BANKRUPTCY TAX ISSUES ©

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One of the principal tax goals of both a troubled company and its creditors in restructurings is preserving the company's net operating losses ("NOLs") and other tax attributes. Restructurings frequently cause a change in control that may limit the debtor's use of its NOLs. In addition, the exclusion of cancellation of debt ("COD") income can substantially reduce or even eliminate NOLs and other tax attributes of the debtor corporation.

I. SECTION 382 AND LIMITATIONS ON THE USE OF LOSS CARRYOVERS

Section 382[1] applies after a corporation with net operating losses or built-in losses (either, a "loss corporation") undergoes an ownership change or an equity structure shift to limit the amount of the new corporation's taxable income that may be offset by pre-change NOLs. Specifically, the new loss corporation's annual use of NOLs is generally limited to an amount equal to the loss corporation's equity value immediately prior to the ownership change multiplied by the long-term tax-exempt rate, a number published monthly by the IRS (4.37% for May 2005).

A. **Ownership Changes**. A section 382 ownership change occurs when the percentage of loss corporation stock owned by 5-percent shareholders increases more than 50 percentage points over the lowest percentage of stock of the loss corporation owned by those shareholders at any time during a testing period.

1. A loss corporation ("L") is required to determine whether an ownership change has occurred at the end of any date on which there has been any "owner shift"; the date on which the loss corporation is required to make this determination is the "testing date."[2] An owner shift occurs whenever there is a change in the percentage of stock owned by a 5-percent shareholder. A 5-percent shareholder is anyone who holds 5 percent or more of the stock of the loss corporation at any time during the testing period.[3] The testing period generally consists of the 3-year period prior to any testing date.

2. To determine whether an ownership change has occurred, the corporation must measure changes in the ownership of all stock except preferred stock that (i) does not vote (or votes only if dividends are not paid), (ii) is limited and preferred as to dividends and does not participate in corporate growth to a significant extent, (iii) does not have redemption and

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1 All section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and to the Treasury Regulations promulgated thereunder.

2 I.R.C. § 382(i); Treas. Reg. § 1.382-2(1)(4). All computations of increases in percentage ownership are made as of the close of the testing date, and all transactions that occur on that date are treated as occurring simultaneously at the end of the testing date. As a result, offsetting changes that occur on a testing date are effectively disregarded. Treas. Reg. § 1.382-2(a)(4)(i).

3 I.R.C. § 382(k)(7).

liquidation rights that exceed the issue price of the stock (except for a reasonable redemption or liquidation premium), and (iv) is not convertible into common or other participating stock ("Straight Preferred").[4] Under certain circumstances, an ownership interest that would otherwise be treated as stock is instead not treated as stock if its likely participation in corporate growth is disproportionately small compared to its value. Similarly, under certain circumstances, an ownership interest that would otherwise not be treated as stock is treated as stock if that interest offers its owner a potentially significant participation in corporate growth.[5]

3. To determine whether a 50-percentage-point increase has occurred, a corporation must aggregate the percentage point increases in ownership of each 5-percent shareholder. Stock owned by shareholders of a corporation who are not 5-percent shareholders is treated as stock owned by a single notional 5-percent shareholder of that corporation.[6]

   - Since the percentage-point increase is measured by subtracting the lowest percentage ownership of each shareholder during the testing period from the percentage ownership of the shareholder on the testing date, an ownership change can occur even if the same shareholder owns more than 50% of the corporation at the beginning and end of the testing period. For example, the following sequence of events occurring within a three-year period would produce an ownership change: (i) on date 1, A owns 80% and B owns 20% of the loss corporation stock; (ii) on date 2, A sells 31% of the loss corporation stock to C; and (iii) on date 3, A buys 20% of the loss corporation stock from B. A has a 20-point increase from its lowest point (69%-49%) and C has a 31-point increase (31%-0%), resulting in a combined 51-point increase and thus an ownership change, even though A owned more than 50% of the stock both before and after the transaction.

B. **Loss Corporation Value**. The old loss corporation's value is the value of all of the debtor's stock immediately before the ownership change, including Straight

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4 I.R.C. §§ 382(k)(6)(A), 1504(a)(4). Note that while Straight Preferred is not counted when determining an ownership change, it is included when determining the value of the loss corporation under section 382(e). Treas. Reg. § 1.382-2(a)(3)(i).

5 Treas. Reg. § 1.382-2T(f)(18)(ii), (iii); *see also* F.S.A. 1999-10-009 (Mar. 12, 1999) (ruling that under Treasury Regulation section 1.382-2T(f)(18), if certain other conditions are also met, an ownership interest not constituting stock under section 1.382-2T(f)(18)(i) (other than an option subject to section 382(h)(4)) may nonetheless constitute stock for the purpose of determining whether there has been an ownership change if the ownership interest offers a potential significant participation in the growth of the corporation). By contrast, a debtor that simply modifies the terms of a debt interest to increase the likelihood of repayment is likely not participating in the growth of the company, and the interest does not constitute stock under Treasury Regulation section 1.382-2T(f)(18)).

6 I.R.C. § 382(g)(4)(A).

Preferred stock.[7] Because the value of an insolvent debtor's stock immediately before an ownership change is typically small, an ownership change will often significantly reduce or effectively eliminate a troubled corporation's post-ownership-change NOL utilization.

1. The value of an old loss corporation is reduced by the value of its nonbusiness assets (less applicable indebtedness) if a third or more of its assets are nonbusiness assets.[8] Nonbusiness assets are defined broadly by section 382(l)(4)(C) as assets held for investment.[9] If L has sold business assets to raise cash to pay creditors, that cash presumably will be treated as an investment asset that could reduce L's section 382 limitation.

2. Under the "anti-stuffing" rule of section 382(l)(1)(A), the value of the old loss corporation will be reduced by any capital received by the corporation as part of a plan that has as a principal purpose increasing the section 382 limitation. Any contributions made during the two years immediately preceding the ownership change date are deemed made for the proscribed purpose.[10] The Conference Report states that the regulations are expected

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[7] I.R.C. § 382(e); *see also* F.S.A. 200140049 (July 6, 2001) (ruling that under section 382(e)(2), if a redemption or other corporate contraction occurs in connection with (either before or after) an ownership change, the value of the loss corporation's stock is determined after taking the redemption into account; this rule applies to a "bootstrap" acquisition in which the aggregate value of the loss corporation is directly or indirectly reduced to provide funds to the old shareholders).

[8] I.R.C. § 382(1)(4).

[9] Cash and marketable stock or securities are included in the definition of nonbusiness assets. Joint Comm. on Taxation, 98th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1986* (1987) at 319.

[10] I.R.C. § 382(l)(1)(B). An interesting question arises if L undergoes a second ownership change within 2 years after a capital contribution. Will the anti-stuffing rule invoked in the first ownership change apply again to reduce L's utilization of the losses L incurs during the period following its first ownership change and preceding its second ownership change? Although section 382(l)(1)(B) can be read literally to require that reduction, no discernable policy requires a reduction in a company's section 382 limitation after a second ownership change because of a contribution to capital made before a first ownership change.

Assume L has a value of $1,000 and NOLs of $1,000. Its stockholders make a capital contribution of $1,000 and, soon after, sell L for $2,100. The federal long-term tax-exempt rate is 10%. Because section 382(l)(1) requires that L's $2,100 value for purposes of computing the section 382 limitation be reduced by $1,000 to $1,100, L may use only $110 of its $1,000 NOL in each post-ownership change year. During the next year, L incurs $500 in losses, creating an additional $500 NOL. L is sold for $1,550. In determining the section 382 limitation applicable to the new $500 NOL, should L be allowed to treat its value as $1,550? Under a literal reading of section 382(l)(1)(B), L would be required to reduce its value to $550 (the $1,550 sales price less the $1,000 capital contribution made within 2 years) and limit its annual NOL utilization to $55. Regulations or rulings should be published to provide that, as to L's post-first ownership change $500 NOL, the section 382 limitation is $155; while as to the pre-ownership change $1,000 NOL, the section 382 limitation is $55 (10% times $550, L's value at the time of the second purchase reduced by the $1,000 capital contribution). Under a FIFO utilization assumption, L would be entitled to use $55 of its $1,000 NOL and $100 of its $500 NOL ($155 - $55) each year.

to exclude from this anti-stuffing rule capital contributions made when the company was formed or before the losses arose, or made to meet basic operating expenses.[11] Many reorganizations call for L's creditors to exchange their claims for L stock. Stock-for-debt exchanges presumably constitute capital contributions to L by the creditor receiving stock, causing the anti-stuffing rules to apply, reducing L's section 382 limitation.[12] The amount of that contribution is less clear. If a creditor exchanges $11,000 of debt for $1,000 worth of L stock (constituting all of L's stock), is the capital received by L $10,000 or $1,000?

C. **Options**. Under certain circumstances, an option, or an interest similar to an option,[13] will be treated as exercised and thus must be counted toward determining whether an ownership change has occurred.

1. The regulations utilize three tests to determine whether an option will be considered exercised: the ownership, control, and income tests. An option that satisfies any one of these tests on the date it is issued is treated as exercised on that date and generally must be counted toward an ownership change on any subsequent testing date.[14] Each test applies only if a principal purpose of the issuance, transfer, or structuring of the option is to avoid an ownership change or ameliorate its impact. In addition, the tests contain the following requirements:

   a. The ownership test is satisfied if the option provides the holder before exercise with a substantial portion of the attributes of ownership of the underlying stock.[15]

   b. The control test is satisfied if the option holder and any related persons have, in the aggregate, a direct and indirect ownership

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[11] 1986 Act Conference Report, H.R. Rep. No. 841, 99th Cong., 2d Sess. at II-189. Although regulations have not yet been issued, the IRS has applied exceptions to the anti-stuffing rule in certain cases. *See* Tech. Adv. Mem. 9332004 (Apr. 30, 1993) (excepting from the two-year rule proceeds used to continue basic operations, including working capital and payments used to fund a lawsuit settlement and collateralize letters of credit); Priv. Ltr. Rul. 9508035 (Sept. 30, 1994) (stating that proceeds from public stock offerings made ten months before ownership change were not subject to anti-stuffing rule because the stock offerings were made to meet operating expenses arising close in time to the date of the offerings, and the proceeds were traceable to payment of basic operating expenses).

[12] *See* F.S.A. 199910009 (Dec. 2, 1998) (excluding from company valuation debt that is deemed to be converted into stock within two years of ownership change).

[13] Only for the purpose of determining whether there has been an ownership change, an option includes, in general, any contingent purchase, warrant, convertible debt, put, stock subject to a risk of forfeiture, contract to acquire stock, or similar interest. Treas. Reg. § 1.382-4(d)(9)(i); *see also* Treas. Reg. § 1.382-4(d)(9)(iv) ("This paragraph (d) does not affect the determination under general principles of tax law . . . of whether an instrument is an option or stock.").

[14] Treas. Reg. § 1.382-4(d)(2)(ii).

