

Avoiding Phantom Income in Bankruptcy: A Proposal for Reform

Gregory L. Germain

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Avoiding Phantom Income in Bankruptcy: A Proposal for Reform

Gregory L. Germain*

I.	INTRODUCTION - THE PROBLEM OF PHANTOM INCOME IN BANKRUPTCY CASES	251
II.	THE EXISTING METHODS FOR AVOIDING PHANTOM INCOME IN BANKRUPTCY ARE INADEQUATE	257
A.	<i>The Net Operating Loss Carryback Rules Provide Only Limited Relief from the Accounting Method Distortion in Bankruptcy.</i>	257
1.	<i>Discharge of Indebtedness Upon Plan Confirmation Will Often Eliminate the Net Operating Loss Carryback</i>	258
2.	<i>Phantom Income Does Not Always Result in a Net Operating Loss</i>	263
B.	<i>The DSF and QSF Rules Provide Only Limited Relief from Accounting Method Distortion in Bankruptcy</i>	265
1.	<i>The History of Deductions Under the Accrual Method of Accounting</i>	265
2.	<i>The Time Value of Money Problem</i>	266
3.	<i>Congress Enacts Section 461(h) to Prevent Accrual Method Taxpayers from Structuring Transactions to Take Advantage of the Time Value of Money</i> ..	271
4.	<i>Congress Enacts Section 468B to Provide a Method for Structuring Tort Settlements</i>	272
5.	<i>The Treasury Prohibits the Use of a QSF to Pay Bankruptcy Trade Claims</i>	274
6.	<i>Section 468B Funds Were Not Designed to Benefit Cash Method Taxpayers</i>	276
III.	CONTESTED LIABILITY FUNDS PROVIDE ONLY LIMITED RELIEF FROM PHANTOM INCOME IN BANKRUPTCY	279
A.	<i>Creation of Contested Liability Funds</i>	280

* LL.M. in Taxation, University of Florida Levin College of Law 2001; Partner, Landels Ripley & Diamond, LLP, San Francisco, California (1999-2000); B.A., University of California - Santa Cruz 1982; J.D., University of California, Hastings College of Law 1985. This author is grateful for the helpful comments of Professor Martin J. McMahon, Jr., the Clarence J. TeSelle Professor of Law, University of Florida Levin College of Law.

B.	<i>The Signature Requirement for Contested Liability Funds</i>	281
C.	<i>Limiting the Use of Contested Liability Funds by Accrual Method Taxpayers</i>	284
D.	<i>The Maxus Energy Test</i>	286
IV.	THE “GRANTOR TRUST” RULES IMPOSE AN ADDITIONAL LIMITATION ON USING TRUSTS TO AVOID ACCOUNTING METHOD DISTORTION IN BANKRUPTCY.	288
A.	<i>When Payments to a Trust are Deductible as Ordinary Business Expenses.</i>	290
V.	SUMMARY OF ANALYSIS AND RECOMMENDATION FOR REFORM	292

I. INTRODUCTION - THE PROBLEM OF PHANTOM INCOME IN BANKRUPTCY CASES

Chapter 11 of the Bankruptcy Code¹ was designed to give the debtor a breathing spell from creditors by granting the debtor time to formulate a reorganization plan without having to fend off creditor claims. Both the Senate and House Reports accompanying the Bankruptcy Code state that the purpose of the automatic stay is to provide the debtor with “a breathing spell from his creditors.”² Many courts have cited this language in describing the purpose of the automatic stay.³

During this breathing spell, a debtor continues to collect and accumulate money from pre-petition sales and services. Absent extraordinary circumstances, however, the debtor is not allowed to use those receipts to pay pre-petition claims until a plan of reorganization is confirmed.⁴

While designed to benefit the debtor, the breathing spell can also have severe adverse tax consequences for the debtor. For example, a cash method debtor would be taxed on its net income in year one, which would include all revenues collected, but would not be reduced by the offsetting deductions that would normally result from the payment of pre-petition liabilities. This results in phantom income in year one for funds received which are earmarked to pay pre-petition creditor claims, but which cannot be paid due to the bankruptcy prohibition on payment prior to plan confirmation, and mismatched deductions in year two when the plan of reorganization is confirmed and the claims of

1. All references to the “Bankruptcy Code” are to the Bankruptcy Reform Act of 1978, as amended, codified at 11 U.S.C. § 101 et seq. All unspecified section references, and all references to the “IRC” or the “Code” are to the Internal Revenue Code of 1986, as amended, codified at 26 U.S.C. § 101 et seq.

