

ally not be payable at all unless the assets of the company are sufficient to pay the principal and also the interest on all of its debt in full.<sup>3</sup> A subordination agreement

(Footnote Continued)

506(b) entitles holders of nonconsensual oversecured claims—such as a tax lien or judicial lien—to receive postpetition interest, but not fees, costs, or other charges (absent an actual agreement). This is still the case for federal tax liens, whereas in bankruptcy cases filed on or after October 17, 2005 a holder of an oversecured state tax lien may collect reasonable fees, costs and other charges, to the extent permitted by state statute. See discussion at §1015. Of course, the debtor may raise traditional defenses to payment (e.g., the statute of limitations and estoppel). See *In re Lapiana*, 909 F.2d 221, 90-2 U.S.T.C. ¶50,436 (7th Cir. 1990) (also leaves open possibility for additional equitable relief depending on the circumstances). Conversely, the Supreme Court has held that an undersecured creditor is not entitled to postpetition interest on the secured portion of its claim. *United States Assoc. of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365 (1988). The First and Fifth Circuits have held that where both the value of the collateral and the amount of the creditor's claim fluctuate during the bankruptcy proceeding, the creditor is entitled to interest only for the periods during which his claim is oversecured. *The Prudential Ins. Co. of America v. SW Boston Hotel Venture, LLC* (In re SW Boston Hotel Venture, LLC), 748 F.3d 393 (1st Cir. 2014), *rev'g* 2012 Bankr. LEXIS 4662 (Bankr. 1st Cir. 2012); *In re T-H New Orleans Ltd. Partnership*, 116 F.3d 790 (5th Cir. 1997). However, where the collateral is sold during the bankruptcy case, most courts have viewed the actual sales price as the better determinant of the extent of the secured claim (regardless of prior higher or lower estimates of value) and the accrual of postpetition interest. See, e.g., *In re Urban Communicators PCS Limited Partnership*, 379 B.R. 232 (Bankr. S.D. N.Y. 2007).

The allowable rate of interest on oversecured tax claims has been a matter of some uncertainty, but is now specifically addressed in the Bankruptcy Code for bankruptcy cases commenced on or after October 17, 2005. In such cases, new Bankruptcy Code section 511(a) permits interest to accrue on oversecured tax claims at the applicable rate under nonbankruptcy law.

For bankruptcy cases commenced prior to October 17, 2005, the applicable rate of interest on oversecured claims (tax or otherwise) depends, in part, on whether there is a contractual agreement specifying the rate of interest. In the case of consensual oversecured claims (that is, claims bearing contractual interest), the courts generally give deference to the parties' agreed interest rate, but may modify the rate in appropriate circumstances. In cases of equity insolvency, imposition of higher default rates of interest are often disallowed. See, e.g., *Fischer Enters., Inc. v. Geremia* (In re Kallian), 178 B.R. 308 (Bankr. R.I. 1995) (collecting cases; disallowed higher default rate). In the case of nonconsensual oversecured claims (such as most oversecured tax claims), the cases are in conflict as to whether the applicable rate is some federal statutory rate (such as the Code §6621 rate), the federal judgment rate, or possibly a general market rate. Nevertheless, the courts generally appear to prefer the applicable non-bankruptcy statutory rate. Compare *In re Greensboro Lumber Co.*, 95-1 U.S.T.C. ¶50,259 (Bankr. M.D. Ga. 1995) (Chapter 7 case; applied Code §6621 rate); *United States v. Rhodney* (In re R&W Enterprises), 1994 Bankr. LEXIS 2248 (Bankr. N.D. Fla. 1994) (Chapter 7 case; discusses rationale for §6621 rate or, in the case of state tax claims, the applicable state underpayment rate); *Galveston Indep. Sch. Dist. v. Heartland Fed. Sav. & Loan Assn.*, 159 B.R. 198 (S.D. Tex. 1993) (applied state statutory rate under which lien arose, provided the charge could be reasonably characterized as true interest rather than a penalty); *United States Trust Co. v. LTV Steel Company, Inc.* (In re Chateaugay Corp.), 150 B.R. 529, 539-540 (Bankr. S.D. N.Y. 1993) (in dicta, stated that the rate should be determined by reference to applicable state law), *appealed and aff'd on other issues*, 170 B.R. 551 (S.D. N.Y. 1994); *with In re Wasserman*, 151 B.R. 4 (D. Mass. 1993) (Chapter 11; applied federal judgment rate); *In re Kelton*, 137 B.R. 18 (Bankr. W.D. Tex. 1992) (same); see *Goldberg v. City of New York* (In re Navis Realty, Inc.), 193 B.R. 998 (Bankr. E.D.N.Y. 1996) (Chapter 7 case, applied state statutory rate; concluded that a court should only deviate from the statutory rate where (i) the rate constitutes a penalty or (ii) equity mandates it, citing as an example *Wasserman*, *supra*, a Chapter 11 case; court found no Chapter 7 case that applied a reduced rate on equitable grounds). See also discussion at §1016.1; Note, Supreme Court Decisions in Taxation: 1988 Term—*United States v. Ron Pair Enters.*, 43 Tax Law. 475, 488-489 (1990).

<sup>3</sup> See discussion at §1006.1.2; see, e.g., Bankruptcy Code §726(a)(5); *In re Oahu Cabinets Ltd.*, 12 B.R. 160, 163 (Bankr. D. Haw. 1981) (exception to nonpayment of postpetition interest on unsecured claims where existence of surplus after all creditors are otherwise paid in full); *Thompson v. Kentucky Lumber*

will be enforced, however, even as to postpetition interest, provided the agreement unambiguously states that postpetition interest is covered.<sup>4</sup> In addition, a Chapter 11 plan approved by the creditors and stockholders may vary these results.

Two basic questions arise: (1) Will a failing company that uses the accrual method of accounting be able to continue to claim a deduction for the accruing interest? and (2) Will an accrual basis creditor be required to continue to accrue the interest into income? These are discussed in §§302-304 below.

### §302 DEDUCTION OF UNPAID INTEREST AS EXPENSE

There is authority for the proposition that the failing company may be allowed an interest deduction, even with respect to unsecured debt, for interest accruing during the bankruptcy period on debt that has contractual provisions for interest. For example, in *Zimmerman Steel Co.*,<sup>1</sup> the Eighth Circuit Court of Appeals allowed a

(Footnote Continued)

*Co.* (In re Kentucky Lumber Co.), 860 F.2d 674 (6th Cir. 1988) (unsecured creditors not entitled to postpetition interest where debtor was considered insolvent at confirmation but subsequently obtained a large unexpected settlement of a pending lawsuit); *Comm'r of Rev. v. Adcom, Inc.* (In re Adcom, Inc.), 89 B.R. 2 (D. Mass. 1988) (clearly solvent debtor required to pay postpetition interest on unsecured prepetition tax at the applicable rate under state law; according to the lower court decision the state rate was 18 percent), *rev'g* 74 B.R. 673 (Bankr. D. Mass. 1987) (the lower court had set the rate at the Code §6621 rate plus 2.5 percent, since it viewed the state rate as in the nature of a penalty). Cf. *United States v. Robinson* (In re D.C. Sullivan & Co.), 929 F.2d 1, 91-1 U.S.T.C. ¶50,156 (1st Cir. 1991), *rev'g in part* a District Court decision, *aff'g* an unpublished bankruptcy court decision (Bankruptcy Act case; where, during pendency of a bankruptcy filed more than 20 years earlier, the debtor became solvent because of trustee's recovery in a lawsuit for misappropriation of the debtor's assets, so that all creditors, both secured and unsecured, could be paid in full, postpetition interest was recoverable by IRS pursuant to Code §6621 on both lien and nonlien tax claims).

But see *In re New Valley Corp.*, 168 B.R. 73 (Bankr. D. N.J. 1994), which, in the context of a Chapter 11 bankruptcy case, held that unsecured claims that, under former Bankruptcy Code section 1124(3) were considered unimpaired due to the payment of their prepetition claim in full in cash, were not entitled to postpetition interest (despite the debtor's solvency), subject only to the requirement that the Chapter 11 plan be proposed in "good faith." Highly critical of this result, Congress repealed Bankruptcy Code section 1124(3) as part of the Bankruptcy Reform Act of 1994. See H.R. 5116, 103d Cong., 2d Sess. §213(d) (1994); H. Rep. No. 975, 108th Cong., 1st Sess. §704 (2003).

Also, in the case of a reorganizing Chapter 11 debtor, interest on a prepetition unsecured tax claim may be collectable postbankruptcy if the tax is nondischargeable (which is a fairly new concept to reorganizing corporate debtors and only applies in very narrow circumstances). See discussion of 11 U.S.C. §1141(d)(6)(B) at §1014.

<sup>4</sup> See, e.g., *Continental Ill. Nat'l Bank and Trust Co. v. First Nat'l City Bank of New York* (In re King Resources Co.), 528 F.2d 789 (10th Cir. 1976) (generic subordination to principal and interest not sufficient); *Bankers Life Co. v. Manufacturers Hanover Trust* (In re Kingsboro Mortgage Corp.), 379 F. Supp. 227 (S.D.N.Y. 1974), *aff'd*, 514 F.2d 400 (2d Cir. 1975) (similar provision); *In re Time Sales Corp.*, 491 F.2d 841 (3d Cir. 1974) (same); *In re Envirodyne Indus., Inc.*, 1993 WL 566565, \*36 (Bankr. N.D. Ill.) (enforced subordination that expressly included "interest accruing after the commencement of any [bankruptcy] proceeding . . . whether or not allowed"). Cf. *American Iron & Steel Mfg. Co. v. Seaboard Air Line Railway*, 233 US 261 (1914) (discussing exception for solvent debtors).

<sup>1</sup> §302 *Zimmerman Steel Co. v. Commissioner*, 130 F.2d 1011, 42-2 U.S.T.C. ¶9697 (8th Cir. 1942); see also *Panhandle Refining Co.*, 45 B.T.A. 651, Dec. 12,159 (1941) (nonbankruptcy case; accrual of interest on debt of wholly owned subsidiary to parent); *Butler Consolidated Coal Co.*, 6 T.C. 183 (1946) (receivership case), *acq.*, 1946-1 C.B. 1. But see *Kellogg v. United States* (In re Southwestern States



there was a material change in terms of the debt, triggering an exchange.<sup>34</sup> The split-up gave the transaction the element of a novation rather than an assumption. The result in this latter ruling would appear to have been affected, however, by Code § 1274(c)(4) (as discussed below), which provides that in certain cases the debt instrument would not be retested to determine whether it provides for adequate stated interest. It had been suggested that one factor the IRS has considered in the change-in-obligor rulings is whether the debt is backed by essentially the same assets or additional assets.<sup>35</sup>

Code § 1274(c)(4) provides that if, in connection with the sale or exchange of property, the transferee assumes (or acquires the property subject to) an existing debt instrument, the assumption (or acquisition) shall not be taken into account in determining whether Code § 483 or 1274 applies to such debt instrument, unless "the terms and conditions of such debt instrument are modified (or the nature of the transaction is changed) in connection with the assumption (or acquisition)."<sup>36</sup> In effect, Code § 1274(c)(4) appears to permit a change of obligors in connection with the transfer of property. We would question, however, whether the property transferred must be the original property to which the debt related, at least in the case of acquisition debt. If not, has the "nature of the transaction" changed? Similarly, does a novation change the "nature of the transaction"? The only example given in the legislative history of a change in the "nature of the transaction" is where the existing debt arose in a transaction that was excepted from Code § 483 and the current transaction does not qualify for the exception.<sup>37</sup> Moreover, the regulations under Code § 1274(c)(4) ignore entirely the parenthetical reference to changes in the nature of the transaction and, in determining whether the assumption rule of Code § 1274(c)(4) applies, only consider whether the terms and conditions of the debt have been modified.<sup>38</sup> According to the legislative history, "minor" modifications may be

<sup>34</sup> IRS Letter Ruling 7925065, March 22, 1979.

<sup>35</sup> See Winterer, *supra* note 23, at 514 n.30, 517-518; GCM 37844, February 2, 1979; cf. IRS Letter Ruling 8619021, February 6, 1986 (assumption of mortgage-backed bonds by a newly formed stock savings bank upon the merger of a mutual savings bank not a material change).

<sup>36</sup> This section applies to sales and exchanges occurring after June 30, 1985. In addition, proposed regulations provided transitional rules for debt assumptions in connection with sales or exchanges occurring in the first half of 1985. See 1986 Prop. Reg. § 1.1274-7(b).

<sup>37</sup> H.R. Rep. No. 87, 99th Cong., 1st Sess. 16, at n.6 (1985) (citing, as an example, Reg. § 1.483-1(f)(6)(iv), Example 4); S. Rep. No. 83, 99th Cong., 1st Sess. 20-21, at n.24 (1985) (same).

<sup>38</sup> See 1986 Prop. Reg. § 1.1274-7(a)(1) and 1992 Prop. Reg. § 1.1274-5 (omitting parenthetical). In the event the debt is modified in connection with the assumption (or acquisition of property subject to the debt), the 1986 proposed regulations provided that the modification shall be treated as occurring in a separate transaction immediately before the sale or exchange, unless the seller neither consents to nor participates in the modification (in which case it is treated as occurring in a separate transaction immediately after the sale or exchange). See 1986 Prop. Reg. § 1.1274-7(a)(2), (3) (Examples). *Contra Commissioner v. Stanley Co. of America*, 185 F.2d 979, 51-1 U.S.T.C. ¶9129 (2d Cir. 1951) (immediately following the merger of a wholly owned subsidiary into its parent, the parent exchanged new, lower face amount bonds for the subsidiary's old bonds pursuant to an agreement reached with the bondholders prior to the merger and in which the subsidiary participated; held, the parent had COD income upon the exchange), *rev'g*, 12 T.C. 1122 (1949) (reviewed, with five dissenting). The 1992 Prop. Reg. § 1.1274-5 and the final Reg. § 1.1274-5 somewhat revise the rule contained in the 1986 proposed regulations. They provide that the modification will be treated as a separate transaction occurring

made to the debt instrument without losing the benefits of the assumption rule.<sup>39</sup> The 1986 proposed regulations employed the definition of modification in 1986 Prop. Reg. § 1.1274-1(c), discussed at § 402.15 below. Final Reg. § 1.1274-5(a), as did the 1992 proposed version thereof, does not contain this definition and instead simply refers to modifications constituting deemed exchanges under Code § 1001.

