



January 1981

Kick 'Em While They're Down - A Taxation and Bankruptcy Critique of the Technical and Policy Aspects of the Bankruptcy Tax Act of 1980

Robin E. Phelan

William M. Sharp

Recommended Citation

Robin E. Phelan & William M. Sharp, *Kick 'Em While They're Down - A Taxation and Bankruptcy Critique of the Technical and Policy Aspects of the Bankruptcy Tax Act of 1980*, 35 Sw L.J. 833 (1981)
<https://scholar.smu.edu/smulr/vol35/iss4/1>

This Article is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in SMU Law Review by an authorized administrator of SMU Scholar. For more information, please visit <http://digitalrepository.smu.edu>.

KICK 'EM WHILE THEY'RE DOWN—A TAXATION AND BANKRUPTCY CRITIQUE OF THE TECHNICAL AND POLICY ASPECTS OF THE BANKRUPTCY TAX ACT OF 1980

by

*Robin E. Phelan** and *William M. Sharp***

TABLE OF CONTENTS

	<i>Page</i>
I. SOMETHING FOR NOTHING: GENERAL INTRODUCTION TO INCOME FROM CANCELLATION OF INDEBTEDNESS	835
II. AN APE-LIKE GROWTH: THE EVOLUTION OF THE CANCELLATION OF INDEBTEDNESS DOCTRINE BEFORE THE BANKRUPTCY TAX ACT OF 1980	837
A. Judicial Development: The <i>Kirby Lumber</i> Rule	837
B. Cancellation of Indebtedness Income: Exceptions to the <i>Kirby Lumber</i> Rule Before Passage of the Bankruptcy Tax Act of 1980	838
C. The Interrelationship of Cancellation of Indebtedness and Net Operating Losses	845
III. THE BANKRUPTCY TAX ACT OF 1980: GENERAL SUMMARY	848
IV. TECHNICAL ANALYSIS OF THE ACT: THE DEBT DISCHARGE PROVISIONS	850
A. Debt Discharge of Debtors in Title 11 and Insolvency Cases	850
B. Debt Discharge of Solvent Debtors Outside of Bankruptcy	854
C. The Purchase Price Reduction Exception	855
D. Issuance of Stock by the Corporate Debtor in Satisfaction of Corporate Debt	856

* B.S., J.D., The Ohio State University. Attorney at Law, Haynes and Boone, Dallas, Texas; Chairman of the Tax Subcommittee of the Business Bankruptcy Committee of the Corporation, Banking and Business Law Section of the American Bar Association.

** B.S., Drake University; J.D., Indiana University; LL.M., New York University. Attorney at Law, Haynes and Boone, Dallas, Texas.

E.	Miscellaneous Rules Concerning Cancellation of Indebtedness Income	858
1.	Investment Tax Credit Recapture	858
2.	Related Party Transactions.....	859
3.	Lost Deductions	859
V.	THE "G" TYPE CORPORATE REORGANIZATION	859
A.	General Background	859
B.	Definitional and Operational Aspects of the "G" Reorganization	864
C.	Treatment of Accrued Interest on Exchanged Securities.....	867
VI.	OTHER CORPORATE AMENDMENTS UNDER THE ACT	867
A.	Exceptions from Personal Holding Company Status ...	867
B.	Extension of the Twelve-Month Period of Section 337 .	868
C.	Certain Transfers to Controlled Corporations.....	869
D.	Interrelationship Between Debt Discharge Amounts and Earnings and Profits	870
VII.	PROCEDURAL ASPECTS OF THE BANKRUPTCY TAX ACT OF 1980.....	870
A.	Jurisdictional and Procedural Aspects Under the Old Bankruptcy Act	870
B.	Jurisdictional and Procedural Aspects Under the New Bankruptcy Code and the Bankruptcy Tax Act of 1980.....	872
VIII.	BANKRUPTCY TAX ASPECTS OF THE INDIVIDUAL DEBTOR ..	874
A.	Prior Tax Law Concerning Individual Debtors	874
B.	The Bankruptcy Tax Act of 1980: Rules Concerning the Individual Debtor	874
IX.	THE FUTURE COURSE OF THE ACT.....	876

I. SOMETHING FOR NOTHING: GENERAL INTRODUCTION TO INCOME FROM CANCELLATION OF INDEBTEDNESS

THE creation of taxable income normally requires the occurrence of a taxable event, the character or form of which may vary considerably. With respect to dealings in property, a taxable event typically occurs when gain is realized¹ and is included in gross income.² In transactions not involving the transfer, sale, or exchange of property, ordinary income may accrue under an accession to wealth or net benefit theory,³ which results in the creation of gross income. In a typical loan transaction, however, where a debtor borrows funds, no realization of gain or net accession to wealth generally exists, and no taxable event therefore occurs upon which to justify taxation. These conclusory tax results are premised on the balanced economic position of the debtor after the loan transaction; while the loan proceeds increase the debtor's assets, his liabilities are correspondingly increased, thereby causing no increase in the debtor's net worth. Thus, no income tax is imposed on the debtor with respect to the cash proceeds of the loan.⁴

Complete cancellation or reduction of the debtor's loan obligation to repay the creditor, however, will give rise to a taxable event under either of

1. Income tax generally is not imposed on unrealized but accrued gain that reflects the appreciation in value of property held by the taxpayer. Only when the taxpayer makes a substantial change in his economic position with respect to a given asset will the justification arise for imposing a tax on the accrued gain. Thus, one prerequisite to the imposition of income tax is the disposition of appreciated property in a "realization" transaction. The early case of *Eisner v. Macomber*, 252 U.S. 189 (1920), established the general rule that property must be disposed of in some type of realization transaction to justify taxation of its accrued gain. In *Eisner* the Court held unconstitutional Congress's attempt to tax the receipt of stock dividends because no "income," defined as "the gain derived from capital, from labor, or from both combined," was present. *Id.* at 207 (quoting *Stratton's Independence, Ltd. v. Howbert*, 231 U.S. 399, 415 (1913)). The *Eisner* definition of realization of income, however, has not served as a universal benchmark. See, e.g., *Helvering v. Horst*, 311 U.S. 112 (1940); *Helvering v. Bruun*, 309 U.S. 461 (1940); *Prescott v. Commissioner*, 561 F.2d 1287 (8th Cir. 1977). See generally *Surrey, The Supreme Court and the Federal Income Tax: Some Implications of Recent Decisions*, 35 ILL. L. REV. 779 (1941).

Additionally, Treasury Regulations define "realization" as the gain or loss realized from the "conversion of property into cash, or from the exchange of property for other property differing materially either in kind or in extent." Treas. Reg. § 1.1001-1(a), T.D. 7142, 1971-2 C.B. 295. Assuming a transaction constitutes a realization event, the next inquiry is to determine if the realized gain or loss is recognized. I.R.C. § 1001(a). Thereafter, one must determine whether the recognized gain or loss is excepted from recognition by a statutory or judicial nonrecognition rule. See, e.g., *id.* §§ 351, 1031, 1033.

2. I.R.C. § 61(a)(3).

3. Whether an economic benefit received by a taxpayer constituted gross income was the issue addressed by the Supreme Court in *Old Colony Trust Co. v. Commissioner*, 279 U.S. 716 (1929). The proposition developed in *Old Colony Trust Co.* and later cases focuses on the net benefit or "accession to wealth" accruing to the taxpayer. See, e.g., *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955). The general tenor of this broad-based rule also can be found in § 61, which defines gross income as "all income from whatever source derived." I.R.C. § 61. Unless otherwise excluded, an economic benefit or accession to wealth with respect to a given taxpayer generally will constitute ordinary income and not a capital gain, due to the absence of a sale or exchange. See *id.* § 1222. Although the sources from which ordinary income and capital gain emanate are conceptually divergent, their respective authorities for taxability both lie in § 61. See generally *id.* § 61.

4. See notes 1, 3 *supra*.

two theories. First, the debtor can be deemed to have experienced an accession to wealth to the extent of the loan cancellation or reduction; the net proceeds from the loan fall within the "income from discharge of indebtedness" classification of gross income.⁵ Alternatively, the debt cancellation can be viewed as a gain realized from the transfer of property to which the debt relates, or perhaps even the transfer of the debt obligation itself, in exchange for the cancellation or reduction of the debt.⁶ The applicability of either theory depends on the nature of the transaction in which the cancellation or modification of indebtedness arises.⁷ In any event, when cancellation or reduction of the debt occurs, requiring the debtor to recognize as income an amount equal to the debt cancellation generally is considered appropriate in the absence of special circumstances.⁸

While the concept that debt cancellation or reduction results in taxable income may appear to be a simplistic one, several years of judicial decisions coupled with congressional and administrative action have cultivated the cancellation of indebtedness garden into a vast and seemingly endless field of havoc. The underlying guidelines with respect to cancellation of indebtedness income are widely divergent, highly technical, and in several instances irreconcilable with taxation theory and basic economics.⁹ In an attempt to provide certainty in the debt cancellation area and to coordinate bankruptcy law and tax law, the well-intended, but in several respects ill-conceived, Bankruptcy Tax Act of 1980¹⁰ was signed into law by President Carter on December 24, 1980.

5. I.R.C. § 61(a)(12). See also note 3 *supra*.

6. See note 1 *supra*. For an excellent discussion of the taxation issues arising from cancellation of indebtedness, see Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 TAX L. REV. 225 (1959).

7. For example, when property other than money is transferred by the debtor in cancellation of indebtedness, the debt discharge is deemed to arise by sale or exchange, with the amount of the gain measured by the excess of the debt over the debtor's adjusted basis in the transferred property. See *R. O'Dell & Sons v. Commissioner*, 169 F.2d 247 (3d Cir. 1948); *Welch v. Street*, 116 F.2d 953 (1st Cir. 1941); *Estate of Delman v. Commissioner*, 73 T.C. 15 (1979); Rev. Rul. 76-111, 1976-1 C.B. 214. On the other hand, when no property is transferred in the cancellation transaction, the debtor realizes ordinary income to the extent of debt cancellation, due to the absence of a sale or exchange. See, e.g., *Fairbanks v. United States*, 306 U.S. 436 (1939). *But cf.* I.R.C. § 1232 (retirement of certain corporate obligations treated as sale or exchange). For an excellent discussion of the various means of debt discharge and their effect on the classification of income, see Eustice, *supra* note 6, at 231-36. See also Eustice, *Cancellation of Indebtedness Redux: The Bankruptcy Tax Act of 1980 Proposals—Corporate Aspects*, 36 TAX L. REV. 1 (1980).

8. See text accompanying notes 11-14 *infra*.

9. See generally text accompanying notes 11-71 *infra*.

10. Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389. The genesis of the Act was the result of recommendations from the Commissioner on the Bankruptcy Laws of the United States, whose proposals ultimately were enacted into law as a major overhaul of the bankruptcy laws. Eustice, *supra* note 7, at 1.

II. AN APE-LIKE GROWTH: THE EVOLUTION OF THE CANCELLATION OF INDEBTEDNESS DOCTRINE BEFORE THE BANKRUPTCY TAX ACT OF 1980

A. *Judicial Development: The Kirby Lumber Rule*

In *United States v. Kirby Lumber Co.*¹¹ the Supreme Court, in a cryptic one-page opinion, ruled that where a corporate debtor purchased its own bonds on the open market at a price less than the face amount of such bonds, the corporate debtor "realized within the year an accession to income" to the extent that the principal amount of each bond exceeded its purchase price. The Court reasoned that the net amount of debt cancelled (the excess of the face amount of the bonds over their purchase price) did not reflect a concomitant "shrinkage of assets" of the corporation. Because the net economic position of the corporation in *Kirby Lumber* failed to remain in balance, *i.e.*, the taxpayer's net worth increased as a result of the debt cancellation, the transaction could not have constituted a mere repayment of debt.¹² The *Kirby Lumber* holding, which reversed prior law,¹³ sets forth the basic proposition that taxable income will be realized and thus recognized to the extent indebtedness of a taxpayer is cancelled, unless some nonrecognition rule applies.¹⁴ While the reasoning underlying the *Kirby Lumber* rule seems clear, for several years the courts, Congress,

11. 284 U.S. 1 (1931). The Court in *Kirby Lumber* relied to some extent on the un cited Treasury Regulations supposedly related to the Revenue Act of 1921. The Regulations provided that if the corporation purchased and retired any bonds at a price less than the issuing price or face value, the excess of the issuing price or face value over the purchase price constituted gain or income for the taxable year. *Id.* at 3. The interchanged usage of the terms "gain" and "income" makes unclear whether the Court intended cancellation of indebtedness to result in income à la *Glenshaw Glass*, or as gain from dealings in property with the attendant realization concept of *Eisner*. See notes 1, 3, 7 *supra*. See also Eustice, *supra* note 6, at 230. For a thorough discussion of the evolutionary development of the taxation of cancellation of indebtedness income area, see *id.* at 228-31.

12. See note 14 *infra*.

13. See, *e.g.*, *Bowers v. Kerbaugh-Empire Co.*, 271 U.S. 170 (1926); *Burnet v. John F. Campbell Co.*, 50 F.2d 487 (D.C. Cir. 1931). The Regulations later adopted the *Kirby Lumber* approach with respect to corporate open market purchases at a discount. Treas. Reg. § 1.61-12(c)(3), T.D. 6984, 1969-1 C.B. 38; *cf.* *Peter Pan Seafoods, Inc. v. United States*, 417 F.2d 670, 672-74 (9th Cir. 1969) (corporation that acquired notes with funds derived in part from stockholders of obligor corporation did not acquire its own indebtedness because transaction had economic substance).

14. Accordingly, one can theorize that the *Kirby Lumber* rule simply recognizes the basic accounting treatment of cancellation of indebtedness: to decrease or debit the loan payable and to increase or credit income or retained earnings. This results in a net benefit or increase in the net worth of the debtor, because as this accounting entry demonstrates, the debtor's liability is shifted into an income account with no offsetting reduction of cash or other asset. The nature or underlying character of the cancellation transaction will determine whether capital gain or ordinary income results. See note 7 *supra*. Note, however, that the manner in which the cancellation transaction occurs seemingly will not matter for purposes of seeking relief under the postponement of income rule of I.R.C. § 108. S. REP. NO. 1622, 83d Cong., 2d Sess. 186 (1954); see text accompanying notes 38-56 *infra*. See also Eustice, *supra* note 6, at 276. In recent years, however, the courts have limited the breadth of the special nonrecognition treatment of § 108 so as to exclude cancellation of indebtedness income that results from the transfer, sale, or exchange of property in discharge of the underlying indebtedness. See, *e.g.*, *Estate of Delman v. Commissioner*, 73 T.C. 15 (1979); *Tufts v. Commissioner*, 70 T.C. 756 (1978), *rev'd on other grounds*, 651 F.2d 1058 (5th Cir. 1981).

and the Internal Revenue Service have developed a myriad of exceptions and exceptions-to-exceptions with respect to this general rule. The result of this tampering has been a great deal of uncertainty, complexity, and general confusion.

B. Cancellation of Indebtedness Income: Exceptions to the Kirby Lumber Rule Before Passage of the Bankruptcy Tax Act of 1980

The *Kirby Lumber* rule, which eventually was codified and adopted by the Treasury Regulations,¹⁵ is subject to several complex and sometimes irreconcilable judicial, regulatory, and statutory exceptions, most of which are now dealt with by the Act. A principal exception is the so-called "insolvency" exception,¹⁶ which generally provides that no income will be realized from the discharge of indebtedness if the debtor is insolvent both before and after the transaction in which the discharge arose. To the extent the debtor is made solvent as a result of the discharge, however, cancellation of indebtedness income may result.¹⁷ Indeed, the rationale for this exception is to permit an insolvent debtor who otherwise would realize income upon cancellation of indebtedness to avoid the additional drain caused by increased tax liability on a possibly nonexistent cash flow. Thus, cancellation of an insolvent taxpayer's debt apparently does not result in a sufficient net economic benefit to the insolvent debtor that would justify taxation. The logic of basing a system of taxation on the taxpayer's net worth or financial ability to pay taxes rather than on income generation, however, is debatable, because income results from the cancellation of debt whether or not the debtor is insolvent.¹⁸

Another exception to the *Kirby Lumber* rule is the "shareholder cancel-

15. I.R.C. § 61(a)(12); Treas. Reg. § 1.61-12(a) (1960).

16. See *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95 (5th Cir. 1934). See also *Astoria Marine Constr. Co. v. Commissioner*, 12 T.C. 798 (1949); *Kramon Dev. Co. v. Commissioner*, 3 T.C. 342 (1944), acq. 1944 C.B. 17; *Madison Rys. v. Commissioner*, 36 B.T.A. 1106 (1937). The Regulations also have adopted the insolvency exception in the context of a bankruptcy proceeding, so long as the fair market value of the debtor's assets do not exceed his liabilities after such proceedings. Treas. Reg. § 1.61-12(b)(1) (1960). The term "insolvency" in this context generally means an excess of the debtor's liabilities over the fair market value of his assets, including intangibles such as goodwill. *Conestoga Transp. Co. v. Commissioner*, 17 T.C. 506 (1951), acq. 1952-1 C.B. 2. See also *Davis v. Commissioner*, 69 T.C. 814 (1978). In *Davis* the Service unsuccessfully argued that the fair market value of the debtor's business expertise, business relationships, and assets exempt from creditors should be included in the debtor's net worth calculation. *Id.* at 834. In rejecting this argument, the court reasoned that such expertise and exempt assets were not included in the debtor's estate by the Bankruptcy Act, and that inclusion of such items in the net worth calculation would cause substantial valuation problems. *Id.*

17. *Lakeland Grocery Co. v. Commissioner*, 36 B.T.A. 289 (1937); Treas. Reg. § 1.61-12(b) (1960). The insolvency exception will apply even when the cancelled debt resulted in some type of previous tax benefit. *1180 E. 63rd St. Bldg. Corp.*, 12 T.C. 437 (1949). *But cf.* I.R.C. § 111(b)(4) (amount of bad debt that is excluded from gross income includes only amount that did not result in reduction of tax).