2. S. Rep. No. 95-989 at 54-55 (1978); H.R. Rep. No. 95-595 at 340 (1977).

3. In re *Commonwealth Oil Ref. Co.*, 805 F.2d 1175, 1182 (5th Cir. 1986) (“The purpose of the automatic stay is to give the debtor a ‘breathing spell’ from his creditors, and also, to protect creditors by preventing a race for the debtor’s assets.”) cert. denied, 483 U.S. 1005 (1987). See also *Krystal Cadillac Oldsmobile GMC Truck, Inc. v. GMC*, 142 F.3d 631 (3rd Cir. 1998); In re *Javens*, 107 F.3d 359 (6th Cir. 1997); *Jove Eng’g v. IRS*, 92 F.3d 1539 (11th Cir. 1996).

4. See e.g., Fed. R. Bankr. § 3021 (mandating that distributions to be made to creditors after confirmation of the plan of reorganization); In re *Conroe Forge Mfg. Corp.*, 82 B.R. 781, 784 (Bankr. W.D. Penn 1988) (stating that “[t]he general rule is that distribution should not occur except pursuant to a confirmed plan of reorganization, absent extraordinary circumstances”); *Air Beds, Inc. v. I.R.S.*, 92 B.R. 419, 424 (9th Cir. B.A.P. 1988) (denying debtor’s request to distribute proceeds from sale of assets to Internal Revenue Service in satisfaction of pre-petition priority claims prior to plan confirmation); *Howe v. Equitable Gas Co.*, 112 B.R. 754, 759 (Bankr. W.D. Penn. 1990) (denying distribution to secured creditor because “[d]istribution to all but oversecured creditors must await distribution pursuant to a confirmed Plan”).

creditors are paid. Thus, in many cases, if the bankruptcy debtor is not able to confirm a plan of reorganization and make creditor payments during a single tax year, the debtor's tax accounting method is distorted.

Not all Chapter 11 debtors have phantom income. Debtors are allowed in the ordinary course of business to use cash receipts to pay the on-going post-petition expenses of their businesses⁵. Many debtors spend all of their cash receipts on the continuing cash needs of their businesses and would not set aside funds for creditor payment even if allowed to do so. Because of their on-going cash needs, debtors who would not set aside excess funds earmarked for payment of pre-petition creditor claims do not suffer from accounting method distortion, and no relief is needed.

However, in other cases, especially liquidation cases,⁶ a debtor may quickly accumulate cash in excess of its operating requirements. Many debtors would use this excess cash to pay pre-petition claims if they could, in order to deduct the payments from their income to minimize their taxes and thereby prevent the distortion of their accounting method. However, the bankruptcy restrictions on payment of pre-petition claims prior to plan confirmation prevent debtors from arranging their own affairs to minimize their income taxes.

While some distortion in the matching of revenues and expenses is inherent in the cash method,⁷ the gross distortion that can result in bankruptcy

5. 11 U.S.C. § 363(c)(1).

6. Liquidating Chapter 11 cases are a proper use of Chapter 11 of the Bankruptcy Code. See e.g. 11 U.S.C. § 1123(a)(5)(D) (permitting a plan of reorganization to provide for "the sale of all or any part of the property of the estate . . . or the distribution of all or any part of the property of the estate among those having an interest in such property of the estate"); *Sandy Ridge Dev. Corp. v. Louisiana Nat'l Bank*, 881 F.2d 1346, 1352 (5th Cir. 1989) (stating that "[I]t is clear from these statutory provisions that although Chapter 11 is titled 'Reorganization,' a plan may result in the liquidation of the debtor"); *Air Beds, Inc.*, supra note 4, at 423; *In re WHET, Inc.*, 12 B.R. 743, 750 (Bankr. D. Mass. 1981); *In re River Village Assocs.*, 181 B.R. 795, 805 (E.D. Pa. 1995).

7. From a financial accounting prospective, the cash method of accounting does not paint an accurate picture of the taxpayer's net income for an accounting period. Instead, financial reporting is governed by the accrual method of accounting, under which an attempt is made to match expenses to the revenues generated thereby. See *Shalala v. Guernsey Mem'l Hosp.*, 514 U.S. 87, 104 (1995) (recognizing that there are many different forms of the accrual method). In its purest form, the cash method of accounting requires recognition of income and allows deduction of expenses only when received or paid. There is no attempt to match expenses to the accounting period in which the income generated by the expense is earned. See *Fong v. Commissioner*, 48 T.C. Memo (CCH) 689, 716, T.C. Memo (P-H) ¶ 84,402, 84-1590 (1984) ("Respondent seizes upon Mr. Gray's testimony that the cash method did not accurately match income and expenses pertaining to any given year. Respondent's argument is misplaced. Such matching is the purpose of accrual basis accounting and not of the cash method."). Many courts have recognized that the cash method distorts the taxpayer's true accounting position, but is permitted for tax accounting purposes for ease of administration. See e.g., *Zaninovich v. Commissioner*, 616 F.2d 429 (9th Cir. 1980). In *Zaninovich*, the Ninth Circuit allowed a cash

cases deserves special relief. Bankruptcy debtors are often unable to control the timing of pre-petition payments. Indeed, the debtor's only real control is its right to propose a plan of reorganization during the exclusivity period.⁸ In many cases, that control is illusory because the debtor is simply not in a position to propose a confirmable plan during the first tax year in which its bankruptcy case is filed.

