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# Beginning with a Head Start: The Transfer and Use of Tax Attributes by Debtors in Bankruptcy

## INTRODUCTION

Section 524(a) of the Bankruptcy Code ("BC"),<sup>1</sup> with certain exceptions, allows debtors<sup>2</sup> to discharge their personal liability on debts that arose before the commencement of bankruptcy proceedings. The purpose of the discharge is to give the debtor a fresh start.<sup>3</sup> Discharge of indebtedness ("DI"), however, gives rise to income that must be included in gross income<sup>4</sup> under the Internal Revenue Code ("IRC").<sup>5</sup> One exception to this general rule is that the taxpayer can exclude DI income from gross income to the extent that the discharge occurred due to bankruptcy.<sup>6</sup> Where this exception is applicable, IRC section 108(b) requires the taxpayer to reduce his tax attributes<sup>7</sup> to absorb the DI income excluded from gross income. Accordingly, to the extent that the debtor's tax attributes are not fully depleted because of the recognition of DI income, the debtor begins with more than a fresh start — he begins with a head start.

Part I discusses the requirements and effects of Chapter 7, 11, and 13 bankruptcy proceedings. Part II discusses tax principles concerning the use and transfer of tax attributes by corporations

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1. The BC is located at Title 11 of the United States Code. "11 U.S.C." and "BC" are used interchangeably in this comment.

2. "Debtor", as used here and in the BC, is a "person . . . concerning which a case under this title has been commenced." 11 U.S.C. § 101(13) (1994). "Person" includes an individual, partnership, corporation, and certain governmental units. *Id.* § 101(41).

3. S. Rep. No. 1035, 96th Cong., 2d Sess. 24-25 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7038.

4. "Gross income" is defined under the IRC as "income from whatever source derived," and is the starting point for calculating taxable income. 26 U.S.C. §§ 61(a), 63(a) (1994). The IRC does not define "income"; instead, it identifies what is, and is not, included in gross income. *Id.* § 61.

5. 26 U.S.C. § 61(a)(12). The IRC is located at Title 26 of the United States Code. "26 U.S.C." and "IRC" are used interchangeably in this comment.

6. *Id.* § 108(a)(1)(A). The IRC defines "discharge pursuant to a bankruptcy case" as occurring in a case under the BC where "the taxpayer is under the jurisdiction of the court and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court." *Id.* § 108(d)(2).

7. "Tax attributes," as used in this comment, refers to those items that reduce the amount of income subject to tax (such as exclusions and deductions) or that directly reduce the amount of tax due on income that is subject to tax (such as credits).

and individuals, with particular emphasis on their transfer and use in bankruptcy. Part III considers the various head start options available to corporate and individual debtors through the interaction of the IRC and the BC.<sup>8</sup> Part IV discusses some of the problems presented by Congress' efforts to reconcile the objectives behind the IRC and the BC.

## I. GENERAL BANKRUPTCY PRINCIPLES

### A. *Requirements and Effect of a Bankruptcy Filing*

Only persons who reside, are domiciled, own property, or have a place of business in the United States can be debtors.<sup>9</sup> Upon filing for bankruptcy, acts against the debtor's property and affecting the debtor's personal liability are "automatically stayed."<sup>10</sup> In addition, an "estate" is created that includes any legal or equitable property interest that the debtor has at filing or certain interests the debtor acquires within 180 days after filing.<sup>11</sup> "Estate property" includes any property generated by estate property, but does not include earnings resulting from an individual debtor's personal services (i.e., labor) performed after the bankruptcy filing.<sup>12</sup> Furthermore, estate property includes any property interest acquired by the estate after the filing.<sup>13</sup>

8. Very few rules relating to affiliated corporations, S corporations, and partnerships will be discussed here. For a discussion of affiliated corporations, see BORIS I. BITTKER AND JAMES E. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ch. 13 (6th ed. 1994). See also, *id.* chs. 12, 14.

9. 11 U.S.C. § 109(a). Municipalities can also be debtors. *Id.*

10. *Id.* § 362(a). "Automatic stay" is defined as the statutory bar (that becomes effective immediately upon the filing of a voluntary petition under the BC) on "all debt collection efforts against the debtor or property of his bankruptcy estate" on account of a debt arising before the bankruptcy petition was filed. BLACK'S LAW DICTIONARY 134 (6th ed. 1990). There is, however, a lengthy list of exceptions to the automatic stay. See 11 U.S.C. § 362(b).

In addition, creditors can request relief from the stay. *Id.* § 362(d). Some of the situations in which relief from the stay is generally available to creditors are the following:

(1) for cause, including the lack of adequate protection of an interest in property of such party in interest; [or]

(2) with respect to a stay against property under subsection (a) of this section, if —

(A) the debtor does not have an equity in such property; and

(B) such property is not necessary to an effective reorganization.

*Id.* § 362(d)(1), (2).

11. *Id.* § 541(a)(1), (5).

12. *Id.* § 541(a)(6).

13. *Id.* § 541(a)(7). Interests that are not property of the estate are described in 11 U.S.C. section 541(b). Some of the interests excluded from the estate include: "(1) any power that the debtor may exercise solely for the benefit of an entity other than the debtor[.]" (2) certain interests of the debtor in leases of nonresidential real property that expired before

The primary reason for entering bankruptcy is to obtain a discharge in some form. One effect of a bankruptcy discharge is the voiding of any judgment against the debtor to the extent that the judgment is a determination of personal liability on the discharged debt.<sup>14</sup> Another “operates as an injunction against the commencement or continuation of an action . . . to collect, recover or offset” any discharged debt relating to the debtor’s personal liability.<sup>15</sup> These effects occur despite any waiver of discharge by the debtor.<sup>16</sup>

The BC, however, lists many exceptions to debts that would otherwise be dischargeable.<sup>17</sup> Among the exceptions from discharge are certain tax debts, such as unsecured tax liability or customs duties accruing in an involuntary case<sup>18</sup> during the period (“gap period”) beginning with the date of the filing and ending at the earlier of the date a trustee is appointed or the date the court orders relief.<sup>19</sup> Such debt must also arise “in the ordinary course of the debtor’s business or financial affairs” conducted within that period.<sup>20</sup> Unsecured claims for certain taxes are also included.<sup>21</sup> Tax debts arising during the gap period in involuntary cases are classified as second-level priority unsecured claims.<sup>22</sup> Certain other unsecured taxes are classified as eighth-level priority unsecured claims.<sup>23</sup>

Priority unsecured claims of any level are paid after higher level claims are paid in full, and must be paid before any nonpriority

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filing, and (3) cash, or similar, proceeds from certain sales of a money order by the debtor. *Id.* § 541(b)(1), (2), (5), respectively.

14. 11 U.S.C. § 524(a)(1).

15. *Id.* § 524(a)(2).

16. *Id.* § 524(a)(1), (2).

17. Because the scope of discharge varies according to the chapter of the BC under which a case is filed, only some exceptions will be discussed here.

18. An “involuntary case” is one commenced by a debtor’s unsecured creditors who have claims that are not contingent, or subject to a bona fide dispute, and total at least \$10,000. 11 U.S.C. § 303(a), (b). Furthermore, only Chapter 7 or 11 can be commenced involuntarily, but not against certain Chapter 7 or 11 debtors. *Id.*

19. 11 U.S.C. §§ 523(a)(1)(A), 507(a)(2), 502(f). The petition in a voluntary case constitutes the order for relief. *Id.* § 301. Therefore, this exception to discharge does not apply in voluntary cases because there is no such gap period in these cases.

20. *Id.* § 502(f).

21. *Id.* § 523(a)(1)(A). Such unsecured tax claims include income taxes “for which a return, if required, is last due, including extensions,” within three years before the filing. *Id.* § 507(a)(8)(i).

22. *Id.* § 507(a)(2).

23. *Id.* § 507(a)(8).

unsecured claims.<sup>24</sup> Accordingly, the unsecured tax debts described previously are accorded the privileges of priority status and nondischargeability.<sup>25</sup> Since these tax debts receive priority status, it is more likely that these debts will be paid during the course of the bankruptcy case and will not follow the debtor after discharge. There are, however, nonpriority tax debts that are not dischargeable.<sup>26</sup> Although the intent behind the BC is to provide debtors a fresh start,<sup>27</sup> certain debts (such as those previously described) will continue to follow the debtor after discharge.

### 1. *The Chapter 7 Bankruptcy Proceeding*<sup>28</sup>

Chapter 7 of the BC is entitled "Liquidation."<sup>29</sup> A trustee is appointed to oversee and maintain the bankruptcy estate property in cases filed under that chapter.<sup>30</sup> Persons eligible to file a Chapter 7 proceeding are those who meet the eligibility requirements for filing bankruptcy described above, except: (1) railroads, (2) certain domestic entities insured under section 3(h) of the Federal Deposit Insurance Act<sup>31</sup> or licensed under section 301(c) or (d) of the Small Business Investment Act of 1958,<sup>32</sup> or (3) certain foreign entities that conduct the same business in the United States as such insured or licensed domestic entities.<sup>33</sup>

The bankruptcy court will grant a discharge unless: (1) the debtor is not an individual, (2) the debtor has committed certain specified acts of misconduct, or (3) the court approves a written waiver of discharge.<sup>34</sup> A Chapter 7 discharge will not be granted if the debtor previously obtained a bankruptcy discharge within six

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24. 11 U.S.C. § 507(a).

25. *Id.* §§ 523(a)(1)(A), 507(a)(2), (8).

26. These debts include tax debts or customs duties for which a return, if required, was either not filed or was filed after the date it was last due, plus extensions, and more than two years before the filing of the bankruptcy petition. 11 U.S.C. § 523(a)(1)(B). Also included are such debts "with respect to which the debtor made a fraudulent return or willfully attempted in any manner to evade or defeat such tax." *Id.* § 523(a)(1)(C). The last type of these nondischargeable tax debts is certain debt constituting "a fine, penalty, or forfeiture to and for the benefit of a governmental unit." *Id.* § 523(a)(7).

27. *See supra* note 3.

28. Except as provided in BC section 1161, "[C]hapters 1, 3, and 5 of th[e] BC] . . . apply in a case under [C]hapter 7, 11, 12, or 13 of" the BC. 11 U.S.C. § 103(a).

29. 11 U.S.C. ch. 7.

30. *Id.* §§ 701-704.

31. 12 U.S.C. § 1813(h) (1994).

32. 15 U.S.C. § 681(c), (d) (1994).

33. 11 U.S.C. § 109(b).

