of the plan of reorganization that could bear upon either the success or failure of the specific proposals contained in the plan of reorganization. n19

The overriding purpose of the disclosure statement is to give meaningful information to a "typical" investor who might find such information helpful in making an informed decision. n20 However, what constitutes a meaningful disclosure statement varies depending upon the circumstances of each case. n21

The important theme which emerges from an examination of the cases is that the disclosure statement must reveal the "risks" to creditors and equity interest holders under the terms and provisions of the proposed plan of reorganization. n22 The factors which courts have required to be included in a disclosure statement assist in informing creditors of "risks" and "financial results" of voting on a plan. n23 Thus, it is unnecessary to overburden the disclosure statement with information which might be helpful and comprehensible to lawyers, but incomprehensible to a lay person. n24

[4] Definition of "Adequate Information"

"Adequate information" is defined as

information of a kind, and in sufficient detail, as far as is reasonably practical 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. n25

The "investor typical of holders of claims or interests of the relevant class" is defined to mean an investor having a claim or interest of the relevant class, having such a relationship with the debtor as the holders of other claims or interests of the relevant class have, and having such ability to obtain information from sources other than the disclosure statement as holders of claims or interests of the relevant class have. n26 In other words, the adequacy of disclosure is measured against the "typical" investor, not an extraordinary investor. n27

In determining whether a disclosure statement contains "adequate information," the court must not only determine what information the typical holder of a claim or interest of a particular class needs to make an informed judgment, but the court must consider whether the typical member of a class is able to obtain sufficient information to make a reasonable judgment from sources other than the disclosure statement which must be furnished pursuant to section 1125(b). n28

[5] Types of Information Required

A comprehensive list of categories that should be covered in a disclosure statement is set forth in the case of *In re Metrocraft Publishing Service, Inc.* n29 In its opinion, the bankruptcy court explained in detail some of the elements necessary to comply with section 1125(a):

Case law under *section 1125 of the Bankruptcy Code* has produced a list of factors, disclosure of which may be mandatory, under the facts and circumstances of a particular case, to meet the statutory requirement of adequate information. Disclosure of all factors is not necessary in every case. Conversely, the list is not exhaustive, and a case may arise in which disclosure of all these enumerated factors is still not sufficient to provide adequate information for the creditors to evaluate the plan. n30

[a] What Information Should Be Contained in the Disclosure Statement?

The first 15 factors cited by the bankruptcy court in *Metrocraft* were developed by other bankruptcy courts. n31 In response to certain objections raised by the creditors' committee, the *Metrocraft* court added factors 16 through 19. n32

The factors considered relevant for evaluating the adequacy of a disclosure statement may include:

- (1) The events which led to the filing of a bankruptcy petition; n33
- (2) A description of the available assets and their value; n34
- (3) The anticipated future of the company; n35
- (4) The source of the information stated in the disclosure statement; n36
- (5) A disclaimer; n37
- (6) The present condition of the debtor while in chapter 11; n38
- (7) The scheduled claims; n39
- (8) The estimated return to creditors under a chapter 7 liquidation; n40
- (9) The accounting method utilized to produce financial information and the name of the accountants responsible for such information; n41
- (10) Future management of the debtor; n42
- (11) The chapter 11 plan or summary thereof; n43
- (12) The estimated administrative expenses, including attorneys' and accountants' fees; n44
- (13) The collectability of accounts receivable; n45
- (14) Financial information, data, valuations or projections relevant to the creditors' decision to accept or reject the chapter 11 plan; n46
- (15) Information relevant to the risks posed to creditors under the plan; n47

(16) The actual projected realizable value from recovery of preferential or otherwise voidable transfers; n48

(17) Litigation likely to arise in a nonbankruptcy context; n49

(18) Tax attributes of the debtor; n50 and

(19) The relationship of the debtor with affiliates. n51

[6] Financial Information

Generally, the type of financial information required in a disclosure statement can be categorized into three types: (1) historical; (2) valuation of assets; and (3) future projections.

A disclosure statement which provides no financial information, data, evaluations or projections relevant to the determination by a creditor of whether to accept or reject a debtor's plan does not meet the requirements of section 1125(a). The mere fact that the creditor may be sophisticated, highly informed and have the ability to obtain such financial information from sources other than the disclosure statement does not eliminate the need for the disclosure statement to contain such information. Basic financial information must be supplied under the disclosure statement. n52

Another bankruptcy court required the following amendments to be made prior to approving the disclosure statement:

(1) The preparation of profit and loss statements on an accrual basis;

(2) The inclusion of cash flow statements; and

(3) The description of financial arrangements with future partners. n53

FOOTNOTES:

(n1)Footnote 1. Act of March 3, 1933, Pub. L. No. 72-420, 47 Stat. 1474, ch. 204, *codified at 11 U.S.C. § 205* (repealed).

(n2)Footnote 2. Act of June 7, 1934, Pub. L. No. 73-296, 48 Stat. 912, ch. 424, *codified at 11 U.S.C. § 207* (repealed).

(n3)Footnote 3. Act of June 22, 1938, Pub. L. No. 75-696, 52 Stat. 883-905, ch. 575, *codified at 11 U.S.C. §§ 501-676* (repealed).

(n4)Footnote 4. Swanstrom, *Reorganization Under the Federal Statutes*, 17 *Chi.-Kent L. Rev.* 1, 3 (1938).

(n5)Footnote 5. Moller & Foltz, *Chapter 11 of the Bankruptcy Code*, 58 *N.C. L. Rev.* 881, 917 (1980).

(n6)Footnote 6. H.R. 6, 95th Cong., 1st Sess. (Jan. 4, 1977), *renumbered as* H.R. 8200, 95th Cong., 1st Sess. (July 11, 1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised); S. 2266, 95th Cong., 1st Sess. (Oct. 31, 1977), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th

Ed. Revised). Congress adopted H.R. 8200, enacted as the Bankruptcy Reform Act of 1978. Pub. L. No. 95-598, 92 Stat. 2549, *codified at* 11 U.S.C., *reprinted in* Vol. A Collier on Bankruptcy, App. Pt. 4(a) (Matthew Bender 15th Ed. Revised).

(n7)Footnote 7. H.R. Rep. No. 595, 95th Cong., 1st Sess., 408-09 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n8)Footnote 8. *In re Jeppson*, 66 B.R. 269, 291 (Bankr. D. Utah 1986) ; followed by *In re Concrete Designers*, 173 B.R. 354 (Bankr. S.D. Ohio 1994) . See *In re Egan*, 33 B.R. 672, 675 (Bankr. N.D. Ill. 1983) . See also *In re Brandon Mill Farms, Ltd.*, 10 C.B.C.2d 283, 285, 37 B.R. 190, 192 (Bankr. N.D. Ga. 1984) .

(n9)Footnote 9. *In re Northwest Recreational Activities, Inc.*, 8 B.R. 10, 12 (Bankr. N.D. Ga. 1980) ; *In re Bloomingdale Partners*, 155 B.R. 961 (Bankr. N.D. Ill. 1993) .

(n10)Footnote 10. H.R. Rep. No. 595, 95th Cong., 1st Sess., 408 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised); Sen. Rep. No. 989, 95th Cong., 2d Sess. 120 (1978), *reprinted in* Vol. D Collier on Bankruptcy, App. Pt. 4(e)(i) (Matthew Bender 15th Ed. Revised).

(n11)Footnote 10a. Pub. L. No. 109-8, § 717 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bedner 15th Ed. Revised).

(n12)Footnote 11. *Fed. R. Bankr. P. 3016(c)* provides: "In a chapter 9 or 11 case, a disclosure statement pursuant to § 1125 or evidence showing compliance with § 1126(b) of the Code shall be filed with the plan or within a time fixed by the court."

(n13)Footnote 12. *Fed. R. Bankr. P. 3017(a)* provides, in relevant part:

Following the filing of a disclosure statement as provided in *Rule 3016(c)*, the court shall hold a hearing on not less than 25 days notice to the debtor, creditors, equity security holders and other parties in interest as provided in *Rule 2002* to consider such statement and any objections or modifications thereto.

(n14)Footnote 13. H.R. Rep. No. 595, 95th Cong., 1st Sess., 227, 229 (1977), *reprinted in* Vol. C Collier on Bankruptcy, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n15)Footnote 14. which states the following, in pertinent part:

(1) "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, but adequate information need not include such information about any other possible or proposed plan; and

(2) "investor typical of holders of claims or interests of the relevant class" means an investor having--

(A) a claim or interest of the relevant class;

(B) such a relationship with the debtor as the holders of other claims or interests of such class generally have; and

(C) such ability to obtain such information from sources other than the disclosure

required by this section as holders of claims or interest in such class generally have.

(n16)Footnote 15. *In re Werth*, 8 C.B.C.2d 480, 484, 29 B.R. 220 (Bankr. D. Colo. 1983) .

(n17)Footnote 16. *In re Tavern Motor Inn, Inc.*, 14 C.B.C.2d 366, 374, 56 B.R. 449 (Bankr. D. Vt. 1985) .

(n18)Footnote 17. *In re Tavern Motor Inn, Inc.*, 14 C.B.C.2d 366, 374, 56 B.R. 449 (Bankr. D. Vt. 1985) .

(n19)Footnote 18. *In re Werth*, 8 C.B.C.2d 480, 483, 29 B.R. 220 (Bankr. D. Colo. 1983) , citing *In re Stanley Hotel*, 5 C.B.C.2d 64, 13 B.R. 926 (Bankr. D. Colo. 1981) .

(n20)Footnote 19. *In re Werth*, 8 C.B.C.2d 480, 483, 29 B.R. 220 (Bankr. D. Colo. 1983) , citing *In re Stanley Hotel*, 5 C.B.C.2d 64, 13 B.R. 926 (Bankr. D. Colo. 1981) .

(n21)Footnote 20. *In re Werth*, 8 C.B.C.2d 480, 484, 29 B.R. 220 (Bankr. D. Colo. 1983) , citing *In re Stanley Hotel*, 5 C.B.C.2d 64, 13 B.R. 926 (Bankr. D. Colo. 1981) .

(n22)Footnote 21. 7 *Collier on Bankruptcy*, P 1125.02[1] (Matthew Bender 15th Ed. Revised). See *In re Werth*, 8 C.B.C.2d 480, 484, 29 B.R. 220 (Bankr. D. Colo. 1983) . See also H.R. Rep. No. 595, 95th Cong., 1st Sess., 409 (1977), reprinted in Vol. D *Collier on Bankruptcy*, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised).

(n23)Footnote 22. *In re Adana Mortgage Bankers, Inc.*, 14 B.R. 29, 31 (Bankr. N.D. Ga. 1981) . *In re Galerie des Monnaies of Geneva, Ltd.*, 13 C.B.C.2d 1176, 55 B.R. 253 (Bankr. S.D.N.Y.) , *aff'd*, 62 B.R. 224 (S.D.N.Y. 1985) (facts which inform claimants about the financial results of acceptance or rejection of a plan must be included).

(n24)Footnote 23. See, e.g., *In re Metrocraft Publishing Serv., Inc.*, 10 C.B.C.2d 1182, 1184, 39 B.R. 567 (Bankr. N.D. Ga. 1984) (listing of over 19 factors in evaluating the adequacy of disclosure). See also *In re Tavern Motor Inn, Inc.*, 14 C.B.C.2d 366, 373, 56 B.R. 449 (Bankr. D. Vt. 1985) (listing of eight minimal financial presentations).

(n25)Footnote 24. *In re Werth*, 8 C.B.C.2d 480, 484, 29 B.R. 220 (Bankr. D. Colo. 1983) .

(n26)Footnote 25. H.R. Rep. No. 595, 95th Cong., 1st Sess. 408-09 (1977), reprinted in Vol. C *Collier on Bankruptcy*, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised); 11 U.S.C. § 1125(a)(1).

(n27)Footnote 26. H.R. Rep. No. 595, 95th Cong., 1st Sess. 409 (1977), reprinted in Vol. C *Collier on Bankruptcy*, App. Pt. 4(d)(i) (Matthew Bender 15th Ed. Revised); 11 U.S.C. § 1125(a)(2).

(n28)Footnote 27. 7 *Collier on Bankruptcy*, P 1125.01[2] (Matthew Bender 15th Ed. Revised).

(n29)Footnote 28. 7 *Collier on Bankruptcy*, P 1125.01[2] (Matthew Bender 15th Ed. Revised). *In re Bel Air Associates, Ltd.*, 2 C.B.C.2d 103, 4 B.R. 168 (Bankr. W.D. Okla. 1980) ; *Northwest Recreational Activities, Inc.*, 8 B.R. 10, 11 (Bankr. N.D. Ga. 1980) .

(n30)Footnote 29. See, *In re Metrocraft Publishing Serv., Inc.*, 10 C.B.C.2d 1182, 39 B.R. 567 (Bankr. N.D. Ga. 1984) (listing of over 19 factors in evaluating the adequacy of disclosure). The debtor sought approval of its disclosure statement. The creditors' committee filed an objection to the adequacy of the information contained in the disclosure statement. But see *In re Phoenix Petroleum Co.*, 278 B.R. 385 (Bankr. E.D. Pa. 2001) (where the court noted that it is well understood that certain categories of information that may be necessary in one case may be omitted in another.

(n31)Footnote 30. 10 C.B.C.2d 1182, 1184 .

(n32)Footnote 31. Factors one through eleven were taken from the case of *In re A.C. Williams Co.*, 25 B.R. 173 (Bankr. N.D. Ohio 1982) . Factors 12 and 13 appeared in the case of *In re William F. Gable Co.*, 10 B.R. 248, 249 (Bankr. N.D. W. Va. 1981) . Factors 14 and 15 were developed in the case of *In re Adana Mortgage Bankers, Inc.*, 14 B.R. 29, 31 (Bankr. N.D. Ga. 1981) .

(n33)Footnote 32. See, e.g., *In re Metrocraft Publishing Serv., Inc.*, 10 C.B.C.2d 1182, 1184, 39 B.R. 567 (Bankr. N.D. Ga. 1984) (listing of over 19 factors in evaluating the adequacy of disclosure). The list of 19 factors also appears in *In re U.S. Brass Corp.*, 194 B.R. 420 (Bankr. E.D. Tex. 1996).

(n34)Footnote 33. *In re A.C. Williams Co.*, 25 B.R. 173, 176 (Bankr. N.D. Ohio 1982) ; *In re William F. Gable Co.*, 10 B.R. 248, 249 (Bankr. N.D. W. Va. 1981) .

(n35)Footnote 34. *In re A.C. Williams Co.*, 25 B.R. 173, 176 (Bankr. N.D. Ohio 1982) .

(n36)Footnote 35. *In re A.C. Williams Co.*, 25 B.R. 173, 176 (Bankr. N.D. Ohio 1982) . See also *In re Malek*, 10 C.B.C.2d 189, 190-91, 35 B.R. 443 (Bankr. E.D. Mich. 1983) .

(n37)Footnote 36. *In re A.C. Williams Co.*, 25 B.R. 173, 176 (Bankr. N.D. Ohio 1982) .