[15] Treas. Reg. § 1.382-4(d)(3).

interest in the loss corporation of more than 50 percent on the date the option is issued or transferred (including stock issued upon the deemed exercise of the option).[16]

c. The income test is satisfied if the abusive principal purpose is achieved by facilitating the creation of income (or any value) before the exercise or transfer of the option.[17]

2. The option regulations include several important safe harbors which provide that the following types of options will not be treated as exercised:

a. typical contracts to acquire stock that are closed on an ownership change date within one year of execution,

b. options that are part of security arrangements in typical lending transactions,

c. ordinary compensatory options,

d. options exercisable only on death, disability or retirement, and

e. rights of first refusal.[18]

D. Built-in Gains and Losses. Certain gains and losses recognized by a new loss corporation may be subject to special rules. Generally, a new loss corporation's section 382 limitation may be increased by certain gains known as "built-in gains." Conversely, "built-in losses" are subject to the same annual limitations as pre-change NOLs. To determine whether a built-in gain or loss has been timely recognized, the IRS looks at the 5-year "recognition period," beginning on the change date of any ownership change.[19] The IRS also takes into account only those built-in gains and losses that exceed the threshold of the lesser of (i) 15% of the value of the corporation's assets or (ii) $10 million on the ownership change date. Such gains and losses are known as "net unrealized built-in gains" and "net unrealized built-in losses," respectively, and are subject to the rules described below.[20]

1. Net unrealized built-in gain or loss is the difference between the fair market value of the assets of an old loss corporation immediately before an ownership change, and the aggregate adjusted basis of the assets at that

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[16] Treas. Reg. § 1.382-4(d)(4).

[17] Treas. Reg. § 1.382-4(d)(5).

[18] Treas. Reg. § 1.382-4(d)(7).

[19] I.R.C. § 382(h)(7)(A).

[20] I.R.C. § 382(h)(3)(B)(i). If the amount of built-in loss or gain does not exceed the threshold, the net unrealized built-in gain or loss is zero. *See also* Priv. Ltr. Rul. 2002-17-009 (Apr. 29, 2002) (ruling that no portion of income earned from a wasting asset should be treated as recognized built-in gain for the purposes of section 382(h)(6)).

time.[21] Recognized built-in gain is any gain recognized during the recognition period on the disposition of any asset to the extent that the new loss corporation establishes that the asset was held by the old loss corporation immediately before the change date and that the gain does not exceed the excess of the fair market value of the asset on the change date over the adjusted basis of the asset on that date.[22] Recognized built-in loss is any loss recognized during the recognition period on the disposition of any asset, except to the extent that the new loss corporation establishes that the asset was not held by the old loss corporation immediately before the change, or that the loss exceeds the difference between the adjusted basis of the asset on the change date over the fair market value of the asset on that date.[23]

2. The corporation's section 382 limitation for any year within the recognition period is increased by the recognized built-in gain for that year, including COD income.

3. The net built in loss recognized during the 5-year recognition period after the ownership change is treated as a pre-change loss, and thus its use is limited by section 382(a).

4. A net unrealized built-in gain is particularly helpful if a new loss corporation fails to satisfy the continuity of business requirement. As a rule, if the new loss corporation does not continue the business enterprise of the old loss corporation for 2 years after the ownership change, the

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[21] I.R.C. § 382(h)(3)(A)(i). If 80 percent or more in value of the stock of a corporation is acquired in one transaction (or a series of related transactions during a twelve-month period), for purposes of determining the net unrealized built-in loss, the fair market value of the assets of such corporation shall not exceed the grossed-up amount paid for such stock properly adjusted for the indebtedness of the corporation, and other relevant items. I.R.C. § 382(h)(8); *see also* F.S.A. 200010003 (Mar. 10, 2000) (ruling that Straight Preferred is not treated as stock for purposes of applying section 382(h)(8), unless doing so would result in an ownership change); F.S.A. 199914002 (Apr. 9, 1999) (ruling that under section 382(h)(8), stock will be deemed "acquired" where the parties to the transaction are likely to look to and rely upon the value of the underlying assets of the loss corporation; that stock should probably be treated as "acquired" in a stock-for-debt exchange because the amount of stock received by the creditors is likely to depend upon a bargained-for exchange based on the underlying value of the loss corporation's assets; and that stock should be treated as "acquired" when it is received in a section 1032 transaction).

[22] I.R.C. § 382(h)(2)(A); *see also* Tech. Adv. Mem. 199942003 (July 6, 1999) (ruling that prepaid amounts are not treated as recognized built-in gain by reason of section 382(h)(6)(A) when taken into account in the tax period following the change date); 1998 F.S.A. LEXIS 429 (June 4, 1998) (ruling that COD income may constitute recognized built-in gain and thereby increase a company's section 382 limitation under section 382(h)(6)).

[23] I.R.C. § 382(h)(2)(B). Recognized built-in loss also includes any amount allowable as depreciation, amortization, or depletion for any period within the recognition period except to the extent the new loss corporation establishes that the amount so allowable is not attributable to the excess of the adjusted basis of the asset on the change date over the fair market value of the asset on that date. I.R.C. § 382(h)(2)(B).

section 382 limitation for any post-change year is reduced to zero. The continuity of business enterprise requirement is satisfied if the loss corporation either continues at least one significant line of its historic business or uses a significant portion of its historic assets in a new business.[24] There are, however, two exceptions to the continuity of business requirement.[25] First, the section 382 limitation must include any built-in gains and any gain recognized by reason of an election under section 338.[26] Second, even if a corporation does not continue the business enterprise of the old loss corporation, the new corporation is still allowed to carry forward any unused portion of its previous year's section 382 limitation.[27]

E. **Consolidated Section 382 Rules**. Section 382 applies in the consolidated group context. The regulations generally adopt a single entity approach to determine the section 382 limitation and the built-in gain or loss threshold. The single entity approach to section 382 reflects the principle that losses that arise while two or more corporations are members of a consolidated group and are available to be used by all group members should remain available for that use following an ownership change, subject only to the restrictions that would be imposed on a single entity in similar circumstances.

1. A consolidated group will qualify as a loss group in three cases. First, a consolidated group is a loss group if it is entitled to use an NOL carryover to the current taxable year that did not arise in a separate return limitation year ("SRLY"), and is not treated as a SRLY loss under regulation section 1.1502-21(c). Second, a group is a loss group if it has a consolidated net operating loss for the taxable year in which a testing date of the common parent occurs; this is determined by treating the common parent as a loss corporation. Finally, a group is a loss group if it has a net unrealized built-in loss, determined as described below.[28]

2. As a general rule, when a loss group's parent experiences a section 382 ownership change, the resulting section 382 limitation applies to the entire group's pre-change NOLs, rather than to each individual member separately.[29] The value of the loss group is generally the total value of the stock of each member, other than stock owned directly or indirectly by

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24 Treas. Reg. § 1.368-1(d). When it enacted section 382(c), Congress stated that the continuity of business enterprise requirement in section 382(c) is the same as that applied to corporate reorganizations under section 368 and that the standard under section 1.368-1(d) is to be used in determining whether the requirement has been satisfied. *See* 1986 Act Conference Report, H.R. Rep. No. 841, 99th Cong., 2d Sess. at II-189.

25 I.R.C. § 382(c)(1).

26 I.R.C. § 382(c)(2)(A); *see also* I.R.C. §§ 382(h)(1)(A), (C).

27 I.R.C. § 382(c)(2)(B); *see also* I.R.C. § 382(b)(2).

28 Treas. Reg. § 1.1502-91(c).

29 Treas. Reg. §§ 1.1502-91(a)(l), 1.1502-92(b)(1)(i).

another member, immediately before the ownership change.[30] The continuity of business requirement is applied on a single entity basis.[31]

3. The loss group's net unrealized built-in gain is determined on a consolidated basis by aggregating each member's separate net unrealized built-in gain.[32] By contrast, for purposes of computing the loss group's net unrealized built-in loss, the regulations exclude the net unrealized built-in loss of any member that joined the group within the last 5 years and, either (i) did not have a built-in loss at the time of joining or (ii) has a SRLY built-in loss as to which no ownership change occurred at the time of joining.[33] The $10 million or 15% section 382 threshold is applied on a consolidated basis to the sum of the separately computed net unrealized built-in gains or losses.[34]

4. The regulations specifically reserve on the application of the special rules of section 382(l)(5) and section 382(l)(6) to consolidated groups.[35]

5. A loss group member that leaves a group that underwent a consolidated section 382 ownership change will have a zero section 382 limitation, unless the common parent of the loss group elects to apportion all or part of the consolidated section 382 limitation to the departing member.[36] This provision must be weighed when purchasing or selling a subsidiary out of a consolidated group.

6. Assuming proper procedures are met, a common parent may elect (with its subsidiary's consent) under section 1.1502-20(g)(5) to reattribute to itself the subsidiary's share of unused consolidated NOLs carryforwards to the extent of the loss that would otherwise be disallowed.[37] The reattributed losses are deemed absorbed by the subsidiary with the result that the common parent's basis is reduced by the amount of the reattributed loss.[38]

7. If a subsidiary ceases to be a member of a group during the group's taxable year, the periods ending and beginning with the subsidiary's

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[30] Treas. Reg. § 1.1502-93(b). This value is subject to adjustment under various section 382 rules.

[31] Treas. Reg. § 1.1502-93(d)(1).

[32] Treas. Reg. § 1.1502-91(g)(2)(i).

[33] Treas. Reg. § 1.1502-91(g)(2)(ii).

[34] Treas. Reg. § 1.1502-91(g)(1).

[35] Treas. Reg. § 1.1502-97.

[36] Treas. Reg. §§ 1.1502-95(b)(2), 1.1502-95(c).

[37] The election to reattribute losses must be made in a separate statement, signed by the common parent and each subsidiary whose losses are being reattributed, and filed with the group's return for the taxable year of disposition. The statement must be filed with the group's income tax return for the tax year of the disposition. Treas. Reg. § 1.1502-20(g)(5).

[38] Treas. Reg. § 1.1502-20(g)(3).

becoming or ceasing to be a member are separate years for all federal income tax purposes. NOL carryovers attributable to the subsidiary are first carried to the consolidated return year, and only the amount so attributable to the subsidiary is first carried to the consolidated return year, and only the amount so attributable that is not absorbed by the group in that year is carried to the subsidiary's first separate return year.[39]

F. **Capital Loss Carryovers**. Under section 383, the use of capital loss carryovers from tax years prior to the change year is limited under rules similar to section 382.

G. **Limitation on Use of Preacquisition Losses to Offset Built-in Gains**. Section 384 prevents a corporation with net built-in gains from using losses acquired by acquiring control (80% of stock by vote and value) of a loss corporation to offset built-in gains recognized within 5 years of the acquisition. This provision does not apply, however, if both the gain corporation and the loss corporation were members of a controlled group during the 5 years prior to the acquisition.[40]

II. **THE BANKRUPTCY EXCEPTIONS**. Sections 382(l)(5) and 382(l)(6) provide relief for loss corporations and their acquirers in a Title 11 or similar proceeding. However, section 269 prevents taxpayers from acquiring NOLs free of the section 382 limitation under section 382(l)(5) without continuing a historic business of the loss corporation.