18. See *Eustice*, *supra* note 6, at 246. To adhere more closely to tax theory, the insolvency exception perhaps should concede that cancellation of indebtedness constitutes the realization of cancellation of indebtedness income, but reach the result of nontaxability on the policy grounds that such income should not be recognized.

lation of corporate indebtedness" rule. A gratuitous cancellation of the indebtedness of a corporation to its shareholder generally does not give rise to cancellation of indebtedness income.¹⁹ The reasoning underlying this exception is that a cancellation of debt by a shareholder-creditor in substance represents a tax-free contribution to the capital of the debtor corporation.²⁰ The cancellation of the corporate debt by the shareholder-creditor must be made in the cancelling party's capacity as a shareholder in order for the exception to apply.²¹ When the amount owed to the shareholder previously has been deducted but never paid by an accrual basis corporate debtor,²² however, the applicability of this exception was unclear prior to the Act. In such an instance, the corporate debtor would receive a reduction in its taxable income by reason of the accrued deduction. Because the corporate debtor avoided payment of the accrued expense by reason of the shareholder cancellation, however, the corporation could accrue the deduction without funding it in the form of a cash payment. The overall result to the corporate debtor would be an accession to wealth equal to the net tax benefit of the accrued but cancelled expense. On these facts, the court in *Putoma Corp. v. Commissioner*²³ held that a corporate debtor was shielded from cancellation of indebtedness income even though it previously had accrued but never paid the interest expense giving rise to a tax benefit to the corporation.²⁴ In *Commissioner v. Fender Sales, Inc.*,²⁵ however, the court held to the contrary on similar facts, relying on the literal language of the regulations²⁶ to deny the corporate debtor the use of this exception.²⁷ Thus, prior to the passage of the Act,

19. Treas. Reg. § 1.61-12(a) (1960) provides that "if a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation to the extent of the principal of the debt." The shareholder exception to the *Kirby Lumber* rule has been denied when the transaction lacked "shareholder intent" to upgrade the shareholder's equity portion of the corporation. *Briarcliff Inv. Co. v. Commissioner*, 90 F.2d 330 (5th Cir.), cert. denied, 302 U.S. 731 (1937).

20. With respect to the tax treatment of the debtor-corporation, I.R.C. § 118 generally provides that "gross income does not include any contribution to the capital" of such corporation. The Regulations specify that this exception will apply only "to the extent of the principal of the debt" of the debtor-corporation. Treas. Reg. § 1.61-12(a) (1960). This exception will apply to a shareholder's cancellation of interest on the debt when the interest has not been deducted. *Commissioner v. Auto Strop Safety Razor Co.*, 74 F.2d 226 (2d Cir. 1934); *Hartland Assocs. v. Commissioner*, 54 T.C. 1580 (1970), nonacq. 1976-2 C.B. 3. *But see* text accompanying notes 23-27 *infra*. *See also* Eustice, *supra* note 6, at 250-51.

21. If the shareholder's cancellation of a corporate debt is in some capacity other than as a shareholder, then the corporation-shareholder nexus required by § 118 would be missing. *See* note 19 *supra*.

22. I.R.C. § 446(c)(2). An accrual basis taxpayer generally can deduct an expense when the liability giving rise to the expense is a fixed obligation rather than a mere contingency, and the amount of the liability can be determined with reasonable accuracy. Treas. Reg. § 1.461-1(a)(2) (1960).

23. 66 T.C. 652 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979).

24. 66 T.C. at 671.

25. 338 F.2d 924 (9th Cir. 1964), cert. denied, 382 U.S. 813 (1965). *See also* *Dwyer v. United States*, 439 F. Supp. 99 (D. Or. 1977).

26. The Regulations specifically provide that the cancellation of indebtedness exception in the shareholder-corporation context shall apply only "to the extent of the principal of the debt." Treas. Reg. § 1.61-12(a) (1960).

27. The Service maintains that when interest previously has been accrued and deducted by the corporate debtor, resulting in the generation of a tax benefit, cancellation thereof by

the extent to which the contribution to capital exception applied to corporate indebtedness previously accrued and deducted but never paid by the corporate debtor was unclear.

A related exception to the *Kirby Lumber* rule holds that no cancellation of indebtedness income arises if stock of the corporate debtor is issued to a creditor in satisfaction of an outstanding corporate indebtedness.²⁸ This exception applies even if the creditor already was a shareholder of the debtor corporation, and even if the fair market value of the stock issued by the corporate debtor is less than the face amount of the obligation satisfied.²⁹ The theory underlying this exception is that the mere substitution of corporate stock for its outstanding debt represents a continuation of an investment in the corporate debtor in essentially the same economic form.³⁰ Thus, because no investment change has occurred from the corporation's viewpoint, an appropriate point has not been reached to require the realization of cancellation of indebtedness income.³¹

the shareholder-creditor is not to be shielded by the contribution to capital rule, but rather is to be treated as income. Rev. Rul. 76-316, 1976-2 C.B. 22, *superseding* Rev. Rul. 73-432, 1973-2 C.B. 17. The result in *Fender Sales* seems to be an odd one insofar as the court held that the cancellation of indebtedness income was properly includible in the income of the closely held corporate shareholders rather than the corporate debtor. Although this holding reaches the theoretically correct result, in that a tax benefit for which no cash is disbursed and which is later cancelled should give rise to cancellation of indebtedness income, it tends to disregard the separate taxable entities: the corporate debtor should have borne the tax burden rather than its shareholders because the corporation experienced the direct tax benefit of the accrued deduction. To justify taxation at the shareholder level, however, one can argue that the true beneficiaries of a closely held corporation's deduction are its shareholders.

28. *Commissioner v. Motor Mart Trust*, 156 F.2d 122 (1st Cir. 1946); *Capento Sec. Corp. v. Commissioner*, 47 B.T.A. 691 (1942), *aff'd*, 140 F.2d 382 (1st Cir. 1944). Inexplicable confusion seems to exist in the debt-for-stock exchange area, where the capital structure of a financially distressed corporation is reorganized. In addition to the *Motor Mart Trust* nonrecognition of stock-for-debt rule, various statutory safe havens are available. See text accompanying notes 38-56 *infra*. Furthermore, the now-repealed Bankruptcy Act provided that no income was to be recognized by a corporation due to adjustments of its outstanding indebtedness in a chapter X proceeding. Bankruptcy Act of 1938, Pub. L. No. 75-696, §§ 268, 270, 52 Stat. 840, 904 (repealed 1978). The Bankruptcy Act extracted a toll charge for this nonrecognition of cancellation of indebtedness income, however: such a corporation had to reduce the bases of its assets by the amount of indebtedness cancelled in such proceedings, although not below fair market value. *Id.* § 270. Additionally, I.R.C. §§ 371-374 override all other rules when the insolvency reorganization involves a transfer of the corporate debtor's assets to another corporation. In this instance no basis adjustments are required to be made to the corporate debtor's assets, notwithstanding the nonrecognition of cancellation of indebtedness income. See text accompanying notes 174-207 *infra*.

29. *Alcazar Hotel Inc. v. Commissioner*, 1 T.C. 872 (1943); *Capento Sec. Corp. v. Commissioner*, 47 B.T.A. 691 (1942), *aff'd*, 140 F.2d 382 (1st Cir. 1944). The stock-for-debt rule also is applicable to capitalized interest obligations of the corporate debtor. Rev. Rul. 59-98, 1959-1 C.B. 76.

30. See *Eustice*, *supra* note 6, at 239. Apart from theoretical underpinnings, generally accepted accounting principles require that the corporate debtor debit the payable account and credit the income account for financial reporting purposes, resulting in a "wash" transaction without an increase in net worth of the corporate debtor.

31. *Tower Bldg. Corp. v. Commissioner*, 6 T.C. 125 (1946), *acq.* 1947-1 C.B. 4. The creditor exchanging his debt for stock will recognize gain or loss so long as the obligation held by the exchanging creditor is not debt represented by a security and the debtor is a corporation. Rev. Rul. 59-222, 1959-1 C.B. 80. Certain other aspects of a corporate debtor's exchange of stock for outstanding obligations should be examined. When the creditor exchanges outstanding securities for stock of the debtor but also receives cash or other non-

Another exception to the *Kirby Lumber* rule is the "reduction of purchase price" rule, which has been adopted by several courts.³² Generally, when the debtor and the creditor agree as a result of direct negotiations to decrease a purchase money liability incurred in connection with the purchase of property by the debtor from the creditor, no income will be realized with respect to such debt reduction as long as the value of the property in question is at least equal to the indebtedness outstanding after the reduction of the purchase money debt.³³ This exception emanates from judicial concern for financially distressed taxpayers, in that it permits the debtor's unrealized loss in an economically depreciated asset to offset the cancellation of indebtedness income.³⁴ In some instances, however, this exception has been narrowly construed. For example, the holding in one case was that the debtor-vendee must have a purchase money obligation secured by the property subject to the sale.³⁵ While the purchase price reduction rule has been described as "irrational,"³⁶ its continued existence as an exception to *Kirby Lumber* seems well-accepted.³⁷

stock property, he will recognize gain to the extent of cash or other property. I.R.C. §§ 354, 356. In no event may a loss be recognized. *Id.* § 356(c). These conclusions presuppose the exchange of securities for stock in a tax-free reorganization. *See, e.g., id.* §§ 368(a)(1)(E), 371(a).

32. *Commissioner v. Sherman*, 135 F.2d 68 (6th Cir. 1943); *Helvering v. A.L. Killian Co.*, 128 F.2d 433 (8th Cir. 1942); *Hirsch v. Commissioner*, 115 F.2d 656 (7th Cir. 1940).

33. *Commissioner v. Sherman*, 135 F.2d 68, 70 (6th Cir. 1943); *Helvering v. A.L. Killian Co.*, 128 F.2d 433, 434-35 (8th Cir. 1942); *Hirsch v. Commissioner*, 115 F.2d 656, 657-58 (7th Cir. 1942).

34. *See Eustice, supra* note 6, at 245. The appropriate accounting entry would debit the payable account and credit the asset account. Consequently, no income would result. *See* note 30 *supra*.

35. *Edwards v. Commissioner*, 19 T.C. 275 (1952), *acq.* 1953-1 C.B. 4. The exception thus appears inapplicable to indebtedness arising out of loan transactions secured by property already owned.

36. *Fifth Ave.-Fourteenth St. Corp. v. Commissioner*, 147 F.2d 453, 457 (2d Cir. 1944).

37. *See, e.g., Commissioner v. Sherman*, 135 F.2d 68 (6th Cir. 1943); *Helvering v. A.L. Killian Co.*, 128 F.2d 433 (8th Cir. 1942); *Hirsch v. Commissioner*, 115 F.2d 656 (7th Cir. 1940). *But see* *Fifth Ave.-Fourteenth St. Corp. v. Commissioner*, 147 F.2d 453, 457 (2d Cir. 1944) (exception should be applied only to cases in which vendor-mortgagee agrees to reduction in purchase price after negotiations directly relating to price). For a more comprehensive discussion of the foregoing exceptions and other exceptions to the *Kirby Lumber* rule, see generally *Eustice, supra* note 6, at 236-53. Two other exceptions to the rule are worthy of note: the "gift" exception and the "no accession to wealth" exception. Section 102 generally excludes from gross income any amount received as a gift or bequest. I.R.C. § 102. This exception is difficult to apply in an arms'-length commercial setting because a creditor's cancellation of an unrelated debtor's obligation to repay a loan hardly involves the detached and disinterested generosity required of gifts. *See Commissioner v. Duberstein*, 363 U.S. 278 (1960). The gift exclusion seems to be a dead letter today insofar as cancellation of indebtedness is concerned. *See Commissioner v. Jacobsen*, 336 U.S. 28, 51-52 (1949) (cancellation of indebtedness from sale of securities creates taxable income). *But see Helvering v. American Dental Co.*, 318 U.S. 322, 330-31 (1943) (voluntary release by creditor of open account for rent or of interest held gift). The Court in *Jacobsen* distinguished *American Dental*, noting that a gift will be found only when the debtor receives something for "nothing" and the creditor clearly intends to make a gift. *Id. But cf. Hartland Assocs. v. Commissioner*, 54 T.C. 1580, 1586 (1970) (cancellation of interest indebtedness by shareholder-creditor represents contribution to capital of corporation-debtor). To reach a cancellation of indebtedness income conclusion, the debtor generally must experience some increase in his net worth or an accession to wealth in some concrete or tangible sense. Assuming the debtor has not experienced a net benefit with respect to the cancelled loan, *e.g.*, a cash basis tax-

Perhaps the most important exception to the *Kirby Lumber* rule was found in section 108 before its alteration by the Act.³⁸ Section 108 generally permitted a debtor that otherwise would be required to recognize income from debt cancellation pursuant to *Kirby Lumber* to elect to reduce the basis of its assets by the amount of the debt discharged.³⁹ The manner in which the adjustment was made to the taxpayer's basis in assets was described in section 1017 and the regulations thereunder.⁴⁰

The first step in analyzing the application of section 108 was to determine whether or not it would apply to a given debtor.⁴¹ The nonrecognition

payer whose past-due rental obligation is cancelled, cancellation of indebtedness income arguably should not be realized. *See, e.g.*, *Commissioner v. Rail Joint Co.*, 61 F.2d 751 (2d Cir. 1932); *Fashion Park, Inc. v. Commissioner*, 21 T.C. 600 (1954), *nonacq.* 1955-1 C.B. 7.

38. The text of all sections prior to their revision by the Bankruptcy Act of 1980 can be found in the 1980 edition of the Internal Revenue Code and are cited as I.R.C. § — (1980). I.R.C. § 108 (1980) provided:

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.

39. *Id.* § 108(2). Prior to the passage of the Act, the § 108 election was inapplicable to the discharge of indebtedness in any bankruptcy proceeding under either § 77(b) or chapters X or XI of the now-repealed Bankruptcy Act. Bankruptcy Act of 1938, Pub. L. No. 75-696, §§ 101-399, 52 Stat. 840, 883-916 (repealed 1978). Nonrecognition relief was provided in these bankruptcy instances, however, by §§ 268 and 270 of the Bankruptcy Act, assuming similar basis adjustments to the debtor's assets were made. *See* note 28 *supra*.

40. I.R.C. § 1017 (1980) provided:

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.

41. Before determining those persons to whom the nonrecognition treatment of § 108 would apply, the threshold issue had to be examined: whether the income resulting from the cancelled or reduced indebtedness of a taxpayer would qualify for § 108 treatment. The legislative history underlying § 108 indicated that its scope should not be limited by the nature or form in which the cancellation of indebtedness income arose; a transfer of property in cancellation should be treated no differently than a cancellation not involving the

tion rule of section 108 seemingly was available to any type of indebtedness of a corporation.⁴² In addition, section 108 applied to indebtedness held by an individual in connection with property used in his trade or business.⁴³ The underlying theory of section 108 therefore permitted certain types of debtors, confronted with possible cancellation of indebtedness income under *Kirby Lumber*, to postpone the recognition of such realized income. This postponed recognition of income later was recognized in two manners: by the lower depreciation deductions⁴⁴ resulting from the reduction in the bases of depreciable assets of an electing debtor, and by the realization of a commensurately larger gain attributable to the reduced bases accounts upon sales by the electing debtors of the downward adjusted assets.⁴⁵ The nonrecognition treatment of section 108, however, was not available to the extent the debt cancelled or reduced exceeded the basis of the debtor's property that could be adjusted.⁴⁶

While the scope of section 108 differed according to the nature of the taxpayer,⁴⁷ the election procedure under section 108 was similar for all

transfer of property. S. REP. NO. 1622, 83d Cong., 2d Sess. 186 (1954). In recent years, however, various courts have held § 108 unavailable to gain realized from cancellation transactions involving the transfer of property. See note 7 *supra*. In contrast, the Regulations suggested a bifurcated approach to determine the application of § 108 to these transactions. Treas. Reg. § 1.1017-1(b)(5) (1960) (§ 108 applies to excess of debt over fair market value of property; presumably difference between fair market value of property and its basis will produce gain or loss). For a discussion of this concept, see *Estate of Delman v. Commissioner*, 73 T.C. 15, 31 n.6, 34 n.11, 38 nn.16-18 (1979).

42. The language of § 108(1)(A) apparently extended the nonrecognition election under § 108 to any debt cancellation of a corporate debtor, assuming that the debt arose out of the ordinary course or within the normal scope of such corporation's trade or business. I.R.C. § 108(1)(A) (1980). For instance, indebtedness for which the corporation is not liable as a matter of law, *e.g.*, a personal debt of an officer or director, probably would not be included within the scope of this rule. Thus, a sufficient relationship between the debt and the corporation's trade or business was necessary.

43. *Id.* § 108(1)(B).

44. I.R.C. § 167.

45. Debatable is whether a justification exists for conversion of § 61(a)(12) cancellation of indebtedness income, which is ordinary income for want of a sale or exchange, into capital gain upon sale of a downward-adjusted § 1231(b) asset. Perhaps justification can be premised on the notion that a financially sound taxpayer that reduces the bases of its assets by ordinary depreciation deductions taken under I.R.C. § 167 later can sell such assets in such a manner to reap long-term capital gains under I.R.C. § 1231, assuming the various recapture pitfalls of section 1245 and 1250 are avoided. In effect, such a taxpayer can reap the benefit of ordinary deductions at a tax cost of long-term capital gain rates with respect to his § 1231(b) assets. Along the same line of reasoning, the financially distressed taxpayer required to reduce the bases of its assets under §§ 108 and 1017 similarly avoided an ordinary income event at a tradeoff of long-term capital gain upon the later disposition of the adjusted asset. See Rev. Rul. 67-200, 1967-1 C.B. 15.