(n38)Footnote 37. *In re A.C. Williams Co.*, 25 B.R. 173, 176 (Bankr. N.D. Ohio 1982) .

(n39)Footnote 38. *In re A.C. Williams Co.*, 25 B.R. 173, 176 (Bankr. N.D. Ohio 1982) .

(n40)Footnote 39. *In re A.C. Williams Co.*, 25 B.R. 173, 176 (Bankr. N.D. Ohio 1982) .

(n41)Footnote 40. *In re A.C. Williams Co.*, 25 B.R. 173, 176 (Bankr. N.D. Ohio 1982) . *In re William F. Gable Co.*, 10 B.R. 248, 250 (Bankr. N.D. W. Va. 1981) .

(n42)Footnote 41. *In re A.C. Williams Co.*, 25 B.R. 173, 176 (Bankr. N.D. Ohio 1982) .

(n43)Footnote 42. *In re A.C. Williams Co.*, 25 B.R. 173, 176 (Bankr. N.D. Ohio 1982) . *In re Adana Mortgage Bankers, Inc.*, 14 B.R. 29, 31 (Bankr. N.D. Ga. 1981) ; *In re William F. Gable Co.*, 10 B.R. 248, 250 (Bankr. N.D. W. Va. 1981) . See also *In re Malek*, 10 C.B.C.2d 189, 190-91, 35 B.R. 443 (Bankr. E.D. Mich. 1983) .

(n44)Footnote 43. *In re A.C. Williams Co.*, 25 B.R. 173, 176 (Bankr. N.D. Ohio 1982) . See also *In re Malek*, 10 C.B.C.2d 189, 190, 35 B.R. 443 (Bankr. E.D. Mich. 1983) .

(n45)Footnote 44. *In re William F. Gable Co.*, 10 B.R. 248, 249 (Bankr. N.D. W. Va. 1981) .

(n46)Footnote 45. *In re William F. Gable Co.*, 10 B.R. 248, 249, 250 (Bankr. N.D. W. Va. 1981) .

(n47)Footnote 46. *In re Adana Mortgage Bankers, Inc.*, 14 B.R. 29, 30 (Bankr. N.D. Ga. 1981) . See also *In re Malek*, 10 C.B.C.2d 189, 190-91, 35 B.R. 443 (Bankr. E.D. Mich. 1983) .

(n48)Footnote 47. *In re Adana Mortgage Bankers, Inc.*, 14 B.R. 29, 31 (Bankr. N.D. Ga. 1981) .

(n49)Footnote 48. *In re Metrocraft Publishing Serv., Inc.*, 10 C.B.C.2d 1182, 1184, 39 B.R. 567 (Bankr. N.D. Ga. 1984) (listing of over 19 factors in evaluating the adequacy of disclosure).

(n50)Footnote 49. *In re Metrocraft Publishing Serv., Inc.*, 10 C.B.C.2d 1182, 1184, 39 B.R. 567 (Bankr. N.D. Ga. 1984) (listing of over 19 factors in evaluating the adequacy of disclosure). *In re William F. Gable Co.*, 10 B.R. 248, 250 (Bankr. N.D. W. Va. 1981) . See also *In re Malek*, 10 C.B.C.2d 189, 191, 35 B.R. 443 (Bankr. E.D. Mich. 1983) .

(n51)Footnote 50. *In re Metrocraft Publishing Serv., Inc.*, 10 C.B.C.2d 1182, 1184, 39 B.R. 567 (Bankr. N.D. Ga.

1984) (listing of over 19 factors in evaluating the adequacy of disclosure). *See also In re Malek*, 10 C.B.C.2d 189, 191, 35 B.R. 443 (Bankr. E.D. Mich. 1983) .

(n52)Footnote 51. *In re Metrocraft Publishing Serv., Inc.*, 10 C.B.C.2d 1182, 1184, 39 B.R. 567 (Bankr. N.D. Ga. 1984) (listing of over 19 factors in evaluating the adequacy of disclosure); *In re William F. Gable Co.*, 10 B.R. 248, 249 (Bankr. N.D. W. Va. 1981) . *See also In re Scioto Valley Mortgage Co.*, 88 B.R. 168, 171 (Bankr. S.D. Ohio 1988) (information concerning the status of various partnerships in which the debtor may have an interest, including the nature or extent of any such interest or relationship, is normally to be disclosed).

(n53)Footnote 52. *In re Adana Mortgage Bankers, Inc.*, 14 B.R. 29, 30-31 (Bankr. N.D. Ga. 1981) .

(n54)Footnote 53. *In re Hughes Marina, Inc.*, 16 B.R. 6 (Bankr. W.D.N.Y. 1980) .



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Collier on Bankruptcy Taxation

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CHAPTER TX16 Tax Disclosure in a Bankruptcy Disclosure Statement

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P TX16.03 Disclosure of Tax Consequences

As amended by the BAPCPA, n1 section 1125(a) now provides:

(1) "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 it; *including a discussion of the potential material Federal tax consequences of the plan to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case*, that would enable such a hypothetical investor to make an informed judgment about the plan ... *but adequate information need not include such information about any other possible or proposed plan and in determining whether disclosure statement provides adequate information, the court shall consider the complexity of the case, the benefit of additional information to creditors and other parties in interest, and the cost providing additional information...*

It is unclear how this change will be interpreted by the bankruptcy bar and the courts. As discussed above, the courts have already read *Bankruptcy Code section 1125* as requiring that adequate information be provided to the hypothetical creditor. Presumably, there will be more detail contained in the Tax Disclosures, but it probably will not cause significant changes to what prior case law has held to be appropriate for discussions. n1a

The disclosure statement must reveal the probable tax consequences of the chapter 11 plan of reorganization. n1b If there are no tax consequences, one bankruptcy court has held that the disclosure statement must contain an affirmative statement of that fact. n2

[1] Rationale

The tax implications of a plan of reorganization may have a bearing on the likelihood of achieving such financial return to creditors under a plan and the risks associated with the return under the plan. In addition, discussion of the tax position of a debtor can reveal assets (*e.g.*, net operating losses) which may be of value to the debtor and its creditors under a plan of reorganization but not under a plan of liquidation. Furthermore, in some cases the tax discussion puts the creditors on notice that the feasibility of a proposed plan of reorganization is contingent upon the resolution of IRS claims. n3

[2] Specific Tax Related Disclosures**[a] Tax Consequences of Plan Confirmation**

As previously stated, the disclosure statement should state the probable tax consequences of the proposed plan of reorganization. n4 The bankruptcy court in *Smith v. Bank of New York* n5 determined that the bank's failure to investigate the tax consequences and the failure to include a provision for the payment of taxes in the plan of reorganization constituted negligent misrepresentation for which the bank was responsible to the trustee. In *Smith*, the bank failed to include any analysis of the tax consequences of the proposed reorganization scheme in its disclosure statement. n6 However, care should be exercised since the tax discussion in a disclosure statement may ultimately undermine a later tax position by the debtor with respect to future IRS audits. n7

[b] Tax Attributes of Debtor

The disclosure statement in *Metrocraft* n8 made no mention of net operating loss carryovers which might have been available to reduce the debtor's tax liability in the future. Furthermore, the bankruptcy court would not impose upon the debtor the obligation to render a lengthy analysis of law under the Internal Revenue Code. But, the court stated that if such tax attributes were available for the debtor's use, they should be described so that creditors could evaluate the actual after-tax position of the debtor. If such tax attributes were not available, a brief explanation of the reasons leading to that conclusion would be sufficient. n9

[c] Tax Impact on Liquidation and Who Will Be Liable

The disclosure statement should estimate the impact, if any, of federal and state income taxes in liquidation. n10 Moreover, the disclosure statement should identify who would be liable for the payment of such taxes. n11

[d] Treatment of IRS Claims

The manner of treatment of IRS claims should be specifically set forth. n12

[e] Taxation of Disputed Claims Reserves

The plan of reorganization may provide for a portion of the distributions to creditors to be set aside for future distributions, depending on the outcome of disputes concerning the allowance of creditor claims. Taxation of such arrangements is subject to uncertainty. n13 Disclosure of the possible tax consequences of such disputed claims arrangements would be prudent. n14

[3] Prior Legislative Proposals**[a] Establishment of National Bankruptcy Review Commission**

The National Bankruptcy Review Commission was created under the Bankruptcy Reform Act of 1994. It was instructed to study the current state of bankruptcy law and to submit a final report to Congress by October 20, 1997. The final report is to include recommendations for legislative amendments to the bankruptcy laws. In February of 1997, a Tax Advisory Committee was formed and its members, consisting of legal and accounting experts from the private sector and the judiciary, were appointed by the Commission. The Commission charged the Advisory Committee to propose and discuss all issues related to federal, state, and local tax collection, compliance, and reporting relating to bankruptcy. The Advisory Committee considered numerous tax-related issues and made various affirmative proposals to the Commission. There were two proposals particularly relevant to the issue of tax disclosure.

[b] Proposal to Amend 11 U.S.C. section 1125(b)

The full text of the Advisory Committee proposal on this issue was as follows:

The Advisory Committee recommends that *11 U.S.C. section 1125(b)* be amended to require a discussion of the potential material federal and state tax consequences of the plan to the debtor and any entity created pursuant to the plan, and a discussion of the potential material federal tax consequences of the plan to a hypothetical investor typical of the holders of claims or interests. A failure to discuss the potential tax consequences of a plan of reorganization in the disclosure statement can result in seriously misleading creditor constituencies and other parties in interest about the plan's economic effects. *See Smith v. Bank of New York, 161 B.R. 302 (Bankr. S.D. Fla. 1993)*. There is no justification for allowing a plan proponent to ignore a plan's tax consequences in the disclosure statement. A plan's tax consequences represent an important aspect of the plan and should be fully discussed to the extent they are material. A Chapter 11 debtor or other plan proponent who possesses the financial resources to propose a plan of reorganization and draft a disclosure statement is likely to possess the necessary resources to analyze the plan's tax effects. A debtor or other plan proponent cannot be expected to provide each creditor with individually tailored tax information; it would be impractical and unreasonably expensive. On the other hand, addressing the material federal tax matters affecting a hypothetical creditor or equity security holder in each class created under the plan is not burdensome, and a plan proponent fairly can be required to supply such information in its disclosure statement.

The proposal as outlined in the report to the Advisory Commission seemed to codify the existing judicial standard of requiring that "adequate information" be disclosed. While it may not suggest a higher standard than enunciated by case law, the very fact that the Advisory Committee felt that legislative changes were desirable suggests that many tax disclosures did not satisfy the judicial standards. Thus, implicit in the proposal is the idea that more tax detail is required in more disclosure statements to convey "adequate information." The amendment to section 1125(a) made by the BAPCPA appears to incorporate the recommendation of the Tax Advisory Committee.

[c] Proposal to Allow Bankruptcy Court to Issue Declaratory Judgment on Federal Tax Issues

The Advisory Committee also recommended to the Commission that *11 U.S.C. section 1146(d)* be amended to allow bankruptcy courts to issue declaratory judgments as to the tax consequences of a proposed plan of reorganization. The rationale was that under present law, courts generally do not have jurisdiction to determine the prospective tax consequences of an event or transaction. n14a In many cases, the prospective tax consequences of a plan may be unclear. If there is not time to secure a private letter ruling from the Internal Revenue Service, the discussion of the probable tax consequences is likely to be general and "non-committal." It is unlikely that debtor's counsel would be willing to render a strong opinion as to future tax consequences. Thus, unless the bankruptcy court can render a declaratory judgment, it may not be possible to describe the actual tax consequences of the plan of reorganization to the debtor or the creditors, thus making it impossible to provide "adequate information." Accordingly, allowing bankruptcy courts the opportunity to make a declaratory judgment as to the future tax results would enable the debtor's counsel to include "adequate information" in the disclosure statement.

Unfortunately, there were no changes made by the BAPCPA n14b that address this issue. Thus, practitioners will continue to deal with the difficult task of providing adequate information as to the tax consequences of a Plan that poses novel and unanswered questions.

[4] Sample Disclosure Statement Tax Section

The following tax discussion was contained in the Disclosure Statement accompanying the Plan of Reorganization for Calpine Corporation. The Calpine Chapter 11 proceeding was filed after the October 17, 2005 effective date for Bankruptcy Abuse Prevention and Consumer Protection Act of 2005. Accordingly, this disclosure statement is subject

to the new or revised Code section 1125(a)(1).

VII. CERTAIN FEDERAL INCOME TAX CONSEQUENCES

The following is a summary of certain U.S. federal income tax consequences of the Plan to the Debtors and certain Creditors and Interest Holders, including Holders of Allowed Second Lien Debt Claims, Other Secured Claims, Unsecured Claims, and Old Calpine Common Stock Interests. This summary is based on the Internal Revenue Code, Treasury Regulations thereunder, and administrative and judicial interpretations and practice, all as in effect on the date of the Disclosure Statement and all of which are subject to change, with possible retroactive effect. Due to the lack of definitive judicial and administrative authority in a number of areas, substantial uncertainty may exist with respect to some of the tax consequences described below. No opinion of counsel has been obtained, and the Debtors do not intend to seek a ruling from the IRS as to any of the tax consequences of the Plan discussed below. There can be no assurance that the IRS will not challenge one or more of the tax consequences of the Plan described below.

This summary does not apply to Holders of Claims or Interests that are not United States persons (as such term is defined in the Internal Revenue Code) or that are otherwise subject to special treatment under U.S. federal income tax law (including, for example, banks, governmental authorities or agencies, financial institutions, insurance companies, pass-through entities, tax-exempt organizations, brokers and dealers in securities, mutual funds, small business investment companies, and regulated investment companies). The following discussion assumes that Holders of Allowed Second Lien Debt Claims, Other Secured Claims, Unsecured Claims, and Old Calpine Common Stock Interests hold such Claims and Interests as "*capital assets*" within the meaning of section 1221 of the Internal Revenue Code. Moreover, this summary does not purport to cover all aspects of U.S. federal income taxation that may apply to the Debtors and Holders of Allowed Second Lien Debt Claims, Other Secured Claims, Unsecured Claims, and Old Calpine Common Stock Interests based upon their particular circumstances. Additionally, this summary does not discuss any tax consequences that may arise under any laws other than U.S. federal income tax law, including under state, local, or foreign tax law.

The following summary is not a substitute for careful tax planning and advice based on the particular circumstances of each Holder of a Claim or Interest, including Holders of Second Lien Debt Claims, Other Secured Claims, Unsecured Claims, and Old Calpine Common Stock Interests. Each Holder of a Claim or Interest is urged to consult his, her, or its own tax advisors as to the U.S. federal income tax consequences, as well as other tax consequences, including under any applicable state, local, and foreign law, of the restructuring described in the Plan.

IRS Circular 230 Disclosure: To ensure compliance with requirements imposed by the IRS, any tax advice contained in this Disclosure Statement is not intended or written to be used, and cannot be used, by any taxpayer for the purpose of avoiding tax-related penalties under the U.S. Internal Revenue Code. The tax advice contained in this Disclosure Statement was written to support the promotion or marketing of the transactions described in this Disclosure Statement. Each taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.