Reg. § 1.1001-3 addresses the change-in-obligor issue. Reg. § 1.1001-3(c)(2)(i) says that "the substitution of a new obligor, the addition or deletion of a co-obligor," or a change in the recourse nature of the instrument constitutes a modification, even if the change occurs pursuant to the terms of the original instrument. Even if there has been such a modification, the modification will not be deemed to produce an exchange unless it is "significant."

Usually, the threshold question of whether there has been a change in the obligor or a change in the recourse nature of the debts, and thus a modification (whether or not "significant"), involves only a factual analysis. However, an interesting issue on this point potentially arises where the obligor is an entity that changes from one that is "regarded" for federal income tax purposes to one that is "disregarded"—that is, one which is not treated as separate from its owner for all "federal tax purposes"—under Reg. § 301.7701-3 (or vice-versa). This change may take several forms, including an elective state law conversion of a wholly-owned corporation from corporate form into a limited liability company, a merger of the corporation into a limited liability company, or in the case of a limited liability company that previously elected corporate tax treatment, a reversing tax election. If on the facts there has been no change in the rights and obligations of the debtor and the creditors under state law—that is, the disregarded entity remains the only obligor under state law—does the entity becoming "disregarded" nevertheless effectuate, for deemed exchange purposes, a change in the obligor of the debt from the disregarded entity to its parent, or a change in the recourse nature of the debt? The IRS has faced this question in several private letter rulings. Initially, the IRS concluded that, for the limited purpose of applying Reg. § 1.1001-3, such a conversion will not be considered to have produced a change in obligor or a change in the recourse nature of the debt.<sup>40</sup> This seems to us to be the proper result. However, the IRS has subsequently treated the conversion as a "modification" due to a change in obligor, but *not* as a "significant" modification under the exceptions (discussed below) for acquisitions in reorganizations governed by Code § 381 or for acquisitions of substantially all of an obligor's assets.<sup>41</sup> The latter

(Footnote Continued)

immediately before the sale and will be attributed to the seller (unless the seller did not know or have reason to know of the modification), unless the seller and buyer jointly elect to have the modification treated as occurring in the hands of the buyer in a separate transaction immediately after the sale.

<sup>39</sup> H.R. Rep. No. 87, 99th Cong., 1st Sess. 16 (1985); S. Rep. No. 83, 99th Cong., 1st Sess. 20-21 (1985).

<sup>40</sup> IRS Letter Ruling 200315001, September 19, 2002. For an analysis of this issue, see Cummings, *The Disregarded Entity Is and Isn't Disregarded*, 99 Tax Notes 743 (May 5, 2003); Cuff, *Indebtedness of a Disregarded Entity*, 81 Taxes 303 (2003); Hoffer, *Give Them My Regards: A Proposal for Applying the COD Rules to Disregarded Entities*, 107 Tax Notes 327 (April 18, 2005).

<sup>41</sup> See, e.g., IRS Letter Ruling 201010015, November 5, 2009 (conversion of a corporation into a disregarded LLC treated as a "D" reorganization); IRS Letter Ruling 200630002, April 24, 2006; IRS Letter Ruling 200709013, November 22, 2006.



of the new debt.<sup>73</sup> However, where real doubt exists at the time of the exchange as to the ultimate collectibility of the new debt, an accrual basis creditor may, rather than computing gain or loss (or basis) using the principal amount of the new debt, compute gain or loss (or basis) by reducing the new debt's principal amount for the portion likely to be uncollectible.<sup>74</sup> Collectibility is only sufficiently in doubt for this purpose where the debtor is insolvent in the bankruptcy sense, *i.e.*, its liabilities exceed the fair market value of its assets.<sup>75</sup> Mere financial difficulty is insufficient.<sup>76</sup> This rule is sometimes referred to as the "doubtful collectibility doctrine."

As a practical matter, uncollectibility at the time of the exchange may be difficult to establish if the exchange was voluntary.<sup>77</sup> If the debtor becomes insolvent after the exchange, but prior to the end of the taxable year in which the exchange took place, the IRS position would be that an accrual basis creditor should probably compute gain or loss using the principal amount of the new debt adjusted for OID or imputed

<sup>73</sup> Reg. § 15A.453-1(d); Reg. § 1.1001-1(g). Rev. Rul. 89-122, 1989-2 C.B. 200; Rev. Rul. 79-292, 1979-2 C.B. 287; *First Savings and Loan Assn. v. Commissioner*, 40 T.C. 474, Dec. 26, 158 (1963); see also Schler, *supra* note 43, at 212-216 (discusses the weaknesses inherent in using the principal amount); GCM 37218, August 4, 1977; IRS T.A.M. 8052023, September 25, 1980.

A persuasive argument can be made that the rule in the regulations is wrong, that even for an accrual basis taxpayer, the amount realized from any noninventory sales of property (including exchanges of debt) is limited to the fair market value of the new debt received. See Adrion, *Reducing the Uncertainty Regarding the Amount Realized in Debt-for-Debt Exchanges*, Tax Notes, May 30, 1994 at 1169. Adrion analyzes the authorities under Code § 1001 that support this conclusion. In considering this point, it should also be noted that Code § 1001 applies only to the holder of the debt and does not necessarily govern the tax consequences to the issuer. This point is analyzed in American Bar Association Section of Taxation Task Force, Report on Prop. Regs. § 1.1001-3: Modifications of Debt Instruments [Parts I-V], 47 Tax Law. 987 (1994). Thus, use of the fair market value rule for Code § 1001 purposes could lead to different results for the holder of the debt than for the issuer. One situation where this can occur is where old fixed-payment debt is exchanged for new debt having some payments of interest or principal that are contingent rather than fixed. The holder's amount realized from the exchange includes the fair market value of the contingent payments. Reg. § 1.1001-1(g)(2)(ii). But where the debt is subject to Code § 1274, the issuer cannot take these contingent amounts into account in determining the new debt's adjusted issue price for COD and OID purposes. See § 403.1.3 above; Asofsky, *A Guide to the Tax Treatment of Contingent Payment Debt Instruments*, 56 NYU Inst. on Fed. Tax'n, Chapter 5 (1998).

<sup>74</sup> See *Spring City Foundry Co. v. Commissioner*, 292 U.S. 182, 4 U.S.T.C. ¶ 1276 (1934) ("It is the right to receive and not the actual receipt that determines inclusion"); cf. *Clifton Mfg. Co.*, 137 F.2d 290, 43-2 U.S.T.C. ¶ 9539 (4th Cir. 1943) (income not includible until "collectibility is assured"; "not accruable as long as reasonable doubt exists as to amount collectible by reason of the financial condition or insolvency of the debtor"); *Electric Controls and Service Co. v. Commissioner*, T.C. Memo. 1996-486 (income not accruable when, in the same year that the right to income arises, collection and receipt of the income becomes sufficiently doubtful, or it becomes reasonably certain that the income will not be collected; nor is it accruable if the right to receive it is contingent upon the happening of a future event such as the realization of future profits); GCM 38426, June 26, 1980.

<sup>75</sup> *Moore v. Commissioner*, 45 T.C.M. 557, Dec. 39,845(M), T.C. Memo. 1983-39 (insufficient); *Harmont Plaza, Inc. v. Commissioner*, 64 T.C. 632, Dec. 33,348 (1975), *aff'd*, 549 F.2d 414, 77-1 U.S.T.C. ¶ 9276 (6th Cir. 1977), *cert. denied*, 434 U.S. 955 (delay in payment due to negative cash flow insufficient). See *Greer-Robbins Co. v. Commissioner*, 119 F.2d 92, 41-1 U.S.T.C. ¶ 9406 (9th Cir. 1941) (generally taxpayer's burden to establish bad debt character of accrual).

<sup>76</sup> *Koehring Co. v. United States*, 421 F.2d 715, 70-1 U.S.T.C. ¶ 9242 (Ct. Cl. 1970).

<sup>77</sup> Cf. *Moore*, *supra* note 75 (court reasoned that if taxpayer had any real doubt as to collectibility he would not have extended credit to the debtor).

interest.<sup>78</sup> In such event, however, the creditor may be entitled to a bad debt deduction.<sup>79</sup> However, case law suggests that in such an event, the creditor need not accrue the income at all.<sup>80</sup>

As to a cash basis creditor not using the installment method, there is a direct conflict in authority. The final regulations dealing with sales not reported on the installment method flatly hold that the amount realized would be the fair market value of the new debt.<sup>81</sup> On the other hand, the Code § 1001 regulations equally flatly hold that the amount realized is the adjusted principal amount of the new debt determined under Code § 1273 or § 1274.<sup>82</sup> Reg. § 1.1001-1(g)(3) provides generally that this conflict is to be resolved by applying the Code § 1001 regulations.

Where the old debt had been written down by the holder through a partial bad debt deduction, the exchange could produce a gain that in effect reverses that deduction. This could create a problem for the holder, since a partial worthlessness deduction can be taken only when the reduction is charged off on the holder's books, and that would have occurred in the earlier year but not in the year of the exchange. However, as mentioned at § 402.13 above, this problem has been solved by a regulation provision that deems such a write-off to have occurred.

#### § 403.2.2 Creation of New OID on New Debt

The taxable exchange of the old debt for the new debt will come within the scope of Code § 1274 (or, if either the old or the new debt is publicly traded, it will come within the scope of Code § 1273). On January 7, 2011, the IRS issued proposed amendments to the Code § 1273 regulations for the purpose of clarifying and simplifying the determination of whether a debt instrument (or the property for which it is exchanged) is to be considered publicly traded.<sup>83</sup> In general, the proposed regulations make it more likely that debt with multiple holders as to which there have been purchases and sales would be considered publicly traded; however, as discussed above at § 403.1.2, when these regulations were made final in 2012, they reduced the

<sup>78</sup> See, e.g., Rev. Rul. 80-361, 1980-2 C.B. 164; Rev. Rul. 81-18, 1981-1 C.B. 295; *Spring City Foundry Co. v. Commissioner*, *supra* note 74.

<sup>79</sup> Code § 166.

<sup>80</sup> *Electric Controls and Service Co. v. Commissioner*, T.C. Memo. 1996-486, *supra* note 74; *Cuba Railroad Co. v. Commissioner*, 9 T.C. 211, Dec. 15,970 (1947) (no accrual required where "real doubt and uncertainty at the end of the taxable year as to whether the amount due and unpaid would ever be paid"; facts substantiated specific refusal and inability of debtor to pay); *Corn Exchange Bank v. United States*, 37 F.2d 34, 2 U.S.T.C. ¶ 455 (2d Cir. 1930) (interest not accruable where debtor was in actual receivership at the close of the taxable year).

<sup>81</sup> See Reg. § 15A.453-1(d).

<sup>82</sup> Reg. § 1.1001-1(g). As noted in note 73, *supra*, Adrion criticizes this result.

<sup>83</sup> The proposed amendments were the subject of detailed comments and suggestions for changes in the Report of the New York State Bar Association Tax Section on Proposed Regulations on the Definition of Public Trading (April 6, 2011), 2011 TNT 68-21. The New York State Bar Association has also made detailed suggestions for improvements in the final regulations. See Report of the New York State Bar Association, Tax Section, Comments on Final "Publicly Traded" Regulations under Section 1273 of the Code (November 12, 2012), reprinted at 2012 TNT 220-30.



before being reduced by the COD, at least from a policy perspective and, possibly, based on a plain reading of the statute. The basic policy of the Code § 108 exclusion of COD from income would seem to be that the COD should not adversely affect the current year cash position of the insolvent or bankrupt company. Thus, a loss carryover from a year before the COD year may be used to reduce the tax liability for the year of the COD, and to the extent it can be so used, it is not reduced by the COD. That much is clearly compelled by the Code § 108(b)(4)(A) language quoted above. This same policy would seem to require that where the NOL for the year of the COD could be carried back to a prior year (if not first reduced by the COD) thereby improving the cash position of the debtor for the year of the COD, the carryback should be allowed, because otherwise the COD would be adversely affecting the current year cash position of the debtor. The same policy is reflected in the Code § 1017 requirement that COD allocated to the reduction of asset basis can affect basis only at the beginning of the *next* tax year, thus not impairing the cash position of the debtor for the COD year. In short, we believe Code §§ 108(b)(4)(A) and 1017 both reflect a policy that COD attribute reduction should affect only the future, not the present or the past.<sup>52</sup> As indicated above, the position we espoused was adopted in mid-July 2003 in Temp. Reg. §§ 1.108-7T(b) and (d), Example 2 and in identical proposed regulations. The preamble to these temporary and proposed regulations said they were clarifying in nature. They applied effective for COD occurring after July 17, 2003. These regulations were made final as Reg. §§ 1.108-7(b) and (d), Example 2 in 2004, effective for COD occurring on or after May 10, 2004.