46. Treas. Reg. § 1.1017-1(a) (1960) provided that the reduction of basis shall not exceed the total available bases; no "negative bases" could result from a § 108/1017 transaction. Moreover, to the extent that the debt discharge exceeded the basis reduction, an amount had to be included in the gross income of the debtor electing § 108 treatment. Rev. Rul. 70-406, 1970-2 C.B. 16. To the extent § 108 was inapplicable by reason of such an excess, however, the debtor could rely on another exception to the cancellation of indebtedness income rule of *Kirby Lumber*. See text accompanying notes 16-37 *supra*.

47. Corporate and individual taxpayers could receive disparate treatment. The Regulations provided that § 108 would apply to an individual debtor if the loan proceeds were used to purchase, repair, or improve business property. Treas. Reg. § 1.108(a)-1(a)(2) (1960).

taxpayers. Pursuant to the regulations under section 1017,⁴⁸ a taxpayer seeking nonrecognition treatment under section 108 was required to file a formal consent for the taxable year within which the cancellation transaction occurred.⁴⁹ The basis adjustment procedures under section 1017 utilized in connection with a section 108 election provided a meticulous basis reduction procedure,⁵⁰ which generally designated a specific order in which the bases of the taxpayer's assets were to be reduced. The basis of property to which the debt relates, *i.e.*, property acquired by the proceeds of the discharged debt, was reduced first, excluding inventory and accounts and notes receivable. The basis of property subject to a lien created by the debt was reduced next, followed by any remaining property other than inventory and accounts and notes receivable, and finally by inventory and accounts and notes receivable.⁵¹ From a timing viewpoint, the adjustment was made as of the first day of the taxable year in which the cancellation event occurred, unless the properties so adjusted were acquired at a later date during such year, in which event the adjustment was made as of the acquisition date.⁵²

More importantly, if the basis adjustment exceeded the available aggregate bases of property held by the debtor, such excess had to be recognized

The key focus was the use to which the proceeds were put rather than the presence or character of any security for the loan.

48. Treas. Reg. § 1.1017-2(b) (1960).

49. In the event the debtor had several cancellations of indebtedness during the taxable year, it could file the § 108 consent "piecemeal" by making the election on a property-by-property basis. Treas. Reg. § 1.1017-1(c), example (a) (1960). Alternatively, a debtor conceivably could bifurcate a single cancellation of indebtedness transaction into recognition and nonrecognition events. A § 108 consent could be filed in an amended return only in special cases. Treas. Reg. § 1.108-2 (1960). The definition underlying the phrase "special cases," however, was unclear. A "special case" seemingly would involve reasonable cause for the taxpayer's failure to file the consent with his original return. *Id.* § 1.108(a)-2. A hindsight determination approach, by which the taxpayer assesses the desirability of a basis adjustment after the fact, would not appear to qualify as sufficient reasonable cause. *Columbia Gas Sys., Inc. v. United States*, 334 F. Supp. 1279 (S.D.N.Y. 1971), *aff'd*, 473 F.2d 1244 (2d Cir. 1973). *See also* *Denmar Tire & Rubber Co. v. Commissioner*, 192 F.2d 261, 264 (6th Cir. 1951) (taxpayer can change election only if original election was in error).

The consent under § 108 was to be made on Form 982. Schedule B of Form 982 had to contain a complete description of the debt cancellation transaction to which the consent applies. Strict adherence to Form 982 was not always required, however. *See, e.g.*, *Ambassador Hotel Co. v. Commissioner*, 23 T.C. 163 (1954), *acq.* 1956-1 C.B. 3. In the event the debt cancellation transaction overlapped two taxable years, a new consent had to be filed for each taxable period. In addition, the Service ruled that a partnership could file a consent under § 108. Rev. Rul. 72-205, 1972-1 C.B. 37. Under I.R.C. § 752, however, the amount of income excluded by § 108 would reduce the basis of each partner's interest in the partnership. For a discussion of the effect of cancellation of indebtedness in a partnership context, see W. MCKEE, W. NELSON & R. WHITMORE, *FEDERAL TAXATION OF PARTNERSHIPS AND PARTNERS* ¶ 9.06 (1977).

50. Treas. Reg. §§ 1.1017-1(a)(1) to (6) (1960). After reduction of purchase money indebtedness, the Regulations required basis reduction to be applied first against depreciable or wasting assets in certain specified categories. Treas. Reg. § 1.1017-1(b)(7) (1960).

51. In the case of an individual debtor, two other categories were included for basis reduction purposes: investment property and "all other" property. Treas. Reg. §§ 1.1017-1(a)(5), (6) (1960).

52. Treas. Reg. §§ 1.1017-1(b)(4)(i), (ii) (1960). The § 1017 adjustment was made ratably with respect to all property in each of the above stated groups, in proportion to their respective adjusted bases. *Id.* § 1.1017-1(b)(4).

as gross income.⁵³ Additionally, the Service had taken the position that a reduction in the basis of the debtor's assets pursuant to sections 108 and 1017 with respect to "qualified investment credit property" was a pro tanto "disposition" of such property⁵⁴ measured by the basis so reduced, resulting in partial recapture of the investment tax credit allowed upon the purchase of the adjusted property.⁵⁵ Prior to passage of the Act, the effect of sections 108 and 1017 with respect to an electing corporation's earnings and profits also was unclear.⁵⁶

C. *The Interrelationship of Cancellation of Indebtedness and Net Operating Losses*

The interrelationship between the exceptions from the realization of cancellation of indebtedness income and the availability of net operating loss carryovers is unclear. The Service originally maintained that the net operating loss carryovers⁵⁷ generated by a taxpayer were not affected by the tax results of a subsequent cancellation of indebtedness in either an insolvency or bankruptcy setting.⁵⁸ Under this view an insolvent debtor corporation or one undergoing bankruptcy proceedings conceivably could reap the benefits of nonrecognition of cancellation of indebtedness income, while simultaneously surviving the insolvency or bankruptcy proceeding with a net operating loss carryover against which the post-bankruptcy or post-insolvency taxable income of the rehabilitated business possibly could be offset.⁵⁹ As long as the corporate debtor fell within either an exception

53. Rev. Rul. 70-406, 1970-2 C.B. 16. When the debtor transfers property in cancellation of an outstanding debt, the tax results are far from certain. See notes 7, 41 *supra*. The Regulations treated the transfer as one to which §§ 108 and 1017 applied to the extent that the cancelled debt exceeded the fair market value of the property transferred. Treas. Reg. § 1.1017-1(b)(5) (1960). See also note 46 *supra*. This approach is a far leap from universal acceptance. See notes 7, 41 *supra*.

54. Rev. Rul. 74-184, 1974-1 C.B. 8. The Service, however, apparently will not maintain the position that basis reduction causes depreciation recapture. Treas. Reg. § 1.167(a)-1(b) (1960).

55. See I.R.C. § 47; Treas. Reg. § 1.47-2(c) (1967).

56. Treas. Reg. § 1.312-6(b) (1960) implicitly provides that even if § 108 was elected, earnings and profits increased by the amounts subject to such election. In *Meyer v. Commissioner*, 383 F.2d 883, 891 (8th Cir. 1967), however, the court held that earnings and profits are not created by the discharge of indebtedness under the Bankruptcy Act. The Service has announced that it will not follow the *Meyer* decision to the extent that the amount of debt discharged exceeds the reduction in basis of the taxpayer's assets. Rev. Rul. 75-515, 1975-2 C.B. 117.

57. I.R.C. § 172(b).

58. Rev. Rul. 58-600, 1958-2 C.B. 29 (cancellation of indebtedness income not recognized due to application of insolvency exception to the *Kirby Lumber* rule). See also *A.L. Davis v. Commissioner*, 69 T.C. 814, 833 (1978) (discharge in bankruptcy of individual debtors did not preclude carryover of net operating losses sustained both before and during bankruptcy; moreover, discharge of indebtedness had no effect on such loss carryovers).

59. In the event such corporate debtors were insolvent, the insolvency exception of *Dallas Transfer* would apply. See text accompanying notes 16-19 *supra*. On the other hand, if such corporate debtor were undergoing a chapter X or XI proceeding, §§ 268 and 270 of the Bankruptcy Act would shield the taxpayer from recognition of cancellation of indebtedness income, subject to certain adjustments. Bankruptcy Act of 1938, Pub. L. No. 75-696, §§ 268, 270, 52 Stat. 840, 904 (repealed 1978); see note 28 *supra*.

to *Kirby Lumber*⁶⁰ or the Bankruptcy Act,⁶¹ or elected the nonrecognition provisions of section 108,⁶² its net operating loss generally would carry over to future taxable years.⁶³

This circumstance provided a key tax planning tool in the bankruptcy and insolvency area if the corporate debtor with substantial net operating loss carryovers incurs cancellation of indebtedness. The corporate debtor could avoid the recognition of income resulting from the cancellation of indebtedness in several ways: by relying on exceptions to the *Kirby Lumber* rule, by falling under the nonrecognition rule of the Bankruptcy Act, or by electing to reduce the bases of its assets under section 108. Having reaped the benefit of the cancellation of indebtedness, the debtor then could revamp its operations and later use those loss carryovers whose underlying debts had been cancelled without resulting in a taxable event. For example, the corporate debtor could sell its stock or merge into a profitable corporation, whereby the acquiring company would purchase the stock or assets of the bankrupt or insolvent corporation for a significant purpose⁶⁴ of reaping a dollar-for-dollar benefit from the debtor corporation's net operating loss carryover. The former shareholders of the acquired corporation would receive an amount of stock of the acquiring corporation adequate to avoid any section 382 problems. Moreover, the purchase price for the debtor corporation's assets or stock presumably would be based on the fair market value of the corporation's net assets, adjusted by several factors. Although early attacks on this type of transaction by the Service were successful, in recent years the success of the Service has been diminished.⁶⁵

60. See text accompanying notes 16-37 *supra*.

61. See note 28 *supra*.

62. See text accompanying notes 38-56 *supra*.

63. Because this conclusion assumes no change of ownership, the limitation provisions of I.R.C. § 382 are not applicable. Similarly, potential problems under *id.* § 269 and limitations imposed by the consolidated return regulations are assumed to be inapplicable.

64. Section 269 problems may arise if the *primary* purpose of the acquiring corporation is to obtain net operating loss carryover advantages.

65. Early cases agreeing with the Service included *Willingham v. United States*, 289 F.2d 283 (5th Cir. 1961) (losses incurred by corporate taxpayer for two years prior to its reorganization in bankruptcy, under a plan that in effect wiped out such losses, not available to carry over and deduct from income generated by the post-bankruptcy corporation, even though the latter corporation continued to engage in substantially the same business), and *Wier Long Leaf Lumber Co. v. Commissioner*, 9 T.C. 990 (1947), *aff'd in part and rev'd in part*, 173 F.2d 549 (5th Cir. 1949) (corporation consented to liquidation and dissolution pursuant to resolutions of stockholders and board of directors, ceased production and sold the bulk of its operating property; corporation not entitled to carry back unused property tax credits to a prior year).

In recent years judicial sentiment has shifted with respect to the utilization of net operating loss carryovers after the loss corporation has undergone bankruptcy reorganization. Recent taxpayer victories include *Daytona Beach Kennel Club, Inc. v. Commissioner*, 69 T.C. 1015 (1978) (de facto dissolution doctrine rejected in determining whether a reorganization pursuant to the Bankruptcy Act extinguished the bankrupt corporation's net operating loss carryover); *Jacqueline, Inc. v. Commissioner*, 36 T.C.M. (CCH) 1363 (1977); *Jackson Oldsmobile, Inc. v. United States*, 237 F. Supp. 779 (M.D. Ga. 1964) (refusing to apply de facto dissolution doctrine in net operating loss situation), *aff'd*, 371 F.2d 808 (5th Cir. 1967). See also Technical Advice Memorandum No. 8014009, IRS Letter Rul. (CCH) (Dec. 17, 1979). For further discussion of this concept, see Glancy, *Carrying Losses Through Chapter X and*

The application of this concept can be explained more fully as follows. Assume a corporate debtor has reorganized in a bankruptcy case, surviving the proceedings with potential pre-bankruptcy net operating loss carryovers. In recent years the Service has unsuccessfully argued that such a debtor has undergone a de facto dissolution,⁶⁶ and that all corporate tax attributes, including net operating loss carryovers, therefore "die." Moreover, assuming the acquiring corporation avoids certain statutory weapons and the "evil purpose" weapon available to the Service,⁶⁷ it may gain the full benefit of the corporate debtor's net operating loss carryovers. Thus, the corporate debtor escapes income and its net operating loss carryovers survive the transaction, even though several of the cancelled liabilities that created deductible expenditures, which in turn generated the debtor's net operating loss carryovers, are wiped clean. Every dollar of cancelled liability essentially gives the corporate debtor two distinct economic benefits: an initial benefit with respect to the cancelled loan⁶⁸ and an additional benefit to both the debtor corporation and any acquiring company that purchases the debtor corporation in a transaction in which the debtor's loss carryover survives. It has been argued that giving such debtor the benefit of the cancelled debt and the loss carryover from the cancelled debt may confer a double benefit.⁶⁹

A portion, or perhaps all, of the cancelled debt may have no nexus or relationship to the deductions giving rise to the loss carryover. When a corporate debtor is deprived of the use of its net operating loss carryover, however, and such debtor is undergoing a bankruptcy or insolvency reorganization proceeding, the cash savings resulting from the loss carryover generally will benefit the corporation's creditors rather than the corporation itself. Finally, the Service has ruled that a debtor's loss carryovers are not affected in an insolvency proceeding.⁷⁰

XI Reorganizations, 28 TAX LAW. 27 (1974); Plumb, *The Tax Recommendations of the Commission on the Bankruptcy Laws—Reorganizations, Carryovers and the Effects of Debt Reduction*, 29 TAX L. REV. 229 (1974).

66. See note 65 *supra*.

67. I.R.C. §§ 382, 269; see note 63 *supra*.

68. The cancelled loan may confer economic benefit upon the debtor by offsetting other income, as in the case of a deductible expense resulting from the cancelled debt, or in the form of cash, as in the case of proceeds derived from the loan.

69. This loss carryover may be available to the acquiring corporation dollar-for-dollar, even though that corporation paid for or funded only a percentage of the net tax benefit of the loss carryover. Every dollar of the cancelled liability of the debtor corporation, which incurred the loss, nonetheless contributed to the total dollar amount of the loss carryover, assuming each dollar of liability gave rise to a dollar of deduction. Because the cancellation of these loss-generating liabilities did not affect the debtor corporation's total loss carryover, and because the acquiring corporation paid the debtor corporation an amount for its stock based on the tax value of the loss carryover less an amount to reflect the discounted net tax benefit of the loss and the attendant economic risks inherent in the debtor corporation's business, the acquiring corporation will derive a net tax benefit from the loss carryover for which it paid, in dollar terms, a substantial discount in relationship to the total net tax dollar amount of the loss carryover.

70. Rev. Rul. 58-600, 1958-2 C.B. 29.

III. THE BANKRUPTCY TAX ACT OF 1980:⁷¹ GENERAL SUMMARY

According to the report of the House Ways and Means Committee,⁷² the

71. Pub. L. No. 96-589, 94 Stat. 3389. The effective date provisions of the Act should be noted carefully. Generally, Jan. 1, 1981, is the effective date for the application of the majority of the Act's provisions: general discharge of indebtedness and corporate reorganizations and other corporate amendments. *Id.* §§ 7(a), (c), (d). With respect to individual bankruptcies, the effective date of the Act's tax provisions is Mar. 24, 1981. *Id.* § 7(b). The provisions of the Act dealing with tax procedure, however, are retroactive to Oct. 1, 1979, which is the effective date of the new Bankruptcy Code. *Id.* § 7(e).

A special transitional rule will delay the effective date of attribute reduction until Jan. 1, 1982. *Id.* § 7(a)(2). In a bankruptcy case or similar judicial proceeding taxpayers may, subject to court approval, elect on an "all or nothing" basis to apply the provisions of the Act dealing with tax treatment of discharge of indebtedness, corporate reorganizations, and miscellaneous corporate changes retroactively to Oct. 1, 1979. *Id.* § 7(f). This twist is due to an earlier draft version of the Act, which had used Oct. 1, 1979, as the effective date.

Pursuant to this special election, a debtor in a bankruptcy case or similar judicial proceeding may, with the approval of the court, elect to apply "certain provisions" of the Act as of Oct. 1, 1979. *Id.* These "provisions" include the Act's rules relating to tax treatment of discharge of indebtedness; however, due to the special transitional rules set forth in § 7(a)(2) of the Act, "attribute reduction" is delayed to apply to bankruptcy cases that commence after Jan. 1, 1982. Essentially, this special election permits a debtor whose bankruptcy case commenced between Oct. 1, 1979, and Jan. 1, 1981, to elect to apply the Act retroactively, presumably on the theory that such a debtor structured its bankruptcy case on the premise that the Act would be ultimately enacted in its present form with the originally suggested Oct. 1, 1979, effective date. It appears that a debtor taking advantage of this special election will be required to apply the amount of debt discharged as a result of the bankruptcy case to reduce its basis in its assets (but not below fair market value), and any amount of debt discharge remaining after the reduction of the basis of the debtor's assets will not be included in income or cause a reduction of net operating loss carryovers or other tax attributes (as will be the case after Jan. 1, 1982).

Temporary regulations have been promulgated by the Secretary of the Treasury dealing with this special election procedure. Temp. Treas. Reg. § 7a.3. The regulations state that the effect of the special election is to change the effective date of certain amendments to the Internal Revenue Code of 1954 as made by the Act, including the provisions mentioned above. *Id.* § 7a.3.(c)(i). More importantly, the temporary regulations make it clear that the special election takes into account the special transitional rule that, as described above, delays the effective date of attribute reduction until bankruptcy cases commencing on or after Jan. 1, 1982. *Id.* § 7a.3.(c)(3).