1. Consequences to Holders of Allowed Second Lien Debt Claims

Pursuant to the Plan, each Allowed Second Lien Debt Claim will be paid in full in Cash. If a Holder of an Allowed Second Lien Debt Claim receives Cash in satisfaction of its Claim, the satisfaction should be treated as a taxable exchange under section 1001 of the Internal Revenue Code. The Holder should recognize capital gain or loss (which capital gain or loss would be long-term capital gain or loss if the Holder has held the debt instrument underlying its Claim for more than one year) (subject to the "*market discount*" rules described below) equal to the difference between (x) the amount of Cash received and (y) the Holder's adjusted tax basis in the debt instrument underlying its Claim. To

the extent that the Cash received in the exchange is allocable to accrued interest that has not already been taken into income by the Holder, the Holder may recognize ordinary interest income. See Article VII.A.5 below for further information.

2. Consequences to Holders of Allowed Other Secured Claims

Pursuant to the Plan, each Allowed Other Secured Claim will either be Reinstated or paid in full in Cash or have all collateral securing such Allowed Other Secured Claim returned. If a Holder of an Allowed Other Secured Claim receives Cash or has all collateral securing such Claim returned in satisfaction of its Claim, the satisfaction should be treated as a taxable exchange under section 1001 of the Internal Revenue Code. The Holder should recognize capital gain or loss (which capital gain or loss should be long-term capital gain or loss if the Holder has held its Claim for more than one year) (subject to the "*market discount*" rules described below) equal to the difference between (x) the amount of Cash or the fair market value of other property received and (y) the Holder's adjusted tax basis in its Claim. To the extent that the Cash or property received in the exchange is allocable to accrued interest that has not already been taken into income by the Holder, the Holder may recognize ordinary interest income. See Article VII.A.5 below for further information. If an Allowed Other Secured Claim is Reinstated, the Holder of such Claim should not recognize gain or loss except to the extent collateral securing such Claim is changed, and the change in collateral constitutes a "*significant modification*" of the Allowed Other Secured Claim within the meaning of Treasury Regulations promulgated under section 1001 of the Internal Revenue Code.

3. Consequences to Holders of Allowed Unsecured Claims

a. Exchange of Allowed Unsecured Claims for New Calpine Common Stock

Pursuant to the Plan, Allowed Unsecured Claims (other than Unsecured Convenience Class Claims) will be exchanged for New Calpine Common Stock. The U.S. federal income tax consequences to Holders of Allowed Unsecured Claims depend on whether: (i) the Allowed Unsecured Claims are treated as "*securities*" of Calpine Corporation (as opposed to not being treated as "*securities*" or being treated as "*securities*" of Calpine Corporation's subsidiaries) for purposes of the reorganization provisions of the Internal Revenue Code; and (ii) the Debtors' restructuring qualifies as a tax-free reorganization.

Whether an instrument constitutes a "*security*" is determined based on all the facts and circumstances, but most authorities have held that term-length of a debt instrument at issuance is an important factor in determining whether such an instrument is a security for U.S. federal income tax purposes. These authorities have indicated that a term of less than five years is evidence that the instrument is not a security, whereas a term of ten years or more is evidence that it is a security. There are numerous other factors that could be taken into account in determining whether a debt instrument is a security, including, among others: the security for payment; the creditworthiness of the obligor; the subordination or lack thereof to other creditors; the right to vote or otherwise participate in the management of the obligor; convertibility of the instrument into an equity interest of the obligor; whether payments of interest are fixed, variable, or contingent; and whether such payments are made on a current basis, or accrued.

To the extent that all or some of the Allowed Unsecured Claims are treated as securities of Calpine, then the exchange of such Allowed Unsecured Claims so treated for New Calpine Common Stock pursuant to the Plan should be treated as a recapitalization and, therefore, a tax-free reorganization. In such case, each Holder of such Allowed Unsecured Claims that are treated as securities of Calpine should not recognize any gain or loss on the exchange, except that a Holder of such Allowed Unsecured Claims may recognize ordinary income to the extent that New Calpine Common Stock is treated as received in satisfaction of accrued but untaxed interest on such Allowed Unsecured Claims. See Article VII.A.5 below for further information. Such Holder should obtain a tax basis in the New Calpine Common Stock equal to the tax basis of the Allowed Unsecured Claims surrendered for the New Calpine Common Stock and should have a holding period for the New Calpine Common Stock that includes the holding period for the Allowed

Unsecured Claims exchanged for the New Calpine Common Stock; provided, however, that the tax basis of any share of New Calpine Common Stock (or portion thereof) treated as received in satisfaction of accrued interest should equal the amount of such accrued interest, and the holding period for such New Calpine Common Stock (or portion thereof) should not include the holding period of the Allowed Unsecured Claims exchanged for the New Calpine Common Stock.

To the extent that Allowed Unsecured Claims are not treated as securities of Calpine, or that Holders receive Cash in lieu of New Calpine Common Stock for such Claims, a Holder of such Allowed Unsecured Claims (including a Holder of Allowed Unsecured Convenience Class Claims) will be treated as exchanging its Allowed Unsecured Claims for New Calpine Common Stock or Cash in a taxable exchange under section 1001 of the Internal Revenue Code. Accordingly, each Holder of such Allowed Unsecured Claims should recognize gain or loss equal to the difference between: (i) the fair market value of New Calpine Common Stock (as of the date the stock is distributed to the Holder) or Cash received in exchange for the Allowed Unsecured Claims; and (ii) the Holder's adjusted basis, if any, in the Allowed Unsecured Claims. Such gain or loss should be capital in nature so long as the Allowed Unsecured Claims are held as capital assets (subject to the "*market discount*" rules described below) and should be long-term capital gain or loss if the Holder has a holding period for Allowed Unsecured Claims of more than one year. To the extent that a portion of the Cash received in exchange for the Allowed Unsecured Claims is allocable to accrued but untaxed interest, the Holder may recognize ordinary income. See Article VII.A.5 below for further information. A Holder's tax basis in New Calpine Common Stock received should equal the fair market value of the New Calpine Common Stock as of the date such stock is distributed to the Holder. A Holder's holding period for New Calpine Common Stock should begin on the day following the Effective Date.

b. Exchange of Allowed Unsecured Claims Against Calpine's Subsidiaries

Holders of Allowed Claims against Calpine's Subsidiaries ("*Subsidiary Claims*") may recognize gain or loss on the exchange of such Claims for New Calpine Common Stock. Although certain Subsidiary Claims may constitute securities, the exchange of Subsidiary Claims for New Calpine Common Stock likely may not qualify as a tax-free reorganization because the Subsidiary Claims were issued by various subsidiaries of Calpine and will be exchanged for equity in Calpine. Accordingly, Holders of Subsidiary Claims may recognize gain or loss equal to the difference between: (i) the fair market value of New Calpine Common Stock (as of the date the stock is distributed to the Holder) received in exchange for the Subsidiary Claims; and (ii) the Holder's adjusted basis in the Subsidiary Claims. Such gain or loss should be capital in nature so long as the Subsidiary Claims are held as capital assets (subject to the "*market discount*" rules described below) and should be long-term capital gain or loss if the Subsidiary Claims were held for more than one year. To the extent that a portion of the New Calpine Common Stock received in exchange for the Subsidiary Claims is allocable to accrued but untaxed interest, the Holder may recognize ordinary income. See Article VII.A.5 below for further information. If gains or losses are recognized, a Holder's tax basis in New Calpine Common Stock received should equal the fair market value of the New Calpine Common Stock as of the date the stock is distributed to the Holder, and a Holder's holding period for New Calpine Common Stock should begin on the day following the Effective Date.

The Debtors intend to take reasonable steps to structure the transaction such that Holders of Subsidiary Claims will not recognize gain or loss on the exchange of such Claims for New Calpine Common Stock. Among other actions, the Debtors may cause certain Calpine subsidiaries to be treated as "*disregarded entities*" solely for U.S. federal tax purposes either by making an election or converting the legal form of certain corporate Entities to limited liability companies. By making this conversion or election prior to the Effective Date, holders of Subsidiary Claims may be treated for tax purposes as though they actually held Claims against Calpine. In that event, the exchange of such Claim (assuming such Claim qualified as a "*security*" for tax purposes) for New Calpine Common Stock should qualify for tax-free treatment. There is no assurance that the effect of such election would permit holders of Subsidiary Claims to exchange those Claims for New Calpine Common Stock without recognizing gain or loss. If the Debtors do not convert

these Entities or make this election, they intend to pursue other alternatives to permit a tax-free exchange for Holders of Subsidiary Claims.

4. Consequences to Holders of Old Calpine Common Stock Interests

Holders of Old Calpine Common Stock Interests that are exchanged for New Calpine Common Stock should not recognize any gain or loss on such exchange. The Holder's tax basis in its New Calpine Common Stock should equal its tax basis in the shares surrendered, and the Holder's holding period for such shares should include the period during which such Holder held its Old Calpine Common Stock interests.

5. Accrued But Untaxed Interest

It is expected that a portion of the New Calpine Common Stock received by Holders of Claims will be attributable to accrued but untaxed interest on such Claims. Such amount should be taxable to that Holder as interest income if such accrued interest has not been previously included in the Holder's gross income for U.S. federal income tax purposes.

If the fair value of the New Calpine Common Stock is not sufficient to fully satisfy all principal and interest on Allowed Claims, the extent to which such New Calpine Common Stock will be attributable to accrued but untaxed interest is unclear. Under the Plan, the aggregate consideration to be distributed to Holders of Allowed Claims in each Class will be treated as first satisfying an amount equal to the stated principal amount of the Allowed Claim for such Holders and any remaining consideration as satisfying accrued, but unpaid, interest, if any. Certain legislative history indicates that an allocation of consideration as between principal and interest provided in a chapter 11 plan of reorganization is binding for U.S. federal income tax purposes. The IRS could take the position, however, that the consideration received by a Holder should be allocated in some way other than as provided in the Plan. Holders of Claims should consult their own tax advisors regarding the proper allocation of the consideration received by them under the Plan.

6. Market Discount

Holders who exchange Allowed Unsecured Claims (including Subsidiary Claims) for New Calpine Common Stock may be affected by the "*market discount*" provisions of sections 1276 through 1278 of the Internal Revenue Code. Under these rules, some or all of the gain realized by a Holder may be treated as ordinary income (instead of capital gain), to the extent of the amount of accrued "*market discount*" on such Allowed Unsecured Claims and Subsidiary Claims.

In general, a debt obligation with a fixed maturity of more than one year that is acquired by a holder on the secondary market (or, in certain circumstances, upon original issuance) is considered to be acquired with "*market discount*" as to that holder if the debt obligation's stated redemption price at maturity (or revised issue price as defined in section 1278 of the Internal Revenue Code, in the case of a debt obligation issued with original issue discount) exceeds the tax basis of the debt obligation in the holder's hands immediately after its acquisition. However, a debt obligation is not a "*market discount bond*" if such excess is less than a statutory de minimis amount (equal to 0.25 percent of the debt obligation's stated redemption price at maturity or revised issue price, in the case of a debt obligation issued with original issue discount, multiplied by the number of complete years remaining until maturity at the time of the acquisition).

Any gain recognized by a Holder on the taxable disposition of Allowed Unsecured Claims and Subsidiary Claims (determined as described above) that were acquired with market discount should be treated as ordinary income to the extent of the market discount that accrued thereon while the Allowed Unsecured Claims and Subsidiary Claims were considered to be held by the Holder (unless the Holder elected to include market discount in income as it accrued). To the extent that the Allowed Unsecured Claims and Subsidiary Claims that were acquired with market discount are exchanged in a tax-free transaction for other property (as may occur here), any market discount that accrued on the Allowed Unsecured Claims and Subsidiary Claims (*i.e.*, up to the time of the exchange) but was not recognized by the Holder is carried over to the property received therefor and any gain recognized on the subsequent sale, exchange,

redemption or other disposition of such property is treated as ordinary income to the extent of such accrued market discount.

7. The Rights Offering

If the Debtors pursue a rights offering, a recipient of subscription rights generally should not recognize taxable gain or loss upon the exercise of such rights. The tax basis in the new common stock received upon exercise of the subscription rights should equal the sum of the holder's tax basis in the subscription rights and the amount paid for such new common stock. The holding period in such new common stock received should commence the day following its acquisition.

8. Information Reporting and Backup Withholding

In general, information reporting requirements may apply to distributions or payments under the Plan. Additionally, under the backup withholding rules, a Holder of a Claim may be subject to backup withholding (currently at a rate of 28%) with respect to distributions or payments made pursuant to the Plan unless that Holder: (a) comes within certain exempt categories (which generally include corporations) and, when required, demonstrates that fact; or (b) provides a correct taxpayer identification number and certifies under penalty of perjury that the taxpayer identification number is correct and that the Holder is not subject to backup withholding because of a failure to report all dividend and interest income. Backup withholding is not an additional tax, but merely an advance payment that may be refunded to the extent it results in an overpayment of tax, provided that the required information is provided to the IRS.

The Debtors will withhold all amounts required by law to be withheld from payments of interest. The Debtors will comply with all applicable reporting requirements of the Internal Revenue Code.

THE U.S. FEDERAL INCOME TAX CONSEQUENCES OF THE PLAN ARE COMPLEX. THE FOREGOING SUMMARY DOES NOT DISCUSS ALL ASPECTS OF U.S. FEDERAL INCOME TAXATION THAT MAY BE RELEVANT TO A PARTICULAR HOLDER OF A CLAIM OR INTEREST IN LIGHT OF SUCH HOLDER'S CIRCUMSTANCES AND INCOME TAX SITUATION. ALL HOLDERS OF CLAIMS AGAINST AND INTERESTS IN THE DEBTORS SHOULD CONSULT WITH THEIR TAX ADVISORS AS TO THE PARTICULAR TAX CONSEQUENCES TO THEM OF THE TRANSACTION CONTEMPLATED BY THE RESTRUCTURING, INCLUDING THE APPLICABILITY AND EFFECT OF ANY STATE, LOCAL, OR FOREIGN TAX LAWS, AND OF ANY CHANGE IN APPLICABLE TAX LAWS.

1. Consequences to Holders of Allowed Second Lien Debt Claims

Pursuant to the Plan, each Allowed Second Lien Debt Claim will be paid in full in Cash. If a Holder of an Allowed Second Lien Debt Claim receives Cash in satisfaction of its Claim, the satisfaction should be treated as a taxable exchange under section 1001 of the Internal Revenue Code. The Holder should recognize capital gain or loss (which capital gain or loss would be long-term capital gain or loss if the Holder has held the debt instrument underlying its Claim for more than one year) (subject to the "*market discount*" rules described below) equal to the difference between (x) the amount of Cash received and (y) the Holder's adjusted tax basis in the debt instrument underlying its Claim. To the extent that the Cash received in the exchange is allocable to accrued interest that has not already been taken into income by the Holder, the Holder may recognize ordinary interest income. See Article VII.A.5 below for further information.