(3) *R&D and ITC Credit Carryovers.* Carryovers of these credits (and any other credits making up the Code § 38 "general business" credit) to or from the year of cancellation are reduced (at the rate of 33 $\frac{1}{3}$  cents for each dollar of debt cancellation) in the order in which they would be taken into account in the year of cancellation.<sup>53</sup> No reduction is made, however, in the portion of the credits attributable to the employee stock ownership credit determined under Code § 41.<sup>54</sup>

(4) *Alternative Minimum Tax Credits.* Payments of alternative minimum tax that are available as carryovers from the year of the debt discharge as credits against

(Footnote Continued)

difference; the Court stated that "whether or not the excluded items have made a difference in the past, or make a difference here, they certainly could make a difference . . .").

<sup>52</sup> Support for reading Code §§ 108(b)(4)(A) and 1017 to be consistent in reaching the same result as to the timing of attribute reduction, namely that it should occur only at the beginning of the year following the COD, can be found in *Gilliz v. Commissioner*, 121 S. Ct. 701, 2001-U.S.T.C. ¶ 50,147 (2001) and one of its predecessor cases, *Farley v. Commissioner*, 202 F.3d 198, 2000-1 U.S.T.C. ¶ 50,179 (3d Cir. 2000). For example, the *Farley* court held that Code § 108(b)(4)(A) "clearly provides for the reduction of NOLs to occur at the beginning of the year following the year of the COD" 202 F.3d at 205-206. And the Supreme Court said that Code §§ 1017(a) and 108(b)(4)(A) contain the "same sequencing" language. 121 S. Ct. at 709. Germain, in the article cited in the preceding footnote, argues that because these cases involve S corporation issues at the shareholder level, they are not in point on the present question. However, we believe the approach taken on this issue in these cases provides very helpful support for the position allowing the loss carryback in advance of attribute reduction. As stated in the text, this position is now confirmed in the regulations.

<sup>53</sup> Code § 108(b)(2)(B), (3)(B), and (4)(C).

<sup>54</sup> Code § 108(b)(2)(B).

future regular tax are reduced (at the rate of 33 $\frac{1}{3}$  cents for each dollar of debt cancellation). This provision was added by the 1993 Act and is applicable to debt discharges occurring in taxable years beginning after December 31, 1993.

(5) *Capital Loss Carryovers.* The net capital loss of the year of cancellation (first) and the capital loss carryovers to the year of cancellation (second) are reduced.<sup>55</sup> The latter are reduced in the order of the years in which they arose.<sup>56</sup>

(6) *Basis of Property.* The basis of any property of the taxpayer as of the beginning of the tax year following the year of cancellation is reduced.<sup>57</sup> Unlike the elective basis reduction mentioned above and discussed further below, this automatic basis reduction applies to nondepreciable property in addition to depreciable property, but the aggregate basis of such property will not be reduced by more than the amount by which the tax basis of property held immediately after the cancellation exceeds the aggregate liabilities remaining at that time.<sup>58</sup> Thus, a sale of all the assets to pay the liabilities remaining after the debt discharge will not result in an income tax liability unless the proceeds after the sale exceed the remaining liabilities. Effective for debt cancellations on or after September 11, 1995, Reg. § 1.108-3 also treats as additional basis subject to reduction any intercompany loss or deduction deferred under Code § 267(t) or Reg. § 1.1502-13. The order in which the basis of property is to be reduced was determined under the rules applicable to prior law under Reg. §§ 1.1016-7 and 1.1016-8 until new regulations were issued.<sup>59</sup> These new regulations were issued on October 22, 1998 as Reg. § 1.1017-1. These do not have retroactive effect, and determine the order in which the basis of property is reduced only for COD occurring on or after October 22, 1998. Basis reduction under this provision does not result in ITC recapture.<sup>60</sup> Any gain on subsequent disposition of the property will result in Code § 1245 or 1250 ordinary income recapture, in the same manner as for elective basis reductions.<sup>61</sup> One way that at least one taxpayer had found to avoid the automatic basis reduction from COD was to utilize a "G" reorganization of the debtor's assets. During the year that the COD arose, the debtor transferred all of its assets to another corporation in a "G" reorganization. The IRS in a 2001 Field Service Advice memorandum agreed that the basis of these transferred assets was not reduced by the COD, because the automatic basis reduction from the COD is made only as of the beginning of the tax year following the year of cancellation, and in that year the debtor has no property at all. To avail oneself of this device it was necessary that the reorganization

<sup>55</sup> Code § 108(b)(2)(A) and (4)(B).

<sup>56</sup> Code § 108(b)(4)(B).

<sup>57</sup> Code §§ 108(b)(2)(D) and 1017(a).

<sup>58</sup> Code § 1017(b)(2).

<sup>59</sup> S. Rep. No. 1035, 96th Cong., 2d Sess. 14 (1980); H.R. Rep. No. 833, 96th Cong., 2d Sess. 11 (1980); see Pollack, *supra* note 47.

<sup>60</sup> Code § 1017(c)(2); Rev. Rul. 81-206, 1981-2 C.B. 9.

<sup>61</sup> Code § 1017(d) (33 $\frac{1}{3}$  rate reduction effective for taxable years beginning after 1986; prior rate reduction was 50 cents for each dollar of debt reduction); see discussion *infra* § 404.3.



which case the exchange would be an "E" reorganization), and whether or not the exchange is pursuant to a conversion occurring pursuant to the terms of the debt.<sup>2</sup> Under prior law (as described in §504A immediately below), the stock-for-debt exception to COD income would have changed that result. But the stock-for-debt exception to COD income no longer applies.

The treatment (both under prior and current law) of a stock-for-debt exchange differs from the treatment accorded to a contribution of the debt to capital (which is discussed below at §505). Since the stock of a troubled corporation may in many cases have little value, the contribution-to-capital exception was very important even for years before the repeal of the stock-for-debt exception, and it retains that importance today.<sup>3</sup>

### §504A PRIOR LAW: STOCK-FOR-DEBT EXCEPTION TO COD INCOME

As discussed at §404, a debtor corporation that cancels part or all of its debt will have cancellation of debt (COD) income, unless one of the exceptions to the COD income rule applies. The consequences of having COD income—which, depending on the status of the taxpayer at the time of the cancellation, may consist of recognition of the income, or the reduction of valuable tax attributes such as NOLs or asset basis—were also discussed in Chapter 4.

Before its repeal in 1993, the most important single exception to the creation of COD income was the stock-for-debt exception. This exception applied, subject to certain limitations, where stock of the debtor was used to satisfy its debt.<sup>1</sup> However, even where this exception was applicable, debt cancellation using stock could raise the possibility of AMT consequences for years beginning before 1990, as discussed at §§404.5 and 504A.6.

As mentioned at §501 above, the Omnibus Budget Reconciliation Act of 1993 repealed the stock-for-debt exception, with a slightly delayed effective date. This was

(Footnote Continued)

shares for canceling corporate debt, and the shares are worth less than the face amount of the debt cancelled, rather than having the excess face amount produce COD income for the debtor, the transaction should be treated as though it had been bifurcated into (a) an exchange of stock for an equal value of debt and (b) a contribution to capital of the excess debt.

<sup>2</sup> Reg. §1.61-12(c)(2); IRS Technical Advice Memorandum 200606037, October 27, 2005.

<sup>3</sup> The continuing importance of the contribution-to-capital exception, and the desirability of applying it even when only a portion of the debt is cancelled, and even when the debtor is partially insolvent, is discussed in Levine and Molins, *Partial Debt Cancellations: Slicing Debt with Occam's Razor*, 129 Tax Notes 311 (October 18, 2010).

<sup>1</sup> §504A For a discussion of the history and application of the stock-for-debt exception, and other consequences of equity-debt exchanges, see Bryan, *Cancellation of Indebtedness by Issuing Stock in Exchange: Challenging the Congressional Solution to Debt-Equity Swaps*, 63 Tex. L. Rev. 89 (1984); Asofsky, *Discharge of Indebtedness Income in Bankruptcy After the Bankruptcy Tax Act of 1980*, 27 St. Louis U. L.J. 583, 600-621 (1983) (hereafter Asofsky, *Discharge of Indebtedness*); see also Eustice, *Cancellation of Indebtedness Redux: The Bankruptcy Tax Act of 1980 Proposal—Corporate Aspects*, 36 Tax L. Rev. 1 (1980); Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 Tax L. Rev. 225, 238-240 (1959).

accomplished by an amendment to Code §108(e)(8) and the repeal of then Code §108(e)(10). Congressional hearings were never held on this repeal. The repeal was made generally effective for stock transferred in satisfaction of debt after 1994, except for transfers in a title 11 or similar case filed on or before the end of 1993.

Because of the delayed effective date provisions, particularly the one for transfers made in bankruptcy cases for which petitions are filed by the end of 1993, the stock-for-debt exception to COD income will continue to be applicable to numerous exchanges occurring after 1993. It will also be of continuing interest to those handling audits of returns for prior years. The remaining portions of this §504A will therefore discuss the provisions of the stock-for-debt exception, as it existed before its repeal by the 1993 Act.

### §504A.1 Unavailability for Solvent Companies Not in Bankruptcy

The stock-for-debt exception developed as a judicially created common law rule of taxation.<sup>2</sup> Before its repeal in 1993, Congress had narrowed its scope by amendments made to Code §108 in 1980, 1984, 1986, and 1990. As narrowed by the 1984 and 1990 changes, the exception only applied to (1) debtors in title 11 cases<sup>3</sup> and (2) insolvent<sup>4</sup> debtors (though only to the extent the debtor is not rendered solvent). The 1990 change eliminated certain preferred stock from qualifying for the exception.

With respect to solvent debtors outside bankruptcy—including insolvent debtors, to the extent the debt cancellation makes them solvent—the legislative amendments made the stock-for-debt exception entirely inapplicable. As a result, companies desiring to rely on the stock-for-debt exception often felt compelled to enter Chapter 11 bankruptcy proceedings. This way, the exception applied even if the company was or was made solvent in a balance sheet (marked to market) sense, and the problem of proving insolvency disappeared.

<sup>2</sup> *Commissioner v. Motor Mart Trust*, 156 F.2d 122, 46-1 U.S.T.C. ¶9301 (1st Cir. 1946), *aff'd* 4 T.C. 931, Dec. 14, 1947 (1945), *acq.* 1947-1 C.B. 3; *Alcazar Hotel, Inc. v. Commissioner*, 1 T.C. 872, Dec. 13, 1949 (1943) (permitted use of successor corporation stock), *acq.* 1943 C.B. 1; *Capento Sec. Corp. v. Commissioner*, 140 F.2d 38, 44-1 U.S.T.C. ¶9170 (1st Cir. 1944), *aff'd* 47 B.T.A. 691, Dec. 12, 1942 (1942), *nonacq.* 1943 C.B. 28; *Tower Building Corp. v. Commissioner*, 6 T.C. 125, Dec. 14, 1947 (1946), *acq.* 1974-1 C.B. 4; GCM 25277, 1947-1 C.B. 44; but see *Claridge Apartments Co. v. Commissioner*, 1 T.C. 143, Dec. 12, 1942 (1942), *rev'd in part*, 138 F.2d 962, 43-2 U.S.T.C. ¶9663 (7th Cir. 1943), *rev'd on other grounds*, 323 U.S. 141 (1944) (the IRS eventually acquiesced in the Tax Court decision at 1947-1 C.B. 2). See also *Los Angeles Shipbuilding & Drydock v. United States*, 289 F.2d 222, 229, 61-1 U.S.T.C. ¶9329 (9th Cir. 1961); *Woodmont Corp. v. Commissioner*, 5 T.C.M. 291, Dec. 15, 1910 (M) (1946); *Potter & Rayfield, Inc. v. Commissioner*, 5 T.C.M. 119, Dec. 15, 1927 (M) (1946).

<sup>3</sup> A "title 11 case" is defined in Code §108(d)(2) as a case under the Bankruptcy Code, but only if the debt cancellation is approved by the court. This limitation under Code §108 to title 11 cases contrasts with the broader bankruptcy concept that applies for "G" reorganization and Code §382 purposes. The latter extend the concept to include title 11 and similar cases, including receivership, foreclosure, or similar proceedings in a federal or state court. Code §§382(l)(5)(G), 382(l)(6), 368(a)(3)(A).

<sup>4</sup> "Insolvent" is defined in Code §108(d)(3) as meaning the excess of liabilities over the fair market value of assets. The application of this test, which is to be applied immediately before the debt cancellation, was discussed in the last chapter. See discussion at §404.



approach, whereby instead of issuing rights, the corporation issues to each shareholder (other than the triggering shareholder), one new share as a stock dividend. The IRS ruled, in Rev. Rul. 90-11,<sup>52</sup> that the creation of a poison pill plan and the associated rights distribution are not taxable to shareholders, nor does the adoption of the plan create an option for Code § 382 purposes.

The poison pill approach offers several advantages over the transfer-restriction approach. The primary one is that it can often be adopted simply by the board of directors, since it is frequently the case in public companies that the board will have previously obtained the shareholders' approval to institute a poison pill as a defensive (non-tax) anti-takeover measure, if and when it deems appropriate. In contrast, the transfer-restriction approach would require a requisite shareholder vote, and depending on the manner instituted and applicable law, may not be binding on any existing shareholders who didn't vote in favor of the restriction. This greatly increases the practicality of the poison pill, such as the ability to adopt the plan for a short period of time (such as the few years remaining for a Code § 382 potential ownership-change problem), and the ability to change the plan rapidly to adjust to changing circumstances.

Because the use of a poison pill plan for protecting against Code § 382 ownership changes is so recent, there is little authority in direct support of its use for this purpose. (Rev. Rul. 90-11, mentioned above, did not deal with a plan designed to protect against a Code § 382 ownership change.) But in 2010, in an important and detailed Delaware opinion, *Selectica, Inc. v. Versata Enterprises, Inc.*,<sup>53</sup> the Delaware Court of Chancery (in a decision affirmed by the Delaware Supreme Court) upheld the validity of a poison pill plan adopted to prevent a Code § 382 problem.