According to these temporary regulations, a debtor in a bankruptcy case makes the special election by doing the following:

1. The debtor must file a written statement containing the name, address, and taxpayer identification number of the debtor, a statement that the debtor is making the election under § 7(f) of the Act, and information (including the date of commencement) sufficient to identify the bankruptcy case or similar proceeding. This written statement must be signed by the debtor or a person duly authorized to sign the income tax return of the debtor.

2. The debtor must file evidence of court approval of this special election which, according to the regulations, must be a copy of an order or other document properly signed by the judge or officer presiding over the bankruptcy case. In addition to information identifying the debtor in the case or proceeding over which the officer presides, the order must state that the court approves the election of the debtor under § 7(f) of the Act.

3. The written statement and evidence of court approval must be filed on or before Nov. 2, 1981, with the District Director or the Director of Internal Revenue Service Center with whom an income tax return for the debtor would be filed if it were due on the date the election is filed.

4. The election shall be considered to be made on the date in which the written statement and evidence of court approval is filed.

debt discharge rules of the Act seek to "accommodate bankruptcy policy and tax policy" so as to "preserve the debtor's fresh start after bankruptcy."⁷³ To accomplish this goal, the Act seeks to ensure that a debtor that undergoes a bankruptcy case or an insolvency proceeding is not "burdened with an immediate tax liability."⁷⁴

The Act generally provides that in either bankruptcy or insolvency cases, the debtor's gross income does not include amounts that otherwise would constitute cancellation of indebtedness income. This amount is termed the "debt discharge amount."⁷⁵ The tax cost of avoiding the inclusion of the debt discharge amount in the debtor's gross income is the reduction of the debtor's net operating losses and certain other tax attributes ("attribute reduction") by an amount equal to the debt discharge amount, unless the bankrupt or insolvent debtor first makes an election to reduce the bases of its depreciable assets.⁷⁶ With respect to solvent debtors outside of bankruptcy, the Act modifies the section 108 election by narrowing nonrecognition relief to such debtors; nonrecognition is available only in those instances when an election to reduce the bases of depreciable assets is made.⁷⁷ The Legislative Reports indicate that the attribute reduction provisions of the Act will give the debtor flexibility in accounting for any debt discharge amount in the manner most favorable to its particular tax situation.⁷⁸ The Reports further note that the attribute reduction method purportedly will avoid a permanent deferral that, according to the Legislative Reports, can be accomplished under present law.⁷⁹ The legislative history states that attribute reduction will carry out the congressional

5. Finally, the debtor should attach a copy of the written statement and evidence of court approval to the next income tax return filed on or after the date the election is made.

72. H.R. REP. NO. 833, 96th Cong., 2d Sess. (1980) [hereinafter cited as Committee Report]. S. REP. NO. 1035, 96th Cong., 2d Sess. (1980), *reprinted in* [1980] U.S. CODE CONG. & AD. NEWS 7017 [hereinafter cited as Senate Finance Report] adopted the House Report in substantially the same form, except for certain changes as discussed herein. Collectively, the House and Senate Reports are referred to hereinafter as the Legislative Reports.

73. Committee Report, *supra* note 72, at 8-9; Senate Finance Report, *supra* note 72, at 9-10. The preservation of the debtor's "fresh start" after bankruptcy is in lieu of permitting the debtor to have what was referred to in the committee hearings as a "head start." The latter concept refers to the ability of a debtor to avoid cancellation of indebtedness income while avoiding any limiting effect on its net operating loss carryovers. This circumstance was deemed to constitute a "head start." See BNA Daily Tax Report No. 213 (Nov. 1, 1979). For a discussion of this concept, see text accompanying notes 57-70 *supra*.

74. Committee Report, *supra* note 72, at 9; Senate Finance Report, *supra* note 72, at 10.

75. I.R.C. § 108(a)(1).

76. *Id.* § 108(b)(5).

77. *Id.* §§ 108(c), (d)(4).

78. Committee Report, *supra* note 72, at 9; Senate Finance Report, *supra* note 72, at 10.

79. *Id.* The Committee Report's concern with permanent deferral seems somewhat unjustified on careful examination of § 1017 in conjunction with § 108. A so-called permanent deferral seems unlikely, because as a general rule the basis of certain depreciable assets first must be reduced when § 108 is elected. Treas. Reg. § 1.1017-1(b)(7) (1960). Hence, smaller depreciation deductions may be taken, and such assets will result in a commensurately larger gain when ultimately sold. See note 45 *supra*. If the corporate debtor has no depreciable assets, however, but only nondepreciable assets, such as stock in a subsidiary, the possibilities of a permanent deferral increase.

intent of "deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge."⁸⁰ To ensure that the postponed cancellation of indebtedness income eventually is recognized as ordinary income, the Act provides a corollary ordinary income recapture rule with respect to the sale of those depreciable assets whose bases are reduced under the special election, the sale of which otherwise would result in long-term capital gain.⁸¹

The debt discharge provisions of the Act not only contain many technical problems, but are replete with policy ramifications contrary to the well-intended but ill-conceived and poorly engineered intent of the Act to "accommodate bankruptcy law and tax law." To provide a better understanding of the technical aspects of the debt discharge rules under the Act, the remainder of this Article contains a technical discussion of the statutory provisions of the Act, primarily focusing on their impact on the corporate debtor. Critical comments from both theoretical and pragmatic tax viewpoints are highlighted. Throughout the course of this analysis several policy considerations are raised from both tax and bankruptcy viewpoints. Finally, the summary portion of this Article makes certain recommendations as to the desirability and nature of future amendments to the Act.⁸²

IV. TECHNICAL ANALYSIS OF THE ACT: THE DEBT DISCHARGE PROVISIONS

A. Debt Discharge of Debtors in Title 11 and Insolvency Cases

Pursuant to new section 108(a)(1), gross income does not include any amount that otherwise would be includable in gross income by reason of a discharge of indebtedness of the debtor, so long as the discharge occurs in a bankruptcy case or when the debtor is insolvent. The toll charge for this deceptively labeled exclusion⁸³ from gross income is that the debt discharge amount first will be applied to reduce certain tax attributes of the debtor.⁸⁴ As an alternative to attribute reduction, the debtor can elect to first reduce its bases in its depreciable assets.⁸⁵ According to the Legislative Reports, any debt discharge amount remaining after attribute reduction is disregarded in bankruptcy or insolvency cases.⁸⁶

80. Committee Report, *supra* note 72, at 9; Senate Finance Report, *supra* note 72, at 10.

81. I.R.C. § 1017(d).

82. Because the attribute reduction provisions of the Act do not become effective until January 1, 1982, the authors hope that remedial legislative action can be taken to amend the debt discharge rules before they become effective. See Part IX *infra*. For a discussion of the effective date provisions of the Act, see note 71 *supra*.

83. Arguably, the statutory language used by new § 108, which implies that the debt discharge amount is "excluded" from gross income, should require no basis adjustments, as is typical for a true exclusion from gross income.

84. I.R.C. § 108(b).

85. *Id.* § 108(b)(5).

86. Compare Senate Finance Report, *supra* note 72, at 13 (any debt discharge amount "left after attribute reduction . . . is disregarded, i.e., does not result in income or have other tax consequences") with Rev. Rul. 70-406, 1970-2 C.B. 16 (if debt discharge amount exceeds basis of debtor's assets, excess must be included in gross income when debtor is solvent and not a party to a bankruptcy proceeding). Under prior law, however, even if an excess debt

A corporate debtor undergoing a bankruptcy or insolvency proceeding and seeking shelter under proposed section 108(a)(1)(A) first must inquire as to the meaning of a "title 11 case." The Legislative Reports define the term "bankruptcy case" as a case under title 11 of the United States Code, but only if the debtor is under the jurisdiction of the court in the case and the discharge of indebtedness is granted by or pursuant to a plan granted by the court.⁸⁷ For purposes of satisfying the "insolvency" exception,⁸⁸ the Act defines insolvency as the excess of the debtor's liabilities over the fair market value of its assets, as determined immediately before the debt discharge.⁸⁹ The chore of determining the fair market value of a taxpayer's assets will be a difficult one and, as has been true in related areas requiring such a determination, a litigation-breeding endeavor.⁹⁰

Assuming the debtor falls within either the bankruptcy or the insolvency classification,⁹¹ and does not elect to reduce the bases of its depreciable assets by the debt discharge amount,⁹² the ordering rules of attribution reduction come into play. Pursuant to new section 108(b), the amount to be excluded from gross income by reason of a debt discharge in a bankruptcy or an insolvency case will reduce the debtor's tax attributes in the following order: (1) any net operating loss of the taxable year in which the discharge occurs and net operating loss carryovers to such taxable year; (2) carryovers to or from the taxable year of discharge of the investment tax credit (other than the ESOP credit), the WIN credit, the new jobs credit,

discharge amount remained after basis reduction pursuant to § 1017, such excess generally could be shielded from taxation by another exception to § 61(a)(12), *e.g.*, the insolvency exception. Whether the results under the new § 108 similarly would apply to discharge of indebtedness outside of bankruptcy or insolvency proceedings is unclear, but the answer appears to be negative. Because the solvent taxpayer has the necessary funds to pay the tax resulting from the recognition of cancellation of indebtedness income, the justification for nonrecognition in bankruptcy or insolvency proceedings does not apply in the solvency situation. The Senate Finance Report therefore states that such excess constitutes § 61(a)(12) gross income. Senate Finance Report, *supra* note 72, at 16.

87. Committee Report, *supra* note 72, at 10 n.11; Senate Finance Report, *supra* note 72, at 12 n.11.

88. I.R.C. § 108(a)(1)(B).

89. *Id.* § 108(d)(3). Section 108 provides that no other insolvency exception will apply except the provision as set forth therein. *Id.* § 108(e)(1). Thus, the clear intent and plain language of the statute appears to be that in the event a case fails to qualify under the § 108(a)(1)(B) insolvency exception, the judicial approach to the insolvency exception will be unavailable. For a discussion of the judicially created insolvency exception, see text accompanying notes 16-18 *supra*.

90. The determination of fair market value in the federal income tax arena has been complex; it invariably is resolved by examining a multitude of facts and circumstances. *See, e.g.*, *Davis v. Commissioner*, 69 T.C. 814 (1978). In light of these factual difficulties, the insolvency exception as contained in the Act not surprisingly has been highly criticized, from both tax and bankruptcy viewpoints. *See* Part IX *infra*. Moreover, the determination of insolvency seems not to include exempt assets or those assets lacking a reasonable ascertainable value. *See Davis v. Commissioner*, 69 T.C. 814 (1978); note 16 *supra*. The statute and Legislative Reports are silent on this point, however. I.R.C. § 1017(c)(1) does provide that an amount excluded from gross income under § 108(a)(1)(A) will not result in the reduction in basis of the property treated by the debtor as exempt under 11 U.S.C. § 522 (Supp. III 1979).

91. I.R.C. §§ 108(a)(1)(A)-(B).

92. *Id.* § 108(b)(5).

and the credit for alcohol used as fuel; (3) net capital losses for the taxable year of discharge and capital loss carryovers to such taxable year; (4) the bases of the taxpayer's depreciable and *nondepreciable* assets (as guided by new section 1017); and (5) foreign tax credit carryovers.⁹³

The reduction of attributes in each of the foregoing categories is made in the order of the taxable years in which the item would be consumed.⁹⁴ In addition, such order is determined as if the debt discharge amount were not excluded from the debtor's gross income, and any limitations on the use of credits that are based on the debtor's gross income are to be disregarded.⁹⁵ Furthermore, the credits in categories (2) and (5) above are reduced at a rate of fifty percent of each dollar of debt discharge amount, in order to avoid the complexity of what otherwise would require the workings of a simultaneous equation.⁹⁶

In lieu of the attribute reduction scenario, the debtor in a bankruptcy case or insolvent debtor may elect to reduce the bases of its depreciable assets,⁹⁷ although not below zero.⁹⁸ As new section 108(b)(5)(C) and the

93. *Id.* §§ 108(b)(2)(A)-(E).

94. *Id.* §§ 108(b)(4)(A)-(C). Accordingly, in the case of net operating basis or capital losses, the debt discharge amount first would reduce the current year's loss and then would reduce remaining loss carryovers in the taxable year in which they arose. *Id.* § 108(b)(4)(B). On the other hand, investment tax credits are to be reduced on a first-in, first-out basis, and other credit carryovers are reduced in the order in which they would be used to offset taxable income. *Id.* § 108(b)(4)(C). See Committee Report, *supra* note 72, at 10 n.13; Senate Finance Report, *supra* note 72, at 13 n.13. These reductions are made after computation of the tax for the current taxable year. I.R.C. § 108(b)(4)(A).

The basis reduction under category (4) is limited by the difference between the aggregate of the bases of property held by the taxpayer immediately after the discharge over the aggregate of the taxpayer's liabilities immediately after the discharge. *Id.* § 1017(b)(2). This limitation will not apply when the debtor makes the § 108(b)(5) election. *Id.* Temporary regulations prescribing the time and manner for making the various elections under the Act were recently issued by the Service. Temp. Treas. Reg. § 1.1017, T.D. 7775, 46 Fed. Reg. 25,291 (May 6, 1981).

95. I.R.C. § 1017(b)(2).

96. *Id.* § 108(b)(3)(B). Reductions of net operating losses and capital losses are on a dollar-for-dollar basis, however. *Id.* § 108(b)(3)(A).

97. *Id.* § 108(b)(5). The Legislative Reports define depreciable property as any property of a character subject to the allowance for depreciation, but only if the basis reduction will reduce the amount of depreciation or amortization otherwise allowable for the period immediately following such reduction. For example, a lessor could not reduce the basis of leased property when the lessee's obligation in respect of the property will restore to the lessor the loss due to depreciation during the leasehold term, because during that term the lessor is prohibited from claiming depreciation with respect to such property. Committee Report, *supra* note 72, at 11 n.14; Senate Finance Report, *supra* note 72, at 13 n.14 (citing *Kern v. Commissioner*, 51 T.C. 455 (1968), *aff'd*, 432 F.2d 961 (9th Cir. 1970)). Section 108(d)(5) defines depreciable property as having the same meaning as that used in § 1017, which adopts the definition as found in the legislative history. I.R.C. § 1017(b)(3)(B). The Act expands the definition of depreciable property in two other instances. First, the debtor can elect to treat as depreciable property real property that is inventory within the meaning of § 1221(1). *Id.* § 1017(b)(3)(E). Secondly, stock of a subsidiary held by a debtor parent corporation can be treated as depreciable property if such corporations are members of the same affiliated group, which files a consolidated return for the taxable year in which the discharge occurs. *Id.* § 1017(b)(3)(D).

98. I.R.C. § 108(b)(5)(B) states that the "amount to which an election . . . applies shall not exceed the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge oc-

underlying legislative history imply, the basis reduction election can be made on an all-or-nothing or piecemeal basis.⁹⁹ For example, assume a corporate debtor's debt discharge amount is \$100, its only new section 108(b)(2) attribute is a net operating loss carryover of \$80, and the aggregate adjusted bases of its depreciable property also are \$80. To maximize preservation of its net operating loss carryover, the corporate debtor should elect to reduce the basis of depreciable assets. If, on the other hand, the corporate debtor does not anticipate the generation of taxable income within the carryover period against which the net operating loss carryover could be offset,¹⁰⁰ it should permit the automatic attribute reduction to apply.¹⁰¹ If, however, the corporate debtor projects the generation of only \$50 of taxable income within the loss carryover period, it should make a partial election to reduce the basis of depreciable assets by an amount equal to \$70. This would permit the corporate debtor to use fully its anticipated loss carryover (\$50) as determined by the amount of the anticipated stream of taxable income in the loss carryover period.¹⁰²

From a procedural viewpoint, the election first to reduce basis in depreciable assets is made on the taxpayer's return for the year in which the debt discharge occurs.¹⁰³ A significant procedural trap is that an electing taxpayer may revoke this election only with the consent of the Secretary of the Treasury.¹⁰⁴ Thus, the electing taxpayer must have full knowledge of both the legal and factual aspects of a given debt discharge situation. Although the legislative history is silent on this point, the consent of the Secretary presumably will be based on reasonable cause, perhaps either some good business reason or a factual ignorance situation.¹⁰⁵ Still unclear is whether a taxpayer making the election could amend its return to withdraw the consent in a later taxable year, if not barred by the applicable statute of limitations.¹⁰⁶

To ensure that the deferred debt discharge amount eventually is taxed as ordinary income,¹⁰⁷ the Act provides a special recapture rule.¹⁰⁸ Pursuant

curs." Thus, in the event the debt discharge amount exceeds the debtor's aggregate adjusted bases, such excess presumably could not be subject to depreciable basis reduction but would be required to undergo attribute reduction. If that avenue is not available, it apparently would be "disregarded" in title 11 or insolvent cases, which presumably means nonrecognized. See text accompanying note 87 *supra*.

99. Committee Report, *supra* note 72, at 11; Senate Finance Report, *supra* note 72, at 12.

100. I.R.C. § 172(b).

101. *Id.* § 108(b)(1)(A).

102. Use of a partial depreciable basis election with attribute reduction ostensibly is permitted by the phrase "any portion" in § 108(b)(5)(A) and the language contained in the legislative history. See note 100 *supra*.

103. I.R.C. § 108(d)(8)(A). Apparently some leeway exists in the manner by which the election is made, insofar as the Secretary is instructed by the Act to promulgate regulations setting forth other methods of making the election.

104. *Id.* § 108(d)(8)(B).