A. **Section 382(l)(5)**. Under section 382(l)(5), section 382(a) does not limit the post-change use of the pre-change NOLs of a bankrupt old loss corporation if two conditions are met. If these conditions are met, section 382(l)(5) automatically applies, unless the loss corporation specifically elects otherwise.

1. First, the exception in section 382(l)(5) applies only if an old loss corporation that is, immediately before the ownership change, under the jurisdiction of a court in a Title 11 or similar case,[41] and the transaction that results in the new loss corporation is "ordered by the court or is pursuant to a plan approved by the court."[42] Second, the loss corporation's old shareholders and certain creditors known as "old and cold" creditors must, immediately before the reorganization, own stock (other than Straight Preferred)[43] that comprises at least 50% of the value and voting power of the loss corporation's outstanding stock immediately after the reorganization. Under the 50% test, stock is counted only if it

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39 Treas. Reg. § 1.1502-21(b)(2)(ii).

40 A shorter period applies if either of the corporations was not in existence throughout the 5-year period. I.R.C. § 384(b).

41 I.R.C. § 382(l)(5)(A)(i); Treas. Reg. § 1.382-9(b)(1).

42 Treas. Reg. § 1.382-9(a).

43 For purposes of this section, "stock" is defined by reference to the consolidated return definition. Because straight preferred stock is excluded from section 1504(a)(4), such stock is not counted for purposes of satisfying the 50% test.

was owned immediately before the reorganization, or it was received in exchange for stock or an "old and cold" creditor's interest that was owned immediately before the reorganization.

a. "Old and cold" creditors are creditors (i) who have held their debt continuously for at least 18 months before the filing of the bankruptcy case,[44] or (ii) whose debt arose in the ordinary course of the corporation's business and who have held the beneficial interest in their debt at all times since issuance.[45] Debt arises in the ordinary course of the corporation's business only if the debt is incurred in the normal, usual or customary conduct of business, without regard to whether the debt funded is an ordinary or capital expenditure.[46] In the case of publicly traded debt held by multiple owners, the 18-month test can be difficult to satisfy.[47] To alleviate the problems associated with public debt qualification, section 1.382-9(d)(3)(i) was issued to relax the continuous ownership rule by providing that less than 5% holders of publicly traded debt may qualify as old and cold creditors without regard to the length of time they have actually held their debt,[48] unless:

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44 A duty of inquiry is imposed on the loss corporation to establish that the continuous ownership requirement has been established. Treas. Reg. § 1.382-2T(k)(3).

45 Treas. Reg. § 1.382-9(d)(1). Regardless of whether there is a change in the control of the entity holding the debt, the Service has held that such debt will be treated as incurred in the ordinary course of a corporation's business so long as the change of control did not have as a principal purpose the avoidance of the section 382(l)(5) rule. Priv. Ltr. Rul. 9019036 (Feb. 9, 1990).

46 Treas. Reg. § 1.382-9(d)(2)(iv). Under this section, debt that arises in the ordinary course of the corporation's business includes trade debt; a tax liability; a liability that arises from a past or present employment relationship, a past or present business relationship with a supplier, customer or competitor, or from tort, breach of warranty, or breach of statutory duty; indebtedness incurred to pay an expense deductible under section 162 or included in the cost of goods sold; or a claim that arises upon the rejection of a burdensome contract or lease pursuant to the Title 11 or similar case, if the contract or lease arose in the ordinary course of the business.

47 *See*, *e.g.*, *In re First Merchs. Acceptance Corp.*, No. 97-1500 JJF, 1997 WL 873551 (Bankr. D. Del. Dec. 15, 1997) (ordering that before any party or acquiring group acquires or accumulates more than a specified number of shares, that party must give 30 days notice to the debtor so that the debtor may object to the transactions); *In re* McLean Indus. Nos. 86-B-12238 through 86-B-12241 (Bankr. S.D.N.Y. 1995) (requiring additional procedures before the court recognized a transfer of a claim because a majority of the stock was to be distributed to "old and cold" creditors under the debtor's bankruptcy plan); *In re* Pan Am Corp., Nos. 91-B-10080 (CB) through 91-B-10017 (CB) (Bankr. S.D.N.Y. 1991) (restricting certain transfers of publicly traded bonds and debentures).

48 Although this rule provides a welcome exception to the continuous ownership requirement, certainty in advance planning is limited by the fact that status as a 5-percent shareholder or entity may not be determinable until after the change date.

i. the creditor's participation in formulating the plan of reorganization makes evident to the loss corporation that it is not an old and cold creditor;[49]

ii. the loss corporation has actual knowledge that the exercise of an option to acquire stock of the loss corporation by a holder of the debt will cause the holder to become a 5-percent shareholder or entity immediately after the reorganization;[50] or

iii. the creditor is a 5-percent entity immediately after the loss corporation's ownership change which itself has undergone an ownership change in the 18 month period, and the indebtedness represents more than 25 percent of its gross assets (excluding cash or cash equivalents).[51]

b. Section 1.382-9(d)(5) provides another exception to the continuous ownership requirement that permits certain transferees of debt to tack their transferors' holding period to their own for purposes of satisfying the 18-month test, and also allows the tacking of holding periods by the same owner after certain debt-for-debt exchanges.[52] The second tacking rule applies where the loss corporation satisfies its debt with new debt, either through an exchange of new for old debt or by a modification of the old debt that is treated as an exchange.[53] The first tacking rule applies where the transferee does not acquire the debt for a principal purpose of benefiting from preserved NOLs, and if the transfer

i. is between parties related under sections 267(b) or 707(b), substituting at least 80 percent for more than 50 percent;

ii. is a transfer of a loan within 90 days after its origination, pursuant to a customary syndication transaction;

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[49] Treas. Reg. § 1.382-9(d)(3)(i).

[50] Treas. Reg. § 1.382-9(d)(3)(ii)(D).

[51] Treas. Reg. § 1.382-9(d)(4). The purpose of this anti-abuse rule is to curb efforts to avoid the restriction on debt transfers by placing the debt in an entity and subsequently transferring interests in that entity rather than transferring the debt itself. As practical matter, a loss corporation should obtain a statement, signed under penalties of perjury, from any holder of debt that becomes a 5-percent entity immediately after the ownership change to the effect that they do not come within the scope of this anti-abuse rule.

[52] This exception applies even if the holder becomes a 5-percent shareholder or entity.

[53] In addition to permitting tacking of holding periods, the regulation treats the new debt as having arisen in the ordinary course of the business of the loss corporation if the old debt so arose. Treas. Reg. § 1.382-9(d)(5)(iv).

iii. is a transfer of newly incurred debt by an underwriter that owned it for a transitory period pursuant to an underwriting;

iv. is a transfer in which the transferee's basis is determined under sections 1014 or 1015 or with reference to the transferor's basis in the debt;

v. is in satisfaction of a right to receive a pecuniary bequest;

vi. is pursuant to a divorce or separation agreement within the meaning of section 71(b)(2);

vii. is pursuant to a subrogation in which the transferee acquires a claim against the loss corporation by reason of a payment to the claimant pursuant to an insurance policy or a guarantee, letter of credit or similar security arrangement; or

viii. is a transfer of an account receivable in a customary commercial factoring transaction made within 30 days after the account rose to a transferee that regularly engages in such transactions.

2. If section 382(l)(5) applies (and the taxpayer does not elect the application of section 382(1)(6) instead), the loss corporation debtor is not subject to a section 382 limitation on the use of its NOLs. Instead, the corporation must reduce, or "haircut," its NOLs by the interest paid or accrued during the pre-reorganization portion of the current tax year and the 3 preceding tax years on debt converted into stock pursuant to the bankruptcy reorganization.[54] Frequently, this adjustment will largely, or completely, eliminate a highly leveraged loss corporation's NOLs. Remaining NOLs generally may offset post-ownership change income without limitation and without regard to whether the continuity of business enterprise requirement is met.

a. If a second ownership change occurs within 2 years of the section 381(l)(5) ownership change, the section 382 limitation with respect to the second ownership change is zero. Because of the severity of this sanction, the reorganized debtor should legend its shares and restrict trading to avoid a second ownership change.

b. A corporation may elect to forego section 382(l)(5) treatment. This election is irrevocable and must be made on the loss

[54] *See, e.g.*, FSA 200006004 (June 28, 1999) (ruling that paid-in-kind instruments issued during the three-year recapture period would be included when determining the reduction of NOL carryovers under 382(l)(5)(B), and thus should not be taken into account in determining the amount of COD income that must be included under 382(l)(5)(C)).

corporation's return for the taxable year in which the ownership change occurs.[55] If the election is made, the corporation is then subject to the annual section 382 limitation, computed under the special rules of section 382(l)(6).

B. **Section 382(l)(6)**. Section 382(l)(6) applies to ownership changes pursuant to a bankruptcy reorganization to which section 382(l)(5) does not apply.[56] Section 382(l)(6) is available only to debtors in bankruptcy. Under section 382(l)(6), when calculating the value of the old loss corporation, the new loss corporation may include the increase in the value of the old loss corporation resulting from any surrender or cancellation of creditors' claims in the ownership change transaction, subject to certain anti-stuffing rules.[57] Determining value in this manner immediately after an ownership change generally increases the company's section 382 annual limitation. Canceling debt increases the total equity value of a company, and so increases the annual NOL limitation under section 382(l)(6). By contrast, canceling debt generally reduces NOLs under section 382(l)(5).

1. For purposes of section 382(l)(6), the value of a loss corporation following reorganization is the lesser of the value of the stock of the loss corporation immediately after the reorganization, or the value of the loss corporation's pre-change assets (determined without regard to its liabilities).[58]

2. The value of the pre-change assets of the loss corporation is reduced by the amount of any capital contribution to which section 382(l)(1) applies.[59] Amounts received by a loss corporation in exchange for the issuance of a debt are treated as a capital contribution that must be excluded from the value of the loss corporation's pre-change assets if the principal purpose of the issuance is to increase the value of the loss corporation under section 382(l)(6).[60]

3. The loss corporation is not limited in determining the value of the loss corporation's pre-change assets to its liquidation value, and may take into account the value of any intangible asset.

4. The value of the loss corporation's stock issued in connection with the reorganization may not exceed the value of the loss corporation's property received in exchange for the issuance of that stock.[61] Further, stock issued with the principal purpose of increasing the section 382 limitation

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55 Treas. Reg. § 1.382-9(d)(6).