34. *Id.* § 727(a)(1)-(7), (10).

years of the filing of the present proceeding, unless the prior proceeding was a Chapter 12 or 13 proceeding and 100% of the allowed unsecured claims were paid or 70% of such claims were paid under a plan proposed in good faith that represented the debtor's best effort to pay his debts.<sup>35</sup> Debts excepted from the Chapter 7 discharge include those described in BC section 523 and those under BC section 502 that arose after the Chapter 7 filing.<sup>36</sup>

## 2. *The Chapter 11 Bankruptcy Proceeding*

Chapter 11 of the BC is entitled "Reorganization."<sup>37</sup> The Supreme Court of the United States has described a Chapter 11 proceeding as "a business reorganization."<sup>38</sup> Chapter 7 individual debtors (except stockbrokers and commodity brokers) and railroads are eligible to file under Chapter 11.<sup>39</sup> In a Chapter 11 proceeding, the debtor remains in possession of the estate property and acts as the trustee of his own bankruptcy estate unless a trustee is appointed by the court for cause or in the best interest of the creditors.<sup>40</sup> The debtor may file a plan of reorganization at the time he files for bankruptcy, or anytime thereafter.<sup>41</sup> The debtor retains the exclusive right to file a plan within 120 days after relief is ordered ("exclusivity period") unless a trustee was appointed.<sup>42</sup> Parties in interest,<sup>43</sup> with some limitations, can file a plan after the close of the exclusivity period.<sup>44</sup> The Chapter 11 plan must be accepted by the creditors in each class "that hold at least two-thirds in amount and more than one-half in number of the allowed claims" in the

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35. *Id.* § 727(a)(8), (9). In no event shall an individual or family farmer be eligible to file for bankruptcy if, within the preceding 180 days, such person filed a bankruptcy petition that was later dismissed due to misconduct, or such person requested and obtained voluntary dismissal of the bankruptcy case after a creditor requested relief from the automatic stay. *Id.* § 109(g). An extensive definition of "family farmer" is located at *id.* section 101(18).

36. *Id.* § 727(b).

37. *Id.* ch. 11.

38. *United States v. Whiting Pools, Inc.*, 462 U.S. 198, 203 (1983).

39. 11 U.S.C. § 109(d).

40. *Id.* §§ 1107, 1104(a).

41. *Id.* § 1121(a).

42. *Id.* § 1121(b), (c)(1). The petition in a voluntary case constitutes the order for relief, whereas the judge determines whether relief is appropriate after an involuntary petition is filed. *Id.* §§ 301, 303.

43. A "party in interest" includes "the debtor, the trustee, a creditors' committee, an equity security holders' committee, a creditor, an equity security holder, or any indenture trustee." 11 U.S.C. § 1121(c).

44. 11 U.S.C. § 1121(c).

class.<sup>45</sup>

The BC requires certain items to be provided for in every Chapter 11 reorganization plan.<sup>46</sup> If a corporation becomes a debtor, its charter must include restrictions on the issuance of securities if its bankruptcy reorganization plan provides for: (1) merger or consolidation, or (2) the transfer of some or all of "the estate to one or more entities."<sup>47</sup> The corporate charter must be amended to prohibit the corporation from issuing nonvoting equity securities and provide for an appropriate distribution of voting power among the classes of equity security holders possessing the right to vote.<sup>48</sup> In addition, the power to vote should be adequately distributed to preferred stock having the right to elect directors representing them, if dividends are not paid on such stock.<sup>49</sup> BC section 1129 provides additional requirements that must be met in order for the bankruptcy court to confirm a proposed Chapter 11 plan.<sup>50</sup>

The effects of confirmation of a Chapter 11 plan are that parties to whom the plan applies are bound by the plan, and estate property vests<sup>51</sup> in the debtor.<sup>52</sup> In addition, the estate property is generally free of all claims and interests of creditors and other entities.<sup>53</sup> Furthermore, the confirmation of a Chapter 11 plan provides for a broader discharge than under Chapter 7. The Chapter 11 plan discharges the debtor from certain debts arising before the plan's confirmation, as contrasted with discharge of debts arising before the date of the order for relief under Chapter

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45. *Id.* § 1126(c). For the purpose of making these calculations, some creditors are excluded if the court determines that their "acceptance or rejection of such plan was not in good faith, or was not solicited or procured in good faith or in accordance with the provisions" of the BC. *Id.* § 1126(e).

46. *Id.* § 1123(a).

47. *Id.* § 1123(a)(5)(B), (C), (6).

48. *Id.* § 1123(a)(6).

49. 11 U.S.C. § 1123(a)(6).

50. Some of these requirements include: (1) the plan and the person offering the plan must comply with the applicable provisions of the BC, (2) the plan was proposed in good faith and does not violate any law, and (3) certain payments of expenses "in connection with the case, or in connection with the plan and incident to the case, ha[ve] been approved by, or [are] subject to the approval of, the court as reasonable." 11 U.S.C. § 1129(a)(1)-(4). It should be noted that "the court may not confirm a plan if the principal purpose of the plan is the avoidance of taxes." *Id.* § 1129(d).

51. "Vest" is defined as "[t]o clothe with possession; to deliver full possession of land or an estate." BLACK'S LAW DICTIONARY 1563 (6th ed. 1990).

52. 11 U.S.C. § 1141(a), (b).

53. *Id.* § 1141(c).

7.<sup>54</sup> The issuance of the order for relief usually occurs earlier in the proceeding than a bankruptcy plan confirmation.<sup>55</sup> Despite this broader discharge, a debtor is not discharged from debts excepted under BC section 523.<sup>56</sup> Discharge will be denied if: (1) “the plan provides for the liquidation of all or substantially all of the property of the estate”, (2) “the debtor does not engage in business after consummation of the plan”, and (3) “the debtor would be denied a discharge under [BC] section 727(a) . . . if the case” was a Chapter 7 proceeding.<sup>57</sup>

### 3. *The Chapter 13 Bankruptcy Proceeding*

Chapter 13 of the BC is entitled “Adjustments of Debts of an Individual with Regular Income.”<sup>58</sup> Persons eligible to file under Chapter 13 are individuals with a regular source of income who have “noncontingent, liquidated, unsecured debts of less than \$250,000 and noncontingent, liquidated, secured debts of less than \$750,000” on the date of filing.<sup>59</sup> A trustee is appointed, who, in addition to other duties, acts as a dispersing agent under the Chapter 13 reorganization plan.<sup>60</sup> The debtor, however, has certain exclusive rights to use, sell, or lease estate property.<sup>61</sup> In addition, and unless the court orders otherwise, the debtor has the exclusive right to operate any business in which he was engaged prior to the bankruptcy filing.<sup>62</sup> The Chapter 13 estate includes more property

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54. *Id.* §§ 1141(d)(1)(A), 727(b).

55. Relief must be ordered initially, so that there may be a case appropriate for a grant of relief (discharge). The period between the order for relief and grant of relief can be substantial, depending on the time consumed in formulating a reorganization plan that can be properly confirmed. See 11 U.S.C. §§ 1121(a) (providing that the debtor may file a plan after a bankruptcy case is commenced), 1123(a) (listing several items that a Chapter 11 reorganization plan must provide for), 1129 (providing additional limitations that such a plan must comply with before it can be confirmed).

56. 11 U.S.C. § 1141(d)(2).

57. *Id.* § 1141(d)(3).

58. *Id.* ch. 13.

59. *Id.* § 109(e). An individual may file in conjunction with his/her spouse, but only if the spouse is not a stockbroker or commodity broker, and together they meet the Chapter 13 debt limitations. *Id.* Debtors can file for bankruptcy with their spouses in cases where the debtor alone is eligible to file. *Id.* § 302(a). A debtor and his/her spouse are the only persons who can file jointly. *Id.* Joint cases cannot be commenced involuntarily. *Id.*

60. *Id.* § 1302.

61. 11 U.S.C. §§ 1303, 363(b), (d)-(f)(1). These exclusive rights of the debtor are subject to the Chapter 13 limitations on trustees. *Id.* § 1303.

62. *Id.* § 1304(b). A debtor is subject to the limitations on trustees under sections 363(c) (relating to the use, sale, or lease of estate property) and 364 (relating to obtaining credit), and any other limitations or conditions prescribed by the court. *Id.*



than either the Chapter 7 or 11 estates. The Chapter 13 estate includes property described under BC section 541, and section 541 property acquired, as well as earnings from services the debtor performed, after the bankruptcy filing, but before the earliest of the closure, dismissal, or conversion of the case.<sup>63</sup>

Unless the plan or the confirming order provides otherwise, the debtor remains in possession of all estate property.<sup>64</sup> Section 1322(a) lists the provisions that a Chapter 13 plan must include, such as surrender of a portion of the debtor's future income necessary to execute the Chapter 13 plan.<sup>65</sup> Further, the plan must provide for full payment of all priority claims, unless the holders of such claims agree otherwise.<sup>66</sup> Section 1325(a) mandates that the court must confirm the plan if the plan satisfies certain requirements.<sup>67</sup> If a creditor objects to the Chapter 13 plan, the plan will not be approved by the court unless the claims held by the objecting creditor are to be paid in full under the plan or the plan requires the debtor to apply all of his disposable income<sup>68</sup> toward plan payments (beginning with the date of the first payment under the plan) for a period of three years.<sup>69</sup>

The effect of a Chapter 13 confirmation is that both the debtor and creditors are bound by the plan and, unless otherwise provided, estate property vests in the debtor free of any creditor's interest or claim.<sup>70</sup> Discharge will be granted as soon as practical after all plan payments are completed.<sup>71</sup> Further, the court must not have "approve[d] a written waiver of discharge executed by the debtor after the order for relief."<sup>72</sup> All debts will be discharged except: debts described in BC section 1322(b)(5),<sup>73</sup> certain

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63. *Id.* § 1306(a).

64. *Id.* § 1306(b).

65. *Id.* § 1322(a)(1).

66. 11 U.S.C. § 1322(a)(2). In addition, "if the plan classifies claims, [it must] provide [for] the same treatment for each claim within a particular class." *Id.* § 1322(a)(3).

67. Some of these requirements are: (1) compliance with the provisions of Chapter 13 and any applicable provisions of the BC, (2) payment of certain fees or charges, (3) the plan was proposed in good faith, and (4) the plan does not violate any law. 11 U.S.C. § 1325(a)(1)-(3).

68. "Disposable income" is defined as income received by the debtor that is not reasonably necessary for the support or maintenance of the debtor or his/her dependents and necessary for continuing, preserving, and operating a business in which the debtor is engaged. 11 U.S.C. § 1325(b)(2).

69. 11 U.S.C. § 1325(b)(1).

70. *Id.* § 1327.

71. *Id.* § 1328(a).

72. *Id.*

73. Section 1322(b)(5) relates to curing of defaults under claims where the last

subsections of BC section 523(a),<sup>74</sup> or payments “for restitution, or criminal fine, included in a sentence on the debtor’s conviction of a crime.”<sup>75</sup>

The discharge available under Chapter 13 is potentially the broadest among the Chapter 7, 11, and 13 discharges. The only person, however, who would actually have a choice of whether to file a proceeding under Chapter 7, 11, or 13 is an individual with regular income who is operating a business. The BC, with its varying degrees of discharge, also offers varying degrees of fresh starts. The impact of the IRC’s provisions on the BC’s provisions extends the BC’s fresh start options even further. Extensions resulting from the effect of the IRC’s provisions are aptly labeled “head starts.”