2. Consequences to Holders of Allowed Other Secured Claims

Pursuant to the Plan, each Allowed Other Secured Claim will either be Reinstated or paid in full in Cash or have all collateral securing such Allowed Other Secured Claim returned. If a Holder of an Allowed Other Secured Claim

receives Cash or has all collateral securing such Claim returned in satisfaction of its Claim, the satisfaction should be treated as a taxable exchange under section 1001 of the Internal Revenue Code. The Holder should recognize capital gain or loss (which capital gain or loss should be long-term capital gain or loss if the Holder has held its Claim for more than one year) (subject to the "*market discount*" rules described below) equal to the difference between (x) the amount of Cash or the fair market value of other property received and (y) the Holder's adjusted tax basis in its Claim. To the extent that the Cash or property received in the exchange is allocable to accrued interest that has not already been taken into income by the Holder, the Holder may recognize ordinary interest income. See Article VII.A.5 below for further information. If an Allowed Other Secured Claim is Reinstated, the Holder of such Claim should not recognize gain or loss except to the extent collateral securing such Claim is changed, and the change in collateral constitutes a "*significant modification*" of the Allowed Other Secured Claim within the meaning of Treasury Regulations promulgated under section 1001 of the Internal Revenue Code.

3. Consequences to Holders of Allowed Unsecured Claims

a. Exchange of Allowed Unsecured Claims for New Calpine Common Stock

Pursuant to the Plan, Allowed Unsecured Claims (other than Unsecured Convenience Class Claims) will be exchanged for New Calpine Common Stock. The U.S. federal income tax consequences to Holders of Allowed Unsecured Claims depend on whether: (i) the Allowed Unsecured Claims are treated as "*securities*" of Calpine Corporation (as opposed to not being treated as "*securities*" or being treated as "*securities*" of Calpine Corporation's subsidiaries) for purposes of the reorganization provisions of the Internal Revenue Code; and (ii) the Debtors' restructuring qualifies as a tax-free reorganization.

Whether an instrument constitutes a "*security*" is determined based on all the facts and circumstances, but most authorities have held that term-length of a debt instrument at issuance is an important factor in determining whether such an instrument is a security for U.S. federal income tax purposes. These authorities have indicated that a term of less than five years is evidence that the instrument is not a security, whereas a term of ten years or more is evidence that it is a security. There are numerous other factors that could be taken into account in determining whether a debt instrument is a security, including, among others: the security for payment; the creditworthiness of the obligor; the subordination or lack thereof to other creditors; the right to vote or otherwise participate in the management of the obligor; convertibility of the instrument into an equity interest of the obligor; whether payments of interest are fixed, variable, or contingent; and whether such payments are made on a current basis, or accrued.

To the extent that all or some of the Allowed Unsecured Claims are treated as securities of Calpine, then the exchange of such Allowed Unsecured Claims so treated for New Calpine Common Stock pursuant to the Plan should be treated as a recapitalization and, therefore, a tax-free reorganization. In such case, each Holder of such Allowed Unsecured Claims that are treated as securities of Calpine should not recognize any gain or loss on the exchange, except that a Holder of such Allowed Unsecured Claims may recognize ordinary income to the extent that New Calpine Common Stock is treated as received in satisfaction of accrued but untaxed interest on such Allowed Unsecured Claims. See Article VII.A.5 below for further information. Such Holder should obtain a tax basis in the New Calpine Common Stock equal to the tax basis of the Allowed Unsecured Claims surrendered for the New Calpine Common Stock and should have a holding period for the New Calpine Common Stock that includes the holding period for the Allowed Unsecured Claims exchanged for the New Calpine Common Stock; provided, however, that the tax basis of any share of New Calpine Common Stock (or portion thereof) treated as received in satisfaction of accrued interest should equal the amount of such accrued interest, and the holding period for such New Calpine Common Stock (or portion thereof) should not include the holding period of the Allowed Unsecured Claims exchanged for the New Calpine Common Stock.

To the extent that Allowed Unsecured Claims are not treated as securities of Calpine, or that Holders receive Cash in lieu of New Calpine Common Stock for such Claims, a Holder of such Allowed Unsecured Claims (including a Holder of Allowed Unsecured Convenience Class Claims) will be treated as exchanging its Allowed Unsecured Claims

for New Calpine Common Stock or Cash in a taxable exchange under section 1001 of the Internal Revenue Code. Accordingly, each Holder of such Allowed Unsecured Claims should recognize gain or loss equal to the difference between: (i) the fair market value of New Calpine Common Stock (as of the date the stock is distributed to the Holder) or Cash received in exchange for the Allowed Unsecured Claims; and (ii) the Holder's adjusted basis, if any, in the Allowed Unsecured Claims. Such gain or loss should be capital in nature so long as the Allowed Unsecured Claims are held as capital assets (subject to the "*market discount*" rules described below) and should be long-term capital gain or loss if the Holder has a holding period for Allowed Unsecured Claims of more than one year. To the extent that a portion of the Cash received in exchange for the Allowed Unsecured Claims is allocable to accrued but untaxed interest, the Holder may recognize ordinary income. See Article VII.A.5 below for further information. A Holder's tax basis in New Calpine Common Stock received should equal the fair market value of the New Calpine Common Stock as of the date such stock is distributed to the Holder. A Holder's holding period for New Calpine Common Stock should begin on the day following the Effective Date.

b. Exchange of Allowed Unsecured Claims Against Calpine's Subsidiaries

Holders of Allowed Claims against Calpine's Subsidiaries ("*Subsidiary Claims*") may recognize gain or loss on the exchange of such Claims for New Calpine Common Stock. Although certain Subsidiary Claims may constitute securities, the exchange of Subsidiary Claims for New Calpine Common Stock likely may not qualify as a tax-free reorganization because the Subsidiary Claims were issued by various subsidiaries of Calpine and will be exchanged for equity in Calpine. Accordingly, Holders of Subsidiary Claims may recognize gain or loss equal to the difference between: (i) the fair market value of New Calpine Common Stock (as of the date the stock is distributed to the Holder) received in exchange for the Subsidiary Claims; and (ii) the Holder's adjusted basis in the Subsidiary Claims. Such gain or loss should be capital in nature so long as the Subsidiary Claims are held as capital assets (subject to the "*market discount*" rules described below) and should be long-term capital gain or loss if the Subsidiary Claims were held for more than one year. To the extent that a portion of the New Calpine Common Stock received in exchange for the Subsidiary Claims is allocable to accrued but untaxed interest, the Holder may recognize ordinary income. See Article VII.A.5 below for further information. If gains or losses are recognized, a Holder's tax basis in New Calpine Common Stock received should equal the fair market value of the New Calpine Common Stock as of the date the stock is distributed to the Holder, and a Holder's holding period for New Calpine Common Stock should begin on the day following the Effective Date.

The Debtors intend to take reasonable steps to structure the transaction such that Holders of Subsidiary Claims will not recognize gain or loss on the exchange of such Claims for New Calpine Common Stock. Among other actions, the Debtors may cause certain Calpine subsidiaries to be treated as "*disregarded entities*" solely for U.S. federal tax purposes either by making an election or converting the legal form of certain corporate Entities to limited liability companies. By making this conversion or election prior to the Effective Date, holders of Subsidiary Claims may be treated for tax purposes as though they actually held Claims against Calpine. In that event, the exchange of such Claim (assuming such Claim qualified as a "*security*" for tax purposes) for New Calpine Common Stock should qualify for tax-free treatment. There is no assurance that the effect of such election would permit holders of Subsidiary Claims to exchange those Claims for New Calpine Common Stock without recognizing gain or loss. If the Debtors do not convert these Entities or make this election, they intend to pursue other alternatives to permit a tax-free exchange for Holders of Subsidiary Claims.

4. Consequences to Holders of Old Calpine Common Stock Interests

Holders of Old Calpine Common Stock Interests that are exchanged for New Calpine Common Stock should not recognize any gain or loss on such exchange. The Holder's tax basis in its New Calpine Common Stock should equal its tax basis in the shares surrendered, and the Holder's holding period for such shares should include the period during

which such Holder held its Old Calpine Common Stock interests.

5. Accrued But Untaxed Interest

It is expected that a portion of the New Calpine Common Stock received by Holders of Claims will be attributable to accrued but untaxed interest on such Claims. Such amount should be taxable to that Holder as interest income if such accrued interest has not been previously included in the Holder's gross income for U.S. federal income tax purposes.

If the fair value of the New Calpine Common Stock is not sufficient to fully satisfy all principal and interest on Allowed Claims, the extent to which such New Calpine Common Stock will be attributable to accrued but untaxed interest is unclear. Under the Plan, the aggregate consideration to be distributed to Holders of Allowed Claims in each Class will be treated as first satisfying an amount equal to the stated principal amount of the Allowed Claim for such Holders and any remaining consideration as satisfying accrued, but unpaid, interest, if any. Certain legislative history indicates that an allocation of consideration as between principal and interest provided in a chapter 11 plan of reorganization is binding for U.S. federal income tax purposes. The IRS could take the position, however, that the consideration received by a Holder should be allocated in some way other than as provided in the Plan. Holders of Claims should consult their own tax advisors regarding the proper allocation of the consideration received by them under the Plan.

6. Market Discount

Holders who exchange Allowed Unsecured Claims (including Subsidiary Claims) for New Calpine Common Stock may be affected by the "*market discount*" provisions of sections 1276 through 1278 of the Internal Revenue Code. Under these rules, some or all of the gain realized by a Holder may be treated as ordinary income (instead of capital gain), to the extent of the amount of accrued "*market discount*" on such Allowed Unsecured Claims and Subsidiary Claims.

In general, a debt obligation with a fixed maturity of more than one year that is acquired by a holder on the secondary market (or, in certain circumstances, upon original issuance) is considered to be acquired with "*market discount*" as to that holder if the debt obligation's stated redemption price at maturity (or revised issue price as defined in section 1278 of the Internal Revenue Code, in the case of a debt obligation issued with original issue discount) exceeds the tax basis of the debt obligation in the holder's hands immediately after its acquisition. However, a debt obligation is not a "*market discount bond*" if such excess is less than a statutory de minimis amount (equal to 0.25 percent of the debt obligation's stated redemption price at maturity or revised issue price, in the case of a debt obligation issued with original issue discount, multiplied by the number of complete years remaining until maturity at the time of the acquisition).

Any gain recognized by a Holder on the taxable disposition of Allowed Unsecured Claims and Subsidiary Claims (determined as described above) that were acquired with market discount should be treated as ordinary income to the extent of the market discount that accrued thereon while the Allowed Unsecured Claims and Subsidiary Claims were considered to be held by the Holder (unless the Holder elected to include market discount in income as it accrued). To the extent that the Allowed Unsecured Claims and Subsidiary Claims that were acquired with market discount are exchanged in a tax-free transaction for other property (as may occur here), any market discount that accrued on the Allowed Unsecured Claims and Subsidiary Claims (*i.e.*, up to the time of the exchange) but was not recognized by the Holder is carried over to the property received therefor and any gain recognized on the subsequent sale, exchange, redemption or other disposition of such property is treated as ordinary income to the extent of such accrued market discount.

7. The Rights Offering

If the Debtors pursue a rights offering, a recipient of subscription rights generally should not recognize taxable gain or loss upon the exercise of such rights. The tax basis in the new common stock received upon exercise of the subscription rights should equal the sum of the holder's tax basis in the subscription rights and the amount paid for such new

common stock. The holding period in such new common stock received should commence the day following its acquisition.

8. Information Reporting and Backup Withholding

In general, information reporting requirements may apply to distributions or payments under the Plan. Additionally, under the backup withholding rules, a Holder of a Claim may be subject to backup withholding (currently at a rate of 28%) with respect to distributions or payments made pursuant to the Plan unless that Holder: (a) comes within certain exempt categories (which generally include corporations) and, when required, demonstrates that fact; or (b) provides a correct taxpayer identification number and certifies under penalty of perjury that the taxpayer identification number is correct and that the Holder is not subject to backup withholding because of a failure to report all dividend and interest income. Backup withholding is not an additional tax, but merely an advance payment that may be refunded to the extent it results in an overpayment of tax, provided that the required information is provided to the IRS.

The Debtors will withhold all amounts required by law to be withheld from payments of interest. The Debtors will comply with all applicable reporting requirements of the Internal Revenue Code.

THE U.S. FEDERAL INCOME TAX CONSEQUENCES OF THE PLAN ARE COMPLEX. THE FOREGOING SUMMARY DOES NOT DISCUSS ALL ASPECTS OF U.S. FEDERAL INCOME TAXATION THAT MAY BE RELEVANT TO A PARTICULAR HOLDER OF A CLAIM OR INTEREST IN LIGHT OF SUCH HOLDER'S CIRCUMSTANCES AND INCOME TAX SITUATION. ALL HOLDERS OF CLAIMS AGAINST AND INTERESTS IN THE DEBTORS SHOULD CONSULT WITH THEIR TAX ADVISORS AS TO THE PARTICULAR TAX CONSEQUENCES TO THEM OF THE TRANSACTION CONTEMPLATED BY THE RESTRUCTURING, INCLUDING THE APPLICABILITY AND EFFECT OF ANY STATE, LOCAL, OR FOREIGN TAX LAWS, AND OF ANY CHANGE IN APPLICABLE TAX LAWS.

1. Cancellation of Debt and Reduction of Tax Attributes

In general, absent an exception, a debtor will realize and recognize cancellation of debt income ("*COD Income*") upon satisfaction of its outstanding indebtedness for total consideration less than the amount of such indebtedness. The amount of COD Income, in general, is the excess of (a) the adjusted issue price of the indebtedness satisfied, over (b) the sum of (x) the amount of Cash paid, and (y) the fair market value of any new consideration (including stock of the debtor) given in satisfaction of such indebtedness at the time of the exchange.

A debtor will not, however, be required to include any amount of COD Income in gross income if the debtor is under the jurisdiction of a court in a case under chapter 11 of the Bankruptcy Code and the discharge of debt occurs pursuant to that proceeding. Instead, as a consequence of such exclusion, a debtor must reduce its tax attributes by the amount of COD Income that it excluded from gross income under section 108 of the Internal Revenue Code. In general, tax attributes will be reduced in the following order: (a) NOLs; (b) most tax credits and capital loss carryovers; (c) tax basis in assets; and (d) foreign tax credits. A debtor with COD Income may elect first to reduce the basis of its depreciable assets under section 108(b)(5) of the Internal Revenue Code.

Because the Plan provides that Holders of Allowed Unsecured Claims will receive New Calpine Common Stock, the amount of COD Income, and accordingly the amount of tax attributes required to be reduced, will depend on the fair market value of the New Calpine Common Stock exchanged therefor. This value cannot be known with certainty until after the Effective Date. Thus, although the Debtors believe that no COD Income will be realized because it is expected that all Claims will be fully satisfied, some COD Income may be realized if the New Calpine Common Stock is worth less than currently expected. In that case, a reduction of tax attributes may be required. Nonetheless, despite this reduction (if any), the Debtors expect that they will have significant NOL carryovers remaining after emergence from chapter 11, subject to the limitations discussed below.