56 Debtors may also elect to apply section 382(l)(6) in lieu of section 382(l)(5).

57 I.R.C. § 382(l)(6).

58 Treas. Reg. § 1.382-9(j).

59 Treas. Reg. § 1.382-9(l)(4).

60 Treas. Reg. § 1.382-9(l)(4).

61 Treas. Reg. § 1.382-9(k)(7).

> "without subjecting the investment to the entrepreneurial risks of corporate business operations" is excluded in valuing stock of the loss corporation.[62]

C. **Section 269 Regulations**. Section 269 generally disallows any deduction or other allowance if (1) any person or persons directly or indirectly acquire control of a corporation,[63] or (2) any corporation acquires property from an unrelated corporation in a transaction in which the basis of the property carries over, and, in either case, the principal purpose for the acquisition is to evade or avoid federal income tax by securing the benefit of a deduction or other allowance that such person or corporation would not otherwise enjoy.[64] The section 269 regulations therefore provide that, absent strong evidence to the contrary, a section 382(l)(5) acquisition will be considered to be made for the principal purpose of evasion or avoidance of federal income tax unless the corporation carries on more than an insignificant trade or business during and subsequent to the Title 11 or similar case. Whether the trade or business is more than insignificant is based upon facts and circumstances, including the amount of business assets and employees the company continues to utilize. The requirement may be met even if all business activities temporarily cease, if subsequently the corporation continues to utilize a significant amount of historic business assets or work force.[65] Treasury regulations also provide that the determination of the Bankruptcy Court under 11 U.S.C. § 1129(d) that the principal purpose of the plan is not avoidance of taxes is not controlling.[66] This injects an unfortunate uncertainty into the restructuring process.[67]

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62 Treas. Reg. § 1.382-9(k)(6).

63 *See, e.g.*, F.S.A. 200201012 (Jan. 4, 2002) (ruling that the control requirement under section 269 may be satisfied if the holder of a convertible security or the holder of a similar equity stake, such as an option, has effective control over the business and management of the acquired corporation, or if the holder of an option has furnished or will furnish substantially all of the funds at risk (other than a nominal amount contributed by the legal owner) and the option holder's investment (not that of the legal owner) will appreciate or depreciate).

64 *See, e.g.*, F.S.A. 200205003 (Feb. 1, 2002) (ruling that so long as the requirements of section 269 are met, the Service may apply section 269(a)(2) to disallow any loss on the abandonment of worthless properties); *see also* F.S.A. 200134008 (May 15, 2001) (ruling that while section 269 is generally used to disallow deductions for losses that occurred before the acquisition of the loss corporation, nothing in the language of the section precludes the application of section 269 to pre-acquisition losses that could not be taken into account for tax purposes until post-acquisition years).

65 Treas. Reg. § 1.269-3(d).

66 Treas. Reg. § 1.269-3(e).

67 *But see In re Hartman Material Handling Sys.*, 141 B.R. 802 (Bankr. S.D.N.Y. 1992) (disagreeing with section 1.269-3(e) and stating that "[t]his Court is at a loss to decipher how the power to promulgate regulations gives the IRS the authority to determine the effect of an order of a court"). *Cf.* F.S.A. 200233016 (May 9, 2002) (ruling that section 269(a) may apply to disallow foreign tax credits and deductions that arise from certain reorganizations if the principal purpose, determined as a question of fact, of the underlying transaction is the evasion or avoidance of Federal income tax by securing tax benefits).

III. CANCELLATION OF DEBT INCOME. Section 61(a)(12) codifies the rule of *United States v. Kirby Lumber Co.*[68] that a debtor recognizes taxable income upon a satisfaction of its indebtedness for less than its adjusted issue price because the satisfaction of a liability at a discount enriches the debtor and should therefore be treated as income. In an actual or deemed debt-for-debt exchange, creditors may also recognize income or loss as a result of the exchange, depending on whether the debt exchanged qualifies as a "security."

IV. BANKRUPTCY AND INSOLVENCY COD EXCEPTIONS. A taxpayer does not recognize COD income to the extent it is insolvent.[69] Any debt discharge in excess of the insolvency amount will result in COD income recognition.[70]

In the case of a debtor in a Title 11 proceeding, its debt discharge is totally excluded from income without regard to its insolvency.[71]

A. <u>Determination of Insolvency</u>. A taxpayer is "insolvent" if its liabilities exceed the fair market value of its assets. Insolvency is determined immediately before the debt discharge.[72]

1. Intangible assets, such as goodwill, should be taken into account in determining the insolvency amount.[73] The fair market value of assets is determined on a going concern basis.[74] It is unclear whether breakup value should be taken into account.[75]

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[68] 284 U.S. 1 (1931).

[69] I.R.C. § 108(a)(1)(B); *cf.* F.S.A. 1999-08-005 (Nov. 17, 1998) (ruling that section 1.1502-13(g)(3)(ii)(B) provides that any gain or loss resulting from an intercompany obligation is not excluded from income under section 108(a), thus effectively promoting the matching principle).

[70] I.R.C. § 108(a)(3); *see also* F.S.A. 200135002 (Apr. 10, 2001) (ruling that proper treatment of a transaction in which property is disposed of in connection with the relief of a debt obligation may depend on whether the debt is recourse or nonrecourse, and that under section 108(a), when assets are contributed to a taxpayer "simultaneously" with a debt discharge, the contributed assets are not taken into account immediately before the discharge; instead, the contributed assets are taken into account immediately after the discharge, for the purposes of determining how much basis the taxpayer must reduce).

[71] I.R.C. § 108(a)(1)(A).

[72] I.R.C. § 108(d)(3).

[73] *See Conestoga Transp. Co. v. Comm'r*, 17 T.C. 506 (1951), *acq.*, 1952-1 C.B. 2. This was also the position taken by the IRS in *J.A. Maurer, Inc. v. Commissioner*, 30 T.C. 1273, 1292 (1958), *acq.*, 1959-1 C.B. 4.

[74] *See Conestoga Transp. Co. v. Comm'r*, 17 T.C. 506, 513 (1951); *see also Ohio Corrugating Co. v. DPAC*, 91 BR. 430 (Bankr. N.D. Ohio 1988).

[75] *See Estate of Newhouse v. Comm'r*, 94 T.C. 193, 237-240, 242 (1990), *non-acq.*, 1991-1 C.B. 1; Bruce D. Haims, *Bankruptcy as a Tax Planning Device: Workouts vs. Chapter 11*, 49 N.Y.U. Inst. on Fed. Tax'n §§ 23.01 and 23.041[2] (1991).

2. Assets exempt from creditor claims under applicable state law are excluded from the insolvency determination.[76]

3. It is unclear whether contingent liabilities may be taken into account in valuing liabilities. In appropriate cases, a reasonable reserve should be included for contingent liabilities.[77] The Tax Court has recently limited a taxpayer's inclusion of contingent obligations to those as to which "it is more probable than not that he will be called upon to pay…in the amount claimed."[78] This conclusion is problematic for troubled companies with a significant amount of contingent liabilities, and may provide a strong reason to conduct debt workouts in a bankruptcy proceeding rather than claim the insolvency exception to COD income. On the other hand, there appears to be no answer as to whether the potential tax liability resulting from the debt discharge or the expense of the reorganization should be taken into account.[79] Presumably, liabilities are taken into account at face (adjusted issue price) regardless of market or credit discounts.

4. It is unclear how a consolidated group's solvency is to be determined. The better view is that insolvency is determined on a separate company basis.[80]

B. **<u>Timing of Insolvency Determination</u>**. Under section 108(d)(3), the amount of COD excluded from gross income is determined on the basis of the assets and liabilities of the debtor immediately before the discharge. Prior to the Bankruptcy Tax Act of 1980, a debtor rendered solvent by the discharge of its debt, recognized COD income to the extent of the excess of the debtor's assets over liabilities immediately after the discharge.[81]

1. If property other than stock is issued to creditors in satisfaction of debt, it would generally not matter when solvency is determined. The total change in solvency would always equal the amount of debt canceled.

2. Where stock is used to cancel debt, different results are obtained depending on whether insolvency is measured immediately before or after an exchange. For example, assume a company with $400 of assets and a

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76 *See Hunt v. Comm'r*, 57 T.C.M. 919 (1989); *Davis v. Comm'r*, 69 T.C. 814 (1978); *Cole v. Comm'r*, 42 B.T.A. 1110 (1940), *non-acq.* 1941-1 C.B. 13; Priv. Ltr. Rul. 89-200-19 (Feb. 14, 1989).

77 *See Conestoga Transportation Co. v. Comm'r*, 17 T.C. 506 (1951) (taking into account going concern value and reserves for contingencies); *J.A. Maurer, Inc. v. Comm'r*, 30 T.C. 1273 (1958). *But see* Priv. Ltr. Rul. 83-480-01 (Aug. 18, 1983) (Issue 6).

78 *Merkel v. Comm'r*, 109 T.C. 463 (1997), *aff'd*, 192 F.3d 844 (9th Cir. 1999).

79 *See, e.g.*, Gordon D. Henderson & Stuart J. Goldring, *Tax Planning for Troubled Corporation* § 404 (2003); Robert D. Blashek, *Tax Planning for Financially Distressed Companies*, 43 U.S.C. Major Tax Planning ¶ 101.2 (1991) (arguing that the tax liability should not be included).

80 *See Wyman-Gordon Co. v. Comm'r*, 89 T.C. 207 (1987) (applying section 108 on a separate company basis).

81 *See Lakeland Grocery Co. v. Comm'r*, 36 B.T.A. 289 (1937); Treas. Reg. § 1.61-12(b).

$1,000 debt cancels the debt by issuing creditors 100% of the stock of the company. The company would be considered insolvent before the discharge by $600 and would have discharged $600 of debt. By reason of the issuance of stock with a fair market value of $400 for $1,000 debt the company becomes solvent to the extent of $400. Pursuant to section 108(d)(3), all $600 of debt discharge should be excluded from gross income under section 108(a), notwithstanding the $400 solvency amount after the exchange, because the company was insolvent by $600 immediately before the discharge. Under prior law, the company would recognize $400 of COD income.

C. **<u>Attribute Reduction</u>**. Taxpayers that exclude COD amounts from gross income because they are either insolvent or bankrupt are required to reduce their tax attributes in the following order:[82]

1. <u>NOLs</u> NOLs from the taxable year of discharge are reduced first, dollar for dollar, followed by NOL carryovers in the order in which they arose.[83] The NOL reduction is applied without regard to any other limitation on their use, *e.g.*, section 382. The impact of an NOL reduction is less for companies whose NOLs carryforwards are subject to a section 382(b) use limitation.

2. <u>General Business Credits</u> General business credits are reduced, 33 1/3 cents on the dollar, in the order they would be used against taxable income.[84]

3. <u>Alternative Minimum Tax Credits</u> Payments of alternative minimum tax that are available as carryovers from the year of the debt discharge as credits against future regular tax are reduced, 33 1/3 cents on the dollar.

4. <u>Capital Loss Carryovers</u> Capital loss carryovers are reduced, dollar for dollar, first from the year of discharge and then in the order in which they arose.[85]

5. <u>Basis of Assets</u> The bases of both depreciable and nondepreciable assets are reduced dollar for dollar.[86]

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82 For a discussion of timing of attribute reduction, see 1997 F.S.A. LEXIS 356 (Feb. 28, 1997), which rules that the date of discharge in a bankruptcy proceeding, for the purpose of determining in which year tax attributes ought to be reduced by the taxpayer under section 108(b), is the effective date of the court's order, if the amount of the discharge can be determined at that time.