105. See text accompanying note 49 *supra*.

106. See I.R.C. § 6511.

107. Committee Report, *supra* note 72, at 9; Senate Finance Report, *supra* note 72, at 11.

108. I.R.C. § 1017(d); see Committee Report, *supra* note 72, at 11; Senate Finance Report, *supra* note 72, at 14.

to this rule, any gain realized on the subsequent disposition of property to which the basis reduction rule has been applied, whether depreciable or nondepreciable,¹⁰⁹ will be subject to recapture provisions similar to those under sections 1245 and 1250.¹¹⁰ Certain other aspects of the Act's debt discharge rules also should be examined. First, the downward adjustment of the bases of depreciable assets generally will accord with present treasury regulations that apply to basis reduction.¹¹¹ The Act provides that the basis reduction in a given case will take effect on the first day of the taxable year following the year in which the discharge of indebtedness takes place.¹¹²

B. Debt Discharge of Solvent Debtors Outside of Bankruptcy

Perhaps the most controversial provisions of the Act are those dealing with solvent debtors outside of bankruptcy. This controversy emanates from the primary congressional concern "to accommodate bankruptcy policy and tax policy," which seemingly has little relationship to financially able debtors.¹¹³ The Legislative Reports, however, comment that discount purchases in the open market by a solvent corporate debtor of its own securities or bonds without the recognition of cancellation of indebtedness income are undesirable; the basis reduction provisions of section 108 presumably can be used in such a manner as to cause a permanent deferral of income of the debt discharge amount.¹¹⁴ Consequently, the Act will have a significant impact on taxpayers outside of bankruptcy or insolvency cases.¹¹⁵

Initially, the general rule regarding solvent debtors seems favorable: it simply states that gross income shall not include debt discharge amounts that relate to "qualified business indebtedness."¹¹⁶ The latter phrase is defined, in a manner reminiscent of old section 108, as indebtedness incurred or assumed by a corporation or by an individual in connection with prop-

109. I.R.C. § 1017(d); see Committee Report, *supra* note 72, at 11; Senate Finance Report, *supra* note 72, at 14.

110. Section 1017(d)(1)(B) treats any reduction under new § 108 as a depreciation deduction; hence, the entire amount of a basis adjustment will be subject to recapture treatment, except in the case of real property using the straight-line depreciation method. I.R.C. § 1017(d)(2).

111. Committee Report, *supra* note 72, at 11; Senate Finance Report, *supra* note 72, at 12.

112. I.R.C. § 108(b)(5)(B).

113. Committee Report, *supra* note 72, at 8-9; Senate Finance Report, *supra* note 72, at 10-11.

114. For example, a corporate debtor buys its outstanding bonds at less than face value. The debtor then reduces the basis of its factory or a subsidiary it does not intend to sell. The debtor effectively has deferred permanently the gain upon purchase of the bonds for less than face value. See Committee Report, *supra* note 72, at 9; Senate Finance Report, *supra* note 72, at 10.

115. The fiscal aspects of the Act are highly suspect when one weighs the meager increase in tax revenue of the solvent taxpayer provisions (\$5,000,000) against the taxpayer cost resulting from the added legal and accounting complexity in addressing these new provisions. Perhaps more importantly, the revenue raising aspects of the Act with respect to title 11 and insolvent taxpayers are uncertain. See Committee Report, *supra* note 72, at 49.

116. I.R.C. § 108(a)(1)(C).

erty used in his trade or business.¹¹⁷ The Act provides, however, that the debt discharge amount attributable to qualified business indebtedness shall be applied to reduce the bases of the solvent taxpayer's depreciable assets.¹¹⁸ The proper measuring rod for determining the available depreciable property to which the reduction rule can apply is the aggregate adjusted bases of such property held by the taxpayer as of the beginning of the taxable year *following* the taxable year in which the discharge occurs.¹¹⁹ If the debt discharge amount exceeds the aggregate bases of the taxpayer's depreciable property, however, contrary to the result in a title 11 or insolvency case, such excess will result in the recognition of cancellation of indebtedness income to the solvent taxpayer.¹²⁰ The recapture rule applicable to bankruptcy or insolvency cases similarly applies to solvent taxpayers upon the disposition of depreciable property to which the basis reduction rules have been applied.¹²¹ If an insolvent taxpayer not involved in a bankruptcy reorganization experiences a discharge of indebtedness, the attribute reduction and insolvency rules will not apply to the extent such discharge renders the taxpayer solvent.¹²² In this instance the taxpayer becomes subject to the rules concerning debt discharge amounts involving qualified business indebtedness.¹²³

C. The Purchase Price Reduction Exception

The Act codifies with expansive and liberal language the judicially created "purchase price reduction" exception¹²⁴ to the *Kirby Lumber* rule.¹²⁵ In the case of solvent taxpayers, only the reduction of a purchase money debt of a purchaser-debtor that "arose out of" the sale of property by the seller to the purchaser will not be treated as income to the purchaser from the discharge of indebtedness; rather, such reduction will be treated as mere purchase price adjustment.¹²⁶ The language employed by the statute appears to liberally expand the exception to apply to any debt that "arose out of" the purchase transaction.¹²⁷ Thus, the debt arising out of the purchase transaction seemingly need not be secured by the property that is the subject matter of the sale.

117. *Id.* § 108(d)(4).

118. *Id.* § 108(c)(1)(A). This section cross-references to *id.* § 1017 to determine the reduction of depreciable basis. While the statutory language of *id.* § 108(a)(1)(C) appears to mandate a reduction, the Legislative Reports indicate that this reduction is "elective." Committee Report, *supra* note 72, at 12; Senate Finance Report, *supra* note 72, at 15. See also I.R.C. § 108(d)(8)(A).

119. I.R.C. § 108(c)(2).

120. Committee Report, *supra* note 72, at 14; Senate Finance Report, *supra* note 72, at 15. For discussion of the result under a title 11 or insolvency case, see text accompanying note 86 *supra*.

121. I.R.C. § 1017(d). See also Senate Finance Report, *supra* note 72, at 16.

122. I.R.C. § 108(a)(3).

123. *Id.* § 108(a)(1)(C).

124. See text accompanying notes 118-23 *supra*.

125. I.R.C. § 108(e)(5).

126. *Id.*

127. For discussion of the narrowness of this exception, see text accompanying notes 35-37 *supra*.

The codified version of the purchase price reduction exception is intended to eliminate taxpayer controversy as to whether a debt reduction should be treated as discharge income or a mere purchase price adjustment.¹²⁸ Moreover, if the purchase money debt has been transferred by the debtor to a third party, whether or not related to the seller, the exception is inapplicable.¹²⁹ The exception will not apply to situations in which the purchase money debt is reduced due to factors not involving direct agreements between the buyer and seller, *e.g.*, the tolling of the statute of limitations on the enforcement of the obligation.¹³⁰

D. Issuance of Stock by the Corporate Debtor in Satisfaction of Corporate Debt

Under prior law the transfer by a corporate debtor of its stock in satisfaction of its outstanding indebtedness did not result in gain or loss to such corporation,¹³¹ even if the fair market value of the stock so transferred was less than the principal amount of the retired debt.¹³² Subject to certain narrow exceptions, the Act does not change this judicially created exception to the *Kirby Lumber* rule.¹³³ Accordingly, subject to certain exceptions, under the Act no debt discharge amount will result from satisfaction of corporate indebtedness by the issuance of stock of the corporate debtor, even if such stock has a fair market value less than the amount of the cancelled indebtedness. The classification of the corporate indebtedness as a security for tax purposes will be irrelevant for purposes of applying this rule.¹³⁴

Two exceptions to the codified stock-for-debt exception exist. Pursuant

128. Committee Report, *supra* note 72, at 13; Senate Finance Report, *supra* note 72, at 16.

129. *Id.*

130. *Id.* This result comports with case law regarding the purchase price reduction exception.

131. I.R.C. § 1032; *see* text accompanying notes 28-31 *supra*.

132. *Commissioner v. Motor Mart Trust*, 156 F.2d 122 (1st Cir. 1946); *Capento Sec. Corp. v. Commissioner*, 140 F.2d 382 (1st Cir. 1944). *See also* text accompanying notes 28-31 *supra*.

133. Senate Finance Report, *supra* note 72, at 17.

134. *Id.* An earlier draft of the Act would have reversed the stock-for-debt exception, contrary to the long line of statutory and judicial authority underlying this rule. *See* text accompanying notes 28-31 *supra*. The Act originally provided that if a corporate debtor transferred stock to a creditor in satisfaction of its indebtedness that was not evidenced by a "security," such corporation was treated as "not having transferred its stock, but . . . as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock." Essentially, this earlier draft of the Act treated the corporate debtor as not having issued its own stock; thus, the general nonrecognition treatment under § 1032 was unavailable. Instead, the corporate debtor was treated as having retired its outstanding indebtedness by paying cash equal to the fair market value of the "disregarded" stock. To the extent the principal amount of the outstanding nonsecurity indebtedness was greater than the amount of the deemed money transfer, cancellation of indebtedness income would have been generated to the corporate debtor. H.R. 5043, 96th Cong., 2d Sess. § 108(f)(1)(A) (1980). Because this rule would have applied to all debtors, solvent, insolvent, or title 11, income would have been recognized unless the transaction was one to which the proposed section 108 general exclusionary rule would have applied. H.R. REP. NO. 833, 96th Cong.,

to new section 108(e)(8), the exception will not apply in the following instances:

(1) when the corporate debtor issues nominal or token shares of its stock in satisfaction of outstanding indebtedness;¹³⁵ and

(2) in the case of an unsecured creditor involved in a "workout,"¹³⁶ if such creditor receives an amount of stock with a value less than one-half the fair market value of stock that such creditor would receive if all of the corporate debtor's unsecured creditors, to the extent their debts are either cancelled or satisfied with the corporate debtor's stock, received a pro rata amount of stock.¹³⁷

The Act additionally provides that if a creditor acquires stock of a corporation in exchange for its debt, and as a part of such transaction the creditor claims a bad debt deduction¹³⁸ with respect to the indebtedness surrendered, a special recapture rule may come into play upon later disposition of the stock received by such creditor.¹³⁹ In this instance, a creditor disposing of stock received in an earlier debt-for-stock exchange will recapture a certain amount as ordinary income. The recapture amount is to be determined by applying the section 1245 recapture rule as if the stock were depreciable property, and the excess of previously taken bad debt deductions over gain recognized by the creditor (or the loss recognized by

2d Sess. 15 (1980). For modifications by the Senate Finance Committee, see S. REP. NO. 1035, 96th Cong., 2d Sess. (1980).

According to the Committee Report, the intent of this attempted reversal of prior law was to "better coordinate the treatment of discharged debt at the corporate level with the treatment at the creditor level." Committee Report, *supra* note 72, at 13. Such an approach seemingly would have required income inclusion to the corporate debtor, subject to deferral under proposed § 108, to the extent that the creditor had taken or would have taken a partial bad debt deduction with respect to the satisfied indebtedness. While the tax theory of this earlier version of the Act appeared to have been sound, in that a partial bad debt deduction to the creditor would have been mirrored by an equal amount of cancellation of indebtedness income, the creation of a taxable event when the economic role of the parties essentially continued intact seemed inappropriate. In addition, this approach shifted the tax burden to the corporate debtor in lieu of other alternatives. Perhaps most importantly, the earlier draft appeared to have been an economically unjustified drain of cash flow in the form of an increased tax liability with respect to insolvent or bankrupt corporate debtors. Finally, the earlier draft's reliance on a fair market value index of the corporate debtor's stock would have created an administrative nightmare so far as valuation is concerned. Accordingly, the use of stock-for-debt rehabilitation programs by corporate debtors could have been hampered severely under the Act as proposed. Primarily in response to these criticisms, an amendment repealed this earlier draft of the Act and reinstated the stock-for-debt exception to the *Kirby Lumber* rule, subject to the two narrow exceptions discussed in the text.

135. I.R.C. § 108(e)(8)(A).

136. As defined in the Senate Finance Report, a "workout" includes a title 11 case or other transaction or series of transactions involving a "significant restructuring of the debt of a corporation in financial difficulty." Senate Finance Report, *supra* note 72, at 17 n.20.

137. I.R.C. § 108(e)(8)(B).

138. *Id.* §§ 166(a), (c). The bad debt deduction taken by the creditor is reduced by the gain recognized on the earlier stock-for-debt exchange that was included in the gross income of the creditor. In addition, any loss recognized by such creditor is subject to this special recapture rule.

139. *Id.* § 108(c)(7)(A). If the stock of the creditor is disposed of in a tax-free transaction, the potential recapture will carryover in the stock received. Senate Finance Report, *supra* note 72, at 18.

such creditor on the exchange) were treated as depreciation deductions.¹⁴⁰

The Act also applies the discharge of indebtedness rules to certain contributions to the capital of the corporate debtor. For the corporate debtor receiving its indebtedness from a shareholder as a contribution to capital, the normal tax-free contribution to capital rule, which generally excludes such amounts from gross income,¹⁴¹ will no longer apply. Rather, to the extent that the amount of the debt transferred to the corporation as a contribution to capital exceeds the shareholder's basis in such debt, such excess will be treated as a debt discharge amount to the corporation.¹⁴² Thus, the discharge of indebtedness rules will override the tax-free capital contribution rule when a cash basis taxpayer contributes to the capital of his accrual method corporation an outstanding corporate indebtedness representing an accrued expense previously deducted by the corporation.¹⁴³ This provision of the Act reverses the holding of *Putoma Corp. v. Commissioner*.¹⁴⁴ Moreover, the Legislative Reports indicate that even a shareholder contribution to capital structured as a gift will not permit the corporate debtor to avoid cancellation of indebtedness income.¹⁴⁵

E. Miscellaneous Rules Concerning Cancellation of Indebtedness Income

1. *Investment Tax Credit Recapture.* In the event the basis of qualified investment credit property is reduced by a debt discharge amount, the Act provides that no investment tax credit recapture will result, because the reduction of basis in this manner is not considered a "disposition" of the property.¹⁴⁶ This provision overturns the position taken by the Service in prior cases,¹⁴⁷ thus precluding the recapture of investment tax credit even in those cases involving basis reduction by insolvent and bankrupt debtors. This safe haven, however, will not extend to purchase price adjustments.¹⁴⁸ The reduction of a purchase price as a result of direct negotiations between the seller and buyer therefore will result in a pro tanto "disposition" within the meaning of the investment tax credit provisions, which will result in the recapture of investment tax credit by an amount attributable to such

140. See Senate Finance Report, *supra* note 72, at 18, example.

141. I.R.C. § 118.

142. *Id.* § 108(e)(6).

143. See Committee Report, *supra* note 72, at 15 n.21; Senate Finance Report, *supra* note 72, at 18-19. See also I.R.C. § 118, effectively incorporating this rule by cross-reference to *id.* § 108. See also text accompanying notes 19-26 *supra*.

144. 66 T.C. 652 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979).

145. Committee Report, *supra* note 72, at 15 n.21; Senate Finance Report, *supra* note 72, at 19 n.22.

146. I.R.C. § 1017(c)(2). See also Committee Report, *supra* note 72, at 15-16; Senate Finance Report, *supra* note 72, at 20.

147. Rev. Rul. 74-184, 1974-1 C.B. 8. The Senate Finance Report indicates, however, that this reversal of the Service's position is not intended as an inference as to the correct interpretation of federal income tax law prior to the effective date of the Act. Senate Finance Report, *supra* note 72, at 20 n.24.

148. Committee Report, *supra* note 72, at 16 n.23; Senate Finance Report, *supra* note 72, at 20.

reduction.¹⁴⁹

2. *Related Party Transactions.* New section 108(e)(4) is intended to preclude the purchase of the debtor's outstanding indebtedness by a related party for token or minimal consideration in an attempt to insulate such debtor from cancellation of indebtedness income. For purposes of determining income of the debtor from the discharge of indebtedness, an outstanding debt acquired from an unrelated party by a related party of the debtor will be treated as having been acquired by the debtor itself.¹⁵⁰ Thus, the purchase of a debtor's outstanding indebtedness from an unrelated party by a related party will be treated as if the debtor had made the purchase. Accordingly, if such purchase involves a discount or bargain element, the debtor will be deemed to have realized cancellation of indebtedness income, subject to the Act's attribution reduction and depreciable basis reduction rules.¹⁵¹ The Act provides that members of the debtor's family include the individual's spouse, children, grandchildren, parents, and any spouse of the individual's children or grandchildren.¹⁵² For purposes of determining the category of related parties to which this provision applies, the rules set forth in section 267(b) or section 707(b)(1) will apply.¹⁵³

3. *Lost Deductions.* The Act also provides that cancellation of indebtedness income will not be realized to the extent of "lost deductions."¹⁵⁴ According to the legislative history, lost deductions include those liabilities for which the debtor has not taken a tax benefit, usually in the form of a deduction, and subsequently are cancelled.¹⁵⁵ This statutory exception essentially encompasses the tax benefit concept: if a debtor has not taken a tax advantage relative to an outstanding liability, no income consequences should result from the cancellation of such debt.¹⁵⁶

V. THE "G" TYPE CORPORATE REORGANIZATION

A. General Background

Under prior law, if a corporation transferred all or part of its assets to another corporation pursuant to a court order in connection with a chapter X proceeding of the old Bankruptcy Act, and the transferee corporation was organized or used to effect the court-approved plan, such transfer

149. I.R.C. § 47(a). Such reduction should not result in recapture of depreciation, however, a result consistent with current law. See note 54 *supra*.

150. I.R.C. § 108(e)(4).

151. See text accompanying notes 71-123 *supra*. For an example of such a related party transaction, see Senate Finance Report, *supra* note 72, at 19 n.23.

152. I.R.C. § 108(e)(4)(B).

153. *Id.* § 108(e)(4).

154. *Id.* § 108(e)(2).