The bankruptcy laws prohibit the debtor from paying pre-petition claims prior to plan confirmation in order to assure ratable distributions to similarly situated creditors, and to assure fair creditor treatment through the plan confirmation process. The restrictions on pre-petition claim payment are not designed to benefit the debtor but to protect creditors. The debtor does not elect to take advantage of the restriction for its own benefit. Because the restriction is imposed on the debtor, the restriction on creditor payments should not come at a tax cost to the debtor.

While the accounting method distortion has the most severe impact on cash method taxpayers, accrual method taxpayers are also affected. The accrual method⁹ of tax accounting is not a purely accrual system. It is a hybrid system

method taxpayer to deduct pre-paid rent which extended eleven months beyond the end of the year of payment for ease of administration, even though the expense does not properly match revenues. "Moreover, if there was a distortion of income in every situation in which an accounting method did not precisely match items of expense and income, the cash basis method would not be a permissible method of accounting, as a certain degree of imprecision is built into the method." *Id.* at 432. See also, *Bonaire Dev. Co. v. Commissioner*, 679 F.2d 159, 162 (9th Cir. 1982) (stating that "We also recognized [in *Zaninovich*] that proration was not needed to reflect income fairly, because the distortion was simply the imprecision built into the cash method, which does not precisely match items of expense and income"); *Osterloh v. Lucas*, 37 F.2d 277, 278-79 (9th Cir. 1930) (requiring that method of accounting shall clearly reflect income is not absolute; cash method kept fairly and honestly, year after year, "will approximate equality as nearly as we can hope for in the administration of a revenue law").

8. 11 U.S.C. § 1121(b). The exclusivity period is the 120 day period following the filing of the bankruptcy petition during which only the debtor may file a plan of reorganization. The exclusivity period is extended for an additional 60 days to obtain confirmation if a plan is filed during the 120 day period. *Id.* § 1121(c)(3).

9. While the cash method is inherently imperfect from a financial reporting prospective, the accrual method of accounting is also not a perfect science. In *Shalala*, the United States Supreme Court recognized that there is no single accrual method, and that even accepted accrual methods for financial reporting do not bind the government in collecting taxes from accrual method taxpayers. The *Shalala* court stated:

[Generally Accepting Accounting Principles] "do[es] not necessarily parallel economic reality." Financial accounting is not a science. It addresses many questions as to which the answers are uncertain and is a "process [that] involves continuous judgments and estimates." In guiding these judgments and estimates, "financial accounting has as its foundation the principle of conservatism, with its corollary that possible errors in measurement [should] be in the direction of understatement rather than overstatement of net income and net assets." This orientation may be consistent with the objective of informing investors, but it still serves the needs of Medicare

under which traditional accrual accounting methods are used for some liabilities and modified cash methods are used for other liabilities. Unlike cash method taxpayers, accrual method taxpayers can deduct most trade debts when incurred, rather than when paid.¹⁰ Obviously, there is no distortion of an accounting method caused by a payment restriction where the taxpayer can deduct the liability without making payment.

However, accrual method taxpayers cannot deduct many liabilities until payment is made. For example, accrual method taxpayers may deduct liabilities for workers' compensation, torts, breaches of contract, violations of law, rebates and refunds, awards, prizes and jackpots, insurance warranty and service contracts, most taxes, and all other liabilities for which an earlier deduction is not specifically permitted, only when these liabilities are paid.¹¹

reimbursement and its mandate to avoid cross-subsidization. . . . There are 19 different GAAP sources, any number of which might present conflicting treatments of a particular accounting question. When such conflicts arise, the accountant is directed to consult an elaborate hierarchy of GAAP sources to determine which treatment to follow.

Shalala, supra note 7, at 100-01.

10. The Code contains a somewhat labyrinthine way of stating this simple concept. § 461(a) states the general rule that a deduction or credit is allowed for the proper taxable year under the method of accounting used by the taxpayer in computing taxable income. The Code provides that, for an accrual method taxpayer, debts are incurred when the "all events test" is satisfied. See § 461(h)(1) (codifying the traditional "all events" test for accrual accounting); Regs. § 1.461-1(a)(2). The all events test is satisfied when all events have occurred to enable the taxpayer to determine the fact of, and with reasonable accuracy the amount of, the liability. § 461(h)(4). However, under the general rule, the "all events" test is not met until "economic performance" occurs with respect to the item. § 461(h)(1); Regs. § 1.461-4(a)(1). With respect to trade debts (for goods and services received or used by the taxpayer) "economic performance" occurs when the goods or services are received or the property is used. § 461(h)(2)(A); Regs. § 1.461-4(d)(2)(i) (stating that economic performance occurs when services are provided to a taxpayer); Regs. § 1.461-4(d)(3)(i) (stating that economic performance for property used by a taxpayer occurs ratably over period used). Thus, under the general rules in the Code and the Treasury Regulations, trade debts are generally deductible when the taxpayer receives the property or services, or uses the property, giving rise to the liability regardless of when payment is made.