83 I.R.C. §§ 108(b)(2)(A), (b)(3)(A), (b)(4)(B).

84 I.R.C. §§ 108(b)(2)(B), (b)(3)(B), (b)(4)(C).

85 I.R.C. §§ 108(b)(2)(C), (b)(3)(A), (b)(4)(B).

86 I.R.C. §§ 108(b)(2)(D), (b)(3)(A).

6. <u>Passive Activity Losses and Credits</u> Carryovers of passive activity loss deductions and credits that have been suspended under the passive activity loss rules are reduced, 33 1/3 cents on the dollar.

7. <u>Foreign Tax Credits</u> Foreign tax credit carryovers to or from the taxable year of discharge are reduced, 33 1/3 cents on the dollar, in the order in which they arose.[87]

8. <u>Attribute Reduction—Depreciable Basis Election</u> Taxpayers may elect to reduce the basis of depreciable property in lieu of the foregoing attribute reduction.[88] For purposes of section 108(b)(5), a taxpayer may elect to treat real property held for sale to customers in the ordinary course of business as depreciable property.[89] The taxpayer may select the depreciable assets whose basis will be reduced.[90]

    a. The general attribute reduction rules of section 108(b)(2) require basis reduction to both depreciable and non-depreciable assets but do not require the basis of assets to be reduced below the aggregate amount of liabilities immediately after the discharge.[91] Under section 108(b)(5), basis reduction applies only to depreciable assets, but their basis may be reduced to zero.[92]

    b. Under section 108(b)(2) basis reduction, subsidiaries of a debtor need not reduce their basis in assets; only the taxpayer's basis in the stock of subsidiaries should be reduced. As a practical matter, reducing basis in the stock of a subsidiary may not significantly impact on projected cash flows. It may also be possible to eliminate any negative effect of reducing basis in subsidiary stock by liquidating the subsidiary under section 332.

    c. When section 108(b)(5) is elected, the stock of consolidated subsidiaries held by the corporation is treated as a depreciable asset to the extent that the subsidiaries consent to a corresponding reduction in the basis of their depreciable property.[93]

9. Basis reductions under either section 108(b)(2) or (b)(5) are treated as depreciation deductions and the property whose basis is reduced is treated

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[87] I.R.C. §§ 108(b)(2)(E), (b)(3)(B), (b)(4)(C).

[88] I.R.C. § 108(b)(5).

[89] I.R.C. § 1017(b)(3)(E).

[90] *See* Priv. Ltr. Rul. 88-240-05 (Jan. 29, 1988); Priv. Ltr. Rul. 87-480-05 (June 26, 1987); Rev. Proc. 85-44, 1985-2 C.B. 504; Bruce D. Haims, *Bankruptcy as a Tax Planning Device: Workouts vs. Chapter 11*, 49 N.Y.U. Inst. on Fed. Tax'n § 23.04[l] n.47 (1991).

[91] I.R.C. § 1017(b)(2).

[92] I.R.C. § 108(b)(5)(B).

[93] I.R.C. § 1017(b)(3)(D).

as section 1245 property if it would not otherwise be treated as section 1245 or 1250 property.[94] Accordingly, subsequent dispositions of that property may give rise to section 1245 or 1250 recapture that treats all or part of the gain as ordinary income.

10. The election under section 108(b)(5) must be made on the tax return for the year of the discharge.[95] The Commissioner may excuse late filing if reasonable cause is shown.[96]

11. It is not clear whether the attribute reduction rule should be applied to a subsidiary leaving a consolidated group during the same taxable year in which another group member realizes COD income.

12. It is not clear whether attribute reduction should be made on a consolidated group basis or a separate entity basis. The Supreme Court, in *United Dominion Industries v. United States*,[97] held that when accounting for product liability losses in a consolidated group, the single-entity approach applies. The IRS has issued only one, thinly reasoned, decision since *United Dominion* that addresses whether the single-entity or separate-entity approach should apply when determining attribute reduction under 108(b).[98] However, several commentators have expressed the belief that *United Dominion* should be read narrowly. Commentators have mixed views on whether NOLs should be treated for the purposes of 108(b) using a separate-entity or single-entity approach, but all at least suggest that reduction of asset basis should be analyzed using a single-entity approach.[99]

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[94] I.R.C. § 1017(d)(1).

[95] I.R.C. § 108(d)(9).

[96] *See Carolina, Clinchfield & Ohio Ry.v. Comm'r*, 82 T.C. 888, 909 (1984), *aff'd*., 823 F.2d 33 (2d Cir. 1987).

[97] 532 U.S. 822 (2001).

[98] CCA 200149008 (Aug. 10, 2001) (stating that when analyzing reduction of attributes under 108(b), "[i]t is the Service's position that, in the case of NOLs, the reduction of attributes of the members of a consolidated group is not done on a member-by-member basis, as apparently proposed by the debtors. In the case of a consolidated group, there is only one NOL, the consolidated NOL ('CNOL')"); *see also* F.S.A. 199912007 (Mar. 26, 1999) (ruling, pre-*United Dominion*, that a consolidated group that excludes COD under section 108(a) must reduce the group's CNOL as a tax attribute, even if no portion of the CNOL is attributable to the member having the excluded income). The Chief Counsel Advice did not mention reduction of basis, and did not support its position with any analysis; it simply cited *United Dominion*. *See also* CCA 200305019 (Jan. 10, 2002) (citing *United Dominion* to support the proposition that a group's corporate equity reduction transaction-tainted ("CERT-tainted") loss under section 172(h)(1) should be applied pro rata among the portions of the CNOL apportioned to members for carryback to separate return years, notwithstanding the fact that the CERT-tainted loss was traceable to acquisition borrowing by one profitable member).

[99] *See, e.g.*, Andrew Dubroff, *Federal Income Taxation of Corporations Filing Consolidated Returns—Second Edition* § 33.06[1] (stating that even after *United Dominion*, "[t]here is little doubt that each member has its own basis in its assets, and the Supreme Court's view of NOLs does not appear to

13. Attributes are reduced after the determination of tax for the taxable year of discharge.[100] Therefore, NOLs are fully available to shelter operating income, including COD income in excess of insolvency, in the year of discharge.

V. ADDITIONAL MISCELLANEOUS EXCEPTIONS TO COD INCOME. Since the bankruptcy and insolvency exceptions to COD income exact costs in the form of reduction of tax attributes, it may be advantageous for a debtor to qualify under other exceptions to COD income.

A. Section 108(e)(2). No COD income is realized from the discharge of a liability to the extent payment of the liability would have given rise to a deduction.[101]

B. Section 111. Under the tax benefit rule, gross income does not include income attributable to the recovery during the taxable year of any amount deducted in a prior year to the extent the deduction did not produce a tax benefit.[102] Therefore, cancellation of a previously deducted accrued expense that produced no tax benefit will not produce COD income. The benefit of this exception is limited because the increase of a carryover is treated as a tax benefit. Section 111(c).

C. Section 108(e)(5). Where purchase money debt is reduced, the reduction will be treated by the purchaser and seller as a purchase price adjustment rather than COD.[103] However, this exception is only available where the purchaser is neither

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alter the generally accepted separate entity approach to the reduction of asset basis (except as otherwise provided in section 1017(b)(3)(D)) …. section 108(b) policy can be protected by treating the Supreme Court's observations as compelling reduction of only the debtor member's contribution to the CNOL"); Jared Gordon, *Unbaking the Consolidated Cake: Deciphering the Impact of United Dominion*, J. Corp. Tax'n, Nov./Dec. 2001 (arguing that *United Dominion* should be read narrowly); Deborah Paul, *United Dominion: Implications for Attribute Reduction*, 95 Tax Notes 262 (Apr. 8, 2002) (stating that "even if United Dominion stands for the proposition that there is no concept of separate entity net operating loss, there is a concept of a separate entity's basis in its assets, a reason that the case should not result in a single-entity approach to property basis reduction," but noting some inconsistency in "applying attribute reduction on a single-entity basis when net operating losses are involved and on a separate-entity basis when basis in involved. If it is not relevant which entity generated a net operating loss, which should it be relevant which entity generated basis?"); Lee Sheppard, *News Analysis—Consolidated Returns, The Courts, and Insolvent Subsidiaries*, 22 Ins. Tax Rev. 492, 495 (2002) (stating that a panel at the January 22, 2002, New York State Bar Association meeting "concurred that [*United Dominion*] means that attribute reduction under section 108(b) should be groupwide, that is, treating the group as a single entity, and should not only concern the member whose debt has been discharged," but that Eric Solomon, Treasury Deputy Secretary for Regulatory Affairs, said that even given *United Dominion*, "[i]f the question was reduction in asset basis, required by section 108(b)(2)(E), reduction must be made on a separate entity basis . . . because asset basis is not available to all members of the group").

[100] I.R.C. § 108(b)(4)(A).

[101] I.R.C. § 108(e)(2).

[102] I.R.C. § 111. The tax benefit rule is applied before section 108. *See* Rev. Rul. 70-406, 1970-2 C.B. 16; Rev. Rul. 67-200, 1967-1 C.B. 15.

[103] I.R.C. § 108(e)(5).

insolvent nor in Title 11. This exception does not apply where the debt has been transferred by the seller to a third party or the property has been transferred by the purchaser to a third party.[104] It is unclear whether the purchase price exception applies if either the property or debt is transferred in a nonrecognition transaction.[105]

1. It is unclear how the purchase price exception applies where an insolvent corporation, prior to discharge of indebtedness, discharges both purchase money and non-purchase money debt and is thereby rendered solvent. Is the purchase money debt deemed discharged first, last or pro-rata?[106]

D. **Section 108(e)(6)**. If a shareholder contributes debt of a corporation to the corporation, the corporation is treated as having satisfied the debt with an amount of money equal to the shareholder's adjusted basis in the debt.[107] Accordingly, the corporation realizes no COD income if the creditor's adjusted basis equals the adjusted issue price of the contributed debt. The provision applies only where the shareholder cancels the debt in his capacity as a shareholder.[108]

When a corporation wishes to forgive a wholly owned subsidiary's debt and the corporation and its subsidiary are members of a consolidated group, it is unclear whether final regulation section 1.1502-13(g)(3), proposed regulation section 1.1502-13(g)(3), or section 108(e)(6) will apply.

1. Final Section 1.1502-13(g)(3) Section 1.1502-13(g)(3) provides that if a member realizes an amount other than zero from the extinguishment of its rights or obligations under an intercompany obligation, the obligation is treated as satisfied immediately before cancellation with an amount of money equal to the fair market value of the debt, and subsequently reissued.

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[104] *See* Bankruptcy Tax Act of 1980, 5. Rep. No. 1035, 96th Cong., 2d Sess. 16 (1980); H.R. Rep. No. 833, 96th Cong., 2d Sess. 13 (1980).