155. Committee Report, *supra* note 72, at 16; Senate Finance Report, *supra* note 72, at 20.

156. This exception should be compared to the "no accession to wealth" exception to the *Kirby Lumber* rule. See note 37 *supra*.

might have qualified as a tax-free reorganization under the special rules relating to insolvency reorganization provisions.¹⁵⁷ These provisions generally allowed less flexibility in structuring chapter X proceedings than the rules applicable to regular corporate reorganizations.¹⁵⁸ In addition, the insolvency reorganization provisions contained several inherent technical defects and ambiguities.

Before its repeal by the Bankruptcy Tax Act of 1980, the application of section 371(a) was limited to transfers of the debtor corporation's assets to another corporation pursuant to a court order in a "receivership, foreclosure, or similar proceeding"¹⁵⁹ or "in a proceeding under Chapter X of the Bankruptcy Act."¹⁶⁰ While this language clearly applied to chapter X proceedings, whether section 371(a) applied to chapter XI proceedings as well was unclear.¹⁶¹ Leading commentators concluded that the application of section 371(a) to chapter XI proceedings was unresolved.¹⁶²

Once section 371 was determined to apply to a given transaction (apparently only chapter X and similar proceedings), the next step was to define the elements of a section 371 transfer and the tax consequences of the transfer. The primary characteristic of a section 371 reorganization was overall flexibility, interlarded with various uncertainties.¹⁶³ While a section 371 transfer had been held not necessarily to involve the transfer of substantially all of the assets of the debtor corporation,¹⁶⁴ certain questions remained unanswered.¹⁶⁵ A reasonable postulation, however, was that a section 371 transfer applied to a receivership, foreclosure, chapter X, or similar proceeding if it had the following elements: (1) a transfer of property of the debtor corporation; (2) in pursuance of the order of a court having jurisdiction over the debtor corporation; (3) to another corporation; (4) that was formed to effectuate the approved plan of the court; (5) in exchange solely for stock or securities in such other corporation.¹⁶⁶

The Regulations indicated that the application of section 371 was to be limited strictly to a transaction having these elements.¹⁶⁷ Moreover, the section 371 transfer need not have been a "direct transfer"; apparently any indirect transfer of the debtor corporation's assets would have sufficed, so

157. I.R.C. §§ 371-374 (1980).

158. Committee Report, *supra* note 72, at 28; Senate Finance Report, *supra* note 72, at 33.

159. For a discussion of the meaning of the phrase "receivership, foreclosure, or similar proceeding," see Tillinghaust & Gardner, *Acquisitive Reorganizations and Chapters X and XI of the Bankruptcy Act*, 26 TAX L. REV. 663, 688-90 (1971).

160. I.R.C. § 371(a) (1980).

161. The regulations provided no authority for the application of § 371 to chapter XI proceedings. Treas. Reg. § 1.371-1(a)(2) (1960). Moreover, a close examination of this Regulation arguably supported the conclusion that § 371 was restricted to the two statutorily enumerated categories.

162. Tillinghaust & Gardner, *supra* note 159, at 690.

163. *Id.* at 697.

164. San Antonio Transit Co. v. Commissioner, 30 T.C. 1215 (1958), *acq. in result* 1963-1 C.B. 4.

165. See text accompanying notes 179-97 *infra*.

166. I.R.C. § 371(a) (1980).

167. Treas. Reg. § 1.371-1(a)(3) (1960).

long as it was made as "an integral step in the consummation" of the court-approved reorganization plan.¹⁶⁸ Finally, a transfer of assets, rather than a mere debt or capital readjustment, must have occurred.¹⁶⁹ Even though a section 371 "reorganization" was not married to the definition of that term in section 368, several of the concepts espoused in the section 368 reorganization area applied to section 371 as well.¹⁷⁰

In terms of the tax results of a section 371 transfer, the acquired debtor corporation recognized no gain or loss upon the transfer of its assets if the consideration received by it was limited to stock or securities of the acquiring corporation.¹⁷¹ Moreover, if cash or nonqualifying consideration ("boot") was received by the acquired debtor corporation, no gain was recognized if such property was distributed immediately to its shareholders.¹⁷² In the event boot was not distributed to shareholders, the acquired debtor corporation recognized gain to the extent of boot, but never was permitted to recognize loss.¹⁷³ The basis of the assets received by the acquiring corporation in a section 371 reorganization was carried over from the acquired debtor corporation,¹⁷⁴ notwithstanding a slightly different result in the case of a regular chapter X or XI proceeding not involving section 371.¹⁷⁵

The tax results to creditors participating in a section 371 transfer depended on the type of creditor involved in the transaction. Generally, creditors who did not constitute security holders were required to recognize gain or loss on the exchange.¹⁷⁶ Accordingly, creditors on open account or those holding short-term notes and commercial paper were required to recognize gain or loss on the exchange of their debt instruments for stock or securities in the acquiring corporation. With respect to security holders, no gain or loss was recognized on the exchange of their securities for stock in the acquiring corporation, even if the principal amount of the securities received was greater than the amount surren-

168. *Id.*

169. *Id.*

170. Treas. Reg. § 1.371-1(a)(4) (1960) (stating that the continuity of business and interest doctrines applicable in noninsolvency reorganizations also applied to § 371 transfers; if the transfer more closely resembles a sale of assets, the transaction constitutes a "sale" rather than a tax-free reorganization).

171. I.R.C. § 371(a)(1) (1980).

172. *Id.* § 371(a)(2)(A).

173. *Id.* §§ 371(a)(2)(A)-(B). In addition, the liabilities of the acquired-debtor corporation assumed by the acquiring corporation were not to be treated as boot, even if such liabilities exceeded the aggregate bases of property transferred. *But cf.* I.R.C. § 357(b) (gain will be recognized if purpose of assumption of liabilities is to avoid taxes).

174. *Id.* § 372(a).

175. Before the enactment of the Bankruptcy Tax Act of 1980, the bases of the debtor's assets were reduced to the extent of the debt discharge amount, but not below their fair market value. Bankruptcy Act of 1938, Pub. L. No. 75-696, §§ 268-270, 395-396, 52 Stat. 840, 904, 915 (repealed 1978).

176. *Bedford v. Commissioner*, 2 T.C. 1189 (1943), *aff'd*, 150 F.2d 341 (2d Cir. 1945); *Bunker Hill & Sullivan Mining & Concentrating Co. v. Commissioner*, 1 T.C. 1057, 1079-80 (1943).

dered.¹⁷⁷ Moreover, if boot was received by security holders, any recognized gain generally was treated as capital gain rather than dividend income.¹⁷⁸

The acquiring corporation in a section 371 transfer had to concern itself with the extent to which the debtor corporation's tax attributes, including net operating loss carryovers, would pass to the acquiring corporation. The crux of this issue was whether the provision of section 381 authorizing such carryover applied to a section 371 reorganization. Leading commentators, while acknowledging the lack of authority on this point, concluded that section 381 appeared to be inapplicable to section 371;¹⁷⁹ the special insolvency reorganization provisions seemingly did not permit carryover of tax attributes to the transferee corporation.¹⁸⁰

The prior law left unclear the extent to which creditors of an insolvent corporation who received stock in exchange for their claims were considered to have stepped into the shoes of the debtor corporation's former shareholders for purposes of satisfying the judicial "continuity of interest" rule.¹⁸¹ The continuity of interest rule requires that owners of the acquired corporation must continue to have a substantial proprietary interest in the acquiring corporation in order to justify nonrecognition treatment for the exchange of the acquired corporation's stock or assets for stock in the acquiring corporation.¹⁸² Courts generally have found the requisite continuity of interest if the creditors' debt interests were transformed into proprietary interests (*i.e.*, stock) prior to the bankruptcy reorganization.¹⁸³ Before enactment of the Bankruptcy Act of 1980, however, it was unclear whether the creditors were required to take affirmative steps, or whether the mere receipt of stock in a bankruptcy reorganization was sufficient to ensure tax-free treatment of the transfer of assets by the debtor corporation

177. I.R.C. § 371(b) (1980); *cf.* I.R.C. § 354(a)(2)(A) (gain recognized if principal amount of securities received exceeds principal amount of securities surrendered).

178. Treas. Reg. § 1.371-2(c)(1) (1960). Gain was not recognized with respect to accrued interest on securities surrendered. *Estate of William Bernstein v. Commissioner*, 22 T.C. 1364 (1954); *Carman v. Commissioner*, 13 T.C. 1029 (1949), *aff'd*, 189 F.2d 363 (2d Cir. 1951); *see* text accompanying notes 216-20 *infra*.

179. *See* Tillinghaust & Gardner, *supra* note 159, at 706.

180. I.R.C. § 381(a) (1980) permitted an acquiring or transferee corporation to inherit the tax attributes of the acquired or transferor corporation if the transaction was one to which § 361 applied and the transfer of assets to the acquiring or transferee corporation was in connection with certain types of § 368(a)(1) reorganizations described in § 381(a). This did not include a § 371 insolvency reorganization. Section 381(a) was the key provision authorizing one corporation's tax history to flow to another corporation. Because a § 371 reorganization was not enumerated in § 381(a), the tax history of a corporation undergoing an insolvency reorganization would not carry over to the transferee corporation. *See also* note 166 *supra*.

181. Committee Report, *supra* note 72, at 28 n.1. Treas. Reg. § 1.368-1(a) (1960). The percentage of equity ownership interests required of shareholders of the acquired corporation in order to satisfy the continuity of interest rule has been a fruitful source of litigation. The Service's official position with respect to continuity of interest is 50%. Rev. Proc. 77-37, 1977-2, C.B. 568. The courts have required a mere 33% interest to satisfy the continuity of interest doctrine. *See, e.g.*, *John A. Nelson Co. v. Commissioner*, 296 U.S. 374 (1935).

182. Treas. Reg. § 1.368-1(b) (1960).

183. *Commissioner v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942); Treas. Reg. § 1.371-1(a)(4) (1960). *See also* Tillinghaust & Gardner, *supra* note 159, at 683-86.

to the transferee.¹⁸⁴

Several other technical aspects of insolvency reorganizations prior to enactment of the Bankruptcy Tax Act of 1980 were problematic. In an insolvency reorganization, the stock or securities used to acquire the assets of the corporation in bankruptcy had to be the acquiring corporation's own stock or securities.¹⁸⁵ This limitation precluded the use of a triangular reorganization, whereby the insolvent corporation could be acquired for stock of the parent corporation in control of the acquiring corporation.¹⁸⁶ Triangular reorganizations outside of insolvency proceedings generally have been approved, assuming certain guidelines are met.¹⁸⁷ In addition, the prior law did not make clear whether and to what extent the acquiring corporation in an insolvency proceeding could have transferred assets that it had received from the insolvent corporation into a controlled corporation as part of the insolvency reorganization.¹⁸⁸ The statute permits "drop-down" transfers of assets acquired in corporate reorganizations in noninsolvency reorganizations.¹⁸⁹

Several provisions concerning reorganizations under section 368 differ from those contained in section 371. In noninsolvency corporate reorganizations, the exchange of stock or securities in one corporation for those of another corporation is not tax-free to the extent the principal amount of the securities received exceeds the principal amount of the securities surrendered¹⁹⁰ (or to the extent of the principal amount of securities received, if no securities are surrendered).¹⁹¹ In regular corporate reorganizations, money or other property received in a corporate reorganization (other than stock or securities of the acquiring corporation) is subject to the "dividend equivalence" test.¹⁹² These rules, however, apparently did not apply to insolvency reorganizations qualifying under section 371.¹⁹³

With respect to all types of reorganizations, a bondholder's claim for unpaid interest generally is treated as an integral part of the underlying security to which it relates, so that the surrender of the security together with the claim for unpaid interest is treated as the surrender of a security only.¹⁹⁴ Prior to passage of the Act, the nonrecognition reorganization provisions accordingly applied to an exchange involving a security with accrued but unpaid interest, even though the unpaid interest would have

184. Committee Report, *supra* note 72, at 28; Senate Finance Report, *supra* note 72, at 33.

185. See I.R.C. § 371(a) (1980) (flush language).

186. For an example of the triangular reorganization, see *id.* §§ 368(a)(2)(D)-(E).

187. *Id.*

188. No statutory provisions apparently covered a "drop down" of assets received from an insolvent corporation in a § 371 insolvency proceeding to a controlled corporation of the acquiring or transferee corporation.

189. *Id.* § 368(a)(2)(C).

190. *Id.* § 354(a)(2)(A).

191. *Id.* § 354(a)(2)(B).

192. *Id.* § 356(a)(2).

193. *Id.* § 371(b)(2); Treas. Reg. § 1.371-1(b) (1960).

194. *Carman v. Commissioner*, 184 F.2d 363 (2d Cir. 1951); *Estate of William Bernstein v. Commissioner*, 22 T.C. 1364 (1959).

been taxable as ordinary income, had it been paid separately.¹⁹⁵

B. Definitional and Operational Aspects of the "G" Reorganization

The Legislative Reports state as a general purpose that the insolvency reorganization rules should be revamped in order to provide consistency to all types of reorganizations, including those involving insolvent corporations,¹⁹⁶ so as to facilitate the rehabilitation of financially troubled businesses.¹⁹⁷ In addition, the Reports state that a creditor that exchanges securities in a corporate reorganization should be treated as receiving interest income on the exchange to the extent it receives new securities, stock, or other property for accrued but unpaid interest on the securities surrendered.¹⁹⁸ To carry out the foregoing objectives, a new reorganization definition, entitled the "G" reorganization, is added by the Act;¹⁹⁹ concomitantly, the Act repeals the insolvency reorganization rules under section 371 and makes certain other conforming amendments.

The Act defines a G reorganization as "a transfer by a corporation of all or part of its assets to another corporation in a bankruptcy or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355 or 356."²⁰⁰ The Legislative Reports note that the transfer need not comply with state merger laws nor be *solely* in exchange for stock of the acquiring corporation to qualify as a G reorganization.²⁰¹ Moreover, the definition of a G reorganization does not require the former shareholders of the financially distressed corporation to "control" the corporation that receives the assets;²⁰² the distribution requirements of section 354(b)(1) are included in the statute, however, to ensure that either "substantially all" the assets of the financially troubled corporation, or assets constituting an active trade or business under section 355, are transferred to the acquiring corporation.²⁰³

The Legislative Reports indicate that the "substantially all" test in the G reorganization context is to be interpreted in light of the underlying intent

195. The theory underlying this rule is that, because the unpaid interest is an integral part of the security to which it relates, the exchange of the security together with the claim for unpaid interest thereon in an otherwise nonrecognition transaction is an inappropriate event upon which to levy tax.

196. Committee Report, *supra* note 72, at 29.

197. *Id.*

198. *Id.* at 29-30.

199. I.R.C. § 368(a)(1)(G) adds this reorganization mechanism. *Id.* Section 370 repeals the old law under § 371. An exception to this blanket repeal is made with respect to certain railroad reorganizations. *Id.* § 370(b).

200. *Id.* § 368(a)(1)(G).

201. Committee Report, *supra* note 72, at 30; Senate Report, *supra* note 72, at 35. Compare this rule to the "solely" requirement of I.R.C. § 371(b)(1).

202. Compare I.R.C. § 368(a)(1)(D). For purposes of reorganizations, the term "control" is defined in § 368(c), which generally requires an 80% equity ownership of specified types of stock. *Id.* § 368(c).

203. *Id.* § 368(a)(2)(C); Committee Report, *supra* note 72, at 30; Senate Finance Report, *supra* note 72, at 36.

of the newly added G category.²⁰⁴ The primary goal of the G reorganization is to facilitate the rehabilitation of financially distressed corporations; thus, the insolvent corporation may be forced to liquidate liabilities or to sell assets or even business divisions to raise cash. These preliminary corporate extractions of cash and assets will not be taken into account in determining whether the transfer of "substantially all" of the assets of the transferor has taken place. For example, a transaction should not be precluded from satisfying the "substantially all" test merely because the acquired corporation sells a significant portion of its assets to raise cash to make payments to its creditors prior to the transfer.²⁰⁵

A transaction that qualifies as a G reorganization is not to be treated as a liquidation under section 332, an incorporation under section 351, or a reorganization under another category of section 368(a)(1).²⁰⁶ The continuity of interest limitations are eased significantly for insolvency reorganizations, because short-term creditors who receive stock of the acquiring corporation in exchange for their claims may be counted for purposes of satisfying the continuity of interest rule. The Legislative Reports indicate, however, that such short-term creditors nonetheless may be required to recognize the gain or loss realized on such exchange.²⁰⁷ This relaxation of the continuity of interest rule will permit insolvency reorganizations to qualify more easily under the G reorganization.

The Act adds consistency to G reorganizations by adopting certain rules used in the general reorganization provisions. For instance, the Act permits a corporation to acquire the claim of a creditor in a G reorganization in exchange for stock of the acquiring corporation's parent;²⁰⁸ thus, the use of triangular reorganizations will be permitted in a G reorganization context. In addition, the transfer of the acquired assets by the acquiring corporation to a controlled subsidiary will no longer endanger the tax-free status of the prior reorganization.²⁰⁹ Perhaps more importantly, the Act provides that the general rule governing carryover of tax attributes in corporate reorganizations will apply to G reorganizations.²¹⁰ The Legislative

204. Committee Report, *supra* note 72, at 30; Senate Finance Report, *supra* note 72, at 35-36.

205. *Id.* This rule should be compared with the more restrictive rule concerning corporate extractions immediately prior to other reorganizations, such as in a "C" type reorganization. Rev. Proc. 77-37, 1977-2 C.B. 568.

206. I.R.C. § 368(a)(3)(C).

207. See Committee Report, *supra* note 72, at 31-32; Senate Finance Report, *supra* note 72, at 36-37. The legislative history indicates that the courts and the Treasury Department will apply a more liberal continuity of interest rule to "G" reorganizations, namely, an approach that takes into account the modification of the so-called "absolute priority" rule as altered by Public Law 95-598. According to the reports, this modification causes shareholders or junior creditors of the bankrupt corporation, who previously might have been excluded from a post-bankruptcy ownership stake in the surviving corporations, to retain an interest in the reorganized corporation. If nonstock consideration is received by the debtor-corporation's shareholders, however, the transaction may resemble a sale rather than a reorganization. *Id.*

208. I.R.C. § 368(a)(2)(D).

209. *Id.* § 368(a)(2)(C).