2. Limitation of Net Operating Loss Carry Forwards and Other Tax Attributes

The Reorganized Debtors will have NOL carryovers and other tax attributes at emergence potentially exceeding \$5.0 billion. The precise amount of NOL carryovers that will be available to the Reorganized Debtors at emergence is based on a number of factors and is impossible to calculate at this time. Some of the factors that will impact the amount of available NOLs include: the amount of tax losses incurred by the Debtors in 2007; the value of the New Calpine Common Stock; and the amount of COD Income incurred by the Debtors in connection with Consummation. The Debtors anticipate that, taking these factors into account, they will have significant federal NOL carryovers following emergence, subject to the limitations discussed below. The Valuation Analysis concludes that a material portion of the Reorganized Debtors' valuation is derived from the Reorganized Debtors' federal NOLs. In addition, the Reorganized Debtors' subsequent utilization of any losses and NOL carryovers remaining and possibly certain other tax attributes may be restricted as a result of and upon Consummation.

Following Consummation, the Debtors anticipate that any remaining NOL and tax credit carryovers and, possibly, certain other tax attributes of the Reorganized Debtors allocable to periods prior to the Effective Date (collectively, "*Pre-Change Losses*") may be subject to limitation under section 382 of the Internal Revenue Code as a result of an "*ownership change*" of the Reorganized Debtors by reason of the transactions pursuant to the Plan.

Under section 382 of the Internal Revenue Code, if a corporation undergoes an "*ownership change*," the amount of its Pre-Change Losses that may be utilized to offset future taxable income generally is subject to an annual limitation. As discussed more fully below, the Debtors anticipate that the issuance of the New Calpine Common Stock pursuant to the Plan will result in an "*ownership change*" of the Reorganized Debtors for these purposes, and that the Debtors' use of their NOL carryovers will be subject to limitation unless an exception to the general rules of section 382 of the Internal Revenue Code applies.

a. General Section 382 Annual Limitation

In general, the amount of the annual limitation to which a corporation that undergoes an "*ownership change*" would be subject is equal to the product of (i) the fair market value of the stock of the corporation immediately before the "*ownership change*" (with certain adjustments) multiplied by (ii) the "*long-term tax-exempt rate*" in effect for the month in which the "*ownership change*" occurs (currently approximately 4.32%, as of July 2007). Any unused limitation may be carried forward, thereby increasing the annual limitation in the subsequent taxable year.

b. Special Bankruptcy Exceptions

An exception to the foregoing annual limitation rules generally applies when so-called "*qualified creditors*" of a debtor company in chapter 11 receive, in respect of their claims, at least 50% of the vote and value of the stock of the reorganized debtor (or a controlling corporation if also in chapter 11) pursuant to a confirmed chapter 11 plan (the "*382(l)(5) Exception*"). Under the 382(l)(5) Exception, a debtor's Pre-Change Losses are not limited on an annual basis but, instead, are required to be reduced by the amount of any interest deductions claimed during the three taxable years preceding the effective date of the plan of reorganization, and during the part of the taxable year prior to and including the effective date of the plan of reorganization, in respect of all debt converted into stock in the reorganization. If the 382(l)(5) Exception applies and the Debtors undergo another "*ownership change*" within two years after Consummation, then the Debtors' Pre-Change Losses effectively would be eliminated in their entirety.

Where the 382(l)(5) Exception is not applicable (either because the debtor does not qualify for it or the debtor

otherwise elects not to utilize the 382(l)(5) Exception), a second special rule will generally apply (the "382(l)(6) Exception"). When the 382(l)(6) Exception applies, a debtor corporation that undergoes an "ownership change" generally is permitted to determine the fair market value of its stock after taking into account the increase in value resulting from any surrender or cancellation of creditors' claims in the bankruptcy. This differs from the ordinary rule that requires the fair market value of a debtor corporation that undergoes an "ownership change" to be determined before the events giving rise to the change. The 382(l)(6) Exception also differs from the 382(l)(5) Exception in that under it the debtor corporation is not required to reduce their NOLs by the amount of interest deductions claimed within the prior three-year period, and the debtor may undergo a change of ownership within two years without triggering the elimination of its NOLs.

The IRS has announced rules that may make it beneficial for the Debtors to utilize the 382(l)(6) Exception. Under these rules, a corporation whose assets generally have a fair market value greater than their tax basis (a "net unrealized built-in gain") is permitted to increase its annual section 382 limitation during the five years immediately after the "ownership change" by an amount equal to the depreciation deductions that a hypothetical purchaser of a debtor's assets would have been permitted to claim if it had acquired the debtor's assets in a taxable transaction. While the Debtors' analysis continues, the Debtors believe they may have a net unrealized built-in gain on assets, and, accordingly their ability to utilize their pre-change losses to offset their taxable income under section 382(l)(6) of the Internal Revenue Code following the Effective Date may be significantly enhanced. At all events, however, it is important to recognize that the Debtors' Pre-Change Losses will be reduced by the amount of COD Income realized as part of the Plan, as discussed above.

While it is not certain, it is doubtful at this point that the Debtors will elect to utilize the 382(l)(5) Exception. In the event that the Debtors do not use the 382(l)(5) Exception, the Debtors expect that their use of their NOLs after the Effective Date will be subject to limitation based on the rules discussed above, but taking into account the 382(l)(6) Exception. The Valuation Analysis determines the Reorganized Debtors' valuation based on the assumption that the Reorganized Debtors will utilize the 382(l)(6) Exception and not the 382(l)(5) Exception. Regardless of whether the Reorganized Debtors take advantage of the 382(l)(6) Exception or the 382(l)(5) Exception, the Reorganized Debtors' use of their pre-change losses after the Effective Date may be adversely affected if an "ownership change" within the meaning of section 382 of the Internal Revenue Code were to occur after the Effective Date.

3. Restrictions on Resale of Securities to Protect NOLs

The Debtors expect to emerge from chapter 11 with valuable tax attributes, including more than \$5.0 billion of NOLs. The Reorganized Debtors' ability to utilize these NOLs could be subject to limitation if an "ownership change" with respect to the New Calpine Common Stock were to occur after emergence. In order to reduce the risk of an ownership change that might impose such a limitation, the Debtors expect that the Reorganized Calpine Charter may include reasonable and customary restrictions on trading in such stock. The Debtors will negotiate in good faith with the Creditors' Committee and the Equity Committee reasonable and customary restrictions on the transfer of New Calpine Common Stock to the extent necessary to avoid any adverse federal income tax consequences resulting from an ownership change (as defined in section 382 of the Internal Revenue Code) in Reorganized Calpine.

4. Alternative Minimum Tax

In general, an alternative minimum tax ("AMT") is imposed on a corporation's alternative minimum taxable income ("AMTI") at a 20% rate to the extent such tax exceeds the corporation's regular federal income tax for the year. AMTI is generally equal to regular taxable income with certain adjustments. For purposes of computing AMTI, certain tax deductions and other beneficial allowances are modified or eliminated. For example, except for alternative tax NOLs generated in or deducted as carryforwards in taxable years ending in 2001 and 2002, which can offset 100% of a corporation's AMTI, only 90% of a corporation's AMTI may be offset by available alternative tax NOL carryforwards. The effect of this rule could cause Reorganized Calpine to owe a modest amount of federal and state income tax on

taxable income in future years even though NOL carryforwards are available to offset that taxable income. Additionally, under section 56(g)(4)(G) of the Internal Revenue Code, an ownership change (as discussed above) that occurs with respect to a corporation having a net unrealized built-in loss in its assets will cause, for AMT purposes, the adjusted basis of each asset of the corporation immediately after the ownership change to be equal to its proportionate share (determined on the basis of respective fair market values) of the fair market value of the assets of the corporation, as determined under section 382(h) of the Internal Revenue Code, immediately before the ownership change. The Debtors do not believe they will have a net unrealized built-in loss in their assets immediately after the ownership change.

FOOTNOTES:

(n1)Footnote 1. *11 U.S.C. § 1125(a)*, as amended by Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n2)Footnote 1a. For a detailed analysis of the potential impact of this amendment, *see* Jack Williams and Jacob Todres, "Tax consequences of Postpetition Income as Property of the Estate in an Individual Chapter 11 case and Tax Disclosure in Chapter 11," *13 Am. Bankr. Inst. L. Rev.* 701 (Winter 2005).

(n3)Footnote 1b. *In re Malek*, 10 C.B.C.2d 189, 191, 35 B.R. 443 (Bankr. E.D. Mich. 1983) .

(n4)Footnote 2. *In re Malek*, 10 C.B.C.2d 189, 191, 35 B.R. 443 (Bankr. E.D. Mich. 1983) .

(n5)Footnote 3. *In re Feldman*, 53 B.R. 355, 358 (Bankr. S.D.N.Y. 1985) .

(n6)Footnote 4. *In re Malek*, 10 C.B.C.2d 189, 191, 35 B.R. 443 (Bankr. E.D. Mich. 1983) . *See also In re Scioto Valley Mortgage Co.*, 88 B.R. 168, 171 (Bankr. S.D. Ohio 1988) ; *In re Jeppson*, 66 B.R. 269, 292 (Bankr. D. Utah 1986) .

(n7)Footnote 5. 161 B.R. 302 (Bankr. S.D. Fla. 1993) .

(n8)Footnote 6. 161 B.R. 302, 307 (Bankr. S.D. Fla. 1993) .

(n9)Footnote 7. *In re Hartman Material Handling Systems, Inc.*, 141 B.R. 802 U.S.T.C. P 50325 n.8 (Bankr. S.D.N.Y. 1992).

(n10)Footnote 8. *In re Metrocraft Publishing Serv., Inc.*, 10 C.B.C.2d 1182, 39 B.R. 567 (Bankr. N.D. Ga. 1984) .

(n11)Footnote 9. *In re Metrocraft Publishing Serv., Inc.*, 10 C.B.C.2d 1182, 1187, 39 B.R. 567 (Bankr. N.D. Ga. 1984) .

(n12)Footnote 10. *In re Haukos Farms, Inc.*, 68 B.R. 428, 434 (Bankr. D. Minn. 1986) .

(n13)Footnote 11. *In re Haukos Farms, Inc.*, 68 B.R. 428, 434 (Bankr. D. Minn. 1986) .

(n14)Footnote 12. *In re Werth*, 8 C.B.C.2d 480, 484, 29 B.R. 220 (Bankr. D. Colo. 1983) .

(n15)Footnote 13. *See* chapter TX7 *supra*.

(n16)Footnote 14. *See, e.g., P TX14.04[6] supra*.

(n17)Footnote 14a. See The Anti-Injunction Act, 26 U.S.C. § 7421, and the Declaratory Judgment Act, 28 U.S.C. § 2201. In *In re Dycoal*, 327 B.R. 220 (W.D. Pa. 2005), the court held that it had no power to grant declaratory relief as to the availability of I.R.C. § 29 tax credits pursuant to debtors request under 11 U.S.C. § 505(a)(1).

(n18)Footnote 14b. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).



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CHAPTER TX17 Checklist: Tax Planning and Practice Strategies for Individuals

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§ TX17.syn Synopsis to Chapter TX17: Checklist: Tax Planning and Practice Strategies for Individuals

P TX17.01 Introduction

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P TX17.01 Introduction

A financially challenged individual may consider commencing a case under the Bankruptcy Code as a way to solve financial problems and obtain a "fresh start." When unpaid federal or state taxes account for some or all of the financial difficulties faced by an individual, the filing of a petition under the Bankruptcy Code may be advisable. However, the decision of whether to commence a bankruptcy case and, if so, when and where to file, and what type of case to commence, should be made only after careful consideration of many issues, especially for cases filed after the effective date of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA").ⁿ¹ In general, it will be more difficult for individual debtors to file a chapter 7 proceeding and the benefits of a chapter 13 proceeding are reduced. The BAPCPA provides that an individual cannot use chapter 7 if the individual's projected five-year income, less certain expenses and a modest living allowance, would produce a surplus that can be used to repay creditors. Chapter 13 plans must utilize a five-year payout requirement utilizing a similarly calculated surplus to satisfy the individual's debts and obligations. No doubt there will be many interpretational issues and questions that will only be resolved after time and relevant decisions. Accordingly, careful analysis of the relevant BAPCPA provisions is advised. Once the decision is made to file, other steps may be appropriate to maximize the benefits of the filing of the petition for the individual. Finally, an individual commencing a chapter 7 or chapter 11 case needs to consider the benefits of various elections available for tax purposes, the most important of which is the ability to elect a short taxable year for the year in which the filing of the petition under the Bankruptcy Code occurs.

Set forth below in checklist format are some of the specific questions which should be analyzed by the individual.

FOOTNOTES:

(n1)Footnote 1. Pub. L. No. 109-8 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised), effective in cases commenced on or after October 17, 2005.



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P TX17.02 Whether to Commence a Case Under the Bankruptcy Code

1. In considering whether to file a petition, analyze carefully the available assets and the outstanding liabilities. It is critical to know which creditors will share in the assets and the amount to be received by each class of creditors.
2. If the tax liabilities will not be dischargeable, n1 as would be the case for income taxes not yet assessed, or if the tax liabilities would never be dischargeable as in the case of "trust fund" taxes for which the 100 percent penalty under *I.R.C. Section 6672* is applicable, the advantages of filing a chapter 7 or chapter 11 proceeding under the Bankruptcy Code may be illusory; however, there may be advantages to a Chapter 13 proceeding.
3. Even if the commencement of a case will eliminate a tax liability (assuming it is dischargeable), will it generate an economic benefit to the debtor? For example, if the IRS has already filed liens against a taxpayer's exempt property, the bankruptcy filing will not prevent the IRS from taking the exempt property, n2 if necessary to satisfy its claim.
4. Are there nonpriority creditors who will be able to improve their status if the commencement of a case does not occur in the near future? For example, if there is an unsecured creditor (*e.g.*, a tort claimant) who is about to get a judgment and thereafter become a secured creditor, it may be necessary to file a petition now so that available assets may be used to satisfy nondischargeable debts including priority tax claims.

FOOTNOTES:

(n1)Footnote 1. *See* chapter TX11 *supra*.

(n2)Footnote 2. *See* chapter TX5 *supra*.



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P TX17.03 When to File

1. One situation where timing is critical from a tax viewpoint is where the debtor has a large tax exposure for a prior year which has not been assessed, or if assessed, not for the requisite 240 days so as to be dischargeable. n1 In that situation, the debtor may want to wait the additional time period so that the taxes will be dischargeable.

2. A similar situation where it may be advantageous to wait is when the potential tax liability, whether or not yet assessed, relates to a year for which the tax return was due within the last three years. Unless the debtor waits long enough before filing, the tax exposure will not be dischargeable. n2

3. On the other hand, a debtor must be careful not to wait too long so as to allow other nonpriority creditors to improve their position and possibly become secured creditors. Of course, depending on the actual assets and liabilities of the bankruptcy estate, the debtor may be better off waiting so that the taxes become dischargeable. It is a matter of comparing the benefits of the unpaid taxes being dischargeable versus the disadvantages of a formerly unsecured creditor acquiring a secured position and therefore entitled to receive assets that could have gone to the IRS to satisfy nondischargeable taxes.