Nonetheless, the use of the poison pill approach for Code § 382 purposes is so new that one should be cautious about potential pitfalls. If used, we would suggest that the stock dividend form of such a plan may involve fewer potential problems than a rights-offering approach, since the latter involves the need for additional investment, and runs the risk that the rights may be exercised on different days, perhaps presenting special (and more harmful) Code § 382 issues. Although the poison pill is a strong deterrent (the purchaser effectively loses value on its entire investment, both old and new), the additional Code § 382 percentage point change in ownership caused by the purchaser becoming a 5 percent shareholder may effectively still count—at a minimum, because the dilution of the purchaser's ownership causes all other shareholders' percentage ownership to increase. In contrast, the transfer restriction is more surgical in nature, applying only to the shares acquired in excess of the specified threshold, and if enforceable, effectively voids the change otherwise caused by the purchase. Accordingly, although a poison pill may serve as an

<sup>52</sup> 90-1 C.B. 10.

<sup>53</sup> *Selectica, Inc. v. Versata Enterprises, Inc.*, 2010 Del. Ch. LEXIS 39 (Del. Ch. February 26, 2010), *aff'd*, *Versata Enterprises, Inc. v. Selectica, Inc.*, 5 A.3d 586 (Del. October 4, 2010). This case is discussed in Erickson and Heitzman, *supra* note 51, and in Varallo and Werrett, Delaware Supreme Court Sanctions Use of 4.99 Percent NOL Poison Pill, 218 BNA Daily Tax Report (November 15, 2010), at p. J-1.

expedient stop gap measure for a loss company nearing an ownership change, it may not be a permanent solution.

#### § 508.2.4 Worthless Stock Rule, Exempt Transfers, and Restricting Transfers in Bankruptcy

The Revenue Act of 1987 added Code § 382(g)(4)(D), which provides that if a person who was a 50 percent shareholder (directly or indirectly) of the loss corporation at any time during the preceding three years treats any of his stock as becoming worthless during any taxable year of such shareholder, and the stock is still held by that person at the close of his taxable year, for purposes of determining whether an ownership change has occurred after the close of his year, he shall be treated as acquiring the stock on the first day of his next taxable year and as not owning it previously. The three-year period means the three 12-month periods ending with the last day of the shareholder's taxable year in which the shareholder treated the stock as worthless.

Note that in applying this rule, the loss corporation needs to know facts that may only be known by the shareholder. Note also that a worthless stock deduction by a person who owns very little stock at that time, but who owned 50 percent at some time during his last three taxable years, invokes this rule. To identify such persons, the loss corporation may have to look back before the beginning of the testing period (where the testing period is less than three years).

In the *Prudential Lines* case,<sup>54</sup> a bankruptcy court, holding that NOLs were property of the bankruptcy estate protected by the automatic stay under the Bankruptcy Code, had permanently enjoined a parent corporation from claiming a worthless stock deduction for stock of its bankrupt subsidiary for any year ending before the effective date of the plan. The action of the bankruptcy court was affirmed by the District Court and by the Second Circuit.<sup>55</sup> The courts took the position that the NOLs of the debtor (whether they might be carried back to produce a refund of previously paid tax or carried forward against income that might or might not be earned in the future) were property of the debtor protected by the automatic stay imposed by Section 362(a)(3) of the Bankruptcy Code, which applies to any act seeking to "obtain possession of property of the estate or of property from the estate or to exercise

<sup>54</sup> *In re Prudential Lines, Inc.*, 107 B.R. 832 (Bankr. D.N.Y. 1989) (preliminary injunction), 3 Bankr. L. Rep. § 73,203 (January 4, 1990) (permanent injunction). The bankruptcy court opinion is criticized in Pisem & Glicklich, Was the Bankruptcy Court Lost at Sea? *Prudential Lines* Collides with the Internal Revenue Code, 48 Tax Notes 1553 (September 17, 1990). One wonders whether the authors' criticism should not have been directed instead at Code § 382 itself, which causes the debtor corporation's tax consequences to be determined by actions occurring at the shareholder, rather than at the corporate level. See Henderson, Controlling Hyperlexis—The Most Important "Law and . . .," 43 Tax Law. 177, 186-191 (1989).

<sup>55</sup> *In re Prudential Lines, Inc.*, 119 B.R. 430 (S.D.N.Y. 1990), *aff'd*, 928 F.2d 565, 92-2 U.S.T.C. ¶ 50,491 (2d Cir. 1991), *cert. denied*, 112 S. Ct. 82 (1991). On the other hand, a parent's claim of a worthless stock deduction was not actionable where the bankrupt subsidiary could not have made use of the NOLs that were destroyed, particularly given the subsidiary's pending liquidation. *In re White Metal Rolling & Stamping Corp.*, 1998 Bankr. LEXIS 901 (Bankr. D.N.Y. 1998).



stock, or as nonstock treated as stock, or as options, that would not be so as to these stock appreciation rights under the facts and circumstances involved. The ruling letter did not indicate what proportion of the equity these stock appreciation rights were equivalent to, nor whether such proportion was considered a relevant fact.

As mentioned at §508.2.2.1, in Notice 88-67 the IRS stated that convertible stock will in most instances be treated *either* as an option or as stock, rather than being treated simultaneously as both, with "pure" convertible preferred (*i.e.*, nonvoting, nonparticipating, convertible preferred) being treated only as an option,<sup>123</sup> and most other convertible stock (unless it requires the payment of additional consideration upon conversion) being treated as only stock. (As mentioned at §508.2.2.1 above, the 1994 final regulations changed the rules for "pure" convertible preferred once again.) Notice 88-67 also said that the IRS intended to amend the regulations to allow the IRS to provide additional exceptions from the option rules through the issuance of revenue rulings. This intention was carried out on December 22, 1989, by the adoption of Temp. Reg. §1.382-2T(h)(4)(x)(Z).

Will a shareholder rights plan (or "poison pill") be treated as an option under Code §382? The Tax Section of the New York State Bar Association recommended that it not be, unless and until a "flip-in" event occurs (*i.e.*, the point at which a hostile bidder has acquired enough stock to give the other shareholders the right to make a bargain purchase of the target's stock).<sup>124</sup> The IRS has so held in Rev. Rul. 90-11.<sup>125</sup> This ruling exercised the power reserved in Temp. Reg. §1.382-2T(h)(4)(x)(Z) to exempt by revenue ruling certain categories of interests from the option attribution rules. The ruling states that poison pill rights like those described in the ruling are exempt from these rules until the rights can no longer be redeemed for a nominal amount without shareholder approval.

What about an option that has been issued but has a delayed effective date? The IRS has issued a letter ruling in a case where a company stapled a warrant to each share of its outstanding stock. The warrant provided that the company could issue up to three "calls." Each call would set the terms and conditions upon which a shareholder could exercise the warrant to purchase additional company stock. The IRS ruled that the warrant would not be considered an option until a call is issued, and each separate call would be a separate option.<sup>126</sup>

Where a bankruptcy plan involving a change in stock interests is confirmed on one date but is to become effective at a later date, does the confirmation produce an option? The IRS initially held that it does.<sup>127</sup> Under this approach, the selective

<sup>123</sup> Note, however, the effective date provisions of Notice 88-67, mentioned at §508.2.2.1.

<sup>124</sup> Report of the Tax Section of the New York State Bar Association on the Taxation of Shareholder Rights Plans at 56 (July 25, 1988).

<sup>125</sup> 1990-1 C.B. 10.

<sup>126</sup> IRS Letter Ruling 200024047, March 21, 2000.

<sup>127</sup> *E.g.*, IRS Letter Ruling 8902047, October 28, 1988. Interestingly enough, the IRS did not consider an "option" to arise at some date before the confirmation, such as the date the creditor proponents agreed to propose the plan. This was true even in the case of a "prepackaged" bankruptcy plan where the creditors agreeing to the plan before the petition was filed had enough votes to confirm the plan. See IRS Letter Ruling 8903043, October 14, 1988 ("prepackaged" bankruptcy plan). See also IRS Letter Ruling 9247017, August 24, 1992 ("prenegotiated" bankruptcy plan); IRS Field Service Advice

exercise rule could create an ownership change on the confirmation date that might not have occurred if all the new stock had been actually issued (and the selective exercise rule did not apply) on that date. The IRS reconsidered that position (*see, e.g.*, IRS Letter Rulings 8903043 and 8930045, at §508A.2.7), and in Reg. §1.382-9(o) provided, effective for testing dates occurring on or after September 5, 1990, that Temp. Reg. §1.382-2T(h)(4)(i), which contains the option attribution rule (including its selective exercise aspect), and its successor in the final regulations, Reg. §1.382-4(d), shall not apply to an option created by the solicitation or receipt of acceptances to the plan, or by confirmation of the plan, or under the plan, until the plan becomes effective.<sup>128</sup> See also the discussion at §510 below. The preamble to the final regulation makes clear that this is intended to include prepetition solicitations for prepackaged or prenegotiated plans, if the plan is later confirmed in a title 11 or similar case. It adds that if the plan is not confirmed, the option created by the solicitation or receipt of acceptances to the plan will ordinarily be treated as having lapsed. The regulation also contains an anti-abuse rule: It will not apply if, in connection with the plan of reorganization, the loss company issues stock (including limited preferred stock) or otherwise receives a capital contribution before the effective date of the plan for a principal purpose of using losses or credits that otherwise would be limited or eliminated by the reorganization. The final regulations allow elections to be made (1) to apply the regulation to testing dates before October 5, 1990, or (2) not to apply the rule of the regulation to testing dates before April 8, 1992. The anti-abuse rule applies only to testing dates on or after April 8, 1992.

Suppose a bankruptcy plan contemplates that a certain amount of stock will be issued in escrow to satisfy disputed claims. As claims are resolved, portions of the stock will be released from escrow for distribution to those whose claims have been allowed. Prior to 1994, under the option attribution rules then in effect, the IRS ruled, in a case where the disputed claims covered by an escrow arrangement that could last for up to 40 years included product liability claims, that "For the purposes of section 382 of the Code, the ultimate recipients of new common stock whose ownership is directly attributable to the terms of the Plan will be deemed to have received any

(Footnote Continued)

1999-1200, April 2, 1993 (stock purchase agreement that required bankruptcy court approval to become effective was "too executory to rise to the level of an option" before that approval), *reprinted at* 1999 TNT 122-83.

<sup>128</sup> On a related issue, where a creditor entitled to receive stock on the effective date of the plan transferred that contingent right *prior* to the effective date, the IRS ruled that the issuance of the stock to the transferee on the effective date would *not* be considered to have occurred *after* the effective date for purposes of determining whether a subsequent ownership change occurs. IRS Letter Ruling 200731020, May 2, 2007.

Before issuance of the 1994 testing date regulations, the IRS had ruled that the confirmation date nonetheless technically remained a testing date. IRS Letter Ruling 9348053, December 3, 1993. Under the 1994 regulations this is not the case, since under these regulations the mere grant of an option does not generally create a testing date. Although in 2007 the IRS issued IRS Letter Ruling 200720012, January 25, 2007, which held that the confirmation date did constitute a testing date under the 1994 regulations, the ruling was quickly repudiated by the IRS and revised by IRS Letter Ruling 200748015, August 21, 2007, to hold that the testing date under these regulations was the effective date of the bankruptcy reorganization, not the confirmation date.



gain or loss items if they arise from a debt owed by or to the corporation at the beginning of the recognition period.

The regulation contains an example that distinguishes mineral property from the mineral that might be extracted from it.<sup>304</sup> In the example, a corporation owned appreciated oil and gas property when it made its S election. After becoming an S corporation, the corporation began the production of oil from the property. The example holds that the revenue from that production is not built-in gain for purposes of Code § 1374. Had the S corporation sold the mineral property itself, however, its gain from that sale would have been built-in gain. The IRS has since amplified this concept, making clear that this separation of the property interest from the mineral (including petroleum, timber, or coal) produced from it applies even if the sale of the mineral is treated as a capital gain item under Code § 631.<sup>305</sup>

An interesting application of the Code § 1374 regulation is reflected in IRS Letter Ruling 200644013, June 21, 2006. Here, a company held real estate that would produce Code § 1374 gain. The company transferred the realty to a charitable remainder unitrust under Code § 664, which then sold the realty and invested the proceeds in investment assets. The unitrust was required to distribute to the S corporation the lesser of the trust's income or a fixed percentage of the value of its assets. The ruling held that the annual distributions from the trust to the S corporation will be treated as ordinary income to the extent of the trust's ordinary income, and any balance will be treated as capital gains to the extent, if any, as so characterized under the unitrust rules. The ruling holds that neither the transfer of the real estate to the trust nor the trust's sale of the real estate is a built-in gain recognition event to the S corporation under Code § 1374, but that any annual distribution treated as a distribution of capital gain attributable to the real estate will be treated as a Code § 1374 recognized built-in gain.

When the Treasury proposed the Code § 1374 regulations on December 8, 1992, it left open the question whether it would apply the Reg. § 1.1374-4 interpretations

<sup>304</sup> Reg. § 1.1374-4(a)(3) Ex. 1.