11. See § 461(h)(2)(C) (workers compensation and tort liabilities); § 461(h)(2)(D) (providing that with respect to other liabilities not mentioned in the Code, economic performance occurs "at the time determined under regulations prescribed by the Secretary"); Regs. § 1.461-4(g)(2) (workers compensation, tort, breach of contract or violation of law liabilities); Regs. 1.461-4(g)(2)(i) (stating that breach of contract liability means claim for incidental, consequential or liquidated damages, but not for direct contract damages); Regs. § 1.461-4(g)(3) (rebate and refund liabilities); Regs. § 1.461-4(a)(4) (award prize or jackpot liabilities); Regs. § 1.461-4(b)(5) (insurance, warranty or service contract liabilities); Regs. § 1.461-4(g)(6)(i) (tax liabilities, including estimated taxes); Regs. § 1.461-4(g)(6)(ii) (governmental license fee liabilities); Regs. § 1.461-4(g)(7) (catch-all for all other liabilities "for which economic performance rules are not provided elsewhere in this section or in any other Internal Revenue regulation, revenue ruling or revenue procedure").

Deferred wage claims present special problems. Under section 404(a), an accrual method taxpayer may not deduct wage claims which are accrued and unpaid, unless the payment is made by the time the taxpayer's return is due.¹² While section 404 was originally enacted to limit traditional deferred compensation arrangements, it has been interpreted broadly to prevent both cash and accrual method taxpayers from deducting compensation payments until the year of actual receipt by the employee or independent contractor,¹³ subject to a limited exception for accrual method taxpayers who make payment prior to the timely filing of their tax return in the year following accrual. Like the cash method economic performance rules applicable to accrual method taxpayers, section 404 operates to further distort the accrual method of a debtor in bankruptcy, because even priority wage claims cannot normally be paid until plan confirmation.

Thus, debtors who use the accrual method for tax purposes suffer the same distortion as cash method taxpayers with respect to liabilities that cannot be deducted until paid, such as most non-trade debts.

Although distortion in the matching of revenues and expenses is inherent in both the traditional cash method and the modified accrual method used for tax accounting, the distortion that results from the bankruptcy prohibition on creditor payments is deserving of relief. The distortion that results in bankruptcy is not the result of the inherent limitations in a calendar year system or the policy decisions made by Congress to assure a steady stream of revenue and prevent abuse.¹⁴ Those accepted distortions are already reflected in the cash and accrual methods of tax accounting. Outside of bankruptcy, taxpayers can learn the rules

12. See § 404(a) (stating the general rule that allows deduction for wages only when paid); § 404(a)(6) (providing exception to general rule for payments made by an accrual method taxpayer not later than the time prescribed by law for the filing of the return for the taxable year of accrual (including extension); Regs. § 1.404(a)-1(c) (same).

13. See Boris I. Bittker & Martin J. McMahon, Jr., *Federal Income Taxation of Individuals*, ¶ 39.4[5] (2d. Ed. 1995 & Supp. 2001).

14. As discussed in greater detail in Part III, the economic performance rules of § 461(h) were designed to prevent accrual method taxpayers from obtaining the time value of money benefits of a full deduction now for liabilities that would not be paid for many years. See e.g., H.R. Rep. No. 98-432, pt. II, at 1254 (1984) (House Ways and Means Committee Report on Deficit Reduction Act of 1984, containing language which became § 461(h) (noting that "the rules relating to the time for accrual of a deduction by a taxpayer using the accrual method of accounting should be changed to take into account the time value of money"); see also *Mooney Aircraft, Inc. v. United States*, 420 F.2d 400, 410 (5th Cir. 1969) (disallowing current deduction by aircraft manufacturer for liability to pay \$1,000 upon retirement of aircraft); *Ford Motor Co. v. Commissioner*, 71 F.3d 209, 216-17 (6th Cir. 1995) (allowing a deduction of only the discounted present value of the structured tort settlement).

and can arrange their affairs in legitimate ways so as to minimize their taxes.¹⁵ For example, outside of bankruptcy, the taxpayer can prevent the distortion by simply paying the liabilities in the appropriate tax year.

But in bankruptcy, it is the accounting method itself that is distorted by the restriction on payment. The debtor's hands are tied. The debtor is not free to arrange its affairs in such a way as to minimize its taxes. The Bankruptcy Court has the ultimate control over the timing of payments through its power to deny confirmation of a plan. Further, the creditors have significant say in the timing and structure of the plan of reorganization through their votes and through their rights to object to plan confirmation.