4. **Example.** John Jones is contemplating filing a chapter 7 case. He owes \$200,000 of unpaid income taxes for the year 2000. The taxes were assessed four months ago. He recently lost a breach of contract lawsuit and the plaintiff was awarded \$1 million for damages. The case is on appeal. He owns a homestead with \$500,000 of equity and has a brokerage account with a \$100,000 balance. If he files bankruptcy now, the plaintiff's claim would be an unsecured liability, but the income tax liability would be non-dischargeable, although the tax liability would be a priority claim and payable before any distribution to unsecured creditors. In this situation, the \$100,000 of nonexempt assets would be used to partially satisfy the \$200,000 tax liability. John Jones would continue to be personally liable for the unpaid \$100,000. His homestead, even if it was an exempt asset in the bankruptcy proceeding, could be taken by the IRS to the extent necessary to satisfy the unpaid \$100,000 tax liability. On the other hand, any exposure he would have otherwise had from the lawsuit should be eliminated as a result of the bankruptcy proceeding. If John Jones waits until the tax liability has been assessed for the requisite 240 days and then files bankruptcy, the tax liability (as a priority claim) would still be satisfied first and the unsatisfied \$100,000 would be dischargeable. However, by waiting, John Jones runs the risk that the plaintiff's claim will be upheld and that the plaintiff will become a secured creditor with respect to his \$200,000 of non-exempt assets. In that event, there would be no assets in the bankruptcy estate to apply toward the tax liability. So long as the unpaid tax liability is dischargeable, John Jones would still emerge from the bankruptcy with his

homestead intact and protected. However, if the IRS files a lien against the homestead before the actual bankruptcy filing, it will be able to foreclose and use the homestead proceeds to satisfy its lien. The analysis becomes even more complex when there are other assets and liabilities to consider.

FOOTNOTES:

(n1)Footnote 1. *See* chapter TX4 *supra*.

(n2)Footnote 2. *See* chapter TX4 *supra*.



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P TX17.04 Where to File

1. In certain situations it may be important for the debtor to consider where to file the bankruptcy petition. The most important considerations will generally be the exemptions available to residents of a particular state. n1 Additionally, the federal appellate court to which an appeal from a bankruptcy court would be made, as well as the particular judicial district within a state, may be relevant. The choice of forum may be particularly important when the debtor's exposure for taxes may hinge on the resolution of a legal issue with respect to which there is a conflict between jurisdictions.

2. A debtor will want to file the petition under the Bankruptcy Code in a state that allows a debtor to retain the maximum amount of assets as exempt. n2 Thus, a debtor with a valuable homestead will want to commence the case in a jurisdiction that allows the maximum amount of such homestead value to be protected. The provisions of the BAPCPA placing limits on the "homestead" exemption are critical to this analysis. Under prior law, generous state exemptions (as in Florida or Texas) were available after an individual had resided in the state 180 days or more. As a result of the BAPCPA, debtors must wait for two years in order to obtain these protections. Moreover, regardless of the level of state exemptions, the debtor may only exempt up to \$125,000 of value that was acquired during the 40-month period preceding the bankruptcy filing (except for equity that was rolled over from one house to another within the same state).

Finally, for those persons who have violated securities laws or engaged in certain criminal conduct, the cap is \$125,000 even if the state exemption would be higher. n3 Similarly, a debtor holding significant life insurance cash values will seek a jurisdiction, if possible, which maximizes exclusions for that type of asset. Obviously, there are jurisdictional and residency requirements which may pose legal and practical restraints on a debtor's choice of venue. However, in some cases the advantages of a particular forum or jurisdiction may outweigh the disadvantages of moving and delaying the filing of a bankruptcy petition. n4

3. In the past, the treatment of pension plans and individual retirement accounts varied from state to state. The Supreme Court's decision in *Patterson v. Shumate*, n5 exempting certain of these interests from the claims of creditors, may eliminate forum shopping based on this issue. However, the past conflict between federal district courts and between appellate courts regarding the treatment of pension plans provides a striking example of the importance of where the bankruptcy case is commenced. n6

4. It is likely that similar conflicts will arise in the future. For example, the determination of whether compensation

received by professional athletes or entertainers should be viewed as postpetition earnings or assets of the bankruptcy estate, may vary among bankruptcy courts within a state and the various appellate courts.

5. Currently, the conflicting treatment afforded a trustee's attempts to abandon assets could be a key factor in deciding where to commence a case under the Bankruptcy Code. n7 A taxpayer who holds assets with a large built-in tax liability would like to find a bankruptcy judge who would be sympathetic to such a debtor, as was the court in the *A.J. Lane* n8 case.

FOOTNOTES:

(n1)Footnote 1. *See* Volume 14, Collier on Bankruptcy (Matthew Bender 15th Edition Revised), for complete coverage of bankruptcy exemptions.

(n2)Footnote 2. *See* discussion at *P TX2.03[1][b] supra*. *See* Volume 14, Collier on Bankruptcy (Matthew Bender 15th Edition Revised), for complete coverage of bankruptcy exemptions.

(n3)Footnote 3. *See* Pub. L. No. 109-8, § 322 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n4)Footnote 4. *See generally* 1 Collier on Bankruptcy, ch. 8 (Matthew Bender 15th Edition Revised) on professional ethics.

(n5)Footnote 5. 504 U.S. 753, 112 S. Ct. 2242, 119 L. Ed. 2d 519, 26 C.B.C.2d 1119 (1992) , *reh'g denied*, 505 U.S. 1239, 113 S. Ct. 13, 120 L. Ed. 2d 940 (1992) .

(n6)Footnote 6. *See generally* Volume 14 Collier on Bankruptcy (Matthew Bender 15th Edition Revised) on pension plans and exemptions. Additionally, there may still be differences regarding the treatment of IRAs in the various states.

(n7)Footnote 7. *See PP TX2.03[2][c] and TX2.06[2] supra* .

(n8)Footnote 8. *In re A.J. Lane & Co., Inc.*, 25 C.B.C.2d 1202, 133 B.R. 264 (Bankr. D. Mass. 1991) .



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P TX17.05 Chapter of the Bankruptcy Code Under Which to File

1. A debtor will generally need to decide between commencing a chapter 7, chapter 11, chapter 12 or chapter 13 case. n1 In general, this decision will be motivated less by tax considerations than the mix of assets held by the debtor and the economic goals the debtor hopes to accomplish. However, the debtor must understand what is likely to occur from a tax viewpoint depending on which type of case is filed.
2. A chapter 7 case has generally been the quickest and least expensive approach toward securing a discharge. However, as a result of changes by the BAPCPA, this may no longer be the case.
3. A chapter 11 case involves a longer, more expensive process but allows the debtor more control over the timing of dispositions of property and presumably will allow the debtor to have the opportunity to preserve a portion of the debtor's assets.
4. For example, a taxpayer who commences a case with assets having built-in tax gains may benefit by filing under chapter 11 and allowing the gains to be triggered during the course of the case. Thereafter, the chapter 11 case could be converted to a chapter 7 case. Under this strategy, the taxpayer could arguably be protected from the risk of an abandonment of property by a chapter 7 trustee. n2

FOOTNOTES:

(n1)Footnote 1. As discussed at the beginning of this chapter, the BAPCPA has complicated the decision- making process as to the whether, when, where, and what type of proceeding to file. Chapter 7 may still be preferred but will be more difficult to qualify for. Chapter 11 is still a possibility where there is a business to reorganize and chapter 13 may well become more common.

BAPCPA has broadened the scope of chapter 12 to include family fishermen along with family farmers and permanently reenacted chapter 12, effective July 1, 2005. *See* Pub. L. No. 109-8, §§ 1001-1007 (2005), *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised). *See generally* Porter, "Phantom Farmer: Chapter 12 of the Bankruptcy Code," 79 *Am. Bankr. L.J.* 721 (2005) (BAPCPA "made chapter 12 a permanent part of the Bankruptcy Code.").

(n2)Footnote 2. *See P TX2.03[2][c] supra.*



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P TX17.06 Actions to Consider Before Commencing a Case Under the Bankruptcy Code

1. If the decision has been made to commence a case under the Bankruptcy Code and the taxpayer will have a priority tax liability that is to be paid by the bankruptcy estate, the debtor should consider paying the taxes before commencing the case. If not paid, the debtor will be personally liable for any interest accruing with respect to such taxes regardless of whether the bankruptcy estate actually pays the tax liability. n1 Accordingly, the individual taxpayer should use available funds to pay any tax liabilities associated with prior returns and should make estimated tax payments to cover the tax liability for the current year. This is so even if the debtor intends to file the short-year election under *I.R.C. Section 1398(d)*.

2. If the commencement of a case under the Bankruptcy Code is inevitable and the individual has assets with significant built-in tax gains and little or no equity *and* the individual has net operating loss carryovers sufficient to offset such gains *or* sufficient liquid assets to pay the tax liability corresponding to such gains, the individual should trigger the taxable gains before the filing of the petition. If the individual triggers the gains and is relying on net operating loss carryovers to avoid tax liability, he or she *must* make the short-year election under *I.R.C. Section 1398(d)*. n2 If the individual is relying on these liquid assets to pay the tax liability, the debtor would be well advised to make estimated tax payments before commencing a case. n3 Failure to take these actions leaves the individual exposed should the trustee of the bankruptcy estate successfully abandon the tax-burdened asset back to the individual.

3. If the individual does not have available net operating loss carryovers to offset built-in gains or any assets to pay the resulting taxes (*e.g.*, a no or nominal asset case), the individual should not trigger the gains but should hope that the trustee does not attempt to abandon the assets and should vigorously resist any attempts by the trustee to abandon assets. The individual should time the filing of the petition under the Bankruptcy Code so as to maximize the likelihood that the gains are triggered shortly after the filing and before the trustee has an opportunity to evaluate the situation and abandon the assets. Alternatively, in this situation, the individual may want to file a chapter 11 petition and allow the asset foreclosures to occur while in a chapter 11 case, even if the case is ultimately converted to a chapter 7 case. n4

4. Where the debtor is an individual and has commenced a case under Chapter 7 or 13, the debtor should obtain, and have available, a copy of the federal tax return filed for the year immediately before the filing of the bankruptcy petition. n5 The debtor will be required to furnish a copy of the tax return to the Trustee or a creditor, who requests a copy of such return. Failure to furnish the tax return may result in dismissal of the case. n6

5. **Example.** John Jones is a real estate developer in financial difficulty because his primary asset, Blackacre, has a fair market value of only \$600,000 and is subject to a debt of \$2 million, \$900,000 of which is recourse and \$1.1 million is non-recourse. His tax basis in Blackacre is only \$100,000 but he does have a net operating loss carryover of \$1 million. If the lender were to foreclose on Blackacre, John Jones will realize a *Tufts* gain of \$1 million and potential cancellation of indebtedness income (COD) of \$900,000. John Jones is considering filing a chapter 7 bankruptcy case. If he files a bankruptcy case after the foreclosure, it is imperative that he make the section 1398(d) election so that the \$1 million net operating loss is available to offset the *Tufts* gain. On the other hand, if he files bankruptcy before the foreclosure, there is a risk that the chapter 7 trustee would abandon Blackacre back to him rather than have the bankruptcy estate deal with the tax consequences of the foreclosure. Unfortunately, in that scenario, the \$1 million net operating loss will have passed to his bankruptcy estate and would not be available to offset the gain. John Jones would now have personal liability for the income tax corresponding to the \$1 million gain. Such tax liability would be post-petition and nondischargeable.

FOOTNOTES:

(n1)Footnote 1. *See* P TX2 *supra*.

(n2)Footnote 2. *See* P TX2.05 *supra*.

(n3)Footnote 3. *See* chapter TX4 *supra* and P TX2.05 *supra* .

(n4)Footnote 4. *See* P TX17.05 *supra*.

(n5)Footnote 5. 11 U.S.C. § 521(e)(2)(A). *See also* with regard to Debtor's duties *In re Grasso*, 341 B.R. 821, 2006 Bankr. Lexis 879 (Bankr. D. N. H. 2006) (discussing the debtor's requirement to deliver tax return to the Trustee and the authority of the Court to dismiss the petition for failure to comply with the code provision). In *Grasso*, the Court concluded there is nothing mandatory in requirements of Section 521(e)(2).

(n6)Footnote 6. 11 U.S.C. § 521(e)(2)(B); for a discussion as to what constitutes compliance with requirement to provide copy of most recent tax return, and how to comply where return is electronically sent, *see In re Houston*, 2006 Bankr. LEXIS 364 (Bankr. E.D. Va. 2006) .



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P TX17.07 When to Make the Short-Year Election Under I.R.C. Section 1398(d)

1. Ideally, even before a case under the Bankruptcy Code is commenced, a taxpayer will have considered whether a short-year election under *I.R.C. Section 1398(d)* will be helpful. n1 In order to make an intelligent decision, the taxpayer must know the nature and extent of the tax attributes that will pass to the bankruptcy estate. Thus, it is imperative that the tax return for the preceding year be completed so that the taxpayer will know what carryover items will be available. Then, the taxpayer must determine as precisely as possible, the amount of income, gain or loss which would be reflected on a short-period return if the election is made, or on the full calendar return if the election is not made. If the election will enable the taxpayer to avoid tax liability for the short-period, it should probably be made.

2. If the taxpayer is married, the analysis should also take into account the tax consequences of making or not making the election depending upon whether the spouse joins in a petition under the Bankruptcy Code with the taxpayer, does not file a petition at all, or files at a later date. Also, the ramifications of filing separate or joint tax returns in each situation should be addressed.

FOOTNOTES:

(n1)Footnote 1. See P TX2.05 *supra*. However, in, *In re Norton*, 347 B.R. 291 (Bankr. Tenn. 2006) the court determined that dismissal of the case was mandatory where debtor failed to deliver a copy of his tax return to the trustee in a timely fashion unless due to circumstances beyond his control.



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P TX17.08 Consideration of Other Tax Planning Elections or Strategies

1. A taxpayer may want to make the election to forego the carryback of net operating loss carryovers under *I.R.C. Section 172(d)*, if the taxpayer is in the situation where a net operating loss carryback will generate a refund which will become property of the bankruptcy estate. This election may be set aside as a fraudulent conveyance. ⁿ¹ However, where failure to make the election will simply increase assets available for distribution to creditors, it would seem that the taxpayer has little to lose by trying.

2. A taxpayer may want to consider filing separate tax returns to maximize the favorable tax attributes allocable to the nonfiling spouse. For example, the taxpayer may want to take the position that one-half of a net operating loss carryover is allocable to a spouse who does not file a petition under the Bankruptcy Code. Thereafter, the taxpayer may resume filing joint tax returns and use the available net operating loss carryover to offset postpetition earnings of the debtor-taxpayer.

3. A debtor may want to apply a potential refund as a prepayment toward estimated tax liability for the succeeding year, or to use other available assets to make estimated tax payments prior to filing bankruptcy. Depending on the timing and other factors, these actions could give rise to preference claims or fraudulent conveyance attacks. However, the debtor may have little to lose in pursuing such actions. ⁿ²

FOOTNOTES:

(n1)Footnote 1. See *P TX2.04[4][d][ii] supra*.

(n2)Footnote 2. See *P TX2.04[2]* discussion and cases cited at footnote 60.