[105] *See* F.S.A. 1998-421 (Jul. 15, 1993) (advising, where the original purchaser of the property was merged into a different corporation in a tax-free reorganization to which section 381 applied, that the successor corporation should be treated as the original purchaser); Priv. Ltr. Rul. 90-370-33 (Jun. 18, 1990) (determining, where purchaser of stock transferred the stock to a holding company in a section 351 transaction, that the holding company was the purchaser in a later reduction of the purchase money debt). For a discussion of the letter ruling and the purchase price exception, see Linda Weindruch & David Brown, *Scope of Purchase Price Exception to COD Income Questioned in New Ruling*, 74 J. Tax'n 302 (1991).

[106] *See* Gordon D. Henderson & Stuart J. Goldring, *Tax Planning for Troubled Corporations* § 404.1.3 (2003).

[107] I.R.C. § 108(e)(6); *see also* F.S.A. 1999-15-005 (Apr. 16, 1999) (ruling that under section 108(e)(6), where a shareholder cancels the debt of its parent corporation, the shareholder is treated as making a capital contribution to the extent that the cancellation enhances the value of the shareholder's stock, and that section 108(a) excludes COD income from gross income to the extent the corporation was insolvent at the time of cancellation).

[108] *See* Bankruptcy Tax Act of 1980, S. Rep. No. 1035, 96th Cong., 2d Sess. 19 n.22 (1980).

Under the final regulation, the subsidiary would realize cancellation of indebtedness income ("COD") equal to the excess of the amount of the debt over the deemed satisfaction amount. The deemed satisfaction would not result in any net item being reflected in the consolidated taxable income, however, because the subsidiary's gain would be offset by the parent's corresponding loss.

The realization of COD would effectively move NOLs from the subsidiary to the parent, since the taxable income of each group member is computed on a separate entity basis. The subsidiary's COD would thus be offset by the subsidiary's NOLs, and the parent would recognize a corresponding loss from the deemed satisfaction transaction.

If the final regulation applies, the parent's basis will be increased by the sum of the amount of COD realized by the subsidiary and the fair market value of the debt.

2. <u>Proposed Section 1.1502-13(g)</u> The proposed regulation differs from the current, final regulation in that under the proposed regulation, as long as there is adequately stated interest on the debt, the deemed satisfaction amount would be the principal amount of the contributed debt. Consequently, as long as there is adequately stated interest on the debt, no COD would be realized.

   If the proposed regulation applies, the parent's basis in the subsidiary's stock would be increased by the parent's basis in the contributed debt.

3. <u>Section 108</u> As discussed above, section 108(e)(6) provides that a debtor corporation whose shareholder contributes its debt to capital is treated as satisfying its debt with an amount of money equal to the shareholder's basis in the debt. In the case of the forgiveness of an actual loan by the shareholder to the corporation, section 108(e)(6) results in COD only to the extent of accrued interest, because the shareholder has a basis in the debt equal to the outstanding balance of funds advanced.

   If section 108(e)(6) applies, the parent's basis in the subsidiary's stock would be increased by the parent's basis in the contributed debt.

   Section 108(e)(2) provides that no COD is realized to the extent that the payment of the debt would have given rise to a deduction. When a parent company forgives the debt of its subsidiary, including unpaid accrued interest, section 108(e)(2) applies to preclude the subsidiary from recognizing COD with respect to the discharge of its interest obligation to the extent payment of the interest would have given rise to a deduction.

4. <u>Choice of Appropriate Section</u> If the IRS argues that section 1.1502-13(g)(3) applies, rather than section 108(e)(6), a strong argument can be made that the proposed regulation, rather than the final regulation, should apply. Specifically, the preamble to the proposed regulation states that "[f]or the purposes of determining the tax treatment

> of transaction undertaken prior to [the] effective date [of the proposed regulation], taxpayers may rely on the form and timing of the recast transaction, as clarified by these proposed regulations."

E. **Acquisition of Debt by Related Persons**. In 1980, Congress enacted section 108(e)(4) to prevent a debtor from avoiding COD income by causing a related party to reacquire the debtor's outstanding debt.[109] Under section 108(e)(4)(A), a debtor is deemed to acquire its debt if a person related to the debtor[110] acquires the debt from a third party. Section 1.108-2 provides rules that apply the provision to direct acquisitions by related parties and to holders of debt that become related to the debtor.[111]

VI. WORTHLESS DEBTS OR SECURITIES.

A. **Section 165**. If a debt evidenced by a security becomes wholly worthless during a taxable year, section 165(g) provides that such a loss shall be treated as a loss from the sale or exchange of a capital asset.[112] A "security" for the purposes of

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[109] Prior to the legislative change, where the related purchaser did not act as a conduit or agent for the debtor, no COD was triggered when the debt was acquired by a person related to the debtor. *See Peter Pan Seafoods, Inc. v. United States*, 417 F.2d 670 (9th Cir. 1969); *Forrester v. Commissioner*, 4 T.C. 907 (1945), *acq*. 1945 C.B. 3.

[110] Whether a party is related to the debtor is determined under either section 267(b) or section 707(b)(1). Section 108(e)(4)(B) provides special family attribution rules in lieu of the regular section 267(c)(4) family attribution rules. Members of a section 1563 controlled group of corporations and other entities treated pursuant to section 414(b) or (c) as under common control for purposes of section 401 are also related. I.R.C. § 108(e)(4)(C). The relationships described in section 707(b)(1) are (i) a partnership and a partner owning, directly or indirectly, more than a 50% capital or profits interest, and (ii) two partnerships in which the same persons own, directly or indirectly, more than a 50% capital or profits interest.

Whether a party is a member of a section 1563 controlled group is determined by reference to ownership of 50% of the vote or value of an affiliated corporation's stock. The Regulation does not specify whether or when fluctuations in the value of stock, *i.e.*, an increase in the relative value of preferred stock, should be considered in the determining related party status. Section 1563(e)(1) provides that options to acquire stock are deemed exercised for purposes of determining controlled group status. *Query*, are options to acquire stock of a related party, or the debtor, held by otherwise unrelated third parties (i) disregarded in determining related party status, or (ii) deemed exercised when a holder acquires stock of a debtor?

[111] The indirect acquisition rule means that section 108(e)(4) could apply where two parties become related because of fluctuations in value or other innocuous changes (*e.g.*, in a partnership context, the change in a profit ratio) that are not tied to debt acquisitions.

[112] I.R.C. § 165(g)(1); Treas. Reg. § 1.165-5(b), (c); *see also* Priv. Ltr. Rul. 199951011 (Sept. 17, 1999) (ruling that a parent company's two holding companies may claim a worthless securities deduction under section 165(a) on the sale of their subsidiary's assets in the course of a restructuring, because by selling all the operating assets of a business, there remains nothing to generate income which could be distributed to the shareholders, thereby foreclosing any potential value; ruling further that the holding companies' loss on the sale of the subsidiary's assets was considered an ordinary loss, because the subsidiary was affiliated with the two holding companies under section 165(g)(3)); FSA 199932011 (May 4, 1999) (ruling that to receive a deduction for worthless stock pursuant to section

section 165(g) is a share of stock in a corporation; a right to subscribe for, or receive, a share of stock in a corporation; or a note or other evidence of indebtedness issued by a corporation or government with interest coupons or in registered form.[113]

B. **Section 166**. An ordinary deduction is available under section 166 for any debt that becomes wholly or partially worthless during the tax year.[114] A deduction is not available under section 166 if the debt in question is evidenced by a security as defined in section 165(g).[115]

C. **Property Received in Satisfaction of a Debt**. Cases have traditionally held that bad debt treatment, rather than loss on a sale or exchange, prevails for the creditor when a debt is compromised and the creditor accepts property worth less than the amount of the debt in full satisfaction of the debt.[116] (In contrast, sale or

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165(g), a taxpayer must establish that the security had no current liquidation value at the end of the year and that it had no potential value, and that if the stock is worthless section 1.1502-80(c), which delays a worthless stock deduction until the stock is deemed disposed of, would not preclude the parent company from taking a worthless stock deduction); 1997 F.S.A. LEXIS 356 (Feb. 28, 1997) (ruling that only when a corporation in a Chapter 11 bankruptcy actually liquidates, rather than continues to seek a reorganization, should a worthless security loss under section 165(g) be allowed); 1997 F.S.A. LEXIS 151 (June 30, 1997) (ruling that an appropriate standard for determining whether stock has become worthless for purposes of section 165 is whether the stock currently has no liquidating value and also whether the stock may acquire value in the future through foreseeable operations of the corporation);

113 I.R.C. § 165(g)(2). A note is in "registered form" if it is transferable on the books of the corporation. *See, e.g.*, *Graham v. Comm'r*, 304 F.2d 707 (2d Cir. 1962) (holding, under a precursor of 165, that "[t]o be in 'registered form' the obligation must be transferable only by entry on the books or records of the debtor or its agent"); *Funk v. Comm'r*, 35 T.C. 42 (1960).

114 I.R.C. §§ 166(a)(1) (wholly worthless debts), 166(a)(2) (partially worthless debts); *see also* Priv. Ltr. Rul. 2001-01-001 (Jan. 5, 2001) (ruling that unsecured debt discharged in a bankruptcy proceeding may give rise to a bad debt deduction under section 166); F.S.A. 2001-29-003 (Apr. 7, 2001) (ruling that section 166 allows for a partial bad debt deduction so long as the taxpayer has established a currently recognizable loss based on partial worthlessness, and that the evidentiary rules of section 166 apply equally to the determination of worthlessness of section 595 property subsequent to foreclosure); T.A.M. 2001-20-001 (July 28, 2000) (ruling that under the section 166 regulations, a taxpayer must consider all pertinent evidence, including the value of any collateral and the financial condition of the obligor, when determining whether a specific debt is worthless in whole or in part); 1997 F.S.A. LEXIS 636 (Sept. 2, 1997) (ruling that in the case of forgiveness of indebtedness by a parent corporation of its subsidiary-member, to properly claim a section 166 loss, the parent must prove that the subsidiary-member was insolvent and that the debt was not discharged with respect to the parent's stock investment in order to improve the financial condition of the subsidiary-member contemplating further operation and prosperity).

115 Section 166(e) specifically states that section 166 "shall not apply to a debt evidenced by a security as defined in section 165(g)(2)(c)."