Congress and the Treasury have recognized the need for relief in similar situations in which the taxpayer's hands are tied in making payments due to legitimate non-tax restrictions. For example, Congress and the Treasury have provided relief for taxpayers who are unable to pay asserted but contested liabilities. The taxpayer may take a deduction without paying the disputed claim by placing the funds outside of the taxpayer's control until the dispute is resolved. Section 461(f) permits a deduction, by both cash and accrual method taxpayers, for contested liabilities if the taxpayer transfers money or property "to provide for" satisfaction of the contested liability, as long as the payment would be deductible but for the contest. Section 461(f) does not specify to whom the payment must be made. As discussed in Part IV, while the Treasury has taken the position that the payment must be made to the creditor, to a qualified trust or fund under an agreement signed by the creditor, or pursuant to a court or government order,¹⁶ several courts have been far more liberal in allowing payments even to secret trusts, as long as distribution from the trust can be made only upon resolution of the contest.¹⁷

Similarly, where there is a dispute over who is entitled to payment, but the taxpayer admits the liability, the Treasury has proposed permitting a deduction for payment to a disputed ownership fund. This would enable a taxpayer to take a deduction upon interpleading funds with a court with jurisdiction to resolve conflicting claims of entitlement.¹⁸

Congress has also granted relief from the harsh economic performance rules by allowing deductions for payments to a designated settlement fund (DSF)

15. In the famous case of *Helvering v. Gregory*, Judge Learned Hand stated: "Any one may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." 69 F.2d 809, 811 (2d Cir. 1934), *aff'd* 293 U.S. 465 (1935).

16. Regs. § 1.461-2(c)(1).

17. See *Varied Invs., Inc. v. United States*, 31 F.3d 651, 655 (8th Cir. 1994); *Edison Bros. Stores, Inc. v. Commissioner*, 69 T.C. Memo (CCH) 2897, 2899-900, T.C. Memo (RIA) ¶ 95,262, 95-1659.

18. Prop. Regs. § 1.468B-9, 64 F.R. 4801 (2/1/99) (disputed ownership fund).

established under section 468B, and the Treasury has granted significantly broader relief for payments made to a qualified settlement fund (QSF) pursuant to the section 1.468B of the Treasury Regulations. Broadly speaking, the DSF statute and the QSF regulations combine to allow accrual method taxpayers to avoid the economic performance limitations by permitting deductions for payments made to a designated fund for satisfaction of disputed and undisputed tort and violation of law liabilities. A full review of the DSF and QSF rules follows in Part III. While the available relief is limited, especially for bankruptcy debtors, the DSF and QSF rules provide a mechanism for relieving the distortion caused by the economic performance rules in many situations in which they would otherwise unintentionally penalize and discourage legitimate non-tax business activities, such as structured tort settlements.

This paper explores the limitations and uncertainties of the current methods available to accrual method and cash method bankruptcy debtors to attempt to avoid taxation on phantom income which is earmarked for the payment of creditor claims, and points out the need for regulatory reform.

II. THE EXISTING METHODS FOR AVOIDING PHANTOM INCOME IN BANKRUPTCY ARE INADEQUATE

A. The Net Operating Loss Carryback Rules Provide Only Limited Relief from the Accounting Method Distortion in Bankruptcy

The Code allows a taxpayer to carry back a net operating loss to its prior two years.¹⁹ A net operating loss is defined generally as deductions in excess of gross income.²⁰ However, section 172(d) prevents most personal deductions, including itemized personal deductions, personal and dependency exemptions and investment expenses, from being carried back as net operating losses. Moreover, no deduction is allowed for capital losses in excess of capital gains.²¹ In essence, the net operating loss is the excess of business deductions over business income, to the extent that the taxpayer does not receive any tax benefit from the excess business deductions.²² However, the excess business deductions result in a tax

19. §§ 172(a), (b)(1)(A). Longer carrybacks are allowed in specified circumstances. See e.g., § 172(b)(1)(C) (10 year specified liability loss carryback); § 172 (b)(1)(D) (10 year carryback for commercial bank bad debt losses); § 172(b)(1)(F) (3 year carryback for casualty losses, small business losses and farming losses).

20. § 172(c).

21. Corporations are not allowed to deduct losses from the sale or exchange of capital assets to the extent they exceed gains from the sale or exchange of capital assets. § 1211(a). Individuals are allowed to deduct up to \$3,000 of excess capital losses over capital gains. § 1211(b). However, this excess deduction of up to \$3,000 is excluded from the net operating loss calculation. § 172(d)(2).