<sup>305</sup> Rev. Rul. 2001-50, 2001-43 I.R.B. 343. See also Smith and Sobol, New Rev. Rul. Says "Timm-Berr" to Built-In Gains Tax for Natural Resource Companies, 96 J. Taxation 46 (2002). See also IRS Letter Ruling 200240002, June 25, 2002 (taxpayer grants customers by agreement to a one-time use of a copyrighted item: income from such agreements made after the S election was made is not built-in gain); IRS Letter Ruling 9712027, December 23, 1996; IRS Technical Advice Memorandum 9727001, September 30, 1996; IRS Letter Ruling 9826017, March 25, 1998; IRS Letter Ruling 9825008, March 16, 1998; IRS Letter Ruling 200205028, October 31, 2001; IRS Letter Ruling 200411015, December 4, 2003; and IRS Letter Ruling 200821022, December 21, 2007. This same concept is reflected in IRS Technical Advice Memorandum 200217009, December 4, 2001, which construes Code § 382(h) rather than Code § 1374. In this Technical Advice Memorandum, a taxpayer purchased a health products business and took the position that its existing patient base was a wasting asset, and that to the extent the value of this base exceeded its basis on the date of acquisition, it had a built-in gain. The taxpayer then treated the operating income attributable to this patient base as a recognized built-in gain for purposes of Code § 382. The taxpayer argued that income from an appreciated wasting asset should be treated as recognized built-in gain, just as the Code now provides that depreciation to the extent of a built-in loss in a wasting asset constitutes a recognition of built-in loss. The IRS rejected the taxpayer's argument, holding that the Code does not treat income from wasting assets symmetrically with depreciation from wasting assets—a position that the IRS has since modified in Notice 2003-65 (discussed below).

under Code § 382(h): the preamble to the proposed Code § 1374 regulation said "the Treasury Department and the Internal Revenue Service intend no inference regarding rules they may adopt in other regulations, such as under sections 382(h)(6) and 384(c)(1)(B), which contain language similar to section 1374(d)(5)." The preamble to the final regulation is silent on the point. In earlier editions of this book we had expressed the hope that the Treasury would not seek to interpret the two provisions very differently: construing identical language differently when it is placed simultaneously in different parts of the Code would seem—aside from possible questions as to validity—to escalate hyperlexis to new and more undesirable heights.<sup>306</sup> This issue is now addressed in IRS Notice 2003-65.

**IRS Notice 2003-65.** In late 2003, the IRS issued Notice 2003-65 to deal with certain built-in gain and built-in loss issues presented by Code § 382(h).<sup>307</sup> The Notice presented two different approaches that might be used. The Notice solicited comments on these, and said that after receiving such comments, the IRS expected to publish proposed regulations providing only a single set of rules for identifying built-in items for purposes of Code § 382(h). However, in the meantime, the Notice said that taxpayers could apply either of the two approaches set forth in the Notice as safe harbor methods. The Notice adds that these safe harbors are not meant to be exclusive, and other methods used by taxpayers will be examined on a case-by-case basis.

The two safe-harbor methods articulated in the Notice are the "1374 approach" and the "338 approach."

The "1374 approach" applies the rules of Code § 1374 and its regulations (which have been discussed immediately above) for determining Code § 382(h) built-in gain and loss items, with the modification that depreciation, amortization and depletion deductions are to be treated as built-in loss items (as is required by the last sentence of Code § 382(h)(2)(B), but is not done for Code § 1374 purposes).<sup>308</sup> Under this approach, net built-in gain and net built-in loss are determined as the net amount of gain or loss that would be recognized in a hypothetical sale of all the corporation's assets (including goodwill) immediately before the ownership change to a third party that assumed all of its liabilities. For this purpose, assets are to be valued at fair market value, and then reduced by basis and other items that would be deductible in such a sale on that date. Under this word formula, one would normally presume that

<sup>306</sup> See generally Henderson, Controlling Hyperlexis—The Most Important "Law and . . .," 43 Tax Law. 177 (1989).

<sup>307</sup> 2003-2 C.B. 747. The Tax Section of the American Bar Association, although unable to reach a consensus favoring either the "1374" or the "338" approach set forth in the Notice or one similar to either of them, has issued a report making detailed comments about both of these approaches. See American Bar Association, Tax Section, Comments Concerning Notice 2003-65 Under Section 382 of the Internal Revenue Code Regarding the Treatment of Recognized Built-In Gains and Losses, April 29, 2005, reprinted in BNA Daily Tax Report (May 3, 2005), BNA Tax Core. See also Simon, Compound Complexity: Accounting for Built-In Gains and Losses Under the AMT After an Ownership Change, 107 Tax Notes 477 (April 25, 2005); Jeong, NOLs and COD: Important Topics in a Down Economy, 2009 TNT 218-8 (October 21, 2009).

<sup>308</sup> That this is not done for Code § 1374 purposes is confirmed in IRS Chief Counsel Advice 201003018, March 30, 2009.



### §604.3.2 Continuity-of-Interest Test

The purpose of the nonstatutory "continuity-of-interest" test is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss. Reg. §1.368-1(e) says continuity-of-interest requires that in substance a substantial part of the value of the proprietary interests in the target corporation must be preserved in the reorganization. For example, if the acquiring entity issues mostly cash or debt for the target stock, or if the target equity owners sell the stock they receive in the reorganization to parties related to the acquiring entity or substantially redeem their stock for cash just before the reorganization, the continuity-of-interest test is not met. However, if the target shareholders sell their stock to strangers, the proprietary interest is preserved and that sale will not disqualify the reorganization.

As discussed at §510.1, the *Alabama Asphaltic* case<sup>46</sup> and its progeny teach that creditors of the old company who receive stock in the new company can sometimes be treated as equity owners of the old company for purposes of satisfying the continuity-of-interest test, but cannot be treated as "shareholders" for purposes of any statutory requirements that refer to "shareholders." On December 12, 2008 (and effective for transactions after that date), the Treasury issued Reg. §1.368-1(e)(6) to clarify this area.

Before issuance of that regulation, it was generally said that this concept applies only where the creditors have taken command of the old company by the institution of an appropriate bankruptcy or other creditor's proceeding. Where no such proceeding was commenced, creditors of a failing company who received stock of the new company had sometimes been counted for purposes of satisfying the continuity-of-interest test where they also owned the stock of the former company.<sup>47</sup> However, where these special circumstances plus the clear insolvency (a factual question) of the old company did not exist, the creditors of the old company who received stock in the new company would not count toward satisfying the continuity of interest test. In that case, the consideration issued to the stockholders of the old company must by itself satisfy the applicable continuity-of-interest requirements.<sup>48</sup> In this regard, it should be noted that even if the company might be insolvent in a balance sheet sense, this does not mean that its stock does not have value, in which case it cannot be

<sup>46</sup> *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179, 42-1 U.S.T.C. ¶9245 (1942). In IRS Chief Counsel Advice 200350016, August 28, 2003, a company in bankruptcy issued all of its new stock to its short-term creditors (there were no security holders). The old stock was cancelled and the stockholders received nothing. The ruling held that, although the short-term creditors would be treated as former equity holders for purposes of the "G" reorganization continuity-of-interest requirement pursuant to *Alabama Asphaltic*, they would not be treated as shareholders or security holders for purposes of Code §§354 and 355. This ruling, and the 2011 Tax Court opinion in *Ralphs Grocery Co. v. Commissioner*, T.C. Memo. 2011-25, are discussed at §709 below.

<sup>47</sup> See, e.g., *United States v. Adkins Phelps, Inc.*, 400 F.2d 737, 68-2 U.S.T.C. ¶9609 (8th Cir. 1968); *Seiberling Rubber Co. v. Commissioner*, 169 F.2d 595, 48-2 U.S.T.C. ¶9343 (6th Cir. 1948); *Norman Scott, Inc. v. Commissioner*, 48 T.C. 598, Dec. 28,551 (1967); Rev. Rul. 54-610, 1954-2 C.B. 152. Where these special circumstances exist, one wonders what might happen if a significant portion of the debt held by such creditors had been redeemed before the reorganization. See the discussion of this issue in §605.1.4, Interim Distributions, below.

<sup>48</sup> For these requirements, see generally Bittker & Eustice, *supra* note 39 at §12-21.

ignored for continuity-of-interest purposes.<sup>49</sup> (We should note that, although Reg. §1.368-1(e)(6) generally seems to require that the stock of the old company be taken into account if it receives any value in the transaction regardless of the insolvency of the company, the 2005 proposed "net value" regulations—which are discussed at §604.3.4 below—ignore stock for purposes of the net value rule if the value of the issuer's liabilities exceeds the value of its assets.)

The aforementioned Reg. §1.368-1(e)(6) was issued in 2008 to liberalize and clarify the rules regarding the extent to which creditors are to be considered equity holders for continuity-of-interest purposes. The regulation is effective for transactions occurring after December 12, 2008. This regulation says that a creditor's claim against a target corporation may be considered a proprietary interest, for continuity-of-interest purposes, if the target is in a title 11 or similar case or if the corporation is insolvent. In such cases, the regulation provides that, if any class of creditor receives an equity interest in the acquiring corporation in exchange for part or all of its claim, a proportion of the most senior class to receive an equity interest and all equal classes (based on the overall proportion of all such classes that receives a proprietary interest), and 100 percent of all junior classes, will be considered proprietary interests in the old corporation. Shares of stock for which any consideration is received will also be considered proprietary interests. The regulation further provides that, if a creditor's claim is bifurcated into a secured and an unsecured claim pursuant to an order in a title 11 or similar case, or pursuant to an agreement between the creditor and the debtor, that bifurcation will be respected for purposes of applying these rules. For further discussion of the regulation, see §605.1.4 below.

Because of the breadth of this rule, an acquiring corporation should be careful not to issue any stock in exchange for a senior debt of the insolvent target corporation, unless it is willing to have all the target debt junior to it (including its intermediate debt and not just its most junior debt) regarded as equity which must receive a substantial portion of its consideration in the form of stock in order to satisfy the continuity-of-interest requirement.

Aside from determining who should be treated for continuity-of-interest purposes as the old equity holders, it should be noted that to satisfy the continuity-of-interest requirement, the new equity need not be issued pro rata to the old equity

<sup>49</sup> See IRS Field Service Advice 200008012, November 8, 1999, reprinted at 2000 TNT 39-64, holding that stock issued for such old stock could satisfy the requirements for an "A" reorganization, citing *Norman Scott v. Commissioner*, *supra* note 47. But see Rev. Rul. 73-233, discussed at §605.1.4 below. Also, it should be noted that the explanation accompanying the 2005 proposed "net value" regulations indicated that the IRS would consider *Norman Scott* to fail the new net-value test, and thus would no longer qualify as a good "A" reorganization, because the value of the corporate assets was apparently less than the value of the corporate liabilities. See also New York State Bar Association, Tax Section, Committee on Bankruptcy and Losses, Report on Reorganizations Involving Insolvent Subsidiaries (November 7, 2003), 101 Tax Notes 761 (November 10, 2003), making recommendations regarding tax-free treatment for upstream restructurings (through mergers, liquidations, or conversions into disregarded entities) and sideways restructurings (through mergers or otherwise) of non-bankrupt but insolvent subsidiaries; and the updating of this report in New York State Bar Association, Tax Section, Report on Claiming Worthlessness for a Failed Subsidiary Within a Consolidated Group (January 28, 2011), 2011 TNT 20-81.



loss of voting rights (which did not, of course, eliminate their right to vote on the bankruptcy plan itself).<sup>8</sup>

Code § 1504(a)(3) provides that a subsidiary is includible in a consolidated return only if the group owns stock of the subsidiary that possesses (1) at least 80 percent of the voting power of its stock and (2) at least 80 percent of the total value of its stock (not including certain nonvoting, nonparticipating, limited preferred stock). Code § 1504(a)(5)(C) authorizes the issuance of regulations that would allow the value test to be considered met if the group relies on a "good faith determination" of value; and Code § 1504(a)(5)(D) authorizes the issuance of regulations that would allow the group to disregard an "inadvertent ceasing" to meet the value test because of changes in relative values of different classes of stock. As of this writing, regulations had not been issued under these provisions. However, in Notice 2004-37,<sup>9</sup> the IRS announced an intention to issue proposed regulations under these provisions in the future. The Notice also announces the tests that the IRS will apply in the meantime under these concepts for determining whether the 80 percent value test has been met. The Notice says that if the group has made a good faith determination that the value test has been met, the "good faith determination" test can be considered satisfied, if the group wishes, until certain "designated events" occur, at which time another good faith determination would become necessary. Similarly, the Notice says that if the value test ceases to be met because of a change in the relative values of different classes of stock that was not caused by a "designated event," the value test can be considered met until a "designated event" occurs. The "designated events" include certain transactions in the stock by members of the group, certain distributions on the stock to a member of the group, and the claiming by the group of a worthless stock deduction for any of the stock. The Notice says that the IRS will not challenge the group if the group takes the position that these "good faith" or "inadvertent" standards are met. On the other hand, it says that the Notice does *not* require the taxpayer to take the position that the value test is met, if in fact it is not met. There is no indication that the issuance of this Notice was triggered by IRS concern about what can happen in the bankruptcy context. Nor is any indication given as to whether the IRS intends the rules announced in the Notice to modify the approach taken in Rev. Rul. 63-104, mentioned at the beginning of this § 804.1. This is a significant question, because these rules, if they applied in bankruptcy, could have a considerable impact on bankruptcy practice.

<sup>8</sup> A similar situation arose in the *Eastern Air Lines* bankruptcy case. There, the bankruptcy court approved a Stipulation and Order enjoining the preferred stockholders from asserting any voting rights until the day after the effective date of a Chapter 11 plan. See *In re Ionosphere Clubs, Inc.*, Ch. 11, Case No. 89-B-10448 (BRL) (Bankr. S.D.N.Y.), Stipulation and Order dated May 31, 1991. This was preceded by a temporary restraining order and a motion similar to that in *Federated* (dated May 9, 1991). Cf. IRS Letter Ruling 200725026, March 20, 2007 (advance waiver of voting rights by requisite percentage of holders in accordance with the terms of the preferred stock).