### *B. Tax Consequences of Discharge of Indebtedness*

Usually, discharge of indebtedness must be included in gross income.<sup>76</sup> If the discharge occurs in a bankruptcy case, however, the DI income is excluded from gross income.<sup>77</sup> To the extent the DI income is so excluded, certain tax attributes are reduced.<sup>78</sup> Those tax attributes must be reduced in the following order: (1) any net operating loss (“NOL”)<sup>79</sup> or NOL carryover for the tax year of discharge, (2) IRC section 38 credits that are carried over to or from the year of discharge, (3) IRC section 53(b) credits allowable

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payment due under those claims is due after the last plan payment. 26 U.S.C. § 1322(b)(5).

74. These subsections do not include the tax debts described in *supra* Part I.A. (paras. 3, 4).

75. 11 U.S.C. § 1328(a). A broad discharge may still be obtained if plan payments are not completed. This failure to make payments must be “due to circumstances for which the debtor should not justly be held accountable.” *Id.* § 1328(b)(1). *See, e.g., In re Edwards*, 207 B.R. 728 (Bankr. N.D. Fla. 1997) (holding that a Chapter 13 debtor may be granted a “hardship discharge” pursuant to BC section 1328(b) when his business failed after confirmation of the Chapter 13 plan and he was “unable to secure a job with sufficient income to make his plan payments”). Additionally, payments that have already been made to creditors must be at least what the creditors would have received under a Chapter 7 proceeding, and modification of the plan must be impractical. 11 U.S.C. § 1328(b)(2), (3). The debts excepted from BC section 1328(b)’s “hardship discharge” are those described in sections 1322(b)(5) and 523(a). *Id.* § 1328(c).

76. *See* 26 U.S.C. § 61(a)(12). For a discussion of situations where DI income is not realized, *see* Robert A. Jacobs & Linda Z. Swartz, *Tax Pitfalls and Opportunities In and Out of Bankruptcy Proceedings*, 394 PLITAX 773, 856-60, 868-71 (1996).

77. 26 U.S.C. § 108(a)(1)(A). For other exclusion rules under IRC section 108, *see* BITTKER & EUSTICE, *supra* note 8, at 12 - 147.

78. 26 U.S.C. § 108(b)(1).

79. “Net operating loss” (“NOL”) “means the excess of the deductions allowed . . . over the gross income.” 26 U.S.C. § 172(c).

after the close of the year of discharge, (4) any net capital loss for such year, or carryover amount to such year under IRC section 1212, (5) bases in property,<sup>80</sup> (6) carryovers of passive activity losses or credits from the year of discharge, and (7) IRC section 27 foreign tax credit carryovers to, or from, the year of discharge.<sup>81</sup>

All the attributes described above are reduced dollar-for-dollar by the amount of DI income excluded from gross income, except that credits are reduced by one-third of a dollar for each dollar of DI income excluded.<sup>82</sup> In addition, these tax attributes are reduced after tax is imposed for the tax year of discharge.<sup>83</sup> Accordingly, the tax year of discharge is the last opportunity to effect real tax savings by using these tax attributes before they are reduced by DI income. DI income has no impact on taxable income for that year.<sup>84</sup>

## II. GENERAL TAX PRINCIPLES CONCERNING TAX ATTRIBUTES

### A. Corporations' Ability to Transfer and Use Tax Attributes

IRC section 381(a)<sup>85</sup> limits corporate tax attribute transfer transactions to: (1) a liquidation of a subsidiary by its parent corporation in a transaction to which IRC section 332 applies<sup>86</sup> or (2) transfers connected with reorganizations<sup>87</sup> described in IRC

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80. For debts discharged in a bankruptcy proceeding, property bases are not reduced beyond the amount that the adjusted bases in the property the taxpayer holds immediately after discharge exceeds the debtor's aggregate liabilities after discharge. 26 U.S.C. § 1017(b)(2).

81. 26 U.S.C. § 108(b)(2).

82. *Id.* § 108(b)(3).

83. *Id.* § 108(b)(4)(A). NOLs and capital loss carryovers "shall be made first in the loss for the taxable year of the discharge and then in the carryovers to such taxable year in the order of the taxable years from which each such carryover arose." *Id.* § 108(b)(4)(B). IRC section 27 and 38 credits are reduced "in the order in which carryovers are taken into account under this chapter for the taxable year of the discharge." *Id.* § 108(b)(4)(C).

84. For a further discussion of IRC section 108 in the context of the BC, see Jack F. Williams, *Rethinking Bankruptcy and Tax Policy*, 3 AM. BANKR. INST. L. REV. 153, 153-78 (1995).

85. IRC sections 381 and 382 are the primary focus of this comment's discussion of corporate tax attributes.

86. If the parent corporation elects, under IRC section 338, to step-up its basis in the subsidiary's assets (as if the subsidiary had sold all of its assets to its parent at fair market value ("FMV")), the subsidiary's tax attributes will not pass to the parent. BRITKER & EUSTICE, *supra* note 8, at 14 - 18. See 26 U.S.C. § 338(a).

87. "Reorganization" is defined under IRC section 368(a) and separated into eight types under IRC section 368(a)(1). These types are: (1) an "A" reorganization ("a statutory merger or consolidation"), (2) a "B" reorganization (a stock-for-stock exchange), (3) a "C" reorganization (a stock-for-assets exchange), (4) a "D" reorganization (an assets-for-stock exchange where the corporation transferring its assets, or the shareholders of that corporation, hold stock constituting control of the other corporation), (5) an "E"

section 368(a)(1)(A), (C), (D), (F), or (G),<sup>88</sup> where gain or loss is not recognized due to the application of IRC section 361.<sup>89</sup> Twenty-six tax attributes may be carried over when one of the preceding qualifying tax-free<sup>90</sup> transactions occurs.<sup>91</sup> These tax attributes include NOL carryovers, earnings and profits, capital loss carryovers, excess charitable contributions, and credits under IRC sections 38 and 53.<sup>92</sup> IRC section 381 is not applicable, or needed, if a corporation's stock is acquired because the corporation's "legal identity is not affected by such a transaction."<sup>93</sup>

### 1. *General Requirements for Transferring Tax Attributes*

IRC section 381's carryover provisions only apply to the liquidation of a subsidiary by its parent under IRC section 332 or certain reorganizations to which IRC section 361 applies.<sup>94</sup> IRC section 332 applies when a parent corporation satisfies the requirements of IRC section 1504(a)(2) from the date the subsidiary liquidation plan is adopted through the date that the parent receives the final distribution of the liquidated subsidiary's property.<sup>95</sup> In addition, one of two other requirements must be met. The first is that the distribution involves the transfer of all the subsidiary's property, within the tax year, "in complete cancellation or redemption of all its stock."<sup>96</sup> Alternatively, the distribution must be one of a series of distributions that result in complete

reorganization ("a recapitalization"), (6) an "F" reorganization ("a mere change in identity, form, or place of organization of one corporation, however effected"), and (7) a "G" reorganization (an assets-for-stock exchange where one of the corporate parties to the exchange is in bankruptcy). 26 U.S.C. § 368(a)(1)(A)-(G), respectively.

88. Where a reorganization under section 368(a)(1)(D) or (G) is involved, the requirements of section 354(b)(1) (*see infra* note 129), must also be met. 26 U.S.C. § 381(a).

89. *See infra* Part II.A.1. (para. 2).

90. "Tax-free", as used in this comment, describes a transaction where gain or loss is not immediately recognized in the year in which the transaction occurred.

91. 26 U.S.C. § 381(c).

92. *Id.* § 381(c)(1)-(3), (19), (24), (25).

93. BITTKER & EUSTICE, *supra* note 8, at 14 - 20. The corporation's "legal identity" (as a separate legal entity) is not altered merely because that corporation's stock has changed hands. That is, the corporate entity is not changed merely because its owners have changed.

94. 26 U.S.C. § 381(a).

95. *Id.* § 332(a), (b)(1). IRC section 1504(a)(2) requires that the parent own sufficient stock in its subsidiary to "(A) possess[ ] at least 80 percent of the total voting power of the stock . . . , and (B) [the stock held by the parent] has a value equal to at least 80 percent of the total value of the stock of the subsidiary." 26 U.S.C. § 1504(a)(2).

96. *Id.* § 332(b)(2). The adoption of a resolution authorizing such a distribution "shall be considered an adoption of a plan of liquidation, even though no time for the completion of the transfer of the property is specified in such resolution." *Id.*

cancellation or redemption of all of the subsidiary's stock pursuant to a liquidation plan.<sup>97</sup> Such transfer must be actually completed "within 3 years from the close of the taxable year which is made the first of the series of distributions under that plan."<sup>98</sup>

A corporate party to a reorganization<sup>99</sup> cannot recognize gain or loss if such party is exchanging property, pursuant to a plan of reorganization, "solely for stock or securities" of another such party.<sup>100</sup> If the corporation exchanging property receives such stock or securities along with other property ("boot"),<sup>101</sup> then that corporation must recognize gain to the extent that boot is not distributed to its own shareholders or creditors.<sup>102</sup> If the corporation receiving boot realizes a loss on the exchange, however, no portion of that loss can be recognized.<sup>103</sup>

Where the requirements of IRC section 381 are met, the tax year of the corporation distributing or transferring property ends on the date of the distribution or transfer.<sup>104</sup> Where the provisions of IRC

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97. *Id.* § 332(b)(3).

98. *Id.*

99. Such a party is usually defined as "(1) a corporation resulting from a reorganization, and (2) both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another." 26 U.S.C. § 368(b).

100. 26 U.S.C. § 361(a).

101. "Boot" refers to consideration that is not accorded favorable tax treatment under statutory provisions, i.e., it is *in addition* to consideration that is accorded favorable statutory treatment. *Commissioner v. Clark*, 489 U.S. 726, 730 (1989).

102. 26 U.S.C. § 361(b)(1), (3). The corporation does not recognize gain on distributions to its shareholders and creditors made pursuant to a plan of reorganization unless certain appreciated property is distributed. *See id.* § § 361(b)(1), (c)(1)-(3).

103. *Id.* § 361(b)(2).

104. *Id.* § 381(b). Specifically, this is the date that the distribution or transfer of substantially all of the assets of a corporation is completed and "th[at] distributor or transferor corporation ceases all operations, other than liquidating activities, after such date." *Id.* § 381(b)(2); *Treas. Reg. § 1.381(b)-1(b)* (1997).

In addition, a corporation acquiring such property "shall not be entitled to carry back a net operating loss or a net capital loss for a taxable year ending after the date of distribution or transfer to a taxable year of the distributor or transferor corporation." 26 U.S.C. § 381(b)(3). Furthermore, deficits in earnings and profits can only "offset earnings and profits accumulated after the date of transfer." *Id.* § 381(c)(2)(B).