22. See Bittker & McMahon, *supra* note 13, at ¶ 19.2[2].

benefit to the extent they offset capital gains or other personal income, and in such event cannot be carried back.²³

When the deferred deductions in year one result in an equal amount of net operating loss carrybacks upon confirmation of the plan of reorganization in year two, the net operating loss carryback does provide relief from the distortion of the accrual and cash method of accounting in bankruptcy cases. For example, if the debtor received all of its income in year one, and took all of its deductions in and had no income in year two, the net operating loss would work as intended – by allowing the deductions to be carried back and matched against the year one income. The only loss to the taxpayer from the distortion would be the time value of the taxes paid for year one and later refunded for year two.²⁴

1. *Discharge of Indebtedness Upon Plan Confirmation Will Often Eliminate the Net Operating Loss Carryback.*—But in the real world, the net operating loss carryback does not work perfectly. The first limitation arises out of the discharge of indebtedness rules. In many bankruptcy cases, the debtor's plan of reorganization provides for the discharge of indebtedness because creditor claims are not to be paid in full, and are discharged upon confirmation of the reorganization plan.²⁵ As a general rule, discharge of indebtedness results in

23. *Id.*

24. When a net operating loss is carried back to an earlier year, the taxpayer's tax liability for the earlier year must be recomputed. The taxpayer must then file a request for a refund of the difference between the amount paid in the earlier year and the amount properly due after taking into consideration the carryback. See Internal Revenue Service, U.S. Dep't. of Treas., Pub. No. 536, Net Operating Losses (NOL's) For Individuals, Estates and Trusts, 7 (2000). A request for refund must be filed within three years after the date prescribed by law for the filing of the return for the loss year. § 6511(d)(2). The Code disallows any claim for interest on the overpayment in the carryover year unless the Treasury fails to pay the refund within 45 days after filing the request for refund, and then only allows interest from the date of the filing of the return for the loss year (not the carryback year) to the date payment is made. § 6611(e)(1). These rules are set forth in several different subsections in the Code. First, for purposes of computing interest on the overpayment of tax, the "overpayment" for the carryback year is deemed not to have been made prior to the filing date of the return for the year in which the net operating loss occurred. § 6611(f)(1). This permanently eliminates any claim for interest between the later of the due date or filing date of the return for the carryback year and the due date or filing date of the return for the loss year. Second, §§ 6611(e) and 6611(f)(4) combine to disallow any interest between (1) the later of the time for filing or the due date of the return for the loss year, and (2) 45 days after the filing of the claim for refund, if the refund is made within 45 days after the claim for refund is filed. § 6611(e) & (f)(4). Therefore, whether or not the Treasury refunds the overpayment for the carryback year within the statutory 45 day period, if the debtor's deductions are deferred from year one to year two or three, and a carryback is allowed from year two or three to year one, the deferral has resulted in a time-value-of-money loss to the debtor because the refund is made without interest for the time of the deferral.

25. 11 U.S.C. § 1141(d)(1)(A). Relief from indebtedness income does not occur in all Chapter 11 bankruptcy cases. First, if the debtor is solvent and provides for the full payment of all creditor claims, the debtor may still receive a formal discharge in bankruptcy, but no

income to the taxpayer.²⁶ However, when the discharge of indebtedness occurs in a bankruptcy case, no discharge of indebtedness income is recognized.²⁷

There is, however, a tax cost to the relief from discharge of indebtedness income in a bankruptcy case. The debtor is required to reduce its tax attributes for the full amount of discharge of indebtedness income which is not recognized.²⁸ Unless the debtor can and does make a valid election to reduce the debtor's basis in depreciable property, and is able to absorb the full discharge of

discharge of indebtedness for tax purposes results. Second, a corporate bankruptcy debtor who liquidates and does not have post-confirmation operations does not receive a discharge. *Id.* § 1141(d)(3). The creditors' claims may be worthless, but are not discharged (the liability against the shell entity remains). Finally, discharge of indebtedness is unlikely in a partnership bankruptcy case unless the partners are themselves insolvent. In order to confirm a plan of reorganization, each creditor must either affirmatively accept the plan or receive property not less than the holder would receive in a Chapter 7 liquidation. *Id.* § 1129(a)(7). In a Chapter 7 case, the trustee has a claim against the general partners for the deficiency in the estate to pay all creditors, to the extent the partners are liable for the deficiency under applicable law. *Id.* § 723. Therefore, in a Chapter 7 case, solvent general partners would normally be required to pay to the trustee the deficiency in the estate to pay all creditors, and all creditors would receive full payment of their claims. A Chapter 11 plan proposing less than full payment could not be confirmed in such circumstance over the objection of a single creditor. Only where the partners are themselves insolvent, are not personally liable for the particular discharged debts, or where the creditors for some reason all voted to accept less than full payment would a partnership debtor with solvent partners be able to confirm a plan of reorganization and obtain a discharge. Even if the confirmed plan of reorganization provided for the discharge of claims against the partnership, solvent partners may not receive the benefits of non-recognition under § 108(a)(1)(A). See also § 108(d)(6) (providing that the § 108 rules are to be applied to a partnership at the partner level) and § 108(d)(2) (providing that a "title 11 case" means a case under the Bankruptcy Code, "but only if the taxpayer is under the jurisdiction of the court in such case"). Presumably, a non-debtor partner in a debtor partnership would not be under the "jurisdiction of the court," and the discharge of the partnership's debts would not devolve to the partner for the purpose of excluding discharge of indebtedness income under § 108(a)(1). This is contrasted with § 108(d)(7) which requires application of the § 108 rules at the corporate level for an S corporation. § 108(d)(2). In *Gitlitz v. Commissioner*, the Supreme Court, in connection with the insolvency exception in § 108(a)(1)(B), suggested that, outside of the S corporation context, no solvent entity can benefit from the non-recognition provisions of § 108. *Gitlitz*, 121 S.Ct. 701, 710 n.10 (2000). Thus, partners in a partnership can likely benefit from the non-recognition provisions of §§ 108(a)(1) and (2) only if they themselves are debtors in bankruptcy or insolvent at the time of the discharge.