116 *See, e.g.*, *Comm'r v. Spreckels*, 120 F.2d 517 (9th Cir. 1941); *Bingham v. Comm'r*, 105 F.2d 971 (2d Cir. 1939); *McFadden v. Comm'r*, 84 T.C.M. (CCH) 6 (2002); *Henry v. United States*, 180 F. Supp. 597 (Ct. Cl. 1960); David C. Garlock, *Federal Income Taxation of Debt Instruments* ¶ 13.06[E]; Stanley I. Langbein, *Federal Income Taxation of Banks and Financial Institutions* ¶ 4.04[3][a]; Gerald J. Robinson, *Federal Income Taxation of Real Estate* ¶ 10.07; Am. Jur. 2d ¶ 17203; *see also*

exchange treatment prevails for the debtor.[117]) However, section 1271(a) provides that amounts received by the holder on retirement of a debt instrument constitute amount received in exchange for the debt instrument. Thus it is possible that the I.R.S. would try to characterize the amount received by the creditor in satisfaction of a debt instrument as an amount received in exchange for the debt instrument, and thus that the loss on the debt would be a capital loss under section 165, and not an ordinary loss under section 166.[118]

VII. TRUST FUND AND PERSONAL LIABILITY TAXES

A. **Scope of Taxes**. Whenever a taxpayer is required to collect or withhold any tax from any person and pay over such tax to the United States, the amount of tax collected or withheld is held in a special fund in trust for the United States (such taxes, "trust fund taxes").[119] Section 6672 imposes a penalty equal to 100% of any such tax on responsible persons who "willfully" fail to collect, account for or pay over such tax.[120] Many state sales, use and similar taxes and certain foreign taxes also impose personal liability on officers and directors for taxes required to be collected and paid over to the state and in some cases, taxes directly imposed

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Nat'l-Standard Co. v. Comm'r, 749 F.2d 369 (6th Cir. 1984) (citing, among others, *Spreckels* and *Bingham* for the proposition that payment or discharge of an obligation is not a sale or exchange for the creditor); 1998 FSA LEXIS 581 (Nov. 13, 1998) (ruling that where property is transferred in lieu of foreclosure, the transaction is bifurcated into the section 1012 cost basis amount and the section 166 bad-debt deduction amount, and the creditor receives a cost basis amount in the property equal to the property's fair market value and a bad-debt deduction equal to the uncollectible difference between the unpaid balance and the property's fair market value).

Early cases held that if a lender accepts less than full payment of a debt and cancels the balance, the loss on the cancelled debt may be governed by section 165. *See, e.g.*, *Thorman v. Comm'r*, 8 T.C.M. (CCH) 653 (1949) (finding a loss rather than a bad debt where the lender accepted partial payment in full settlement of a debt); *First Nat'l Bank v. Comm'r*, 6 BTA 545 (1927) (finding a loss rather than a bad debt when a third party posted security for part of a debt owed to the lender, who cancelled the balance as uncollectible). However, the reasoning of these cases has not been adopted by later courts, and some courts have explicitly rejected these cases' holdings. *See, e.g.*, *Henry v. United States*, 180 F. Supp. 597 (Ct. Cl. 1960) (stating that it is "not in agreement" with various cases, including *National Bank*, that find sale or exchange treatment upon the satisfaction of debt by the transfer of mortgaged property); *see also Comm'r v. Spreckels*, 120 F.2d 517 (9th Cir. 1941); *Bingham v. Comm'r*, 105 F.2d 971 (2d Cir. 1939); *McFadden v. Comm'r*, 84 T.C.M. (CCH) 6 (2002).

117 *See, e.g.*, *Rogers v. Comm'r*, 103 F.3d 790 (9th Cir. 1939); *Phillips v. Comm'r*, 112 F.2d 721 (3d Cir. 1940); GCM 39294 (Oct. 5, 1984).

118 I.R.C. § 1271(a)(1) (stating that amounts received by the holder on retirement of any debt instruments are considered amounts received in exchange therefor). Section 1271(a)(1) may apply notwithstanding the cases cited above in note 115 because those cases either (i) were decided before section 1271(a)(1) became effective in its current form or (ii) do not involve facts that would trigger the application of section 1271(a)(1). (For example, section 1271(a)(1) does not apply to debts issued by natural persons before June 9, 1997; just such a debt was at issue in *McFadden v. Comm'r*, 84 T.C.M. (CCH) 6 (2002).)

119 I.R.C. § 7501.

120 I.R.C. § 6672. Responsible persons include officers, directors and employees of a company with sufficient authority to direct payment of the tax, whether or not they exercise that control directly.

on a debtor. Generally, real and personal property taxes and federal and state income taxes are not trust fund or personal liability taxes. Courts have broadly defined what constitutes a "willful" failure to collect and pay over trust taxes. The clear weight of authority indicates that the willfulness requirement of section 6672 is not negated where the failure to pay taxes is due to reasonable cause.[121] Some courts have, however, added the element of reasonable cause to section 6672 by making acting "without reasonable cause" part of the willfulness requirement of the statute.[122] In such cases, even an intentional failure by a responsible person to remit trust fund taxes to the government may not be considered willful if there is a reasonable cause not to remit taxes, such as the reliance on advice of counsel, accountants or the IRS.[123] Absent factors evidencing significant good faith attempts by a responsible person to determine whether withholding taxes are actually due, the failure to remit taxes based upon a mistaken belief that the taxes are not due will not avoid section 6672 liability. However, the IRS has said that it will not recommend asserting the trust fund recovery penalty against responsible persons for failure to collect, account for, and pay over trust fund taxes, where bankruptcy plans have been approved and are adhered to by the taxpayers.[124]

Other courts have limited the reasonable cause defense in the context of section 6672 to those circumstances where (i) the taxpayer's reasonable efforts to protect the trust funds were frustrated by circumstances outside the taxpayer's control, or (ii) where the taxpayer was operating under a reasonable belief that the

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[121] *See, e.g.*, *Muck v. United States*, 3 F.3d 1378 (10th Cir. 1993) (rejecting the reasonable cause defense because bad motive is not relevant under section 6672); *Olsen v. United States*, 952 F.2d 236 (8th Cir. 1991); *Hochstein v. United States*, 900 F.2d 543 (2d Cir. 1990) (holding that a good-faith belief is no defense to willfulness); *Sorenson v. United States*, 521 F.2d 325 (9th Cir. 1975) (holding that having inadequate funds to pay trust fund taxes is not a defense); *Harrington v. United States*, 504 F.2d 1306 (1st Cir. 1974); *Pac. Nat'l. Ins. Co. v. United States*, 422 F.2d 26 (9th Cir. 1970); *Monday v. United States*, 421 F.2d 1210 (7th Cir. 1970); *United States v. Strebler*, 313 F.2d 402 (8th Cir. 1963); *Bloom v. United States*, 272 F.2d 215 (9th Cir. 1959); *Katz v. United States*, 92-2 USTC ¶ 50, 615 (E.D. Pa. 1992) (holding that the Third Circuit does not recognize the reasonable cause defense); *Peterson v. United States*, 758 F. Supp. 1209 (N.D. Ill. 1990); *Alioto v. United States*, 593 F. Supp. 1402 (N.D. Cal. 1984); *McCarty v. United States*, 437 F.2d 961 (Ct. Cl. 1971).

[122] *See Newsome v. United States*, 431 F.2d 742 (5th Cir. 1970).

[123] *See Gray Line Co. v. Granquist*, 237 F.2d 390 (9th Cir. 1956) (imposing no penalty where taxpayer relies on advice of counsel and IRS agent); *Crowd Mgmt. Servs. v. United States*, 889 F. Supp. 1313 (D. Or. 1995) (imposing no penalty under section 6672 where the taxpayer relies on an attorney and accountants). The Ninth Circuit has since distinguished *Gray Line* from later holdings regarding reasonable cause based on the taxpayer's good faith reliance on advice of counsel in *Gray Line*. *See Pac. Nat'l Ins. Co. v. United States*, 422 F.2d 26, 33 n.19 (9th Cir. 1970); *see also Stouffer v. United States*, 98-2 USTC ¶ 50, 715 (D. Colo. 1998) (finding no reasonable cause for the taxpayer's failure to remit taxes where the responsible person allegedly relied on an IRS agent's statement that he needed only to remain current with present tax obligations and that "they would worry about the past-due taxes later").

[124] *See* IRS Policy Statement P-5-60.

taxes were being paid.[125] The Second Circuit has stated that it recognizes a reasonable cause exception to section 6672 with respect to responsible persons. Even where the reasonable cause defense has been adopted, however, the courts have recognized that in order to further the basic purposes of section 6672, reasonable cause must be narrowly defined.[126] Thus, in the typical scenario, it is unlikely that the attendant facts and circumstances will constitute reasonable cause and so negate the element of willfulness.[127]

B. **<u>Prepaying Trust Fund Taxes</u>**. Taxpayers anticipating a bankruptcy filing may avoid the risk that trust fund taxes may be imposed on responsible persons by pre-paying such taxes before the filing date. The Supreme Court has ruled that pre-payments to a taxing authority of trust fund taxes do not constitute illegal preferences under the Bankruptcy Code and may not be recovered by other creditors, since the money is held in trust for the IRS.[128] For bankruptcy law purposes, a trust is created upon the mere act of collecting or withholding taxes. To exclude trust fund taxes from the bankruptcy estate, there must be shown some connection between the trust and the assets sought to be applied to a debtor's trust fund tax obligation."[129] While common-law requires the identification of particular trust property for a trust to be created, the trust created by withholding or collecting funds for a taxing authority is more generally created as to the "amount" collected or withheld rather than particular property, *e.g.*, actual monies

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[125] *Wintor v. United States*, 196 F.3d 339 (2d Cir. 1999) (citing *United States v. Rem*, 38 F.3d 634, 643 (2d Cir. 1994)) (overturning summary judgment for the government when the responsible person had a reasonable belief that the employer had withholding tax overpayments for prior quarters and claimed as credits for later quarters); *Finley v. United States*, 123 F.3d 1342 (10th Cir. 1997) (permitting the reasonable cause defense when the taxpayer made efforts to protect trust fund taxes); *Howell v. United States,* 164 F.3d 523 (10th Cir. 1998) (following *Finley* where taxpayer attempted to protect trust fund taxes but others improperly seized control of the corporation and made payments to different parties); *cf. Kalb v. United States*, 505 F.2d 506 (2d Cir. 1974) (refusing to apply the reasonable cause exception when the employer did not have power to direct the IRS to apply an income tax overpayment to withholding taxes and IRS never agreed that it would do so).

[126] *See Newsome v. United States*, 431 F.2d 742 (5th Cir. 1970).

[127] *See, e.g.*, *Bowen v. United States*, 836 F.2d 965 (5th Cir. 1988) (finding that reliance on a banker that a loan would be forthcoming did not constitute reasonable cause); *Mazo v. United States*, 591 F.2d 1151 (5th Cir. 1979) (same, for the delegation of authority); *Newsome v. United States*, 431 F.2d 742 (5th Cir. 1970) (same, for reliance on the advice of an attorney and an accountant); *Cash v. Campbell*, 346 F.2d 670 (5th Cir. 1965) (same, for the assumption that the government would satisfy its tax claim out of another fund); *Martin v. United States*, 636 F. Supp. 139 (N.D. Ohio 1986) (same, for the one-week hospitalization of the responsible person); *see also White v. United States*, 372 F.2d 513 (Ct. Cl.1967) (holding that the reasonable cause defense is limited to unusual situations such as those in *Gray Line*).

[128] *Begier v. IRS*, 496 U.S. 53 (1990). By contrast, the Court ruled that a bankruptcy trustee can recover any payments that were made from the general accounts and that can not be traced.