<sup>9</sup> 2004-21 I.R.B. 947. For recommendations regarding possible content of the proposed regulation, see New York State Bar Association, Tax Section, Report on Notice 2004-37 (November 18, 2004), reprinted at 2004 TNT 226-13 (November 23, 2004).

For a discussion of similar multi-class valuation issues that can arise in determining whether an ownership change has taken place for purposes of Code § 382, see § 508.2.5.1 above.

Some interesting problems can arise out of the fact that a single entity, generally the common parent, has the authority to act as the sole agent for the other members of the group with respect to all matters relating to the tax liability of the consolidated group. Reg. § 1.1502-77(a) provides that the parent (or other designated entity) "is the sole agent that is authorized to act in its own name regarding all matters relating to the federal income tax liability for the consolidated return year for each member of the group . . . ." In IRS Field Service Advice 200051002, September 15, 2000, a group consisted of a parent, *P*, and subsidiaries *S1* and *S2*. *S1* was placed in receivership. *P* had filed consolidated returns for the group for years 1 through 3, but the sole remaining officer of *P* refused to file returns of any kind for years 4 and 5. The receiver believed that *S1* had overpaid its taxes for year 4, and that the filing of consolidated returns for years 4 and 5 would produce a carryback refund for years 1 through 3. *S1* was not a financial institution to which Reg. § 301.6402-7, issued under Code § 6402(j)—and discussed below at § 806.2.5—applies. Thus, the only provision that in any way addressed this situation was the last sentence of then Reg. § 1.1502-77A(a), which says: "Notwithstanding the provisions of this paragraph appointing the common parent as sole agent for the group, the District Director may, upon notifying the common parent, deal directly with any member of the group in respect of its liability, in which event such member shall have full authority to act for itself." This authority is now contained in Reg. § 1.1502-77(f)(2). Note that this does not make the subsidiary an agent for the other members of the group, nor does it authorize the subsidiary to file a separate, rather than a consolidated, return.

The IRS held that, while *S1* was required to continue to file consolidated returns, the District Director should apply this last sentence of Reg. § 1.1502-77(a) to "break the common parent's agency" to act for *S1* for the years 1 through 5; and *S1* should file a consolidated return for the group for years 4 and 5 and amended returns for years 1 through 3. However, such actions by *S1* would be only on its own behalf, and could not bind the other members of the group, because such breaking of the sole agency allows *S1* only "to act for itself" and does not make it an agent for the group. Thus, the returns, though required to be in form and content consolidated returns, could be filed only on behalf of *S1*. Since the IRS would not be protected against claims by the other members of the group if it paid any of the refunds to *S1*, the IRS would deny the claims for refund, and *S1* would have to sue for the refunds in an action in which the other members of the group were interpleaded. Obviously, this is a very cumbersome procedure, which suggests the desirability of bringing all members of a consolidated return group before the court in the first instance where this is possible.

## § 804.2 Excess Loss Accounts

Where the parent has an excess loss account with respect to the stock of a subsidiary that has a cancellation of debt item, the cancellation of debt may, in certain cases, cause the excess loss account to be triggered into income and to generate ordinary income rather than capital gain.



Thus, the basis redetermination rule only applies where there is a transfer of loss shares (but could impact gain shares transferred at the same time). Among other things, under the rule both positive and negative investment adjustments that have previously been made to the shares are reallocated, first, so as to reduce or eliminate loss on preferred shares, and then to reduce basis disparity on all shares. This rule, in effect, seeks to reduce or eliminate both noneconomic and duplicated losses.

**Basis reduction rule.** If, after application of the basis redetermination rule, any transferred share remains a loss share (even if it only became a loss share by application of the redetermination rule), the basis of the share is subject to reduction under this second rule. The purpose of this rule is to reduce or eliminate any noneconomic losses that remain after application of the redetermination rule. The basis reduction rule operates by reducing the basis of each transferred loss share (but not below value) by the lesser of the share's "disconformity amount" or its "net positive adjustment."

The "disconformity amount" is the excess of the share's basis over its allocable portion at the transfer date of the issuer's net inside tax attributes. The issuer's net inside tax attributes are the sum of the issuer's loss carryovers, deferred deductions, cash, and asset basis, reduced by the issuer's liabilities.

The "net positive adjustment" is computed as the greater of zero and the sum of all investment adjustments (excluding distributions) that have been applied to the basis of the transferred loss share. All items of income, gain, deduction and loss that have been reflected in the share's basis are taken into account.

**Attribute reduction rule.** If any transferred share remains a loss share after application of the foregoing two rules, the subsidiary's duplicating loss attributes (e.g., asset basis, loss carryovers, deferred deductions) are subject to reduction. This rule seeks to reduce or eliminate duplicated losses: the rule is intended to ensure that the group does not recognize more than one loss with respect to a single economic loss, regardless of whether the group chooses to dispose of the subsidiary's stock before or after the subsidiary recognizes the loss with respect to its assets. The rule requires the subsidiary to reduce its tax attributes by the lesser of the net stock loss or the aggregate inside loss (the latter defined generally as the excess of the subsidiary's tax attributes, reduced by the amount of the subsidiary's liabilities, over the value of all of the subsidiary's shares). By focusing on reducing the subsidiary's tax attributes, rather than on suspending or disallowing the group's loss in the stock of the subsidiary, the -36 rule allows the deduction for the loss on the shares, but disallows the use of the duplicating asset basis or other tax attribute of the subsidiary.

This attribute reduction rule also gives the group an election to reduce—instead of the subsidiary's tax attributes—the basis in the subsidiary's shares, or to reattribute the subsidiary's tax attributes within the group (though this latter election can only be made if the subsidiary ceases to be a member of the group and only for certain attributes). This reattribution election is particularly complex, and has the effect, through tiering up of the adjustments, of also reducing the basis of the subsidiary's shares.

Where the consolidated group contains several tiers of subsidiaries, the -36 regulation provides detailed rules about how to apply the foregoing adjustments through the various tiers.

As the reader can tell from even this brief summary, the -36 regulation is exceedingly complex.<sup>132</sup> The good news is that it only applies, and only needs to be considered, when a group transfers a share of a subsidiary that is a loss share. But where that occurs, the regulation will impose heavy analytical and record keeping burdens on taxpayers, and require an expenditure of large amounts of administrative time by both the taxpayer and the government.<sup>133</sup>

Recognizing that the original proposed effective date of the -36 regulation could cause problems for persons negotiating transactions before the regulation becomes final, the IRS in December 2007 issued Notice 2008-9, 2008-3 I.R.B. 277, to provide that the regulation will not apply to a transfer to an unrelated person, within the meaning of Code §267(b), that is pursuant to an agreement which is binding before the date the regulations are made final and at all times thereafter. This concept was included in the effective date provision of Reg. §1.1502-36(h).

#### §804.6 Consolidated §382, SRLY, and CRCO Rules

As discussed at §508.7 above, the consolidated return regulations provide special consolidated rules for the application of Code §382.

Similarly, the members of a consolidated return group must take into account the consolidated SRLY limitations. These were discussed at §509.4 above. In this regard, it should be noted that if a member has a built-in loss when it joins a consolidated return group, the SRLY limitation applies to that built-in loss.<sup>134</sup> For earlier years, the group also had to take into account the CRCO limitations, which were discussed at §509.3 above.

#### §804.7 Leaving or Joining a Consolidated Group: Tactical Considerations for Buyer and Seller

Finally, we should point out that special considerations arise where a member leaves a consolidated return group.<sup>135</sup> A member can leave in a number of different ways, including a taxable or tax-free acquisition of its stock by an unrelated company or the acquisition of its assets in a taxable or tax-free acquisition. In any such case, the

<sup>132</sup> Its complexity is well illustrated by IRS Chief Counsel Advice 20150301F, September 10, 2014. Here, corporation B owned E, a disregarded entity which was in bankruptcy. E in turn owned corporation A, which was not in bankruptcy. The Chief Counsel held that, since A was not in bankruptcy, its tax attributes were not property of E's bankruptcy estate, and thus the bankruptcy automatic stay did not prevent B from reattributing A's NOLs to itself under the -36 regulation.

<sup>133</sup> See generally Pellervo and Siders, The Newest Loss Disallowance Rule for Consolidated Groups—Let the Buyer Beware, 109 J.Tax'n 334 (2008).

<sup>134</sup> See both the temporary Reg. §1.1502-15T and final Reg. §1.1502-15, which are discussed at §509.4 above.

<sup>135</sup> For a further discussion, see Hyman and Hoffman, Consolidated Returns: Summary of Tax Considerations in Acquisition of Common Parent or Subsidiary Member of Affiliated Group, 33 Tax Law. 383 (1980); Henderson, Side Effects of Leaving a Consolidated Return Group, 27 Inst. on Fed. Tax'n 711 (1969).



bility for the payment of prepetition priority and administrative claims. Accordingly, when the liquidating trust fell behind on its payments, the Texas Comptroller imposed (under its normal statutory authority and as permitted by the plan) a lien on all the trust's assets for the full amount of its claims.

The bankruptcy court also may reopen a Chapter 11 case, upon motion by a party in interest, "to administer assets, to accord relief to the debtor, or for other cause."<sup>130</sup> This rule cannot be used to circumvent the 180-day period in which a request must be filed to revoke confirmation on grounds that the order was procured by fraud.<sup>131</sup> In addition, laches may constitute a bar to an action that has been delayed too long.<sup>132</sup> In *In re Wilshire Courtyard*,<sup>133</sup> the Ninth Circuit held that it was within the bankruptcy court's jurisdiction to reopen a 10-1/2 year old bankruptcy case to consider the characterization of the transactions in (and thus the interpretation of) the

<sup>130</sup> 11 U.S.C. § 350(b). See Fed. R. Civ. P. 60; Bankruptcy Rule 9024 (waiving one-year limitation of Rule 60(c) with respect to the reconsideration of an "order allowing or disallowing a claim against the estate entered without a contest"); *Georgia Dept. of Rev. v. Mouzon Enterprises, Inc.* (In re Mouzon Enterprises, Inc.), 610 F.3d 1329 (11th Cir. 2010) (a claim is "contested" if an objection is filed, regardless of whether the claim is subsequently settled and not actually litigated); *In re Smith Audio Visual, Inc.*, 2013 Bankr. LEXIS 1211 (Bankr. D. Kan. 2013) (denied IRS motion to revoke confirmation, even though the plan did not reflect the IRS's amended claim, notice of the disclosure statement and of confirmation was sent to the wrong IRS address, and the IRS filed its motion within 2-1/2 months after confirmation; the court balanced the strong interest for finality in the confirmation process and the fact that the IRS had previously received certain notices from the debtor at such address and admittedly had received electronic notice through the email address it designated for use in Chapter 7 cases); *Dearing v. United States* (In re Catt), 96-2 U.S.T.C. ¶ 50,422 (E.D. Wash. 1996) (reformation of plan more than three years after confirmation to correct for a clerical error was not an abuse of discretion); *City of White Plains, N.Y. v. A & S Galleria Real Estate, Inc.* (In re A & S Galleria Real Estate, Inc.), 1998 Bankr. LEXIS 101 (Bankr. S.D. Ohio 1998) (reopened case to determine existence of tax lien with respect to prepetition taxes and the allowance of other taxes as administrative expenses); *Mass. Dept. of Rev. v. Crocker* (In re Crocker), 362 B.R. 49 (Bankr. 1st Cir. 2007) (upheld the reopening of a bankruptcy case to determine the dischargeability of taxes owed to the Massachusetts Dept. of Revenue and the IRS, in part based on the fact that it involved multiple taxing authorities and thus was more efficiently handled by the bankruptcy court); *In re Redcay*, 2007 Bankr. LEXIS 4075 (Bankr. E.D. Pa. 2007) (individual debtor; taxes incurred upon sale of assets post-Chapter 11 plan were not administrative expenses, even though sales occurred pursuant to the Chapter 11 plan; court therefore denied IRS motion to reopen bankruptcy case to file an administrative claim for the taxes). A bankruptcy case that was dismissed prior to full administration cannot be reopened under Bankruptcy Code section 350(b), but in "extraordinary circumstances" or situations of "extreme and undue hardship," may be able to be reopened for limited purposes under Bankruptcy Rule 9024, which incorporates Fed. R. Civ. P. 60. See *Phoenix Bond & Indemnity Co. v. MCM Enter., Inc.*, 319 B.R. 157 (S.D. Ind. 2005).

<sup>131</sup> Bankruptcy Rule 9024; see *BFP Investments, Inc. v. BFP Investments Limited*, 2005 U.S. App. LEXIS 22243 (11th Cir. 2005) (unpublished decision). Cf. *IRS v. Kostoglou* (In re Kostoglou), 1993 U.S. Dist. LEXIS 11697 (N.D. Ohio). See also *In re Smith Audio Visual, Inc.* (Bankr. D. Kan.), *supra* note 130 (citing cases but, under the circumstances, did not have to decide whether fraud is an overriding precondition to revoke confirmation).

<sup>132</sup> H. Rep. No. 595, 95th Cong., 1st Sess. 338 (1977); S. Rep. No. 989, 95th Cong., 2d Sess. 49 (1978); see also *In re Rundle*, 1991 Bankr. LEXIS 1875 (Bankr. N.D. Ill. December 13, 1991); *United States v. Ashe*, 228 B.R. 457, 98-2 U.S.T.C. ¶ 50,675 (C.D. Cal. 1998); see also *Varde Investment Partners, L.P. v. Comair, Inc.*, *supra* note 121.