For rules relating to accounting methods, see *id.* section 381(c)(4)-(6), (8), (16) and Treasury Regulation section 1.381(c)(4)-1(c), (d). *See also* BRITTKER & EUSTICE, *supra* note 8, at 14 - 31-34. The acquiring corporation receives 100% of the transferor corporation's tax attributes listed under IRC section 381, even though the acquiring corporation may receive less than 100% of the transferor corporation's assets. *Treas. Reg. § 1.381(c)(1)-1(c)(2)*. *See* BRITTKER & EUSTICE, *supra* note 8, at 14 - 97. Treasury Regulation section 1.381(c)(1)-1(b) provides that the loss corporation can carry back its NOLs for its own use and, if that corporation remains in existence, only it may use its NOLs in the future.

"Loss corporation" is "a corporation entitled to use a net operating loss carryover or having a net operating loss for the taxable year in which the ownership change occurs." 26

section 332 and a section 368(a)(1) reorganization concurrently apply, the section 332 provisions control.<sup>105</sup>

## 2. Limitations on the Use of Tax Attributes

Although a corporation can succeed to the tax attributes of another corporation, the IRC limits the use of those attributes. The amount of certain tax attributes of a new loss corporation<sup>106</sup> that are allocable to the period before the date of the ownership change can offset such corporation's income after the ownership change.<sup>107</sup> This offset amount is limited to the old loss corporation's<sup>108</sup> value<sup>109</sup> multiplied by the highest adjusted federal long-term tax-exempt rate in effect within the three calendar-month period ending with the month of the ownership change.<sup>110</sup> In addition, if any portion of the

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U.S.C. § 382(k)(1). Except to the extent the regulations provide otherwise, the term loss corporation "includes any corporation with a net unrealized built-in loss." *Id.* "Net unrealized built-in loss" is defined at *infra* note 120.

105. Treas. Reg. § 1.332-2(d). See BITTKER & EUSTICE, *supra* note 8, at 14 - 20-21 & n.51. This is significant because the limitation rules of IRC section 382 presumably do not apply to section 332 liquidations. BITTKER & EUSTICE, *supra* note 8, at 14 - 21.

106. "The term 'new loss corporation' means a corporation which (after an ownership change) is a loss corporation." 26 U.S.C. § 382(k)(3).

107. 26 U.S.C. § 382(a).

108. "Old loss corporation" is defined as a corporation that, previous to the ownership change, was a loss corporation. 26 U.S.C. § 382(k)(2).

109. A corporation's "value", for this purpose, is the value of all outstanding stock immediately prior to an ownership change. 26 U.S.C. § 382(e)(1). "If a redemption or other corporate contraction occurs in connection with an ownership change, the [corporation's] value . . . shall be determined after taking such redemption or other corporate contraction into account." *Id.* § 382(e)(2). For rules for determining a foreign corporation's value, see 26 U.S.C. section 382(e)(3).

110. 26 U.S.C. § 382(a), (b), (d)-(f). The IRC defines an "ownership change" as an owner shift involving a 5-percent shareholder or an equity structure shift where, immediately afterwards, the percentage shares of one or more 5-percent shareholder's share of the acquired loss corporation's outstanding stock has, in the aggregate, increased by more than 50 percentage points over the lowest percentage share that each of those 5-percent shareholders owned during the applicable testing period. *Id.* § 382(g)(1). See Treas. Reg. § 1.382-2T(e)(1) Exs. 3, 4.

Section 382(h)(3)(B) provides an exception for certain stock acquisitions. Percentage stock ownership is based on stock value, but price fluctuations between classes, absent a stock transfer, will not be considered in determining whether an ownership change has occurred. 26 U.S.C. § 382(k)(6)(C), (1)(3)(C). Additionally, "each share of all the outstanding shares of stock that have the same material terms is treated as having the same value." Treas. Reg. § 1.382-2(a)(3)(i).

A "5-percent shareholder" is any individual or public group that owns, directly or indirectly, 5% or more of the stock of a loss corporation. Treas. Reg. § 1.382(g)(1). All less than 5-percent owners are treated as a single 5-percent shareholder and are designated a "public group". 26 U.S.C. § 382(g)(4)(A); Treas. Reg. § 1.382-2T(c)(2) Ex. i. In addition, a public group is treated as a separate 5-percent shareholder for each corporation. 26 U.S.C. § 382(g)(4)(B), (C). The only exception is that the segregation rules, in regard to owner

section 382 limitation exceeds the new loss corporation's income for any tax year following the ownership change date, the excess carries over and is added to the following tax year's limitation.<sup>111</sup>

For the purpose of determining whether an ownership change has occurred, the term "stock" has a cumbersome definition. Stock may include rights to acquire stock, if certain requirements are met.<sup>112</sup> Stock may not include some instruments that would otherwise be considered stock, such as certain nonvoting preferred stock.<sup>113</sup> If preferred stock that does not otherwise have a right to vote becomes entitled to vote only because of the issuing corporation's failure to pay dividends in arrears, that preferred stock is not considered "stock" for determining the occurrence of an ownership change.<sup>114</sup> Corporate debtors can apparently issue preferred stock with contingent voting rights and still comply with

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shifts, may be modified by regulations. *Id.* § 382(g)(4)(C). For a discussion of such exceptions, as well as examples, see Jacobs & Swartz, *supra* note 76, at 785-90. See also BITTKER & EUSTICE, *supra* note 8, at 14 - 70, 76-77.

An "owner shift involving a 5-percent shareholder" is a change in the ownership of a corporation's stock that affects the percentage of that corporation's stock owned by any person who was a 5-percent shareholder before that change or becomes such a shareholder after such change. 26 U.S.C. § 382(g)(2). Furthermore, for determining whether an ownership change occurred, section 382(l)(3)(A) and (B) provides attribution rules for determining "the ultimate individual beneficial owner" of stock. BITTKER & EUSTICE, *supra* note 8, at 14 - 75 (footnote omitted).

An "equity structure shift" is defined as any reorganization under: (1) IRC section 368(a)(1), except those under section 368(a)(1)(D) or (G), unless the requirements under IRC section 354(b)(1) are met, or (2) IRC section 368(a)(1)(F). 26 U.S.C. § 382(g)(3)(A). An equity structure shift also includes, "[t]o the extent provided in [the] regulations, . . . taxable reorganization-type transactions, public offerings, and similar transactions." *Id.* § 382(g)(3)(B).

111. 26 U.S.C. § 382(b)(2).

112. See Temp. Treas. Reg. § 1.382-2T(f)(18)(iii). Certain interests not constituting stock are treated as constituting stock if: (1) at the time the interest is issued or transferred to or by "a 5-percent shareholder (or a person who would be a 5-percent shareholder if the interest . . . were treated as stock), such interest offers a potential significant participation" in the corporation's growth, (2) treating the interest as stock will cause an ownership change, and (3) the amount of pre-change loss exceeds "twice the amount determined by multiplying . . . the value of the loss corporation . . . on the testing date, by . . . the long-term tax exempt rate . . . for the calendar month in which the testing date occurs." *Id.* § 1.382-2T(f)(18)(iii). See *id.* § 1.382-4(d) (relating to the determination of when stock options are treated as exercised).

113. See Temp. Treas. Reg. § 1.382-2T(f)(18)(i), (ii), (j). Specifically, nonvoting preferred stock must also be:

limited . . . as to dividends and does not participate in corporate growth to any significant extent, . . . ha[ve] redemption and liquidation rights which do not exceed the issue price of stock (except for a reasonable redemption or liquidation premium), and . . . is not convertible into another class of stock.

*Id.* § 1.382-2T(f)(18)(i). See 26 U.S.C. § 1504(a)(4).

114. Temp. Treas. Reg. § 1.382-2T(f)(18)(i).

the content requirements of a Chapter 11 plan while avoiding an ownership change under the IRC.<sup>115</sup>

The section 382 limitation applies to pre-change losses including any NOL carryforwards of the old loss corporation attributable to the period before the date of the ownership change.<sup>116</sup> Where the old loss corporation has net unrealized built-in gain,<sup>117</sup> the section 382 limitation is increased by unrealized built-in gains recognized in the recognition period,<sup>118</sup> to the extent the total amount recognized does not exceed the amount of the net unrealized built-in gains.<sup>119</sup> If the old loss corporation has net unrealized built-in loss,<sup>120</sup> the section 382 limitation applies to such loss recognized in any given tax year within the recognition period.<sup>121</sup> Net built-in losses and gains are deemed to be zero, however, if they do not exceed a certain proscribed minimum value.<sup>122</sup> In addition, with the exception of certain recognized gains, the section 382 limitation is zero for all post-change years if the old loss corporation's business enterprise is not continually conducted throughout the two-year

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115. See Jacobs & Swartz, *supra* note 76, at 791-93.

116. 26 U.S.C. § 382(a), (d)(1). The amount of a NOL is allocated pro rata over the days remaining in the year of the ownership change. *Id.* § 382(d)(1). In addition to the scope of losses and deductions to which the section 382 limitation applies, the value of the loss corporation can be reduced if certain exceptions apply. One such exception is that capital contributions are subtracted from the old loss corporation's value to the extent the contributions are made at least two years before the ownership change date or as part of a plan whose principal purpose is to avoid or increase limitations under section 382. *Id.* § 382(l)(1). Another exception is that the section 382 limitation is reduced if at least one-third of the old loss corporation's assets are nonbusiness assets. See *id.* § 382(l)(4). IRC section 383 places section 382-like limits "on the carryover of capital losses and capital loss carryovers and certain credits." BRITKER & EUSTICE, *supra* note 8, at 14 -99-100.

117. "Net unrealized built-in gain" is the amount by which the aggregate FMV of the assets that the loss corporation owns immediately before the ownership change exceeds the aggregate bases of those assets at that same time. 26 U.S.C. § 382(h)(3)(A)(i). See *id.* § 382(h)(6)(A), (C).

118. The "recognition period" is the five-year period beginning on the date of the ownership change. 26 U.S.C. § 382(h)(7)(A).

119. 26 U.S.C. § 382(h)(1)(A).

120. "Net unrealized built-in loss" is defined under the IRC as the amount by which the aggregate FMV of the assets of an old loss corporation immediately before an ownership change is less than the aggregate adjusted bases of those assets at the time of an ownership change. 26 U.S.C. § 382(h)(3)(A).

121. 26 U.S.C. § 382(h)(1)(B), (7)(B). "Recognized built-in loss" also includes "amounts allowable as depreciation, amortization, or depletion for any period within the recognition period except to the extent . . . that the amount so allowable is not attributable" to the built-in loss. *Id.* § 382(h)(2)(B). See *id.* § 382(h)(6)(B), (C).