26. "Income from discharge of indebtedness" is included in the definition of "net income" under § 61(a)(12). In the famous case of *United States v. Kirby Lumber Co.*, the United States Supreme Court held that a corporation realizes discharge of indebtedness income when it purchases its own bonds on the open market at a price lower than par, because it has realized within the year an accession to income. 284 U.S. 1, 3 (1931).

27. § 108(a)(1)(A).

28. § 108(b)(1).

indebtedness income as a reduction in the basis of depreciable property,²⁹ the unrecognized discharge of indebtedness income will be used first to reduce any net operating loss for the taxable year and any carryover to the taxable year.³⁰ In many bankruptcy cases, the unrecognized discharge of indebtedness income in the year of plan confirmation will swamp any net operating loss for the year. Therefore, because plan confirmation will often both allow the deferred creditor payments to be made (resulting in a potential net operating loss) and result in discharge of indebtedness income, the potential benefit of a net operating loss carryback in bankruptcy is significantly diminished if the attribute reduction occurs before the net operating loss can be carried back. The timing of the attribute reduction is thus crucial to the effectiveness of the net operating loss carryback in bankruptcy cases.

The statute provides that the net operating loss and capital loss attribute reductions “shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge.”³¹ It would appear, then, that the statutory issue is whether the carryback is a “determination of tax for the year of discharge,” or a re-determination of a prior year’s tax.

Section 108(b)(4)(A) was added by the Bankruptcy Tax Act of 1980.³² According to the Report of the Joint Committee on Taxation, the purpose of the provision was to reduce the attributes immediately after the computation of the current year’s tax:

Thus in the case of net operating loss and capital loss, the debt discharge amount first would reduce the current year’s loss and then would reduce the loss carryovers in the order in which they arose. The investment credit carryovers would be reduced on a FIFO basis, and the other credit carryovers also would be reduced in the order they would be used against taxable income. These reductions would be made after the computation of the current year’s tax.³³

The report does not mention the distinction between carryovers and carrybacks. No court has analyzed the effect of this timing provision on a net operating loss carryback.

29. § 108(b)(5) (giving the debtor the election to reduce the basis of the debtor’s depreciable property in lieu of reducing other tax attributes such as the debtor’s net operating losses). However, the debtor must have sufficient adjusted basis remaining in its depreciable property to absorb the entire amount of unrecognized discharge of indebtedness income – otherwise the excess unrecognized discharge of indebtedness income will reduce the debtor’s net operating losses. § 108(b)(5)(B).

30. § 108(b)(2)(A).

31. § 108(b)(4)(A).

32. Pub. L. No. 96-589, 94 Stat. 3,389 (1980).

33. Joint Committee on Taxation, 96th Cong., Description Of H.R. 5043 (Bankruptcy Tax Act Of 1980) 12 n.13 (Jt. Comm. Print 1980).

However, due to the existence of a potential tax loophole, section 108(b)(4)(A) has come under great scrutiny in connection with the pass-through of income from Subchapter S corporations to their shareholders. This scrutiny has resulted in a number of recent circuit court opinions reaching inconsistent results and using inconsistent analysis, followed by the recent opinion of the United States Supreme Court in *Gitlitz v. Commissioner*.³⁴

The actual issue addressed in these opinions is not relevant to this article.³⁵ However, in analyzing the specialized S corporation issues, one circuit

34. 121 S.Ct. 701 (2000); *Witzel v. Commissioner*, 200 F.3d 496 (7th Cir. 2000); *Farley v. Commissioner*, 202 F.3d 198 (3rd Cir. 2000); *Pugh v. Commissioner*, 213 F.3d 1324 (11th Cir. 2000); *Guadiano v. Commissioner*, 216 F.3d 524 (6th Cir. 2000). For a recent article discussing the history, outcome and likely congressional remedy to the *Gitlitz* issue, see Richard M. Lipton, *Supreme Court Hands Taxpayers a Victory in Gitlitz, But Will Congress Take it Away?*, 94 J. Tax'n 133 (2001).