<sup>133</sup> *Wilshire Courtyard v. Calif. Franchise Tax Bd.* (In re Wilshire Courtyard), 729 F.3d 1279 (9th Cir. 2013), *rev'g* 459 B.R. 416 (Bankr. 9th Cir. 2011), *rev'g* 437 B.R. 380 (Bankr. C.D. Cal. 2010). The decision is discussed in greater detail at § 1013 below.

Chapter 11 plan for state income tax purposes. The substantive issue involved, in significant part, whether the reorganization of the debtor partnership constituted for tax purposes a "disguised sale" by the then partners of a 99% ownership interest in the partnership (resulting in capital gain rather than COD income).

Regardless of whether the bankruptcy court reopens the Chapter 11 case, the bankruptcy court generally can still determine if a particular debt was discharged in the case.<sup>134</sup>

### § 1003 BANKRUPT CORPORATION AS TAXABLE ENTITY

For bankruptcy law purposes, the filing of a bankruptcy petition creates a separate "estate" in bankruptcy.<sup>1</sup> When the debtor is a corporation, however, this separate estate has no tax significance. No new or separate taxable entity is created.<sup>2</sup> The debtor corporation continues unchanged as the taxable entity, and is effectively treated as one with the bankruptcy estate for tax reporting and payment purposes. This is true even if a trustee in bankruptcy is appointed.

This result adheres notwithstanding the Supreme Court's decision in *Hall v. United States*,<sup>3</sup> wherein the Court held that a bankruptcy estate under Chapter 12, in a case involving an individual farmer, is not subject to tax because it is not a separate taxable entity under Code §§ 1398 and 1399. As the Court observed, corporate debtors in bankruptcy are different:

Among estates that are not separately taxable, those involving corporate debtors have long been singled out by Congress for special responsibilities. Although estates of corporate debtors are not separate taxable entities under [Code] §§ 1398 and 1399, [Code § 6012(b)(3)] requires a trustee that "has possession of or holds title to all or substantially all the property or business of a corporation" to "make the return of income for such corporation." In effect, Congress provided that the trustee in a corporate-debtor case may shoulder responsibility that parallels that borne by the trustee of a separate taxable entity.<sup>4</sup>

Additionally, the Court observed that Bankruptcy Code section 346 (applicable to state and local income taxes) was amended in 2005 to align to the federal rules, and

<sup>134</sup> See, e.g., *Goldstein v. Diamond* (In re Diamond), 509 B.R. 219 (Bankr. 8th Cir. 2014); *Menk v. Lapaglia* (In re Menk), 241 B.R. 896, 910 (Bankr. 9th Cir. 1999); *In re Chester E. Ehrig*, Order Denying Motion to Dismiss, Adv. No. 03-0142-R (Chapter 7), Bankr. N.D. Okla. (Sept. 12, 2003), *reprinted at* 2004 TNT 10-19.

<sup>1</sup> § 1003 See 11 U.S.C. § 541 (describing property included in the estate).

<sup>2</sup> Code § 1399; *Callahan v. UMW 1992 Plan* (In re Callahan), 304 B.R. 743 (W.D. Va. 2003) (so holding; rejected any distinction between Chapter 7 and Chapter 11, and held that such treatment was also applicable to premiums under the Coal Industry Retiree Health Benefits Act, which had been held under earlier case law to constitute "taxes"). This is also true for state and local income tax purposes. 11 U.S.C. § 346(b), as amended by P.L. 109-8, § 719 (2005); and former 11 U.S.C. § 346(c).

<sup>3</sup> 132 S. Ct. 1882, 2012-1 U.S.T.C. ¶ 50,345 (2012).

<sup>4</sup> 132 at 1892-1893 (citations omitted).



notwithstanding, any reliance on bar date authorities appears strained in light of the differing bankruptcy policy and equitable considerations underlying the allowance of post-bar date amendments.<sup>59</sup>

As indicated above, the Seventh Circuit's decision in *Pettibone* and, more particularly, the district court's decision in *Midway Industrial* represent a departure from prior case law as to what constitutes a setoff within the meaning of Bankruptcy Code section 553.<sup>60</sup> The Seventh Circuit attempted to distinguish the bulk of these cases on the basis that they involved individuals:

Unlike corporations, natural persons rarely shift tax consequences across years. When the end of the year closes the books on taxes, applying refunds from one year to debts from another more closely resembles the traditional notion of a setoff.

As part of a broader decision, the Second Circuit, in *In re Chateaugay Corporation*,<sup>61</sup> disagreed with the *Pettibone* line of authorities and rejected the argument that the crediting of under- and overpayments under Code § 6402(a) is something other than an ordinary right of setoff. The Second Circuit thus observed that the IRS, like any other creditor, must obtain the permission of the bankruptcy court before setting off (or crediting) any amount against a prepetition claim.

<sup>59</sup> It should be noted that a majority of courts have also held that each taxable year, even for the same tax, gives rise to a distinct claim in bankruptcy. Thus, if the bar date analogy were apt, this would suggest a contrary result even on the facts of *Pettibone*.

<sup>60</sup> See, e.g., *Still v. United States* (*In re W.L. Jackson Mfg. Co.*), 50 B.R. 498, 85-2 U.S.T.C. ¶9543 (Bankr. E.D. Tenn. 1985) (approving setoff of income tax under and overpayments); *Rozel Indus. v. IRS* (*In re Rozel Indus., Inc.*), *supra* note 37 ("Section 553 does not grant [a right of setoff], but it does not restrict or impair such a right if it exists under other applicable law. The applicable law in this case is § 6402(a)"; court observed that the exercise of a setoff under Code § 6402(a) would violate the automatic stay); *In re Rush-Hampton Indus., Inc.*, 159 B.R. 343 (Bankr. M.D. Fla. 1993), *aff'd and rev'd in part*, 98 F.3d 614, 96-2 U.S.T.C. ¶50,613 (11th Cir. 1996) (IRS setoff of income tax overpayment against unpaid employment taxes in violation of automatic stay; although bankruptcy court subsequently approved offset for the tax and prepetition interest owing, it refused to "reward the IRS for offsetting prior to receiving relief from the automatic stay by allowing [it] to offset postpetition interest"; the Eleventh Circuit, however, also permitted the IRS to offset postpetition interest); *Matter of Johnson*, 136 B.R. 306, 308 (Bankr. M.D. Ga. 1991) ("the IRS' right to setoff derives from § 6402(a)"; held IRS not permitted to setoff an income tax refund owed to Chapter 13 debtor against an income tax liability for a prior year because IRS was adequately protected under the plan); *In re Miel*, 134 B.R. 229 (Bankr. W.D. Mich. 1991) (IRS setoff of a claimed income tax refund against an income tax liability for a prior year violated automatic stay; however, IRS was not held in civil contempt where notice of bankruptcy proceeding was sent to wrong address); cf. *United States v. Norton*, *supra* note 21 (where the issue was the retention of an overpayment in a "suspense account," the IRS argued that no violation of the automatic stay occurs absent a setoff as defined in Code § 6402; also involved income taxes, as in *Johnson and Miel*); *In re Harris*, 19 B.R. 624 (Bankr. E.D. Pa. 1982) (government admitted and court effectively concluded that a Code § 6402 setoff is a setoff within the meaning of Bankruptcy Code sections 362 and 553; also involved income taxes, as in *Johnson and Miel*). See also cases cited at Stand. Fed. Tax. Rep. (CCH) ¶39,470.072 (setoff either held in violation of automatic stay, or court approval obtained).

<sup>61</sup> *Aetna Casualty & Surety Co. v. LTV Steel Co., Inc.* (*In re Chateaugay Corp.*), 94 F.3d 772, 780-781, 96-2 U.S.T.C. ¶50,458 (2d Cir. 1996).

At least one court, though, in an analogous situation (involving an anticipated refund claimed as exempt property by an individual debtor), described as "the emerging view" the IRS's right to credit under- and overpayments under Code § 6402(a), with only the resulting refund being considered estate property.<sup>62</sup>

In *In re Coastal Bus and Equipment Sales, Inc.*,<sup>63</sup> the IRS sought relief from the automatic stay "out of an abundance of caution" to setoff a corporate debtor's prepetition income tax overpayments against unpaid postpetition payroll tax liabilities (incurred prior to the debtor's conversion from Chapter 11 to Chapter 7). Interestingly, the court asked the parties to consider the applicability of the doctrine of equitable recoupment (discussed below at § 1006.1.1.4), since recoupment—unlike setoff—is not an act precluded by the automatic stay. The IRS's conclusion, however, was that "[s]ince different taxes and periods are involved here, and no single transaction, item, or taxable event is involved, the doctrine of recoupment has no application to the facts of this case" (emphasis added). Surprisingly, the court disagreed. Recognizing that it was adopting an interpretation more favorable to the IRS than the IRS itself espoused, the court held that "the taxes and tax years at issue here form a unified whole where recoupment is singularly appropriate." In support, the court quoted extensively the Seventh Circuit's reasoning in *Pettibone* regarding the interdependence of taxable years.<sup>64</sup> As discussed at § 1006.1.1.4, the IRS was right, recoupment should not have applied.

#### § 1006.1.1.2 Interagency Setoffs by IRS

The federal government's ability to effectuate, with bankruptcy court approval, an interagency setoff of other federal obligations of a debtor against tax overpayments generally depends upon (1) the extent to which such a setoff is permitted under applicable nonbankruptcy law and (2) the "mutuality" of the other federal obligation and the tax overpayment.<sup>65</sup> In addition, some courts have held that the failure to assert a setoff right specifically in a proof of claim constitutes a waiver of such claim.<sup>66</sup> A creditor may, however, generally rescind a waiver unless another

<sup>62</sup> *Jones v. IRS* (*In re Jones*), 359 B.R. 837, 2007-1 U.S.T.C. ¶50,266 (Bankr. M.D. Ga. 2006).

<sup>63</sup> 330 B.R. 328 (Bankr. D. Mass. 2005).

<sup>64</sup> Adopting the Seventh Circuit's distinction between corporations and individuals, the same court a month later refused to apply recoupment to the offsetting of prepetition overpayments and underpayments of an individual debtor. *Beaucage v. United States* (*In re Beaucage*), 334 B.R. 353 (Bankr. D. Mass. 2005) (but granted relief from stay to allow setoff), *aff'd*, 342 B.R. 408, 2006-2 U.S.T.C. ¶50,450 (D. Mass. 2006).

<sup>65</sup> See 11 U.S.C. §§ 553(a) (addresses the setoff of mutual prepetition obligations), 362(a) (restricting the setoff of prepetition claims); *United States v. Carey* (*In re Wade Cook Financial Corp.*) (Bankr. 9th Cir.), *supra* note 13 (IRS right of setoff under Code § 6402 is subject to requirements of Bankruptcy Code section 553). The general ability to set off mutual postpetition obligations has nevertheless been recognized in case law. See, e.g., *In re Calore Express Company, Inc.*, *supra* note 22 (ability to setoff mutual postpetition obligations is similarly subject to the automatic stay; First Circuit reversed on other grounds).

<sup>66</sup> Compare *In re Calore Express Company, Inc.* (1st Cir.), *supra* note 22, at 39-40 (First Circuit held that "as a general matter, a creditor's silence in the early stages of bankruptcy proceedings, at such as the



stay and the debtor's unreasonable behavior was a contributing factor.<sup>65</sup> Also, some courts have granted relief for technical, nonsubstantive violations of the stay.<sup>66</sup> Aside from its equitable powers, the bankruptcy court may also retroactively annul (or otherwise modify) the automatic stay under Bankruptcy Code section 362(d) in certain circumstances.<sup>67</sup> It is in light of these powers that many courts have viewed actions in violation of the automatic stay as simply voidable.<sup>68</sup>

### §1007.7 Damages for Violating Automatic Stay

In the event of certain willful (and, possibly, even inadvertent) violations of the automatic stay, the IRS may be liable for damages.<sup>69</sup> As a result of changes made by

(Footnote Continued)

2004); *New Orleans Airport Motel Assocs., Ltd. v. Lee* (In re *Servico, Inc.*), 144 B.R. 933 (Bankr. S.D. Fla. 1992).

<sup>65</sup> See, e.g., *In re Smith Corset Shops, Inc.*, supra note 63 (debtor could not remain "stealthily silent" when it had advance notice of the proposed action and had an agent present when the action was occurring); *Matthews v. Rosene*, supra note 63 (laches barred debtor's attempt to void a 33-month-old judgment in favor of creditor who had filed a counterclaim in a state court action initiated by the debtor); *In re Calder*, 907 F.2d 953 (10th Cir. 1990) (state court judgment not void where debtor actively participated in action and did not provide notice of bankruptcy until just before final judgment was entered); *In re Downing*, 23 B.C.D. 134 (Bankr. N.D. Okla. 1992) (to same effect); see also 2 Collier on Bankruptcy §362.07 (15th ed.).

<sup>66</sup> See, e.g., *Harbaugh v. United States* (In re *Harbaugh*), 89-2 U.S.T.C. ¶9608 (W.D. Pa.), aff'd without opinion, 902 F.2d 1560 (3d Cir. 1990) (allowed setoff without prior court approval where IRS was unaware of bankruptcy). Cf. *Soares v. Brockton Credit Union* (In re *Soares*), 107 F.3d 969 (1st Cir. 1997) (purely "ministerial" acts, i.e., acts that are essentially clerical in nature, do not violate stay); *Schwartz v. United States* (In re *Schwartz*), supra note 63, at 574-575. But cf. *infra* notes 118-120.