122. *Id.* § 382(h)(3)(B). This minimum value is the lesser of \$10,000,000.00 or 15% of the FMV of such corporation's assets immediately before the ownership change. *Id.* § 382(h)(3)(A)(i)(I), (3)(B)(i). For calculating this limit, cash items and certain marketable securities are not considered. *Id.* § 382(h)(3)(B)(ii).



period beginning on the date of the ownership change.<sup>123</sup>

In addition to limits that IRC section 381(c) and section 382 respectively place on the transfer and use of tax attributes, IRC section 269 further limits the use of tax attributes. In situations where section 269 is applicable, the Secretary of Internal Revenue may disallow the use of tax attributes acquired for the principal purpose of avoiding income tax where the acquirer secures the benefit of tax attributes "which such person or corporation would not otherwise enjoy."<sup>124</sup> This limitation applies where any person acquires control<sup>125</sup> of a corporation.<sup>126</sup> This limitation also applies where a corporation acquires the property of another corporation over which it did not have control beforehand, and the transferor corporation's basis in those assets was carried over to the acquiring corporation.<sup>127</sup> Despite section 382's tax avoidance limitations, section 382 does not expressly prohibit the application of section 269 to situations where both sections apply. There are, however, compelling arguments why section 269 should not be applied in situations where section 382 applies.<sup>128</sup>

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123. *Id.* § 382(c). For a definition of "continuity of business enterprise", see *infra* Part II.A.3.a. (para. 2). For examples of how the section 382 limitation operates, see BRITKER & EUSTICE, *supra* note 8, at 14 - 101-02. In the context of Chapter 11 bankruptcy reorganization plans, see Jacobs & Swartz, *supra* note 76, at 845-47 (discussing ownership-change-prevention clauses). "Ownership-change-prevention clauses" are used to declare transfers void if the transfer will result in an ownership change under the IRC. See *id.* An example of such a clause is: "transfers to a 5-percent shareholder are void." *Id.* at 845.

124. 26 U.S.C. § 269(a).

125. "Control", for the purpose of section 269, is "ownership of stock possessing at least 50 percent of the total: (1) combined voting power of all classes of stock entitled to vote or [(2)] . . . value of shares of all classes of stock of the corporation." 26 U.S.C. § 269(a).

126. 26 U.S.C. § 269(a)(1).

127. *Id.* § 269(a)(2).

128. See Jacobs & Swartz, *supra* note 76, at 817-33. See also BRITKER & EUSTICE, *supra* note 8, at 14 - 94-96. For further discussion of section 269, see BRITKER & EUSTICE, *supra* note 8, at 14 - 40-53. For a discussion of other limitations on the carry over of tax attributes, see *id.* at 14 - 109-11.

If a corporation acquires control of another corporation, or its assets in an A, C, or D reorganization, the ability of either corporation to use some of its own tax attributes to offset the net unrealized built-in gain of the other corporation may be limited by IRC section 384. 26 U.S.C. § 384(a). Section 384 applies if either corporation is a gain corporation. Section 384 prohibits those corporations from offsetting pre-acquisition net unrealized built-in gains against pre-acquisition net unrealized built-in losses where either is recognized in the recognition period.

"A, C, and D reorganizations" are transactions satisfying the statutory requirements for reorganizations under IRC section 368(a)(1)(A), (C), and (D), respectively. "The term 'gain corporation' means any corporation with a net unrealized built-in gain." *Id.* § 384(c)(4).

"Recognition period" has the same definition in this context as it does under IRC section

### 3. Special Tax Rules Concerning Bankruptcy

The IRC provides for a separate type of reorganization that is available to taxpayers in bankruptcy. The requirements for this type of reorganization are codified at 26 U.S.C. section 368(a)(1)(G); it is referred to as a "G reorganization." As previously noted, tax attributes enumerated under IRC section 381(c) cannot be transferred under IRC section 382(a) unless the G reorganization satisfies the requirements of IRC section 354(b)(1).<sup>129</sup> In addition to the special treatment accorded a G reorganization, the section 382 limitation, if it applies, will also be modified if certain exceptions (applying to taxpayers in bankruptcy, and discussed in Part II.A.3.b.) apply.

#### a. G Reorganization

A G reorganization is accomplished when a corporation transfers all, or a portion, of its assets to another corporation that distributes stock or securities of the acquiring corporation in accordance with IRC section 354, 355, or 356.<sup>130</sup> IRC section 354 requires that pursuant to a plan, stock or securities<sup>131</sup> of a corporate party to a

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382(h)(7)(A). *Id.* § 384(c)(8) (incorporating certain definitions by reference to section 382(h)). *See supra* note 118. Legislative history indicates that section 384 is to be applied in addition to section 382, and that section 269 "can have a continuing role to play in the acquisition arena despite" section 382's and 384's "stringent" limitations. BITTKER & EUSTICE, *supra* note 8, at 14 - 108. Certain corporations under common control (defined at section 384(b)(2)) are exempted from application of the section 384 limitation. *See* 26 U.S.C. § 384(b)(1). For further discussion of IRC section 384, *see* BITTKER & EUSTICE, *supra* note 8, at 14 - 103-06.

129. *See supra* note 88. The requirements of IRC section 354(b)(1) are: "(A) the [transferee] corporation . . . acquires substantially all of the assets of the transferor [corporation] . . . ; and (B) the stock, securities, and other properties received by such transferor, as well as the other such properties of such transferor, are distributed in pursuance of the plan of reorganization." "Substantially all" has not been defined in the context of G reorganizations, but has been defined under an A reorganization as at least 90% of the net, and 70% of the gross, FMV of a corporation's assets. Rev. Proc. 86-42, 1986-2 C.B. 722. The "substantially all" requirement should be liberally construed in the bankruptcy context in favor of the debtor, however. *See* S. Rep. No. 1035, 96th Cong., 2d Sess. 35-36 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7050. *See also* Jacobs & Swartz, *supra* note 76, at 852-53.

130. 26 U.S.C. § 368(a)(1)(G). At least one of the corporations must be in bankruptcy and the transfer must be pursuant to a plan. *Id.* § 368(a)(3)(B). Where the requirements of a G and another reorganization are concurrently met, the G reorganization takes precedence. *Id.* § 368(a)(3)(C). For a discussion of the applicability of G reorganizations to S corporations, *see* BITTKER & EUSTICE, *supra* note 8, at 12 - 139-145.

131. "Securities" has been defined as debt instruments that do not mature until at least five years after transfer, but some courts have recently used a "continuity-of-creditor-interest" approach. BITTKER & EUSTICE, *supra* note 8, at 12 - 158 (footnote omitted). Where a shareholder only receives securities in the exchange however, the shareholder will recognize gain. Rev. Rul. 73-472, 1973-2 C.B. 114 (citations omitted). *See*

reorganization be exchanged solely for the stock or securities in that party.<sup>132</sup> The provisions of section 356 apply to exchanges to which IRC section 354 or section 355 would apply, except for the fact boot was also received.<sup>133</sup>

In addition to these requirements, all reorganizations must satisfy the following conditions: (1) continuity of proprietary interest, (2) continuity of business enterprise, and (3) business purpose.<sup>134</sup> Continuity of proprietary interest requires that at least 50% of the aggregate value transferred to shareholders in a reorganization constitute an equity interest in the acquiring corporation.<sup>135</sup> Continuity of business enterprise requires that substantially all assets acquired be used in any future business.<sup>136</sup> The business

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26 U.S.C. §§ 354(a)(2), 356. Under the "continuity-of-creditor-interest" approach, the exchange of debt instruments for stock will be tax-free if the debt instruments are of a term and possess certain characteristics making them analogous to a shareholder's interest as embodied in the shareholder's stock ownership. See BITTKER & EUSTICE, *supra* note 8, ¶ 12.41[3], at 12 - 157-58.

132. 26 U.S.C. § 354(a)(1). The requirements of IRC section 354(b)(1), *supra* note 129, must also be met. Furthermore, for the purposes of a G reorganization, "party to a reorganization" also includes a corporation acquiring stock, securities, or property, and that transferred part or all of such items to a controlled subsidiary. 26 U.S.C. § 368(b), (a)(2)(C). "Party to a reorganization" also includes the parent corporation of an acquiring corporation where the acquiring corporation obtains substantially all of the property of the target corporation in exchange for stock of the acquiring corporation's parent corporation, but without exchanging its own stock. *Id.* § 368(b), (a)(2)(D).

"Control", for this purpose, is defined as owning an amount of stock that represents at least 80% of the total: "combined voting power of all classes of stock entitled to vote and [the] . . . number of shares of all other classes of stock of the corporation." *Id.* § 368(c). In addition, only one corporation in a transaction can qualify as an acquiring corporation. Treas. Reg. § 1.381(a)-1(b)(2). For examples of determining which corporation is the acquiring corporation, see BITTKER & EUSTICE, *supra* note 8, at 14 - 22, 23.

The requirements of IRC section 355 will not be discussed since IRC section 381(a) expressly requires that the requirements of section 354(b)(1) be met. See BITTKER & EUSTICE, *supra* note 8, 14 - 18. IRC section 355 applies to divisive reorganizations (which are corporate divisions), but IRC section 381(a) does not apply to divisive reorganizations. *Id.* at 14 - 17 (footnote omitted). The carryover limitation rules of IRC section 382 do apply, however. *Id.* For a discussion of the treatment of tax attributes not listed in section 381(c), and of IRC section 355 corporate divisions, see *id.* at 14 - 19.

133. 26 U.S.C. § 356(a)(1).

134. See BITTKER & EUSTICE, *supra* note 8, at 12 - 17-18.

135. Rev. Proc. 77-37, 1977-2 C.B. 568; Rev. Rul. 66-224, 1966-2 C.B. 114. This doctrine was developed by the Supreme Court in several cases, and later codified at Treasury Regulation section 1.368-1(b), 2(a). *Paulsen v. Commissioner*, 469 U.S. 131, 136 (1985) (citations omitted). Continuity of proprietary interest was added to the existing statutory requirements to ensure that the purpose of the requirements, and not merely their literal meaning, was satisfied by "requir[ing] that the taxpayer's ownership interest in the prior organization must continue in a [definite and material] . . . fashion in the reorganized enterprise." *Id.* (citations omitted).

136. Rev. Rul. 63-29, 1963-1 C.B. 77. In contrast, Treasury Regulation section

purpose requirement is met if there is at least one non-tax avoidance business purpose for the transaction.<sup>137</sup> The "continuity of interest limitations . . . [a]re significantly eased" for G reorganizations.<sup>138</sup>

*b. Modifications on the Section 382 Limitation*<sup>139</sup>

Under IRC section 382(1)(5), the section 382 limitation will not apply if: (1) the old loss corporation is under the jurisdiction of the court in a bankruptcy proceeding immediately before an ownership change, and (2) its shareholders and certain creditors, immediately before the ownership change, own at least 50% of the voting power and at least 50% of the value of the new loss corporation's stock.<sup>140</sup> Creditors included in this group (of "qualified historic creditors") are those that received stock in exchange for debt: (1) they held for a minimum of eighteen months prior to the bankruptcy filing, or (2) that arose in the ordinary course of the corporation's trade or business, and has been held continuously from its inception by the beneficial owner of the debt.<sup>141</sup> In addition, Proposed Treasury

1.368-1(d)(2) provides that this requirement is satisfied where the acquiring corporation "either (i) continue[s] the acquired corporation's . . . historic business or (ii) uses a significant portion of [the acquired corporation's] historic business assets in a business."