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CHAPTER TX18 Tax Planning Checklist and Practice Strategies for Corporate Chapter 11 Debtors

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§ TX18.syn Synopsis to Chapter TX18: Tax Planning Checklist and Practice Strategies for Corporate Chapter 11 Debtors

P TX18.01 Introduction

P TX18.02 Prefiling Planning Actions and Considerations

P TX18.03 Postfiling Planning and Practice Strategies

P TX18.04 Post Effective Date Practice Items



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P TX18.01 Introduction

The most difficult problem for a tax professional advising a corporation or group of corporations contemplating a chapter 11 filing is that the fiscal exigencies of the situation may result in non-tax professionals and management ignoring tax considerations until after the case has been filed and the most immediate problems have been brought under control. Resources may not be allocated to tax matters. This is a mistake. At the very least the non-tax professional should be aware of the planning and practice strategies for corporate debtors that follow. They can help to prioritize the allocation of scarce human and financial resources.

Some tax issues are best addressed before filing. Failure to address certain issues, such as filing petitions for subsidiaries severally liable with the parent for past federal tax liabilities, may not be correctable later without additional cost to the debtors. Moreover, time is not always on the debtor's side. For instance, tax liabilities may not appear to be pressing when the case is first filed, but if the tax claims are large enough, the resolution of these tax claims may become conditions to the creditors' willingness to support the debtor's plan of reorganization. This will take time and when the plan of reorganization is ready, the parties concerned will not appreciate being told that the time needed to resolve significant tax claims will delay the confirmation proceedings. Finally, assumptions about the availability of the debtor's tax attributes may be found to have been unfounded due to bad facts or subsequent events that could have been avoided.

The following checklist should be consulted before the filing of the petition for the corporate debtor. Thereafter it should be referred to during the administration of the case and following confirmation of the plan. The tax professional should endeavor to keep abreast of significant events in the life of the debtor. It is important in complex cases that the tax professional participate in the strategy sessions concerning the development of the plan of reorganization. Business plans and expectations can be upset by after the fact tax advice.



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P TX18.02 Prefiling Planning Actions and Considerations

1. *Trust Fund Taxes.* Determine whether the corporation has any undeposited or unpaid trust fund taxes. n1 Undeposited or unpaid trust fund tax obligations or state sales, excise and use taxes present special liability problems. Failure to pay over such taxes, such as employee wage income tax withholding and FICA, to the tax authorities may result in the imposition of a 100% penalty on responsible parties who should have caused the corporation to make the deposits and the payments. n2

2. *Diagram Entities.* Determine and diagram the corporate structure of the related group of corporations considering filing chapter 11. Is more than one corporation involved? How are the corporations related? Are any of the corporations involved in partnerships or joint ventures? Determine the nature of any significant intercompany transactions, including payables and receivables.

3. *Consolidated Tax Returns.* Determine whether the corporations file federal and state consolidated (or combined) tax returns. For federal purposes, each member of the affiliated group included in a consolidated return is potentially severally liable for the full amount of the taxes of the group for the years the corporation is included in the consolidated tax return. The potential for additional taxes can be significant in determining which entities should file petitions. n3 In addition, this information is obviously important in determining the tax consequences of any plan of reorganization.

4. *Open Tax Issues.* Consider whether there are any significant tax issues affecting open tax years. n4 Have waivers or extensions of the federal or state statutes of limitations been granted by the taxpayer? Are there circumstances, such as a failure to include substantial gross income in a tax return, that would result in a longer statute of limitations? Determine whether there are any outstanding tax liabilities, including tax liens, or tax controversies affecting open tax years. Will the filing of the petition prevent the running of state or federal time periods for the taking of actions by the taxpayer, such as filing a petition for the redetermination of tax liabilities with the Tax Court? What effect would the filing have on claims for refund of taxes or refund actions? n5 Are there pending administrative or judicial tax proceedings that may be affected by the filing? Remember that even if the petition should toll the running of time periods on the debtor, this benefit (as well as discharge and payment benefits) may not be available for related taxpayers (including corporations included in the same consolidated tax return) that do not file petitions under title 11 of the Bankruptcy Code.

5. *ERISA Liabilities.* Determine whether the corporation has unfunded pension plan liabilities, including multiemployer

plan exposure, or potential liabilities for violations of the statutes governing the administration and operation of employee benefit plans.

6. *End of Tax Periods.* Consider the benefits of delaying the filing of the petition until after the close of the current tax period. This can shift taxes from administrative claim status to prepetition status. While this may not change the necessity of eventually paying such taxes following confirmation, it can change the terms of payment. Moreover, in some cases it may change tax obligations from priority claim status under *section 507 of the Bankruptcy Code* to general unsecured claims or even eliminate obligations such as nonpecuniary penalties. n6

It should be noted that section 705 of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "2005 Act") n6a amended *section 507(a)(8) of the Bankruptcy Code* governing the priority of taxes to provide that income and gross receipts taxes for the year of bankruptcy filing are post-petition administrative expense claims that generally must be paid in full in the ordinary course, rather than pre-petition priority claims (no more bifurcation).

7. *Existence of Tax Attribute Carryforwards.* Consider whether (and the extent) any of the corporations have net operating loss, capital loss or tax credit carryforwards. Do any of the corporations have significant built-in gain or loss assets or items? If so, which corporations? There is a tendency to look at these tax attributes on an aggregate group basis or from the perspective of the amounts reflected for book purposes on the consolidated financial statements. It is important that the tax amounts be ascertained and that the amounts so determined be specifically traced to each of the corporations generating the tax attributes. n7

8. *Limitations on Use of Tax Attributes.* Determine whether there are any limitations on the use of tax attributes already imposed under *I.R.C. Sections 382, 383 and 384* and the comparable provisions under the consolidated return regulations. n8 Pay particular attention to options, ESOPs, redemptions and employee stock purchase plans. Prior limitations on the use of tax attributes will affect tax and business planning for the reorganized corporation, as well as postpetition taxes incurred during the administration of the case.

9. *Continuity of Business.* Determine the "business" of the corporation that must be continued in order to obtain the benefits of the *I.R.C. Section 382* limitation following an ownership change. n9 This determination can serve as a check on sales of assets and operations of the debtor following the filing of the petition.

10. *Changes in Stock Ownership.* An analysis of stock and equity interest ownership must be undertaken. To what extent have there been shifts of "stock" ownership during the testing period within the purview of *I.R.C. Section 382*? n10 This analysis is critical to an understanding of the likely availability of tax attributes following the effective date of the plan of reorganization. Trading by 5 percent shareholders, as defined, can impact the availability of these tax attributes and one must determine whether the debtor upon filing the petition should immediately seek a bankruptcy court order prohibiting transfers of stock and equity interests. n11

11. *Controlling Shareholder Action.* Does one shareholder own fifty percent or more of the corporation? If this shareholder takes a worthless stock deduction, the limitations imposed by *I.R.C. Section 382* will apply. Consider the advisability of the debtor immediately seeking an order prohibiting this action upon filing the petition. n12

12. *Trading of Claims.* Determine the extent the indebtedness of the corporate debtor is likely to be traded or transferred during the chapter 11 case. This can affect the availability of the special bankruptcy exception in *I.R.C. Section 382(l)(5)* n13 and whether the debtor upon filing the petition should immediately seek an order prohibiting transfers of its indebtedness and trading of claims, especially trading involving holders of 5 percent or more of any publicly traded debt.

13. *Simplify Corporate Structure.* Frequently the corporate structure of groups of corporations should be simplified. Determine whether any corporations should be liquidated before filing petitions. If so, will the liquidation trigger an

"excess loss account" under the consolidated return regulations? n14 Determine whether any liquidations that otherwise would be tax free will be taxable events because the subsidiary is insolvent. n15

14. *Nonrecourse Debt*. Determine whether the taxpayer is obligated on secured nonrecourse indebtedness with a liability in excess of basis that on foreclosure will cause income that will be taxable, rather than cancellation of indebtedness that can be excluded from gross income. n16 Can this indebtedness be converted to recourse indebtedness under the proper circumstances prior to the filing without running afoul of the step transaction doctrine?

15. *Tax refunds*. Section 718 of the 2005 Act n17 permits the setoff of pre-petition taxes against refunds owed to a taxpayer-debtor while the automatic stay is in place as long as such setoff would be permitted under non-bankruptcy laws. Furthermore, the taxing authorities are now permitted to hold the refunds pending resolution of an "action to determine the amount or legality of the tax liability," unless the Bankruptcy court grants the taxing authorities adequate protection. The choice of the word "action" suggests that a mere commencement of an audit, or even an administrative appeal, would not entitle the taxing authority to retain taxpayer-debtor's refunds.

FOOTNOTES:

(n1)Footnote 1. *See P TX15.02 supra*.

(n2)Footnote 2. *See I.R.C. § 6672. See generally P TX3.04 supra*.

(n3)Footnote 3. *Treas. Reg. § 1.1502-6(a). See P TX11.08[3][c] supra*.

(n4)Footnote 4. *See generally* chapter TX5 *supra*.

(n5)Footnote 5. The Internal Revenue Service may set off, against debtor's pre-petition overpayment of taxes, the debtor's prepetition tax liability even if such liability is subsequently discharged. *See Internal Revenue Service v. Luongo*, 259 F.3d 323 (5th Cir. 2001) .

(n6)Footnote 6. *See generally* chapter TX4 *supra*.

(n7)Footnote 6a. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n8)Footnote 7. *See P TX11.08[3][b] supra*.

(n9)Footnote 8. *See generally* chapter TX11 *supra*.

(n10)Footnote 9. *See PP TX11.04[2] and TX10.03[4][b] supra* .

(n11)Footnote 10. *See P TX11.04[4] supra*.

(n12)Footnote 11. *See P TX11.04[4][c] supra*.

(n13)Footnote 12. *See P TX11.04[4][c] supra*.

(n14)Footnote 13. *See P TX11.04[6] supra*.

(n15)Footnote 14. *See Treas. Reg. § 1.1502-19*.

(n16)Footnote 15. *See Treas. Reg. § 1.332-2(b)*.

(n17)Footnote 16. *See P TX6.02[6] supra.*

(n18)Footnote 17. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).



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P TX18.03 Postfiling Planning and Practice Strategies

1. *Review Prior Items.* Consider the continuing importance of the prefiling planning and practice issues to the post title 11 filing period.

2. *Serve All Potential Tax Claimants.* At a minimum, all potential tax claimants (no matter how remote their possible claims and irrespective of any agent's knowledge of the proceedings) should be placed on the service list n1 for notices of the proceedings, including the bar date for making claims. n2 Local rules should be followed in providing notice to the various tax authorities. n3

3. *Drafting Items into the Plan.* Coordinate with the counsel preparing the debtor's plan of reorganization to provide tax input to the plan before the plan is finalized.

4. *Reserve Bankruptcy Court Tax Jurisdiction.* Ensure that the plan of reorganization contains a reservation of jurisdiction by the bankruptcy court to resolve tax claims, both prepetition and administrative, affecting the debtor.

5. *Disclosure Statement Tax Items.* Coordinate with the counsel preparing the disclosure statement so that the tax consequences of the plan of reorganization are adequately described in the disclosure statement and the tax section is consistent with the descriptions in other parts of the document. n4

6. *Open Tax Authority Examinations.* If significant tax liabilities are likely to be asserted in the proceedings, consideration should be given to contacting the tax authorities early in the reorganization process to commence negotiations to determine the liabilities. For instance, if the Service is examining the debtor's tax returns, consideration should be given to contacting district counsel to accelerate the audit process and the involvement of an appeals officer who may be able expeditiously to determine the tax claim in administrative proceedings without resort to litigation. n5 This can occur even though a proof of claim has been filed.

7. *Avoid Filing Premature Objections to Tax Claims.* Caution should be exercised before an objection is lodged against a proof of claim for taxes. An objection to a federal tax proof of claim may cause the matter to be referred to the Department of Justice and may preclude resolution of the matter with the local Service authorities. n6 The same result may occur if a proceeding is brought under *section 505 of the Bankruptcy Code*. n7

8. *Examine Tax Proofs of Claim for Inappropriate Items.* Ensure that tax claimants have not filed claims for postpetition interest and penalties. Likewise, determine whether claimants have priority claims for taxes, especially excise taxes, that are no longer entitled to priority under section 507(a)(8) and should have been classified as general unsecured claims. n8 To the extent they have done so, ask them to file amended proofs of claim eliminating or reclassifying these items. Verify whether the debtor has filed bonds covering excise taxes, such as sales and use and gasoline taxes, with the taxing authorities; the bonds can be used to satisfy priority tax claims. Determine whether any tax authorities claim setoff rights of tax overpayments against tax deficiencies in other years.

9. *Taxes During Administration.* Will sales of assets, including transfers in lieu of foreclosure or abandonments, during the proceedings result in significant "administrative claim" taxes? n9 These taxes may include excise, as well as income, taxes. If so, the tax payment must be provided for in the plan.

10. *Document Professional Fees.* Anticipate the need to justify the deductibility for tax purposes of expenses of counsel and other professionals during the case administration. Reliance on the requirements of *Federal Rule of Bankruptcy Procedure 2016* will probably not be sufficient. Ensure there are adequate descriptions, itemizations and documentation of the activities of the professionals. This may reduce the amount of expenses that the Service later seeks to have the debtor capitalize, rather than deduct. n10

11. *Preferred Stock Defaults.* Determine whether there are any preferred stocks issued by subsidiaries that may become voting stock due to the passage of dividends. Consider whether such defaulted preferred may no longer be excluded under *I.R.C. Section 1504(a)(4)*. The result may be to break consolidation for tax purposes between the subsidiary and its immediate parent corporation. n11

12. *Postpetition Interest.* The debtor should consider whether its facts justify continuing to accrue (and deduct) postpetition interest on indebtedness (secured and unsecured) outstanding at the date of filing. n12

13. *"G" Reorganizations.* Consider whether sales or transfers of subsidiaries or assets, or liquidations of subsidiaries, during the case will result in a "G" reorganization. n13 Remember that the drop down of assets into a subsidiary may not qualify under *I.R.C. Section 351* and thus will be a taxable transaction to the extent that such stock is transferred to creditors. n14

14. *Deemed Asset Sales.* Quantify the benefits of electing *I.R.C. Section 338(h)(10)* deemed asset sale treatment for the sales of stock of subsidiaries by a consolidated tax return group when the selling group has net operating loss carryovers. Can a transfer of subsidiary stock to creditors be structured as a "sale" to a qualified purchaser as opposed to a drop down under *I.R.C. Section 351(e)(2)*?