210. *Id.* § 381(a)(2).

Reports note that this rule will eliminate the so called "clean slate" doctrine; the new carryover rule reflects the fact that adjustments may be made to an insolvent corporation's tax attributes to reflect the amount of debt discharge income.²¹¹

As noted earlier, a financially troubled corporation having substantial net operating loss carryovers is frequently the target of either a stock acquisition or merger notwithstanding a limited economic value of the net assets of such corporation.²¹² For example, a corporation having a miniscule net book value but bearing substantial net operating loss carryovers could merge in a tax free transaction into a profitable corporation for a significant purpose of using such loss carryovers against post-acquisition net income of the profitable corporation. In order to use freely the financially troubled corporation's loss carryovers in this fashion, the former shareholders of the acquired corporation must receive a statutorily prescribed amount of stock of the acquiring corporation and meet certain other conditions, under section 382. Generally, section 382 limits carryovers of net operating losses in two separate instances. First, section 382(a) limits carryovers of net operating losses in those instances in which a taxable purchase of control of the loss corporation has been followed by a change in the corporation's business. Secondly, section 382(b) limits the use of net operating loss carryovers when a profitable company acquires in a tax free reorganization a company having substantial loss carryovers and there is an insufficient continuity of shareholder interest following the corporate reorganization. Although the Tax Reform Act of 1976 has made certain fundamental changes to these rules that will become effective during 1982,²¹³ the basic theory underlying section 382 will continue to apply to prospective transactions.

Prior to the passage of the Act, with respect to section 382(a) transactions involving the acquisition of stock of a debtor corporation that has generated substantial net operating losses, acquisitions by a security holder or creditor of stock of the loss corporation in exchange for the relinquishment or extinguishment in whole or part of a claim against the corporation was not to be counted as the purchase of new stock for section 382(a) purposes.²¹⁴ To place tax free reorganizations on a par with taxable purchase transactions, the Act adds a new provision that provides that creditors of a debtor corporation are to be treated as shareholders immediately before the reorganization for section 382(b) purposes.²¹⁵ Accordingly, creditors who obtain stock in a debtor corporation as a part of a tax free reorganization will not be counted against the continuity of interest requirement of

211. Committee Report, *supra* note 72, at 32; Senate Finance Report, *supra* note 72, at 37.

212. See notes 57-70 *supra* and accompanying text.

213. For a discussion of these rules, see Barr, *Net Operating Losses—Sections 381, 382, and 269*, 27-4th TAX MANAGEMENT PORTFOLIO (BNA) A-43 (1981).

214. I.R.C. § 382(a)(5)(C) (1980).

215. Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 2(d)(7), 94 Stat. 3389, 3392.

section 382(b) for purposes of determining the limitation on the loss carryovers of the debtor corporation.

C. *Treatment of Accrued Interest on Exchanged Securities*

The Act provides that a creditor exchanging securities in any corporate reorganization described in section 368(a)(1) will be treated as receiving interest income on the exchange when the security holder receives new securities, stock, or other property attributable to accrued but unpaid interest.²¹⁶ The legislative history indicates that this rule also will apply to accrued original issue discount on securities surrendered in any type of reorganization.²¹⁷ These rules represent a reversal of prior law, under which accrued interest or accrued original issue discount with respect to surrendered securities could be eliminated tax-free in a recapitalization or other reorganization qualifying under section 368.²¹⁸ The new rule will apply whether or not the exchanging security holder realizes gain on the exchange.²¹⁹ In the case of accrued original issue discount, the Act does not appear to provide for a concomitant adjustment in the basis of the stock received in the transaction to reflect the income inclusion attributable to the original issue discount.²²⁰

VI. OTHER CORPORATE AMENDMENTS UNDER THE ACT

A. *Exception from Personal Holding Company Status*

Formerly, a corporation in bankruptcy or insolvency proceedings that had ceased active operations and was generating only passive income could find itself subject to the personal holding company tax²²¹ with respect to certain passive income. This result seemed particularly likely if such corporation's assets were converted into investments that produced passive income before the corporation was liquidated. The Legislative Reports indicate that the involuntary imposition of personal holding company status on an insolvent or bankrupt corporate debtor is beyond the legislative intent of the personal holding company provisions.²²² Accordingly, the Act provides that a corporation subject to bankruptcy court jurisdiction is not to be considered a personal holding company.²²³ The legislative history indicates that this exception is not available if the major purpose in commencing or continuing the bankruptcy proceedings is the

216. I.R.C. § 354(a)(2)(B). *See also id.* § 355(a)(3)(C).

217. Committee Report, *supra* note 72, at 33.

218. *See* note 17 *supra*.

219. Because I.R.C. § 354(a)(2)(B) excludes the tax-free rule of 354(a)(1) in accrued interest situations, implicitly no gain on the exchange is required.

220. To equalize the effect of the recognition of ordinary income resulting from the accrued interest attributable to original issue discount, an adjustment to basis is seemingly necessary, as is the case in § 1232(b)(2).

221. I.R.C. § 541.

222. Committee Report, *supra* note 72, at 36; Senate Finance Report, *supra* note 72, at 40.

223. I.R.C. § 542(c)(9).

avoidance of the personal holding company tax.²²⁴

B. Extension of the Twelve-Month Period of Section 337

Under prior law, a corporation that adopted a plan of liquidation and liquidated in a complete distribution to its shareholders within twelve months thereafter generally did not recognize gain or loss on sales of its assets within the twelve-month period.²²⁵ This rule had two major defects in connection with bankruptcy or insolvency proceedings. First, the Service had ruled that section 337 did not apply in the case of an insolvency proceeding where the corporate debtor's assets were transferred to creditors rather than shareholders in a liquidation.²²⁶ In addition, the period during which liquidation occurred exceeded twelve months in most insolvency or bankruptcy proceedings; therefore, the special nonrecognition rule of section 337 placed an undue hardship if not an impossibility on the financially distressed business forced to accelerate its bankruptcy plan.

The legislative history to the Act notes that the nonrecognition treatment of section 337 should be extended to sales of certain assets by liquidating insolvent corporations in bankruptcy or similar cases.²²⁷ The Legislative Reports indicate that, inasmuch as insolvency proceedings may last longer than twelve months, the nonrecognition period likewise should be extended until the termination of the insolvency case.²²⁸ The legislative history points out, however, that because the nonrecognition period would extend until the termination of the bankruptcy case, a rule should be included to preclude the otherwise abusive tax-free churning of assets. In addition, nonrecognition treatment should be unavailable on sales of property acquired after adoption of the liquidation plan.²²⁹

The Act permits an insolvent corporation in bankruptcy, which does not distribute property to its shareholders in exchange for their stock, to sell certain of its assets tax free, when the corporation adopts a plan of complete liquidation after the bankruptcy case commences and transfers all of the corporation's assets to its creditors upon liquidation. The period for nonrecognition begins on the date of adoption of the plan of liquidation and ends when the bankruptcy case terminates.²³⁰ The new provision, however, does not apply to assets acquired on or after the date of adoption of the plan of liquidation, other than inventory sold in bulk.²³¹

224. *Id.* Committee Report, *supra* note 72, at 36; Senate Finance Report, *supra* note 72, at 40.

225. I.R.C. § 337(a).

226. Rev. Rul. 56-387, 1956-2 C.B. 189.

227. Committee Report, *supra* note 72, at 37; Senate Finance Report, *supra* note 72, at 41.

228. *Id.*

229. *Id.* An exclusion is available, however, with respect to bulk sales of inventory. I.R.C. § 337(c)(2).

230. *Id.* § 337(g).

231. *Id.*

C. Certain Transfers to Controlled Corporations

Before passage of the Act, if property was transferred to a corporation controlled by the transferor, no gain or loss was realized in connection with the transfer, provided certain conditions were met.²³² For purposes of applying this nonrecognition rule, the term "property" included indebtedness of the transferee corporation not evidenced by a security²³³ as well as claims for accrued interest or indebtedness of the transferee corporation.²³⁴ The Legislative Reports indicate that creditors holding a debt not evidenced by a security who exchange their claims against a debtor corporation for stock constituting "control" of such corporation should recognize gain or loss on the exchange.²³⁵ This treatment comports with the treatment of those creditors who exchange nonsecurity debt instruments in a reorganization.²³⁶

The Legislative Reports further note that a transfer of assets to a corporation by a debtor in a bankruptcy or insolvency proceeding, when the stock received later is transferred to the debtor's creditors, should result in gain or loss to the debtor, rather than nonrecognition pursuant to section 351(a). In this instance, the exchange is treated as if the property had been transferred to the creditors, who in turn transferred the property to a controlled corporation. According to the Legislative Reports, this rule is designed to prevent the incorporation by a debtor of high basis, low-value assets, when a transfer of the assets directly to the creditors, followed by a transfer by the creditors to a controlled corporation, otherwise would result in a presumably lower fair market value basis to the corporation.²³⁷

The Act provides that transfers to a controlled corporation of indebtedness of a corporation not evidenced by a security, or claims against the corporation for accrued but unpaid interest on indebtedness, will not be considered property for section 351 purposes; thus, such transfers will not be shielded from taxation by the general recognition rule of section 351(a).²³⁸ In addition, the Act provides that the nonrecognition rule of section 351 will not apply when assets are transferred to a controlled corporation of the debtor in a bankruptcy or similar case, to the extent the stock or securities received in the exchange for the assets are used by the debtors to pay off debts.²³⁹ Gain or loss will be recognized if the debtor

232. *Id.* § 351(a).

233. *Duncan v. Commissioner*, 9 T.C. 468 (1947), *acq.* 1948-2 C.B. 2. *See also* Rev. Rul. 77-81, 1977-1 C.B. 97.

234. *See* note 178 *supra*.

235. Committee Report, *supra* note 72, at 39; Senate Finance Report, *supra* note 72, at 43.

236. *Id.* *See* text accompanying note 207 *supra*. For a further discussion of present law, see B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* 14-76 n.106 (5th ed. 1979).

237. Committee Report, *supra* note 72, at 39; Senate Finance Report, *supra* note 72, at 43.

238. I.R.C. §§ 351(d)(2)-(3). But note that when a transaction qualifies under both § 351(a) and § 368(a)(1)(G), such transaction will be treated under § 368(a)(1)(G) only. I.R.C. § 368(a)(3)(C).

239. *Id.* § 351(e)(2).

transfers its assets to a controlled corporation and the stock received by the debtor then is transferred to its creditors pursuant to a plan approved in a bankruptcy or similar case.²⁴⁰ Because the basis of the stock received is adjusted for any gain or loss recognized, the amount of income recognized in the transfer of the stock to creditors will reflect the amount recognized on the incorporation transfer. The legislative history notes that the sum total of income or loss to the debtor in the two transfers is the same as if the high-basis assets had been transferred directly to the creditors.²⁴¹

*D. Interrelationship Between Debt Discharge Amounts
and Earnings and Profits*

Prior to the enactment of the Bankruptcy Tax Act of 1980, the effect of discharge of indebtedness upon earnings and profits of the corporation in a bankruptcy proceeding was unclear.²⁴² The Act now provides that to the extent income from discharge of indebtedness (including amounts excluded from gross income pursuant to new section 108) is applied to reduce the basis of assets of the corporate debtor under section 1017, the amount of the basis reduction will not affect the debtor corporation's earnings and profits.²⁴³ Reduced depreciation deductions or increased gains on the sale of such reduced-basis assets will affect earnings and profits in years in which the deductions are taken or sales made. Any other discharge of indebtedness income, however, including amounts excluded from gross income, will increase earnings and profits.²⁴⁴

VII. PROCEDURAL ASPECTS OF THE BANKRUPTCY TAX ACT OF 1980

*A. Jurisdictional and Procedural Aspects Under
the Old Bankruptcy Act*

Under the old Bankruptcy Act, the bankruptcy court generally had jurisdiction to determine the income tax liability of the debtor, whether or not the Service had assessed such liability.²⁴⁵ The bankruptcy court's jurisdiction over tax matters was denied, however, when the debtor's tax liability already had been adjudicated by a court of competent jurisdiction.²⁴⁶

240. Committee Report, *supra* note 72, at 39; Senate Finance Report, *supra* note 72, at 43. If less than all of such stock is transferred to creditors, a proportionate share of the gain or loss is recognized. *Id.*

241. Senate Finance Report, *supra* note 72, at 44. The legislative history also notes that the bases of assets in the hands of the corporation are adjusted to reflect any gain or loss recognition on the transfer. If the transaction constitutes a reorganization, § 361 would overrule the application of this new rule in the case of a corporate transferor. *Id.* n.8.

242. Committee Report, *supra* note 72, at 39; Senate Finance Report, *supra* note 72, at 44. See also text accompanying note 56 *supra*.

243. I.R.C. § 312(l).

244. *Id.*

245. Bankruptcy Act, Pub. L. No. 89-496, § 1, 80 Stat. 280 (1966) (repealed 1978). See also *City of Amarillo v. Eakens*, 399 F.2d 541 (5th Cir. 1968), *cert. denied*, 393 U.S. 1051 (1969).

246. See *City of Amarillo v. Eakens*, 399 F.2d 541 (5th Cir. 1968), *cert. denied*, 393 U.S. 1051 (1969).

While a determination by the bankruptcy court with respect to the pre-petition tax liability of a debtor was binding on the Service and the trustee of the bankrupt's estate, such a determination might not have been binding upon the debtor individually, unless the debtor had invoked the jurisdiction of the bankruptcy court. Accordingly, the bankruptcy court's decision with regard to pre-petition income taxes of the debtor might not settle the personal liability of such debtor for the amount of any pre-petition nondischargeable tax claims not satisfied out of the assets of the bankrupt's estate.²⁴⁷ This inability to bind the individual debtor, due to the bankruptcy court's lack of exclusive jurisdiction, led in many instances to duplicative litigation, insofar as the Service was forced by the individual debtor to relitigate the tax issues if the Service's claim was not paid out of the assets of the bankrupt's estate.²⁴⁸

Under prior law, the Service was authorized to assess any income tax liabilities against the debtor upon the institution of a bankruptcy proceeding.²⁴⁹ Essentially, this allowed the Service to deviate from normal statutory safeguard procedures under which a deficiency notice was required to be issued to the debtor before assessment of the tax could be made. Upon issuance of a deficiency notice, the debtor could have challenged such asserted income tax liability in the United States Tax Court without the payment of the asserted tax.²⁵⁰ Even if the statutory deficiency notice had been issued and the time for filing a Tax Court petition had not expired before commencement of the bankruptcy proceeding, the debtor still was barred from contesting the asserted tax liability in the Tax Court if the Service chose to exercise its immediate assessment authority.²⁵¹ Thus, unless the debtor invoked the jurisdiction of the bankruptcy court and obtained from that court a determination of his income tax liability, he effectively was precluded from prepayment review of an asserted income tax liability. The debtor's only alternative was to pay the tax and then contest the issue through refund claim procedures in the United States District Court or the Court of Claims.²⁵² Furthermore, if the notice of deficiency was issued and the Tax Court case was filed prior to the institution of the bankruptcy proceeding, but the Tax Court had not reached a decision as to the debtor's income tax liability, both the bankruptcy court and the Tax Court had jurisdiction to determine the tax liability issue. A decision by the Tax Court would not necessarily have bound the estate of

247. Pursuant to the new Bankruptcy Code, claims made by the Service against the bankruptcy estate for pre-petition tax liabilities not satisfied out of the estate's assets are not discharged upon termination of the bankruptcy proceeding and are collectible from the debtor after such termination. 11 U.S.C. § 523 (Supp. III 1979).

248. Committee Report, *supra* note 72, at 41; Senate Finance Report, *supra* note 72, at 47.

249. I.R.C. § 6871(a) (1980).

250. *Id.* § 6213(a). Even in nonbankruptcy proceedings, however, other exceptions exist to the general rule that a deficiency notice must be issued before assessment can be made. *See, e.g.*, I.R.C. §§ 6213(b)(1)-(4), 6213(c), (d), (e), 6851, 6861.

251. I.R.C. § 6871(a) (1980).

252. I.R.C. §§ 6401-6428.

the bankrupt, however, unless the bankruptcy trustee intervened in the Tax Court litigation. On the other hand, a decision by the bankruptcy court might not have bound the individual debtor unless the debtor individually invoked the bankruptcy court's jurisdiction.²⁵³ Under the old Bankruptcy Act, the bankruptcy court did not have jurisdiction over suits for refunds; thus, the trustee or debtor seeking a refund was required to file suit in the United States District Court or the Court of Claims, even if the government had filed a proof of claim in the bankruptcy matter.²⁵⁴ Under the old Bankruptcy Act, the bankruptcy court could not compel the Service to audit and approve returns, or calculate net operating losses.²⁵⁵

B. Jurisdictional and Procedural Aspects Under the New Bankruptcy Code and the Bankruptcy Tax Act of 1980

The new Bankruptcy Code continues the bankruptcy court's jurisdiction to determine liability for an income tax deficiency, regardless of whether it has been assessed, unless it has been adjudicated by a court of competent jurisdiction prior to filing of the bankruptcy petition.²⁵⁶ The trustee in the bankruptcy proceeding can request the Service to determine the amount of any tax refund, and the Service is given 120 days in which to determine the amount of such refund. After the Service determines the amount, or after the 120-day period expires, the bankruptcy court, contrary to prior law,²⁵⁷ is free to determine the amount of the refund due to the bankruptcy estate.²⁵⁸ The Bankruptcy Code also enables a trustee to file tax returns for the estate and request that the Service determine the estate's tax liability.²⁵⁹

253. Committee Report, *supra* note 72, at 41; Senate Finance Report, *supra* note 72, at 47.

254. This conclusion is premised on § 23(b) of the old Bankruptcy Act, which provided that suits by a trustee or debtor were to be brought only in courts where the bankrupt might have brought or prosecuted them if the bankruptcy proceeding had not been instituted. Bankruptcy Act of 1938, Pub. L. No. 75-696, § 23(b), 52 Stat. 840, 854 (repealed 1978). See also *Danning v. United States*, 259 F.2d 305, 306 (9th Cir. 1958), *cert. denied*, 359 U.S. 911 (1959). The trustee could become a party to or prosecute any existing refund suit, subject to approval by the bankruptcy court. Bankruptcy Act of 1938, § 11(c), 52 Stat. at 849; *Meyer v. Flemino*, 327 U.S. 161, 165 (1946). Apparently the trustee could have prosecuted or entered his appearance, commenced, and prosecuted any action or proceeding on behalf of the estate before any tribunal, with or without court approval. BANKR. R. 610. Old Bankruptcy Act § 70(a)(5) also vested the trustee with title to all of the property, including rights of actions, that prior to the commencement of the filing could have been transferred or levied upon. Bankruptcy Act of 1938, § 70(a)(5), 52 Stat. at 880.