"Historic business" is defined as the business (other than one entered into pursuant to a plan of reorganization) that the acquired corporation has conducted most recently. *Treas. Reg. § 1.368-1(d)(3)(ii)*. "Significant" is defined as "the relative importance of assets to operation of the business." *Id. § 1.368-1(d)(4)(iii)*. The "substantially all" requirement is less rigorous in G reorganizations, however. *BITTKER & EUSTICE, supra* note 8, at 12 - 134 (footnote omitted).

137. *See* *Commissioner v. Transport Trading & Terminal Corp.*, 176 F.2d 570, 572 (2d Cir. 1949) (citing *Gregory v. Helvering*, 293 U.S. 465, 469-70 (1935)); *BITTKER & EUSTICE, supra* note 8, at 14 - 19 n.40 (absence of a business purpose may nullify a reorganization).

138. *BITTKER & EUSTICE, supra* note 8, at 12 - 133-34 (footnotes omitted) (discussing these alleviated limitations).

139. For a further discussion of modifications on the section 382 limitation, *see* *BITTKER & EUSTICE, supra* note 8, at 14 - 84-88.

140. 26 U.S.C. §§ 382(1)(5)(A)(i)-(ii), 1504(a)(2). For a further discussion of section 382(1)(5), *see* *BITTKER & EUSTICE, supra* note 8, at 14 - 90-94. Such shareholders may own stock in the new loss corporation's controlling parent if it is also in bankruptcy. 26 U.S.C. § 382(1)(5)(ii).

141. *Id.* § 382(1)(5)(E). For inclusion of certain other creditors as "qualified historic creditors," *see* Treasury Regulation section 1.382-9(d). *See also* *BITTKER & EUSTICE, supra* note 8, at 14 - 90 n.295. Where a corporation exchanges its own stock to cancel debt, the corporation is deemed to have satisfied the discharged obligation for cash in an amount equal to the FMV of the stock transferred. 26 U.S.C. § 108(e)(8). The corporation will have DI income in an amount equal to the excess, if any, of the FMV of the discharged debt over the FMV of the stock transferred. *BITTKER & EUSTICE, supra* note 8, at 12 - 138 n.452.

The stock-for-debt rules under IRC sections 108(e)(8) and 382(1)(5), and certain other provisions of the IRC, apply to stock transferred after December 31, 1994. Pub. L. No. 103-66

Regulation section 1.382-3(b) provides that IRC section 382(c)'s continuity of business enterprise requirement need not be met in cases where section 382(l)(5) applies.

Although this section can be quite advantageous to taxpayers in bankruptcy, this rule is not without its exceptions. Pre-change losses designated under IRC section 382(a)(2) that may be used after the change date must be reduced by the amount of interest that has been, or has yet to be, deducted by the old loss corporation on the indebtedness exchanged for stock.<sup>142</sup> The maximum amount of interest that may be applied against such tax attributes is the interest paid or accrued in the three-year period ending immediately before the change, plus the period ending on the date of the ownership change.<sup>143</sup>

Under IRC section 382(l)(6) (applicable when IRC section 382(l)(5) is not), the limitation applies to debt canceled or discharged in certain bankruptcy transactions. The application of section 382(l)(6) is limited to G reorganizations and exchanges of debt for stock where the creditors' claims are canceled or surrendered as a result of such transactions. The corporation's value, for the purpose of calculating the section 382 limitation, is increased to the extent that the increase in value is attributable to any debt surrender or cancellation pursuant to one of the transactions described above.<sup>144</sup>

## *B. Transfer of Tax Attributes of Individual Debtors*

### *1. Tax Attributes to Which the Bankruptcy Estate Succeeds<sup>145</sup>*

IRC section 1398 applies to Chapter 7 and 11 bankruptcy cases in which the debtor is an individual.<sup>146</sup> The bankruptcy estate succeeds to certain enumerated tax attributes of the debtor determined as of the first day of the tax year in which the bankruptcy case commenced.<sup>147</sup> These tax attributes are: (1) NOL

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§ 13226(a)(3), 107 Stat. 487-488 (1993). For a brief discussion regarding the stock-for-debt rules applicable to transfers of stock before January 1, 1995, see *BRITKER & EUSTICE, supra* note 8, at 12 - 146-48, 14 - 91-92.

142. 26 U.S.C. § 382(l)(5)(B).

143. *Id.*

144. *Id.* § 382(l)(6).

145. For special tax provisions regarding state and local taxes, see BC section 346. See also sections 728 and 1146 for cases filed under Chapter 7 and 11 of the BC, respectively.

146. 26 U.S.C. § 1398(a).

147. *Id.* § 1398(g).

carryovers;<sup>148</sup> (2) excess charitable contribution carryovers;<sup>149</sup> (3) recovery of tax benefit items;<sup>150</sup> (4) credit carryovers and related items that the debtor would be required to take into account if the bankruptcy case was not commenced; (5) capital loss carryovers;<sup>151</sup> (6) the basis, holding period, and character that assets (transferred to the estate from the debtor via a transfer other than by sale or exchange) had when they were in the debtor's possession; (7) the debtor's accounting method; and (8) any other tax attributes provided for in the regulations.<sup>152</sup> The debtor succeeds to these tax attributes upon termination of the bankruptcy estate.<sup>153</sup> In effect, a separate taxable entity is created when an individual files for Chapter 7 or 11 bankruptcy, but IRC section 1399 provides that no such entity is created when corporations or partnerships enter bankruptcy.<sup>154</sup> Furthermore, IRC section 1398 does not apply when the Chapter 7 or 11 case is dismissed.<sup>155</sup>

The bankruptcy estate's income tax is paid by the trustee.<sup>156</sup> The applicable tax rate is the rate for married individuals filing separately.<sup>157</sup> When the estate does not itemize deductions, the estate shall take the standard deduction provided to such

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148. The relevant carryover provisions are contained in IRC section 172. 26 U.S.C. § 1398(g)(1).

149. The relevant carryover provisions are contained in IRC section 170(d)(1). 26 U.S.C. § 1398(g)(2).

150. The provisions relevant to these items are those under IRC section 111. 26 U.S.C. § 1398(g)(3). IRC section 111 applies to deductions and credits (except IRC section 46 tax credits) used in prior tax years, that did not reduce taxable income or tax liability, respectively, in those prior tax years. *Id.* § 111(a), (b). Income in subsequent tax years is excluded from gross income to the extent such deductions did not affect such reductions (did not provide a tax benefit) in a prior tax year. *Id.* § 111(a).

151. The relevant carryover provisions are contained in IRC section 1212. 26 U.S.C. § 1398(g)(5).

152. 26 U.S.C. § 1398(g). Treasury Regulation section 1.1398-1(c) adds passive activity losses and credits to the list. Treasury Regulation section 1.1398-2(c) adds IRC section 465 losses to the list. For definitions regarding these additional tax attributes, *see* Treasury Regulation section 1.1398-1(b) and 2(b). For allocation rules regarding the effect that certain transfers from the estate to the debtor have on these additional attributes, *see id.* section 1.1398-1(d)(2) and 2(d)(2). These regulations apply to bankruptcy cases filed after November 8, 1992. *Id.* § 1.1398-1(f)(1), 2(f)(1). Debtors can irrevocably elect, however, to apply these regulations to cases filed before the effective date. *Id.* § 1.1398-1(f)(2), 2(f)(2).

153. 26 U.S.C. § 1398(i). The IRC does not define "termination" in this context. For a brief discussion of this failure, *see* Williams, *supra* note 84, at 183, 185-90.

154. IRC section 1398 does apply to an individual debtor's interest in a partnership. 26 U.S.C. § 1398(b)(2).

155. 26 U.S.C. § 1398(b)(1). In such a situation, the debtor becomes liable for taxes incurred by the estate. *See* Williams, *supra* note 84, at 180.

156. 26 U.S.C. § 1398(c)(1).

157. *Id.* §§ 1(d), 1398(c)(2).

individuals.<sup>158</sup> The debtor's tax year is determined without regard to the BC.<sup>159</sup> Estate income includes any income of the debtor to which the estate is entitled under the BC;<sup>160</sup> thus, the debtor's income is limited to income to which the estate is not entitled.<sup>161</sup> The amount of deductions, credits, and employment taxes is determined "as if the amount were paid or incurred by the debtor and as if the debtor were still engaged in the trades and businesses, and in the activities, the debtor was engaged in before the commencement of the [bankruptcy] case."<sup>162</sup> Tax consequences shall not attach to transfers between the debtor and the estate that are not deemed either sales or exchanges.<sup>163</sup>

## 2. Cases to Which IRC Section 1398 Does Not Apply

IRC section 1398 has been interpreted, "through a negative inference," as preventing tax attributes not enumerated under section 1398(g) from becoming estate property in cases to which section 1398 applies.<sup>164</sup> Such a reading is consistent with caselaw holding that estate property includes the debtor's tax attributes in situations where section 1398 did not apply.<sup>165</sup> In *In re Prudential Lines, Inc.*,<sup>166</sup> the parent of the corporate debtor was enjoined from taking a deduction for the debtor's worthless stock because such a deduction would destroy the debtor's substantial NOL that had value to both the estate and the debtor's creditors. The court held that the NOL was estate property to which the automatic stay applied.<sup>167</sup> In addition to NOLs, earned income tax credits have been held to be estate property.<sup>168</sup>

## III. VARIOUS HEAD START POSSIBILITIES

### A. The Choice Between Reducing Tax Attributes or Property

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158. *Id.* § 1398(c)(3).

159. *Id.* § 1398(d)(1).

160. *Id.* § 1398(e)(1).

161. 26 U.S.C. § 1398(e)(2).

162. *Id.* § 1398(e)(3).

163. *Id.* § 1398(f).

164. Jack F. Williams, *The Federal Tax Consequences of Individual Debtor Chapter 11 Cases*, 46 S.C. L. Rev. 1203, 1233 (1995).

165. See cases cited in Williams, *supra* note 164, at 1230-31 nn.161, 163, 171.

166. 928 F.2d 565, 567, 572-73 (2d Cir.), *cert. denied*, 502 U.S. 821 (1991).

167. *In re Prudential Lines*, 928 F.2d at 571.