15. *Related Party Debt Transactions.* Will the acquisition of the debtor's indebtedness from creditors by a related party during or as a result of the chapter 11 case result in deemed cancellation of indebtedness under the related party rules of *I.R.C. Section 108(e)(4)*? n15

16. *Cancellation of Indebtedness and Exceptions.* Which classes of indebtedness will be satisfied with plan consideration equal to less than the adjusted issue price of the indebtedness? n16

17. *Risks of Parent Stock for Subsidiary Debt.* To the extent stock has been issued to creditors, is the stock obligor stock, stock of a successor to the obligor or stock of a related party? n18

18. *Tax Risks of Internal Restructuring.* Will liquidations of subsidiaries be failed *I.R.C. Section 332* transactions that will eliminate carryovers and trigger excess loss accounts under the consolidated return regulations or will they qualify as "G" reorganizations? Is it possible to merge corporations (brother-sister or parent-subsidiary) and satisfy the "G" reorganizations requirements? Will those corporate restructuring transactions be treated as part of the transactions with

creditors under the step transaction doctrine and change the anticipated tax consequences of such later transactions? Likewise, can dispositions or transfers of business assets during the case be recharacterized as reorganizations rather than taxable transactions? n19

19. *Incorporation of "G" Reorganization Into the Plan.* If the plan of reorganization involves an *I.R.C. Section 368(a)(1)(G)* tax reorganization, ensure that the chapter 11 plan of reorganization incorporates the terms of the transaction. n20 Keep in mind the necessity under the tax reorganization rules for post effective date continuity of interest and continuity of business enterprise. n21

20. *Recapitalizations.* Determine whether the exchanges of debt for debt with creditors constitute *I.R.C. Section 368(a)(1)(E)* recapitalization reorganizations. n22 Will there be any "boot" to the exchanging creditors? n23 Determine the extent to which part of the distribution to creditors constitutes interest ineligible for tax-free treatment. n24

21. *Market Discount and Original Issue Discount.* Will the exchanges of debt for debt with creditors, whether or not constituting *I.R.C. Section 368(a)(1)(E)* recapitalization reorganizations, create market discount or original issue discount? n25 Will the new indebtedness trade in the market within ten days after it is issued? If so, is the issue price of the new debt likely to bring the instruments within the rules of *I.R.C. Section 163(e)(5)* governing interest deductions for high yield discount obligations? n26

22. *Qualified Periodic Interest.* Determine whether the new debt instruments have original issue discount because the stated interest payment terms, being specially tailored to the reorganized company's prospects, vary over the life of the debt with the consequence that the new debt n27 instruments do not have qualified periodic interest. Will interest payment in kind ("PIK") provisions cause the new debt instruments to have original issue discount?

23. *Issue Price of Debt.* Cancellation of indebtedness will be calculated by comparing the issue price of debt (rather than its nominal face or principal amount). n28

24. *Issue Price of Preferred Stock.* Consider whether preferred stock with mandatory or optional redemption or "put" features issued under the plan will have an issue price less than the redemption or liquidation preference. Any difference may result in dividend treatment to the recipients under rules. n29

25. *Cancellation of Indebtedness Under the Plan.* Determine the extent to which the implementation of the plan of reorganization will result in cancellation of indebtedness, even if the income would be excluded under the provisions of *I.R.C. Section 108(a)*. n30 Any excluded cancellation of indebtedness income will reduce tax attributes. A convenience class that receives only cash under the plan will generally result in some cancellation of indebtedness.

26. *Ownership Change as a Result of the Plan.* Stock and option transactions from the time the debtor became a loss corporation must be analyzed. Determine whether the issuance of stock (or equity interests such as options) under the plan of reorganization will cause an ownership change under *I.R.C. Section 382* resulting in a limitation on the use of tax attributes. n31 Do arrangements or events, such as confirmation of the plan, in advance of the effective date of the plan of reorganization have the effect of options for purposes of *I.R.C. Section 382* accelerating the date of any ownership change, possibly eliminating the benefits of *I.R.C. Section 382(l)(6)*? Consider the necessity of an election to have the ownership change treated as occurring on the effective date. n32 Consider the advisability of the debtor making an election to determine its income for the period of the tax year before the ownership change on a closing of the books method. n33

27. *Projections.* Consider whether the projections of the debtor and the determinations of feasibility depend to any material extent on the availability of tax attributes of the reorganized company to shelter future income. Have the alternative minimum taxable income costs been included? n34 Ensure that the projections actually incorporate any anticipated reductions or limitations on the use of tax attributes. n35

28. *Qualification for Special Bankruptcy Ownership Change Exception.* Determine whether the benefits of *I.R.C. Section 382(l)(5)*, the special bankruptcy exception to the limitation of use of tax attributes following an ownership change, are available to the debtor by ascertaining the "old and cold" creditors that are to receive stock under the plan of reorganization on account of their claims along with the shareholders continuing to have a stock interest in the reorganized debtor on account of their prior stock holdings. n36

29. *Costs of Special Bankruptcy Ownership Change Exception.* Determine whether the benefits of *I.R.C. Section 382(l)(5)* available to the debtor outweigh costs of the cut in tax attributes associated with this bankruptcy exception. Determine the amount of the interest deductions that must be eliminated. If the costs are too great, plan to elect out of this provision and use the special *I.R.C. Section 382(l)(6)* rule to determine the *I.R.C. Section 382* limitation. n37

30. *Net Unrealized Built-in Gain or Loss.* Determine whether the debtor has net unrealized built-in gain items that can be offset against capital or net operating losses irrespective of the *I.R.C. Section 382* limitation if those items are recognized within five years of the ownership change date. Likewise, determine the extent of the net unrealized built-in loss items that if recognized during the five year period will not be available to offset other income in the periods following an ownership change. n38 Similarly, determine the limitations of the consolidated return regulations. n39 The built-in gain and loss analysis should also include a consideration of the limitations of *I.R.C. Section 384* if acquisitions are anticipated. n40

31. *Continuity of Business Enterprise.* Remember that the *I.R.C. Section 382* limitation following an ownership change is zero if the loss corporation does not continue the same business enterprise. n41

32. *Tax Avoidance Transactions.* Consider whether the transactions contemplated by the plan of reorganization may be characterized as having as their principal purpose tax avoidance. This tax analysis is different than the bankruptcy court determination under *section 1129(d) of the Bankruptcy Code*. n42

Pursuant to the 2005 Act, n42a a corporation which filed its bankruptcy petition after October 17, 2005 will no longer be discharged from a tax or a customs duty with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat the tax or duty. n42b

33. *"Excess Loss" Accounts.* Recognize that excess loss accounts may be triggered and brought back into income under the consolidated return regulations by the worthlessness of the assets of a subsidiary or upon certain discharge of indebtedness of a subsidiary. n43

34. *Preventing Stock Ownership Shifts.* If an ownership change will not occur as a result of the plan, determine the amount of "tainted" stock ownership of the reorganized company and the possibility of a future ownership change upon the transfer of shares by or to a "5-percent shareholder," as defined in *I.R.C. Section 382*, during the testing period. n44 Consider whether a limitation on stock and option transfers should be incorporated into the debtor's plan of reorganization and the articles of incorporation. n45 Will such restrictions preclude listing on a securities exchange?

35. *Disputed Claims Reserves and Creditors' Trusts.* Recognize that creation of a disputed claims reserve or creditors' trust may have tax consequences unanticipated by the parties. n46 Plan for alternative tax consequences.

36. *Additional Tax Deductions.* Remember that the plan consideration paid by the debtor to general creditors, such as trade creditors and lessors, can result in additional tax deductions to the extent that the liabilities have not previously been accrued for tax purposes.

37. *Creditor Information Statements.* When planning for the implementation of the plan of reorganization, remember to arrange for the issuance of information statements such as Forms 1099, 1099-MISC and W-2 to creditors within those

reporting categories. n47

38. *Periodic Payment of Taxes in Chapter 11 Cases*. For cases filed before October 17, 2005, tax claims entitled to priority may be required by the plan to take deferred cash payments over a period not to exceed 6 years after the date of assessment of the tax with the present value equal to the amount of the claim. The 2005 Act n48 levels the playing field by requiring "regular installment payments in cash" of a total value equal to the allowed amount of priority tax claim to be paid over a five-year period from the order for relief. Furthermore, priority tax claims may not be treated less favorably than the most favored nonpriority unsecured claim provided for by the plan (other than convenience class of unsecured claims under *section 1122(b) of the Bankruptcy Code*).

FOOTNOTES:

(n1)Footnote 1. *See Fed. R. Bankr. P. 2002* and any relevant local rules.

(n2)Footnote 2. Adequate notice must be given of any injunction included in the plan. *Fed. R. Bankr. P. 2002(c)(3)*.

(n3)Footnote 3. The Ninth Circuit in *In re Ellett* held that the Bankruptcy Court may enjoin a state tax office from collecting state taxes purportedly discharged in a bankruptcy proceeding in which the state, after proper notice, declined to participate. *254 F.3d 1135 (9th Cir. 2001)*, *cert. denied on February 19, 2002*, *2002 U.S. Lexis 655*.

(n4)Footnote 4. *See* chapter TX16 *supra*.

(n5)Footnote 5. *See PP TX5.02, TX5.13 supra*.

(n6)Footnote 6. *See P TX5.03 supra*.

(n7)Footnote 7. *See P TX5.04 supra*.

(n8)Footnote 8. *See generally* chapter TX4 *supra*.

(n9)Footnote 9. *See generally* chapter TX3 and *P TX4.03 supra*.

(n10)Footnote 10. *See P TX15.04 supra. See also* 3 Collier on Bankruptcy, ch. 330 (Matthew Bender 15th Ed. Revised).

(n11)Footnote 11. *See generally P TX11.08[2] supra*.

(n12)Footnote 12. *See P TX15.05 supra. See In re Dow Corning Corp.*, 270 B.R. 393 (Bankr. E.D. Mich. 2001).

(n13)Footnote 13. *See P TX10.03 supra*.

(n14)Footnote 14. *I.R.C. Section 351(e)(2)*.

(n15)Footnote 15. *See PP TX6.02[4][b], TX13.03[4] supra*.

(n16)Footnote 16. *See generally* chapter TX6 *supra*.

(n17)Footnote 18. *See generally* chapters TX10 and TX11 *supra*.

(n18)Footnote 19. *See P TX10.03 supra*.

(n19)Footnote 20. *See* P TX10.06[1] *supra*.

(n20)Footnote 21. *See* P TX10.03[4] *supra*.

(n21)Footnote 22. *See* P TX10.02 *supra*.

(n22)Footnote 23. *See* P TX10.03[4] *supra*.

(n23)Footnote 24. *See* P TX10.05[4][b] *supra*.

(n24)Footnote 25. *See* PP TX6.02[4]; TX9.04 *supra* .

(n25)Footnote 26. *See* P TX9.04[9] *supra*.

(n26)Footnote 27. *See* P TX9.04[1] *supra*.

(n27)Footnote 28. *See* P TX9.04[2] *supra*.

(n28)Footnote 29. *See* I.R.C. § 305(c).

(n29)Footnote 30. *See generally* chapters TX6 and TX9 *supra*.

(n30)Footnote 31. *See* PP TX11.04[4] and TX11.08[10][b] *supra* .

(n31)Footnote 32. *See* P TX11.04[4][b] *supra*.

(n32)Footnote 33. *See* P TX11.04[7] *supra*.

(n33)Footnote 34. *See* P TX11.02[4] *supra*.

(n34)Footnote 35. *See generally* chapters TX11 and TX16 *supra*.

(n35)Footnote 36. *See* P TX11.04[6] *supra*.

(n36)Footnote 37. *See* P TX11.04[6] *supra*.

(n37)Footnote 38. *See* P TX11.04[7] *supra*.

(n38)Footnote 39. *See* P TX11.08[10][e] *supra*.

(n39)Footnote 40. *See* P TX11.06 *supra*.

(n40)Footnote 41. *See* I.R.C. § 382(c)(1). *See generally* PP TX10.04[3] and P TX11.04[5] *supra* .

(n41)Footnote 42. *See* P TX11.03 *supra*.

(n42)Footnote 42a. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n43)Footnote 42b. Section 708.

(n44)Footnote 43. *See* Treas. Reg. § 1.1502-19.

(n45)Footnote 44. *See* P TX11.04[3] *supra*.

(n46)Footnote 45. *See P TX11.04[4][c] supra.*

(n47)Footnote 46. *See P TX14.01 et seq. supra.*

(n48)Footnote 47. *See generally* chapter TX3 *supra.*

(n49)Footnote 48. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).



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Collier on Bankruptcy Taxation

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CHAPTER TX18 Tax Planning Checklist and Practice Strategies for Corporate Chapter 11 Debtors

15-TX18 Collier on Bankruptcy Taxation P TX18.04

P TX18.04 Post Effective Date Practice Items

1. *Objections to Tax Claims.* Determine whether objections should be filed to late filed tax claims. Some tax authorities will neglect to file timely claims, or attempt to amend previously filed claims to add substantial additional taxes, even though they received notice of the proceedings and the bar date.

2. *Tolling of Tax Statutes.* Determine whether the confirmation or effective date of the plan of reorganization will start the running of time periods applicable to the reorganized company for pursuing administrative or prepayment remedies, such as a petition for redetermination of taxes in the Tax Court, respecting unresolved taxes.

3. *Additional Tax Deductions.* Ensure that procedures are in place to capture tax deductions when disputed claims are resolved. The book-tax differences will likely cause these items to be Schedule M items. Moreover, procedures should be in place to ensure that these claimants receive appropriate information statements, such as Forms 1099-DIV, 1099-MISC and W-2.

4. *Differences Between Book and Tax Reporting.* Ensure that differences between the financial accounting for the effects of plan of reorganization and their tax consequences are appropriately recognized and accounted for in the tax returns. Frequently, financial accounting accrues a transaction earlier than tax accounting allows.

5. *Determination of Tax Liability of the Estate.* Consider whether it would be advantageous for the debtor to avail itself of the provisions of *section 505(b) of the Bankruptcy Code* to obtain a determination of any unpaid tax liability of the bankruptcy estate for any tax during administration of the case. n1

The 2005 Act n1a clarified that the discharge available under *section 505(b) of the Bankruptcy Code* also applies to the "estate" and thus taxing authorities may no longer argue in court that they should be permitted to participate in distributions with respect to late-filed tax claims.

6. *Tracking Stock Ownership Shifts.* Make sure procedures are in place to monitor changes in stock ownership to determine whether an ownership change under *I.R.C. Section 382* has occurred since the beginning of the testing period.

7. *Information Statements.* In addition to the creditor information statements, ensure that information statements relating to any tax reorganization or change in control, n2 any change of ownership under *I.R.C. Section 382*, n3 and a consent

on Form 982 to reduce basis in respect of any cancellation of indebtedness that is to be excluded from income, n4 are filed with the tax authorities.

8. *Get Paid*. Be sure to file your fee application on a timely basis n5 so that you get paid for all of the good tax work you have done for the debtor.

FOOTNOTES:

(n1)Footnote 1. *See P TX5.04[3] supra*.

(n2)Footnote 1a. Pub. L. No. 109-8 (2005), effective in cases commenced on or after October 17, 2005, *reprinted in* Vol. E-2 Collier on Bankruptcy, App. Pt. 10(a) (Matthew Bender 15th Ed. Revised).

(n3)Footnote 2. *See P TX10.06 supra*.

(n4)Footnote 3. *See P TX11.04[2] supra*.

(n5)Footnote 4. *See Treas. Reg. § 1.108-4(a)*.

(n6)Footnote 5. And in compliance with *Fed. R. Bankr. P. 2016*, local rules, local U.S. Trustee Guidelines and any special guidelines issued by the particular bankruptcy judge presiding over the case.