255. See, e.g., *In re Wingreen Co.*, 412 F.2d 1048 (5th Cir. 1969).

256. 11 U.S.C. § 505(a)(1) (Supp. III 1979). The bankruptcy court may not determine any right of the estate to a tax refund unless administrative remedies are first exhausted. *Id.* § 505(a)(2)(B).

257. See note 247 *supra*.

258. 11 U.S.C. § 505(a)(2)(B) (Supp. III 1979).

259. *Id.* § 505(b). Upon the trustee's request to determine the estate's tax liability, the Service has 60 days to notify the trustee that the return has been selected for audit examination. If an examination is made, the Service has an additional 120 days after the date of the request to complete the examination and notify the trustee of any tax due. The bankruptcy court may extend the 180-day period for just cause. If this time period expires without any action by the Service, the trustee, the debtor, or any successor to the debtor is discharged

Perhaps one of the most important procedural provisions of the Bankruptcy Code is the rule that commencement of the bankruptcy matter triggers an automatic stay of any Tax Court proceeding regarding the debtor's asserted tax deficiency.²⁶⁰ Contrary to the concurrent jurisdiction rule under prior law, this rule essentially will permit the bankruptcy court to exert exclusive jurisdiction over tax matters concerning the debtor. Subject to certain exceptions discussed below, the Act similarly provides that the Service no longer will have the power immediately to assess or collect a pre-petition tax claim against the debtor; instead, such assessment power will be stayed by the commencement of the bankruptcy case.²⁶¹ The stay does not preclude the Service from issuing a deficiency notice during the bankruptcy case.²⁶² Unless the bankruptcy court lifts the stay or grants or denies a discharge, the stay continues until termination of the bankruptcy case.²⁶³ The exclusive ability or power of the bankruptcy court to lift the automatic stay will ensure the elimination of the duplicative litigation problems common under prior law.

Under the Act the Service no longer can assess certain pre-petition tax deficiencies immediately upon institution of a bankruptcy case.²⁶⁴ If the bankruptcy court lifts the automatic stay, therefore, the debtor will not be precluded from filing a petition in Tax Court to challenge an asserted pre-petition tax deficiency, provided the usual procedural prerequisites have been satisfied.²⁶⁵ In effect, this change permits the individual debtor to have pre-petition review of an asserted tax liability.

Two exceptions to this general prohibition against immediate assessment exist. First, the Act provides that the Service will be able to make immediate assessments of tax imposed on the bankruptcy estate of an individual debtor. Also permissible is the immediate assessment of a tax imposed on a debtor if liability for such tax has become *res judicata* against the debtor pursuant to a bankruptcy court determination.²⁶⁶

from any liability for the tax, unless the return is fraudulent or contains a misrepresentation. If the Service determines the tax to be due and owing within the specified time period, the trustee may elect to pay the amount determined by the Service or may pay the amount determined by the bankruptcy court after a hearing. In either event, if the return is not fraudulent and contains no misrepresentations, the trustee, debtor, or any successor to the debtor is discharged from any tax liability. If the trustee merely files the tax return without requesting a determination of tax liability, a solvent debtor remains liable for the taxes as a transferee of assets of the estate. *Id.* See also 124 CONG. REC. S17,428 (daily ed. Oct. 6, 1978) (remarks of Senator De Concini).

With respect to state and local taxes, § 1146(d) of the Bankruptcy Code authorizes a plan proponent in a reorganization to request a determination from a state or local government regarding the tax effects of a plan of bankruptcy reorganization. If the government does not respond to such request within 270 days, the bankruptcy court may declare the tax effects of the plan of the reorganization. 11 U.S.C. § 1146(d) (Supp. III 1979).

260. 11 U.S.C. § 362(a)(8) (Supp. III 1979).

261. I.R.C. § 6871(a).

262. 11 U.S.C. § 362(b)(8) (Supp. III 1979).

263. *Id.* § 362(c).

264. I.R.C. § 6871(a).

265. The remedies to the debtor under § 6213(a) thus will spring into life upon lifting of the stay.

266. *Id.* § 6871(b). According to the Senate Finance Report, these exceptions to the new

VIII. BANKRUPTCY TAX ASPECTS OF THE INDIVIDUAL DEBTOR

A. *Prior Tax Law Concerning Individual Debtors*

According to the Legislative Reports, the tax aspects of bankruptcy law with respect to individuals were in a state of confusion prior to the Act.²⁶⁷ For example, no statutory rule specified whether the bankruptcy estate constituted a taxable entity apart from the individual debtor. Little guidance was available as to the allocation of tax attributes between the estate and the debtor, assuming that they constituted separate taxable entities. In addition, uncertainty existed as to the extent to which the debtor's pre-petition tax liability could be collected out of the estate assets as a pre-bankruptcy liability. For instance, under prior law the individual debtor's taxable year would not close as of the commencement date of the bankruptcy proceeding, but rather would continue uninterrupted. The individual debtor would report income earned by him for the entire taxable year, notwithstanding the fact that the debtor's assets passed to the bankruptcy estate and arguably could not be used to satisfy his tax liability.²⁶⁸ It generally was accepted, however, that most tax claims against the bankruptcy estate were not dischargeable and, hence, could be collected from the individual debtor after discharge of the bankruptcy case.²⁶⁹

B. *The Bankruptcy Tax Act of 1980: Rules Concerning the Individual Debtor*

With respect to individual debtors, the Act provides for changes in four major areas: the treatment of the debtor and the bankruptcy estate as separate entities, the debtor's election to close its taxable year, computation of the bankruptcy estate's tax liability, and the computation of the individual's income tax liability. While a thorough discussion of each of these topics is beyond the scope of this Article, several noteworthy points in each area bear mentioning.

First, the Act treats the bankruptcy estate of an individual as a separate taxable entity for federal income tax purposes.²⁷⁰ The entities are not treated separately, however, if a bankruptcy case involving an individual is

"no immediate assessment" rule merely reflect situations in which the pre-petition safeguard is irrelevant. That is, the bankruptcy estate's tax liability is determined by the Bankruptcy Court, and by law cannot be litigated in the Tax Court. Senate Finance Report, *supra* note 72, at 46-47. The situation involving *res judicata* of the debtor's tax liability is more obvious. The district director of the Internal Revenue Service is notified by the bankruptcy clerk upon the filing of a bankruptcy case. The Service must file a proof of claim with respect to pre-petition tax liabilities within the time frame set forth by the Bankruptcy Code. This generally is handled by the special procedures division of the district director's office.

267. Senate Finance Report, *supra* note 72, at 24-32.

268. Rev. Rul. 72-387, 1972-2 C.B. 632. Under prior law, the Service treated the bankruptcy estate as a separate taxable entity. *Id.*

269. See note 260 *supra*.

270. I.R.C. § 1398(a). The effective date for bankruptcy tax rules affecting individuals is March 24, 1981. A special election to apply the new law retroactive to October 1, 1979, is available if the proceeding was commenced on or after October 1, 1979, and before January 1, 1981.

commenced but subsequently dismissed by the bankruptcy court.²⁷¹ When the bankruptcy case is prematurely dismissed, the legislative history of the Act indicates that the debtor is to be treated as if no proceeding had been brought.²⁷² No separate taxable entity results from the commencement of a bankruptcy case concerning a partnership or a corporation.²⁷³ While this rule reverses the current position of the Service with respect to partnerships, it appears to comport with the rule concerning bankruptcy cases involving corporations.²⁷⁴

Another important provision of the Act concerns the debtor's election to close his taxable year upon the filing of a bankruptcy petition. If the election is made, the debtor's taxable year, which otherwise would include the commencement date of the proceeding, will be divided into two short taxable years of less than twelve months. The first short period ends on the day before the commencement date of the bankruptcy proceeding; the second short period begins on the commencement date of such proceeding.²⁷⁵ In the event no election is made, the commencement of a bankruptcy case will not affect the taxable year of the individual debtor.²⁷⁶ The substantive results of such election should be examined carefully. In effect, the election will cause the debtor's federal income tax liability for the pre-petition or first short taxable year to become an allowable claim against the bankruptcy estate, as a claim arising before bankruptcy. Thus, any pre-petition tax liability for the short period is collectible from the estate, depending upon the availability of estate assets to pay debts of that priority. In the event such pre-petition tax liability is not satisfied out of the estate's assets, it will remain a liability of the individual debtor insofar as such claims are nondischargeable.²⁷⁷ If the debtor does not make the election, no part of his tax liability for the year in which the bankruptcy case arose is collectible from the estate; it is collectible directly from the individual debtor. However, the debtor may then offset post-petition income against pre-petition losses since the taxable year of the debtor continues. The extent to which the election is available with respect to individual debtors, and the means by which the election is made, are specifically covered by the Act.²⁷⁸

In an attempt to clarify prior law, the Act states that the bankruptcy estate succeeds to most of the income tax attributes of the individual

271. *Id.* § 1398(b)(1).

272. Committee Report, *supra* note 72, at 20; Senate Finance Report, *supra* note 72, at 25.

273. I.R.C. § 1399; *cf.* Rev. Rul. 68-48, 1968-1 C.B. 301 (prior law involving partnerships); Treas. Reg. § 1.641(b)-2(b), T.D. 6580, 1961-2 C.B. 123 (prior law involving corporations).

274. *See* Rev. Rul. 68-48, 1968-1 C.B. 301; Treas. Reg. § 1.641(b)-2(b), T.D. 6580, 1961-2 C.B. 123.

275. I.R.C. § 1398(d)(3)(A). This special election is not allowed when the individual debtor's assets are comprised of exempt property only. *Id.* § 1398(d)(3)(C).

276. *Id.* § 1398(d)(2).

277. 11 U.S.C. § 523(a)(1) (Supp. III 1979).

278. Committee Report, *supra* note 72, at 21-22; Senate Finance Report, *supra* note 72, at 26-27.

debtor, including net operating loss carryovers.²⁷⁹ Upon termination of the bankruptcy estate, however, the debtor succeeds to all unused tax attributes.²⁸⁰ During the pendency of the bankruptcy estate, the tax liability of the estate must be determined using the rules provided by the Act.²⁸¹ If the bankruptcy estate itself incurs a net operating loss, the Act provides that the estate can carry back such net operating loss to previous taxable years of the estate as well as to taxable years of the individual debtor, even though such years relate to periods prior to commencement of the bankruptcy proceeding.²⁸² The Act treats all items of income and deductions arising after the commencement of the bankruptcy case as properly reportable by the bankruptcy estate.²⁸³

IX. THE FUTURE COURSE OF THE ACT

Although the Act is a substantial improvement over earlier draft versions²⁸⁴ and incorporates many changes previously advocated by the bankruptcy bar and other interested parties,²⁸⁵ its provisions regarding attribute reduction seriously limit the effectiveness of the new Bankruptcy Code reorganization provisions and are inconsistent with the basic purposes of a bankruptcy reorganization proceeding. Because the attribute reduction provisions of the Act will not be effective until January 1, 1982, remedial legislative action with respect to these provisions is still possible.

The attribute reduction provisions of the Act overlook three important considerations. First, retention of net operating loss carryovers or other tax attributes by a debtor that experiences a cancellation of indebtedness pursuant to a bankruptcy proceeding does not give such a debtor a head start. The plan resulting from the bankruptcy proceeding has been negotiated between the debtor and its creditors, and a sound creditors' committee should be able to ensure that creditors receive any excess cash derived from the utilization of a net operating loss carryover. Any reduction in net operating loss carryovers and other tax attributes, therefore, results in a direct cash drain out of the creditors' pockets. The apparent result is a "Catch-22" situation in which the creditors' debts are further reduced, resulting in greater debt discharge amounts and further reductions of the debtor's tax attributes.

Secondly, proponents of the tax attribute reduction provisions of the Act have failed to consider whether these provisions actually will increase revenues to the Treasury. The Committee Report states that some revenue

279. I.R.C. § 1398(g).

280. *Id.* § 1398(i).

281. *Id.* § 1398(e).

282. *Id.* § 1398(j)(2).

283. Committee Report, *supra* note 72, at 25-26. Moreover, the income tax liability of the bankruptcy estate will be computed as if the estate were an individual. I.R.C. § 1398(c).

284. For a discussion of an earlier draft of the Act, see Rabinowitz & Rubin, *The Bankruptcy Act of 1980—H.R. 5043: Proposals for New Tax Treatment of Debtors and Creditors*, 57 TAXES 911 (1979).

285. BNA Daily Tax Report No. 189, at G-1 to -4 (Sept. 27, 1979); BNA Daily Tax Report No. 190, at K-5 to -6 (Sept. 28, 1979).

gain will result, but it probably will be offset by some revenue loss in connection with the new reorganization provisions added by the Act.²⁸⁶ The proponents of attribute reduction have overlooked the probability that attribute reduction will destroy the ability of many debtors to recover from financial chaos and continue as operating entities. Moreover, a successful bankruptcy reorganization gives creditors and other interested parties an opportunity to supply additional goods and services to the rehabilitated debtor, permits the debtor to continue the long-term employment of those individuals in need of steady work, and provides the Service and other taxing authorities with a continuing economic entity that presumably will generate profits in the future and pay taxes upon those profits. In the aggregate, these potential future taxes should far exceed those taxes resulting from a bankruptcy liquidation in which the debtor meets its demise due to an overly burdensome tax law. The purpose of a chapter 11 reorganization case under the Bankruptcy Code is to provide the debtor with a fresh start, to provide creditors with an opportunity to recoup their claims, to provide suppliers with an ongoing entity that will purchase goods and services from such suppliers, to provide employees with continued employment, to provide the community with an economic entity, and to provide the taxing authorities with a rehabilitated debtor capable of earning profits and paying taxes.

Thirdly, attribute reduction is not necessarily directly related to those debts that are cancelled in a bankruptcy proceeding. Thus, an immediate head start to the discharged debtor does not always result. The Service acknowledged this concept in ruling that discharge of indebtedness has no effect on net operating losses of the debtor.²⁸⁷

The rehabilitated debtor causes a favorable ripple effect and generates a significant positive contribution to the community and to the economy in general. A successful rehabilitation often will result in the generation of substantially greater tax revenues than the small sums that will be collected in connection with a liquidation of the debtor. By advocating its priority and nondischargeability advantages, the Service has maintained in most instances the short-sighted viewpoint that it must collect its pre-petition taxes in full, even if the collection of such taxes destroys the debtor by preventing its reorganization into a long-term and ongoing business.

The old Bankruptcy Act contained a simple and workable formula for the tax treatment of cancellation of indebtedness in a bankruptcy proceeding. Generally, no gain was recognized from the forgiveness of debt in such a proceeding, and the debtor made a downward adjustment of the bases in its assets in certain instances. The old Act was simple and consistent for the purposes of reorganization, insofar as it maximized the amount

286. Committee Report, *supra* note 72, at 41.

287. In Rev. Rul. 58-600, 1958-2 C.B. 29 the Service ruled that cancellation of indebtedness did not affect the debtor's net operating loss carryovers. Arguably this position is based on the inability to match cancelled debts neatly with the deductible cash expenditures that gave rise to the losses. See note 65 *supra* and accompanying text.

of cash flowing to creditors and did not confer a head start benefit to the discharged debtor. Elimination of net operating loss carryovers and tax attributes under the Bankruptcy Tax Act will render many reorganizations economically impracticable, because the potentially rehabilitated debtor is deprived of the working capital necessary to carry on its operations and make further payments to creditors. Moreover, it will entail significantly greater expenses for attorneys, accountants, appraisers, and other professional persons, due to the complexity of determining the appropriate tax treatment of a reorganization. Reorganization of a small business debtor in a chapter 11 case is already an expensive endeavor; in many instances the debtor cannot bear the additional cost of tax counsel that seemingly will be required under the Bankruptcy Tax Act.

The Bankruptcy Tax Act should be amended before the January 1, 1982, effective date for attribute reduction to provide that a bankrupt or insolvent debtor is not taxed upon income from cancellation of indebtedness, and that the tax attributes of a bankrupt or insolvent debtor are not reduced by the amount of the indebtedness forgiven. To alleviate the abuses that have resulted from the exploitation of section 108 by solvent debtors, section 108 should be repealed; solvent debtors should recognize income from cancellation of indebtedness, with the tax upon such income to be payable at the time when the cancelled debt would have been payable. Alternatively, the payment of such tax could be spread over a reasonable period of time, perhaps ten years. Implementation of these suggestions will result in a positive revenue impact for the Treasury, generate greater returns to creditors, and be consistent with both the tax policy and the purposes of the Bankruptcy Code.