[129] *Begier v. IRS*, 496 U.S. 53, 66 (1990). However, courts have refused to expand *Begier* to apply to involuntary pre-petition payments. *See, e.g.*, *In re TCB Carpet Servs.*, 86 AFTR 2d 2000-6670 (N.D. Ill. 2000) (refusing to find a nexus when the pre-petition payment of trust fund taxes was prompted by a levy, and reasoning that to rule otherwise would "render the nexus requirement meaningless").

collected or withheld.[130] Whether a trust is created upon the collection or withholding of funds or the specific identification of property depends on the statute that gives rise to such obligation. A taxpayer may wish to further insulate itself from liability by establishing and funding segregated accounts and making pre-payments of trust fund taxes from such accounts.

In the case of pre-petition trust fund taxes not paid prior to the commencement of a bankruptcy proceeding, the Third Circuit has concluded that a trust was established at the time the debtor withheld such taxes.[131] However, if amounts attributable to trust fund taxes are in commingled accounts, it may be difficult to demonstrate the requisite connection. Whether such a connection exists is a question of fact that is determined on a case-by-case basis.[132] The Third Circuit suggested that while not necessarily the only method of identifying trust fund taxes, the "lowest intermediate balance test" (the "LIBT") would constitute a "reasonable assumption" under which a governmental agency can show that the debtor still possesses the funds on the petition date.[133] While courts seem to suggest that segregation alone would establish the requisite nexus, an argument could be made that such segregated funds must also satisfy the LIBT. In other words, if at all times, the debtor's combined accounts did not have a net balance greater than the trust fund taxes due, a subsequent segregation may be of no consequence, at least to the extent of the deficiency. Conversely, even if a debtor did not segregate pre-petition, it may still be able to pay trust fund taxes

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130 *Begier v. IRS*, 496 U.S. 53, 62 (1990).

131 *City of Farrell v. Sharon Steel Corp.*, 41 F.3d 92 (3rd Cir. 1994). In reaching its decision, the Third Circuit gave significant weight to the Supreme Court's observation in *Begier* that, if segregation was required, a debtor could avoid the creation of a trust and its accompanying responsibilities as a trustee by refusing to segregate trust fund taxes. *See also In re Russman's, Inc.*, 125 B.R. 520 (Bankr. E.D. Tenn. 1991) (describing the actions of a trustee operating the debtor's business post-petition and stating that "[t]his court, on the strength of *Begier*, has no reservation in concluding that the trustee's voluntary segregation of trust fund retail sales taxes out of the general operating account serves to establish the required nexus between the amount held in trust and the funds paid"). *But see In re Spirit Holding Co.*, 166 B.R. 367 (Bankr. E.D. Mo. 1993) (denying a motion for authority to pay pre-petition sales taxes, based in part on the debtor's failure to "place the taxes collected into a segregated account, or do anything else indicative of the existence of a nexus between the funds they seek to surrender").

132 *See City of Farrell v. Sharon Steel*, 41 F.3d 92 (3rd Cir. 1994).

133 *See In re Edison Bros.*, 243 B.R. 231 (Bankr. D. Del. 2000) (stating, in deciding whether constructive trust funds held in commingled accounts were property of the estate that, although not the only way, "using the lowest intermediate balance test will satisfy the nexus requirement"); *In re Megafoods Stores*, 163 F.3d 1063 (9th Cir. 1998) (affirming the lower court's ruling that the state comptroller satisfied its burden of establishing a nexus between funds in the debtor's commingled accounts and sales tax trust funds by use of the LIBT); *In re Al Copeland Enter.*, 133 B.R. 837 (Bankr. W.D. Tex. 1991) (determining whether Texas met its burden of establishing a nexus between the debtors commingled funds and sales taxes collected and finding that the lowest intermediate balance rule has been satisfied).

post-petition from its commingled accounts to the extent such funds satisfy the LIBT.[134]

VIII. TAX PROCEDURE IN BANKRUPTCY.

A. **Priority of Claims**. Under section 507(a)(8)(A)(iii) of the Bankruptcy Code, taxes that are still assessable (including by reason of extending a relevant statute of limitations) but are not yet assessed are considered eighth-priority claims. An "assessable" tax includes taxes for a period in which the statute had been extended by operation of law. In addition, a tax can be assessable by agreement when a taxpayer moves a court for approval of a settlement with the taxing authority. Case law appears to support the position that a claim would be eighth priority if the statute had been extended by an agreement with the taxing authorities.

B. **Tax Liens and Priority**. A tax lien is not effective against third parties until proper notice has been filed.[135] Such notice must be filed in the county where the real property resides, or in the case of personal property, in the county where the taxpayer resides. Although a tax lien is effective against the taxpayer without recordation, the IRS is required to give notice and make demand for payment within 60 days of the assessment.[136] If notice has been properly filed before the petition date, the IRS will be treated as a secured creditor to the extent of the value of the property to which the lien attaches.[137] If the notice has not been filed before the date of the petition, the IRS will be treated as an unsecured creditor. Once a tax lien is attached to property of the debtor, the priority of competing liens is determined under federal law. Federal law provides, subject to certain exceptions, that the first lien recorded has the highest priority.

Even after proper recordation of a tax lien, the following items are granted priority over the tax lien: (1) interest of purchasers of securities who are without actual notice of the tax lien; (2) interest of purchasers of motor vehicles who are without actual notice of the tax lien and who have retained possession of the motor vehicle; (3) interest of purchasers of personal property purchased at retail in the ordinary course of seller's business; (4) interest of purchasers of household goods and personal effects purchased in a casual sale for less than $250 without knowledge of the lien; (5) personal property subject to a possessory lien under local law for repair and improvement; (6) certain personal property taxes; (7) residential property subject to a mechanic's lien to the extent of $1000; (8) attorneys' liens for reasonable compensation for obtaining judgment; (9) certain insurance contracts; and (10) passbook loans.

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[134] Leave from the court may be required in this situation.

[135] I.R.C. § 6323.

[136] I.R.C. § 6303.

[137] Myron M. Sheinfeld et al., *Collier on Bankruptcy Taxation* ¶ 4.04[1], at 4-49 (2002).

C. **Immediate Implications of Bankruptcy Filings**. Upon the filing of bankruptcy, all creditors, including the IRS, are enjoined or stayed from taking action or continuing action to collect their claims or enforce their liens against the property of the debtor.[138] The stay specifically applies to "any act to collect, assess or recover a claim against the debtor that arose before the commencement" of the bankruptcy case.[139] The automatic stay also enjoins any proceedings in the Tax Court, whether ongoing or not yet instituted, to challenge an asserted deficiency of the debtor.[140] However, the IRS remains authorized to make immediate assessments of (1) a tax imposed on the bankruptcy estate, and (2) a tax imposed on the taxpayer-debtor if liability for the tax has become res judicata against the taxpayer-debtor by virtue of a bankruptcy court determination of the tax liability.[141] In addition, although the automatic stay prevents the IRS from taking administrative action to collect a tax, the stay does not prevent the IRS from issuing a statutory notice of deficiency. If a taxpayer's property is placed in receivership, the IRS is still authorized to make an immediate assessment of tax.[142]

The stay and section 6871 give the bankruptcy court the discretion to (1) lift the stay to permit the taxpayer to file a petition in the Tax Court, or (2) determine the taxpayer's liability itself (even if the case is already pending in Tax Court).[143] Section 6213(f) suspends the 90-day period for filing a Tax Court petition for the period during which the debtor is prohibited from filing a petition in the Tax Court because of the impending case and for 60 days thereafter. The statute of limitations on assessment is extended for the same period.[144] The period for collection is suspended for the stay period plus 6 months. If a notice of deficiency was issued before bankruptcy commenced, the unexpired portion of the 90-day period for filing the Tax Court petition is carried over and added onto the 60-day period to determine the last day for filing a timely petition.[145]

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[138] 11 U.S.C. § 362(a).

[139] 11 U.S.C. § 362(a)(6).

[140] 11 U.S.C. § 362(a)(8).

[141] I.R.C. § 6871(b).

[142] I.R.C. § 6871(a); *see also* F.S.A. 2002-03-007 (Sept. 28, 2001) (ruling that a bankruptcy petition does not prohibit the making of a tax assessment, but that the assessment period for the tax liability of the debtor is suspended pursuant to section 6503(a)(1) if a timely notice of deficiency is issued during the bankruptcy case; the assessment period will be suspended for the nondebtor subsidiaries under section 6503(a)(2) to the same extent that the assessment period is suspended for the debtor); F.S.A. 200127008 (Mar. 30, 2001) (ruling that when the common parent of a consolidated group is in bankruptcy, the period of limitations on assessment for the parent as well as nonbankrupt members of the group is suspended with the issuance of a notice of deficiency, and that the bankruptcy proceedings do not affect the validity of consents to extend periods of assessment nor the powers of attorney given to sign such consents).

[143] I.R.C. § 6871(e).

[144] I.R.C. § 6503(i).

[145] *McClamma v. Comm'r*, 76 T.C. 754 (1981).

If a receiver is appointed for a taxpayer, the Code does not require a notice of deficiency to be sent before an assessment is made, and unlike a jeopardy assessment, a notice of deficiency is not required within 60 days after the assessment. As a result, the taxpayer in receivership does not have the same rights as other taxpayers to contest deficiency determinations by the Tax Court.[146]

In contrast to assessments under jeopardy proceedings, the tax assessed under section 6871 is usually not collected immediately because the taxpayer's property is already under the jurisdiction of the receivership court at the time of the assessment. If the receivership is terminated and a tax claim remains unpaid, the unpaid tax may be collected immediately from the taxpayer's property subject to levy after notice and demand.[147]

D. **Judicial Review of Tax Claims in Bankruptcy**. The Tax Court and the bankruptcy court have concurrent jurisdiction to determine the taxpayer's liability for tax.[148] Unless the bankruptcy court lifts the automatic stay, a taxpayer may not file a petition in the Tax Court or continue a case already pending in Tax Court. Consequently, the bankruptcy court may decide to lift the stay to permit the taxpayer-debtor to file a petition or continue litigation of his case, or it may retain jurisdiction and decide the issue itself. However, if the taxpayer is permitted to contest a deficiency in the Tax Court, the trustee has the right to intervene.[149]

When a debtor's case is pending in Tax Court but the bankruptcy court assumes jurisdiction over the issue of tax liability, the tax claim may be presented in the bankruptcy court.[150] Two exceptions apply to the general rule of concurrent jurisdiction, (1) if at the time the bankruptcy case is commenced, the taxpayer has filed a petition in the Tax Court and the issue has been "contested before and adjudicated by" the Tax Court, the bankruptcy court has no jurisdiction to decide the matter[151] and (2) where the tax involved is one over which the Tax Court has no jurisdiction (*e.g.*, employment and excise taxes), the bankruptcy court has sole jurisdiction.

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[146] I.R.C. § 6871(c)(2).

[147] I.R.C. § 6873.

[148] 11 U.S.C. § 505(a)(1); *see* I.R.C. §§ 6871(b), (c).

[149] I.R.C. § 7464.

[150] I.R.C. § 6871(c)(1).

[151] 11 U.S.C. § 505(a)(2).