<sup>67</sup> See, e.g., §1002.4 (criteria for modifying stay); *Soares v. Brockton Credit Union* (In re *Soares*), supra note 66 (1st Cir.) (retroactive relief is appropriate only in circumstances in which the facts are "both unusual and unusually compelling"); *In re Kissinger*, 72 F.3d 107, 109 (9th Cir. 1995) (stated that retroactive relief should be granted only in "extreme circumstances," but employed more of a balancing of the equities, including prejudice to the parties); *Fjeldsted v. Lien* (In re *Fjeldsted*), 293 B.R. 12 (Bankr. 9th Cir. 2003) (laying out suggested list of factors for assessing equities); *In re Reisbeck*, 505 B.R. 546 (Bankr. D. Mont. 2014) (denied retroactive relief for amounts received and applied by the IRS postpetition pursuant to a prepetition levy, where the IRS did not seek relief until two months later and the amounts provided the debtor the opportunity to reorganize its debts); *In re Murray*, 193 B.R. 20 (Bankr. E.D. Cal. 1996) (denied IRS retroactive relief where IRS acted with continuous indifference to bankruptcy process, even though there was no harm to creditors); *In re Halas*, 194 B.R. 605 (Bankr. N.D. Ill. 1996) (granted creditor partial retroactive relief where no prior knowledge of bankruptcy), appeal dismissed, 199 B.R. 654 (N.D. Ill. 1996); *Goldman v. United States* (In re *Schild*), 242 B.R. 1, 99-2 U.S.T.C. ¶50,829 (Bankr. C.D. Cal. 1999) (granted retroactive relief, without specific reference to Bankruptcy Code section 362(d), where the IRS had mistakenly believed that a prepetition offer in compromise effectuated an assignment of debtor's tax refund and that it could therefore setoff the refund without violating the automatic stay). See also *George v. United States* (In re *George*), 2001 U.S. App. LEXIS 2361 (9th Cir. 2001) (unpublished opinion; relief under section 362(d) must be requested by a party in interest; court cannot act *sua sponte*).

<sup>68</sup> See, e.g., *Bronson v. United States*, supra note 64.

<sup>69</sup> In *In re Innovation Instruments, Inc.*, supra note 24, the bankruptcy court (although ultimately concluding that no violation of the automatic stay occurred) held that it did not have authority to disallow the IRS's claim as punishment for violating the automatic stay, and that the debtor's only recourse would be to seek damages.

the IRS Restructuring and Reform Act of 1998, a debtor's ability to recover damages differs significantly depending on whether the violation occurs after July 22, 1998.<sup>70</sup>

For violations of the automatic stay by the IRS after July 22, 1998, in connection with the collection of federal tax from the debtor, a debtor's potential bases for damages are circumscribed by Code §7433(e) ("Actions for Violations of Certain Bankruptcy Procedures"), as discussed at §1007.7.1 below. As a result, a debtor can no longer seek monetary sanctions against the IRS for contempt or seek recovery of costs under the Equal Access to Justice Act for such violations. Actual, direct economic damages are potentially recoverable only under Code §7433 or Bankruptcy Code section 362(k)(1). And Code §7430 is now the exclusive basis for recovering attorneys' fees, as well as certain other costs, from the IRS with respect to such damage actions. Exhaustion of all available administrative remedies is a prerequisite to any damage action under Code §§7430 and 7433.

Aside from violations of the automatic stay, it should be noted that the bankruptcy court's contempt power, Code §7430 and the Equal Access to Justice Act are also potentially available to a debtor where there are other violations of bankruptcy court procedures (e.g., postdischarge collection efforts) or abuses of the bankruptcy process. For example, in appropriate cases, the IRS could be held liable for filing a frivolous or unjustified proof of claim.<sup>71</sup> However, with respect to any IRS violations of the postdischarge injunction after July 22, 1998, Code §§7430 and 7433 provide the exclusive basis for recovering damages.<sup>72</sup>

For IRS violations of the automatic stay that occurred on or before July 22, 1998, as well as any IRS violations occurring thereafter that are not in connection with the collection of federal tax from the debtor, there are four potential bases for a claim for damages:

- (1) the civil contempt power of the bankruptcy court;
- (2) Bankruptcy Code section 362(k)(1)—formerly section 362(h), and often referred to herein accordingly;<sup>73</sup>
- (3) Code §7430 ("Awarding of Costs and Certain Fees"); and
- (4) the Equal Access to Justice Act (28 U.S.C. §2412).

However, depending on the court, some or all of these may not be available (see §§1007.7.2 through 1007.7.5). Prior to the Bankruptcy Reform Act of 1994, it was the IRS's position that, because of the United States' sovereign immunity and the fact that any stay violation is in connection with the determination or collection of tax, Code §7430 was the exclusive means for obtaining attorneys' fees against the IRS in

<sup>70</sup> See Code §7433(e), discussed at §1007.1.1 below.

<sup>71</sup> See, e.g., *In re Brickell Investment Corp.*, 922 F.2d 696, 91-1 U.S.T.C. ¶50,056 (11th Cir. 1991); and *infra* §1010.1 note 28 (involving proof of claim). With respect to postdischarge collection efforts, see supra §1005 notes 54-56 and accompanying text, and *infra* §1014 note 24.

<sup>72</sup> See Code §7433(e) and Reg. §301.7433-1(b), (h), discussed at §1007.7.1 below. Although actions under Bankruptcy Code section 362(h)—now section 362(k)(1)—are permitted by Code §7433(e)(2), Bankruptcy Code section 362(h) applies by its terms only to violations of the automatic stay.

<sup>73</sup> The redesignation occurred as part of the 2005 bankruptcy reform changes.



the order confirming the plan," it would seem that the Chapter 11 plan can be easily drafted to align the discharge event with the effectiveness of the plan. And in fact, most plans are drafted to do this. However, despite such a plain reading of the statute, the Eleventh Circuit Court of Appeals in a 2006 decision held that the discharge occurs upon entry of the confirmation order and cannot be varied by the plan or order.<sup>3</sup> The court reasoned that, because Congress used the concept of "effective date" in various provisions in the Bankruptcy Code, its absence in section 1141(d) is significant. The Fifth Circuit has since adopted this view as well.<sup>4</sup> This reasoning seems to us to be backwards, since within the context of the broad override for the terms of the plan or confirmation order, the plain reading would also seem to be the more sensible reading: namely, by not referencing the effective date, Congress intended to grant greater latitude as to the timing of the discharge, not less (see also discussion at § 510 above). This is not to suggest that the factual outcome in these cases is necessarily inappropriate and without support on other grounds.<sup>5</sup>

To satisfy Bankruptcy Code section 1141(d)'s statutory conditions for discharge in the context of a liquidating plan, it appears that the business the debtor continues does not have to be the same as that conducted by the debtor prior to the discharge. In addition, in determining whether a debtor should be denied a discharge under a liquidating plan, the courts have distinguished between a wholesale liquidation of a debtor's assets (seemingly more akin to a Chapter 7 proceeding for which no discharge is available) and a more orderly divestiture process where the debtor continues to manage its assets while seeking to liquidate them in a commercially reasonable manner, particularly if the wind down may be a prolonged and complicated process.<sup>6</sup> In the latter instance, the liquidating nature of the plan generally has not been a bar to a discharge.

Although Bankruptcy Code section 1141(d) reads as if self-contained, for a discharge of any claim to be effective, due process (or, in the case of governmental entities, concepts of fundamental fairness) requires that proper notice be made to the

<sup>3</sup> *United States v. White*, 466 F.3d 1241 (11th Cir. 2006). The relevance of the timing of discharge related to the lifting of the automatic stay (see § 1007 above), and whether certain actions taken by the IRS with respect to nondischargeable tax liabilities of an individual debtor between the confirmation date and the effective date were void as violations of the stay. Presumably, in the case of a corporate debtor, the court would also consider the postdischarge injunction imposed by the plan to be operative despite the absence of the plan effective date. Moreover, as the court recognizes, "holders of debts pursuant to the plan face formal constraints that holders of nondischargeable debts do not. Holders of debt pursuant to the plan cannot move for collection until the plan becomes effective because the plan defines their rights and the terms of repayment." 466 F.3d at 1247.

<sup>4</sup> *Elixir v. City Bank & Trust Co. (In re Ahern Enterprises Inc.)*, 507 F.3d 817 (5th Cir. 2007). This decision involves the extinguishment of a creditor's lien where the Chapter 11 plan was confirmed but never fully consummated, and the bankruptcy case was thereafter converted to Chapter 7. In effect, the plan was abandoned. Nevertheless, the Fifth Circuit held that the lien stripping provision of the plan still operated to extinguish the creditor's lien, since section 1141(d) was effective upon confirmation and the creditor could have, but did not, object to the plan or the order confirming the plan.

<sup>5</sup> For example, in *White*, *supra* note 3, the court could have retroactively lifted the automatic stay on equitable grounds (see discussion at § 1007.6).

<sup>6</sup> See, e.g., *In re Enron, Inc.* (Bankr. S.D. N.Y.), *supra* note 1, at \*215-\*217 (and cases cited therein).

holder of the claim.<sup>7</sup> Because the IRS should automatically receive notice of the commencement of the bankruptcy case, the bar date for filing claims, and the confirmation hearing (see § 1004), these due process requirements should usually be met with respect to federal tax claims.<sup>8</sup> However, incomplete or false notice may render the notice inadequate.<sup>9</sup>

Also, despite the breadth of its language, Bankruptcy Code section 1141(d) generally will not operate to effectively discharge liability for postpetition taxes and most prepetition taxes for which claims are filed. This is because: Bankruptcy Code section 1141(d) applies only to the extent it does not conflict with the Chapter 11 plan; Bankruptcy Code section 1129(a)(9) requires the payment of all priority claims to be provided for in the Chapter 11 plan (see § 1016); and all postpetition taxes (to the extent not discharged pursuant to Bankruptcy Code section 505(b)), and many prepetition taxes, are treated as priority claims (see § 1015). With respect to prepetition taxes, however, the plan will usually limit the debtor's liability, at most, to that

<sup>7</sup> See generally *United States v. State Street Bank and Trust Co. (In re Scott Cable Comm., Inc.)*, 259 B.R. 536, 543-45 (D. Conn. 2001); Bienenstock, *Bankruptcy Reorganizations*, at Ch. 16, nn. 304-306 (and accompanying text) (1987); *Hairopoulos v. United States*, 118 F.3d 1240, 97-2 U.S.T.C. ¶ 50,568 (8th Cir. 1997) (Chapter 13 case) (burden of establishing that creditor received appropriate notice rests with debtor; a letter properly addressed and mailed is presumed to have been delivered; however, debtor could not prove timely mailing or receipt of notice of conversion from Chapter 7 to Chapter 13, bar date or confirmation hearing); *In re Penn. Cent. Transp. Co.*, 771 F.2d 762 (3d Cir. 1985) (notice of claims filing procedure sufficient), *cert. denied*, 474 U.S. 1033 (1985); *Reliable Electric Co. v. Olson Constr. Co.*, 726 F.2d 620 (10th Cir. 1984) (held creditor's claim nondischargeable, since no formal notice of confirmation hearing received); *Broomall Indus., Inc. v. Data Designs Logic Systems, Inc.*, 786 F.2d 401, 406 (Fed. Cir. 1986) (actual notice of creditor does not obviate debtor's obligation to provide formal notice within the meaning of the Bankruptcy Code; in certain instances, notice by publication will suffice); see also *In re American Properties, Inc.*, 30 B.R. 247 (Bankr. D. Kan. 1983) (claim not dischargeable where known creditor did not receive formal notice of bar date).

<sup>8</sup> Nevertheless, the IRS has sometimes received late or no notice. Cf. IRS Memorandum, *Reissuance of Procedures for Processing Bankruptcy Cases When the IRS Receives No Notice or Late Notice*, SBSE-05-1213-0089 (December 6, 2013), reprinted at BloombergBNA Daily Tax Report (December 11, 2013), TaxCore; *In re Moseley*, 74 B.R. 791, 801-803 (Bankr. C.D. Cal. 1987) (Chapter 13 case; additional IRS claim was barred by confirmation order; because Chapter 13 plan specified amount to be received by IRS and was timely served on the IRS, it was irrelevant that the IRS had not received notice of the bar date for filing proofs of claim or of the first meeting of creditors).

<sup>9</sup> Cf. *Ellet v. Stanislaus*, 506 F.3d 774 (9th Cir. 2007) (Chapter 13 case; tax liability for California franchise tax not discharged where notice of creditor meeting provided incorrect social security number, but correct name and address; discusses contrary cases); *In re Ryse Construction, Inc.*, 2013 Bankr. LEXIS 1404 (Bankr. D. Ariz. 2013) (by sending notices to IRS in Ogden, Utah, rather than address listed in the IRS proof of claim and Bankruptcy Noticing Center, debtor did not comply with statutory notice requirements, but nevertheless satisfied the IRS's fundamental due process rights since it was clear that appropriate IRS personnel had received actual notice of the plan and disclosure statement prior to entry of the confirmation order, and the IRS accepted notice at such address throughout the case without prior objection); *In re Trembath*, 205 B.R. 909, 914-915, 97-2 U.S.T.C. ¶ 50,738 (Bankr. N.D. Ill. 1997) (Chapter 13 case). Consider also *Joye v. Calif. Franchise Tax Bd. (In re Joye)*, 2009 U.S. App. LEXIS 18841 (9th Cir. 2009), *rev'g* 2007 U.S. Dist. LEXIS 24855 (N.D. Ca. 2007) (discussing principle of "fundamental fairness" and concluding that notice was adequate where the state taxing authority was scheduled as a creditor in the amount of \$10,000, even though the debtor did not file its tax return showing a liability of approximately \$28,000 until after the claims bar date; court observed that the taxing authority could have protected itself by filing an estimated proof of claim or requesting an extension of time to file a claim).