168. See cases cited in Williams, *supra* note 164, at 1230 n.161.

### Bases

Debtors have the option to either apply a portion of excluded DI income toward reducing the bases of depreciable property, or reducing the tax attributes listed under IRC section 108.<sup>169</sup> If the debtor chooses the latter option, the IRC section 1017(b)(2) basis reduction limitation is not applicable.<sup>170</sup> For purposes of this election, "depreciable property" includes property for which a depreciation allowance is permitted, if the allowance is reduced by the election.<sup>171</sup> If the debtor so elects, depreciable property may also include real property the taxpayer holds for sale to customers in the ordinary course of business.<sup>172</sup> Depreciable property does not include property the debtor exempts from the bankruptcy estate under BC section 522.<sup>173</sup> In addition, the amount by which the taxpayer chooses to reduce such bases cannot exceed the aggregate adjusted bases of all the eligible property that he holds on the day after the close of the tax year in which the discharge occurred.<sup>174</sup>

This election allows the debtor to save, for future use, some tax attributes that would otherwise be reduced under IRC section 108. The IRC, however, provides for a recapture procedure that is detrimental to taxpayers.<sup>175</sup> Under this recapture procedure, when the property whose basis was reduced by the section 108(b)(5) election is later disposed of, some of the gain on disposition may be treated as ordinary income.<sup>176</sup> This may be a drawback to the taxpayer in the future with regard to capital assets<sup>177</sup> because the taxpayer's ordinary income tax rate may be higher than the capital gains rate.<sup>178</sup> This potential increase in taxes, however, will occur

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169. 26 U.S.C. § 108(b)(5)(A), (C). A drawback to the use of this election is the impact of IRC section 1017(d) recapture rules that apply when the property is later sold. See *BITTKER & EUSTICE, supra* note 8, at 12 - 147. For a discussion of these recapture rules, see *infra* text following note 175.

170. 26 U.S.C. § 1017(b)(2). See *supra* note 80.

171. 26 U.S.C. § 1017(b)(3)(B). A debtor partner's proportionate share in a partnership's depreciable property is included. *Id.* § 1017(b)(3)(C).

172. *Id.* §§ 1017(b)(3)(E)(i), 1221(1).

173. *Id.* § 1017(c)(1).

174. *Id.* § 108(b)(5)(B).

175. *Id.* § 1017(d).

176. 26 U.S.C. §§ 1017(d), 1245, 1250.

177. A "capital asset" is property used in a trade or business, other than inventory, or property held for investment. IRC section 1221 negatively defines capital asset by listing types of property that do not constitute capital assets.

178. The maximum rate at which capital gains are currently taxed is 28%. 26 U.S.C. § 1(h). The maximum and some intermediate rates on other income exceed that rate. *Id.*



only if the property is disposed of in a manner triggering recapture.

## B. Short Tax Year Elections

### 1. The IRC Section 1398(d)(2) Election

Individuals, who are debtors to which IRC section 1398 applies, can irrevocably elect to end their tax year on the day before the bankruptcy filing.<sup>179</sup> The remaining portion of the debtor's tax year is a separate "short" tax year, beginning on the date the bankruptcy case is filed.<sup>180</sup> This election is not available, however, to a debtor whose only assets are those "which the debtor may treat as exempt property under" BC section 522.<sup>181</sup> In any event, an eligible debtor can create real tax savings by offsetting tax attributes against income that accrues prior to the commencement of the bankruptcy case. Indeed, more often than not, the short year election is advantageous to a debtor.<sup>182</sup>

If a short year election gives rise to income in the first short tax year, taxes may create a claim against the bankruptcy estate.<sup>183</sup> Such tax debt is an eighth-level priority unsecured claim, but it is also a nondischargeable debt, that accordingly will follow the debtor if not paid during the pendency of the estate administration.<sup>184</sup> If the debtor does not make the election, he will be liable for taxes incurred during the entire tax year in which the bankruptcy was filed.<sup>185</sup> Therefore, if incremental estate property satisfies eighth-level priority unsecured claims, the debtor, by electing the short tax year, can rid himself of some, or all, tax debts on which he would otherwise remain personally liable.

If the short year election results in a NOL for the first short tax year, a debtor can still realize an advantage from the election. The IRC section 1398(d)(2) election can allow a debtor to reduce the amount of nondischargeable debts that follow him/her after discharge. In order for a debtor to realize any significant advantage,

#### § 1(a)-(d).

179. 26 U.S.C. § 1398(d)(2)(A)(i), (D).

180. *Id.* § 1398(d)(2)(A). The debtor's spouse can join in this election, but only if the debtor and spouse file a joint tax return for the first short tax year. *Id.* § 1398(d)(2)(A)(i), (B).

181. *Id.* § 1398(d)(2)(C).

182. Williams, *supra* note 84, at 182. The election must be timely made, however, or it is lost. *See id.* To be timely made, the election must be made by the fifteenth day of the fourth month following the last day of the tax year. *Id.* at 182 n.197 (citations omitted).

183. *Id.* at 182.

184. *Id.* (footnote omitted).

185. *Id.* (footnote omitted).

the first short tax year must give rise to a NOL because, as discussed previously, DI income reduces tax attributes after taxable income for the tax year of discharge is calculated.<sup>186</sup> NOLs are carried back to offset income generated in the three tax years immediately preceding the start of the tax year creating the NOL that is subject to the carryback.<sup>187</sup> Carryback reduces prior years' income taxes that a debtor still owes. Accordingly, if the first short tax year does not give rise to a NOL that can be carried back to prior tax years, the IRC section 1398(d)(2) election does not make a real difference. Alternatively, if a debtor has no taxable income in any of the tax years to which a NOL can be carried back, this election will also fail to effect a meaningful difference.

The IRC section 1398(d)(2) election will create a head start if the incremental income created by this election reduces amounts owed on nondischargeable debts, in turn reducing a debtor's liability on debts that follow him/her through the bankruptcy proceeding. If a debtor has delinquent tax liabilities for income taxes in prior tax years to which a NOL will be carried back, a reduction in taxable income for such years will reduce the amount owed on such delinquent and nondischargeable debt.

If a debtor has already satisfied the tax liability for such prior years, the debtor will be entitled to a refund to the extent that the recalculated taxable income is less than the taxable income upon which the prior income tax payments were made. This refund gives rise to incremental property that must be included in the bankruptcy estate because it constitutes an interest in property belonging to the debtor prior to the bankruptcy filing. Again, assuming incremental increases in estate property reduce

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186. 26 U.S.C. § 108(b)(4).

187. *Id.* § 172(b)(1)(A)(i). If the preceding tax years have not generated enough taxable income to offset the NOL, the NOL can be carried forward to offset taxable income generated in the 15 tax years immediately following the tax year in which the NOL arose. *Id.* § 172(b)(1)(A)(ii). IRC section 172(d), however, provides for several modifications to calculating taxable income for the purpose of deducting NOLs. The taxpayer can irrevocably elect to forego carrying back any portion of a NOL. *Id.* § 172(b)(3). For NOLs generated by the debtor in a tax year ending after the tax year in which the bankruptcy case was filed, the debtor cannot carry back any portion of a NOL to a tax year ending prior to year of filing. *Id.* § 1398(j)(2)(B), (C). For other special accounting rules, see IRC section 1398(j).

The tax year of the acquired corporation ends when such a corporation makes a distribution or transfer to which section 381(a) applies. *Id.* § 381(b). "[A]cquisition of the loss company on the last day of the corporation's taxable year is necessary to avoid consumption of an extra loss carryover year." BITTKER & EUSTICE, *supra* note 8, at 14 - 27 n.78. The extra loss carryover year is the second short tax year, that, under IRC section 381(c)(1)(A), also becomes the first loss carryover year. See *id.* at 14 - 27. IRC section 381(c)(1)(C) contains elaborate rules for tracing NOLs. *Id.*

nondischargeable debts, these refunds will reduce such debts and give the debtor a head start to the extent such nondischargeable debt would not be extinguished, but for the availability of the IRC section 1398(d)(2) election.

## 2. *The Treasury Regulation Section 1.382-6(b) Election*

A corporation can irrevocably elect to end its tax year on the ownership change date if such a change occurs.<sup>188</sup> This election allows the corporation to use its tax attributes for one final tax period before application of the section 382 limitation. This is an important option for corporations because, if the corporation has generated income up to that change date, the election will allow corporate debtors to offset income generated up to that time without regard to the section 382 limitation. For a corporation in bankruptcy, however, DI income is also allocated to the short tax year if an ownership change occurs on the effective date of the Chapter 11 plan. Excluded DI income does not reduce tax attributes, however, until taxable income for the tax year has been calculated. Therefore, a corporation can strategically generate income in this pre-change period.<sup>189</sup>

## C. *The IRC Section 382(l)(5)(H) Election*

In transactions where IRC section 382(l)(5) applies, a corporate debtor's tax attributes are subject to certain reductions.<sup>190</sup> If reduction of attributes is unattractive, a new loss corporation can elect not to have IRC section 382(l)(5) apply.<sup>191</sup> IRC section 382(l)(6) applies when section 382(l)(5) does not, and provides for an increase in a corporation's value for debt either canceled or surrendered in certain transactions.<sup>192</sup> Accordingly, if the provisions of IRC section 382(l)(5) are less attractive than the provisions of IRC section 382(l)(6) (where the latter is applicable if the former is not), a taxpayer can elect to make section 382(l)(5) inapplicable.

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188. Treas. Reg. § 1.382-6(b). The tax year in which the ownership change occurs is not actually terminated. *Id.* § 1.382-6(b)(1) ("e.g., the change year is a single tax year for purposes of section 172" (relating to the NOL deduction)). *Id.* The election must be made by the due date of the debtor's tax return, plus extensions, for the tax year in which the ownership change occurred. *Id.* § 1.382-6(b)(2)(i).

189. For a further discussion of this election, see Jacobs & Swartz, *supra* note 76, at 804-07.

190. See *supra* Part II.A.3.b.

191. 26 U.S.C. § 382(l)(5)(H).

192. See *supra* Part II.A.3.b. (para. 3).

This election out of IRC section 382(1)(5) automatically subjects the taxpayer to the provisions of section 382(1)(5). The ability to elect out of section 382(1)(5), however, is subject to any terms and conditions prescribed by the Secretary of Internal Revenue.<sup>193</sup> Despite these restrictions, election out of IRC section 382(1)(5) may still be attractive and worthwhile.

#### IV. PROBLEMS IN THE INTERACTION OF THE IRC WITH THE BC

Congress' objectives behind the IRC and the BC are very different, and often at odds with each other. The objective of the IRC is to provide an effective means of raising revenue for the federal government.<sup>194</sup> The IRC is extremely effective in this regard. Section 382's purpose is to defeat abusive tax avoidance schemes that transfer tax attributes between corporations for no other purpose than to reduce tax liability.<sup>195</sup> The BC's objective is to restructure the debtor-creditor relationship in such a way as to provide the debtor with a fresh start in some form, while taking into consideration the competing interest of the debtor's creditors.<sup>196</sup> Congress has tried to reconcile these conflicting objectives by enacting provisions such as IRC section 382(1)(5),<sup>197</sup> the G reorganization,<sup>198</sup> and IRC sections 1398 and 1399.<sup>199</sup> Despite Congress' attempts to reconcile the objectives of the IRC and the BC, significant problems are present.

##### A. *Erosion by Treasury Regulations*

Although Congress may conscientiously attempt to reconcile conflicts between the various statutes it enacts, the IRS is not as sensitive to the need to reconcile conflicts between the IRC and the BC. The IRS is primarily concerned with carrying out the purposes of the IRC with unwavering loyalty to the IRC — sometimes with absurd results. Because of this single-minded purpose, some of the regulations promulgated by the Secretary of

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193. 26 U.S.C. § 382(1)(5)(H). These terms and conditions include proposed Treasury Regulations that limit the application of, and election into, the alternative provisions to IRC section 382(1)(5) — the provisions of IRC section 382(1)(6). See BRITKER & EUSTICE, *supra* note 8, at 14 - 93 n.306 (discussing these proposed Treasury Regulations).

194. See Jacobs & Swartz, *supra* note 76, at 820.

195. *Id.*

196. *Id.*

197. See *supra* Part II.A.3.b.

198. See *supra* Part II.A.3.a.

199. See *supra* Part II.B.1.

Internal Revenue constrict a taxpayer-debtor's ability to obtain a head start under the IRC. Furthermore, the IRS' zealous adherence to the revenue-raising objectives of the IRC calls for further action by Congress to shorten the leash on the IRS' ability to subvert Congress' reconciliatory attempts.

### 1. *Treasury Regulation Section 1.269-3(d)*

Despite a dearth of caselaw applying IRC section 269 to Chapter 11 bankruptcy proceedings to which section 382 applies,<sup>200</sup> the scope of section 269 is not expressly limited by the IRC.<sup>201</sup> Due to the lack of an express limitation on the applicability of section 269, the IRS has promulgated Treasury Regulation section 1.269-3(d). When IRC section 382(1)(5) is applicable,<sup>202</sup> the acquisition of the requisite control or property is presumed<sup>203</sup> "to be made for the principal purpose of evasion or avoidance of Federal income tax unless the corporation carries on more than an insignificant amount of an active trade or business during and subsequent to" the bankruptcy case.<sup>204</sup> IRC section 382(1)(5) requires shareholders and qualified historic creditors to assume control of a corporation, but to apply section 269's disallowance provision<sup>205</sup> because such control was acquired has been called "perverse."<sup>206</sup>

Congress has expressed its intent that section 269 should not apply where IRC section 382 applies.<sup>207</sup> Although subsequent congressional statements are ambiguous on this issue,<sup>208</sup> these statements should be resolved by reading those statements in the context of Congress' prior unequivocal expression of intent on this matter.<sup>209</sup> The IRS seems to believe that absolutely no deference is due an uncodified intent of Congress. The IRS' position is clear

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200. See Jacobs & Swartz, *supra* note 76, at 823.

201. See *supra* Part II.A.2. (para. 4).

202. See *supra* Part II.A.3.b.

203. A "presumption" is "[a] legal device which operates in the absence of other proof to require that certain references be drawn from the available evidence." BLACK'S LAW DICTIONARY 1185 (6th ed. 1990).

204. Treas. Reg. § 1.269-3(d). See Jacobs & Swartz, *supra* note 76, at 819-20. This presumption can be overcome by "strong evidence to the contrary." Treas. Reg. § 1.269-3(d).

205. See *supra* Part II.A.2. (para. 4).

206. See Jacobs & Swartz, *supra* note 76, at 820-21.

207. *Id.* at 821-23 (footnotes omitted).

208. One such statement was made in the legislative history of the Tax Reform Act of 1986: "[t]he conference agreement does not alter the continuing application of section 269, relating to acquisitions made to evade or avoid taxes, as under present law." H.R. Rep. No. 99-841, 99th Cong., 2d Sess. II-194 (1986), reprinted in 1986 U.S.C.C.A.N. 4075, 4282.

209. Jacobs & Swartz, *supra* note 76, at 824-25.

from its promulgation of the blatantly contradictory Treasury Regulation section 1.269-3(d). In the context of IRC section 269 and its accompanying regulations, Congress should codify its intent by expressly including a statement in IRC section 382 that section 269 is inapplicable when section 382 applies.<sup>210</sup>

## 2. Treasury Regulation Section 1.269-3(e)

Treasury Regulation Section 1.269-3(e) provides that a court's determination under BC section 1129(d)<sup>211</sup> "that the principal purpose of the [Chapter 13] plan is not avoidance of taxes is not controlling" on the issue of whether section 269 is applicable to a particular case.<sup>212</sup> The rendering of BC section 1129(d) as ineffective in relation to matters concerning the IRC is another example of the IRS' practice of subverting Congress' reconciliatory policies. Again, it is evident that the only way to force the IRS to comply with congressional policy in reconciling the objectives of the IRC with the BC, is by a provision in either statute that expressly limits the scope of IRS action. In this instance, a minor statutory amendment to BC section 1129(d) is all that is required. This amendment need only provide that a court's determination, under BC section 1129(d), is controlling in subsequent proceedings brought by the IRS against Chapter 11 debtors.<sup>213</sup> In light of this regulation, the head start that a Chapter 11 debtor receives upon discharge (by obtaining a favorable 1129(d) determination from the court) can be rendered a mere mirage at the whim of the IRS.

## B. Failure to Define "Termination" Under IRC Section 1398<sup>214</sup>

There are multiple methods through which a debtor's bankruptcy estate can be terminated, such as dismissal of a case, closing of a case, or when specific estate property is abandoned by the bankruptcy trustee.<sup>215</sup> Because of this failure to define "termination

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210. For an extensive discussion of this conflict, *see id.* at 817-33.

211. *See supra* note 50.

212. Treas. Reg. 1.269-3(e)(1).

213. For a further discussion of Treasury Regulation section 1.269-3(e), *see* Jacobs & Swartz, *supra* note 76, at 827-32.

214. *See supra* Part II.B.1. (para. 1).

215. *See Williams, supra* note 84, at 183 n.201 (citation omitted). Dismissal of a bankruptcy case has the effect of terminating the estate by "revest[ing] the property of the estate in the entity in which such property was vested immediately before the commencement of the case." 11 U.S.C. § 349(b)(3).

Closing of the case is the termination contemplated under BC section 350, but as one commentator points out, closing of the case is a type of termination and should not be

of the estate" under IRC section 1398, litigation ensues and courts differ on the resolution of this ambiguity.<sup>216</sup> Congress should define this term so the hardship facing debtors litigating this issue can be ended and the debtor can obtain his/her fresh start (and head start, if the IRC extends the debtor's fresh start) in a less burdensome manner.

### C. Omitted Tax Attributes Under IRC Section 381(c)

Where a tax attribute is not listed in IRC section 381(c)'s carryover provisions, there is confusion as to how these attributes should be handled. There are two views on this issue.<sup>217</sup> The first is that "[n]o carryover occurs because [section] 381 is the exclusive provision for carryover treatment."<sup>218</sup> The other view is that caselaw principles developed prior to the enactment of section 381 apply.<sup>219</sup> Legislative history demonstrates that section 381 does not affect tax attributes not listed in section 381(c), nor is any inference to be drawn with regard to the exclusion of those attributes from section 381(c).<sup>220</sup> Despite this expression of congressional intent, the resolution of how tax attributes not listed under section 381(c) are to be treated involves a convoluted and piecemeal process.

The current IRS position on this issue is not uniform<sup>221</sup> and caselaw differs on which theory should be applied.<sup>222</sup> Furthermore,

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considered the exclusive definition under IRC section 1398 because Congress "could have easily used the term "closing" [, but] . . . chose not to. . . ." See Williams, *supra* note 84, at 183, and n.201 (citation omitted). Specifically, section 350 provides, in relevant part, that "[a]fter an estate is fully administered and the court has discharged the trustee, the court shall close the case." 11 U.S.C. § 350(a).

Abandonment is provided for under BC section 554. It is permissible when the property concerned is "burdensome to the estate or . . . is of inconsequential value and benefit to the estate." *Id.* § 554(a), (b).

216. See Williams, *supra* note 84, at 185-91 (discussing abandonment of estate property by the trustee in bankruptcy, noting that the majority of courts "conclude that no federal tax consequences attach to abandonment").

217. A third approach is that a section 381-type carryover policy should apply to transfers of tax attributes not listed under section 382(c) if the transfer of those attributes "is similar to a [section] 381(a) transfer." BITTKER & EUSTICE, *supra* note 8, at 14 - 37. This view is: (1) more or less transaction oriented (and, therefore, not germane to this comment), (2) does not provide a substantial resolution to the 381(c) attributes versus non-381(c) attributes problem, and (3) "is specifically rejected by the regulations." *Id.*

218. *Id.*

219. *Id.*

220. *Id.* (footnote omitted).

221. See *id.* at 14 - 37 n.107.

222. See BITTKER & EUSTICE, *supra* note 8, at 14 - 37-38.

any judicial resolution of this issue is conducted on a piecemeal basis — only those attributes not listed in section 381(c) that are at issue in a particular case are governed by the court's decision.<sup>223</sup> Since many corporate parties to a reorganization may possess at least one tax attribute not listed under section 381(c), the absence of a clear statutory provision on the matter gives rise to an unnecessary burden of litigating the fate of such attributes. A resolution by Congress to include a provision in the IRC to govern these unlisted tax attributes could greatly contribute to resolving this controversy and clearly establish the policy to be followed in resolving cases in which an unlisted tax attribute is involved.

## V. CONCLUSION

The BC provides debtors with the opportunity to readjust their debt. The primary manner by which adjustment is accomplished is by discharging the debtor from most types of debts to provide a fresh start. The readjustment process has many tax implications under the IRC, however. Although many, if not most, of these implications are negative, the IRC may provide a debtor with advantageous options regarding tax attributes to further enhance the fresh start provided by the BC. To the extent that the IRC adds to the fresh start provided by the BC, a debtor begins with a head start after a bankruptcy discharge. In addition, the BC establishes several different bankruptcy proceedings. The extent of a debtor's fresh start varies according to the type of proceeding that a debtor chooses. In any event, a debtor is provided with options under the combined provisions of the IRC and the BC when the debtor enters, or is considering entering, bankruptcy. Through the interaction of the IRC and the BC, debtors can significantly reduce liability on debts in general and on potential tax liability after the close of a bankruptcy proceeding.

Despite the benefits provided through the interaction of the IRC and the BC, there are significant problem areas that require necessary and prompt resolution by Congress. Many of these problems<sup>224</sup> can be remedied through relatively simple amendments to the IRC and the BC. Other problems may require more extensive amendments. Nonetheless, a taxpayer-debtor is given a significant head start when the provisions of the IRC and the BC complement each other, but the few problem areas that unnecessarily obstruct

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223. *Id.* at 14 - 20 (brief discussion of caselaw).

224. *See supra* Part IV.



such a complementary result mandate swift remedial measures by Congress.

*Charles R. Pass, III*