35. Subchapter S corporations pass through items of income and loss to their shareholders, who pay any resulting tax liabilities. § 1366(a)(1). Passed-through items of income increases the S corporation's shareholders' stock basis, and passed-through items of loss decrease the S corporation's shareholders' stock basis. § 1367(a). If the passed-through losses of the S corporation exceed the shareholder's stock basis, the S corporation's losses are not passed-through to the shareholder, and are carried-over indefinitely until the shareholder recovers basis. § 1366(d). The suspension of pass-through losses in excess of basis under § 1366(d) set the stage for the series of cases leading to the Supreme Court's decision in *Gitlitz*. In all of these cases except *Pugh*, the shareholders of insolvent S corporations sought to pass-through discharge of indebtedness income in order to increase their basis so that suspended losses could be passed-through to and recognized by them. Because the S corporations were insolvent, the discharge of indebtedness income was not recognized under § 108(a)(1)(B). The issue in these cases was whether the reduction of net operating losses required by § 108(b)(2)(A) as a result of the non-recognition of discharge of indebtedness income occurs before or after the pass-through of income from the discharge of indebtedness for purposes of the basis adjustment. Prior to the Supreme Court's opinion in *Gitlitz*, the Circuit Courts came to conflicting results. The *Farley* court held that the attribute reduction required by § 108(b)(2)(A) was to take place in the year after the discharge, allowing the shareholders to deduct suspended losses without recognizing any taxable income. *Farley*, 202 F.3d at 205-06. Similarly, the *Pugh* court allowed an upward basis adjustment without recognition of gross income. *Pugh*, 213 F.3d at 1328. The other courts to consider the issue disallowed a basis increase for the unrecognized discharge of indebtedness income on various different theories. See Lipton, *supra* note 34 at 34-35. The Supreme Court agreed with the result in *Farley* and *Pugh*, but did not adopt the *Farley* court's reading of § 108(b)(4). Rather, the Supreme Court simply held, consistent with the wording of the statute, that the pass-through of losses by an S corporation to its shareholders was part of the "determination of the tax imposed . . . for the taxable year of discharge" within the meaning of the statute. *Gitlitz*, 121 S.Ct. at 708-09; "In order to determine the 'tax imposed,' an S corporation shareholder must adjust his basis in his corporate stock and pass through all items of income and loss. Consequently, the attribute reduction must be made *after* the basis adjustment and pass-through." *Id.* at 709 (emphasis in original, citation omitted). The Supreme Court permitted the S corporation shareholders to recognize a double benefit, noting that the "S" shareholders "would be exempted from paying taxes on the full amount of the discharge of indebtedness income, and they would be able to increase basis and deduct their previously suspended losses. Because the Code's plain text

court concluded that section 108(b)(4)(A) “clearly” provides for the reduction of net operation losses to occur at the beginning of the year **following** the year of discharge.

The language in section 108(b)(4)(A) clearly indicates that tax attributes are reduced on the first day of the tax year following the year of the discharge of indebtedness. The statutory language is unambiguous, and the operation of the statutory language is straightforward.³⁶

The Supreme Court in *Gitlitz*, did not adopt or reject this characterization of section 108(b)(4)(A). Instead, the Supreme Court made two statements concerning the meaning of section 108(b)(4)(A) that point in different directions. First, the Supreme Court interpreted the language of section 108(b)(4)(A) to allow the S corporation to pass-through the discharge of indebtedness income to its shareholders for the year of discharge prior to the reduction of attributes, because the S pass-through was a determination of the shareholders taxes for the year of discharge. In *Gitlitz*, the Court stated that “in order to determine the ‘tax imposed,’ an S corporation shareholder must adjust his basis in his corporate stock and pass through all items of income and loss.”³⁷ Thus, the Court concluded that “the attribute reduction must be made *after* the basis adjustment and pass-through.”³⁸

Conspicuously absent from the Supreme Court’s language is any suggestion that the attribute reduction occurs at the beginning of the year following discharge, as suggested by the Third Circuit in *Farley*.

However, after fitting its case neatly into the statutory language, the Supreme Court threw a curve: “See also § 1017(a) (applying the **same sequencing** when § 108 attribute reduction affects basis of corporate property.)”³⁹ Section 1017(a) does not contain the same sequencing language as

permits the taxpayers here to receive these benefits, we need not address this policy concern.” *Id.* at 709-10 (citations omitted). The Court noted that this loophole only applies in the S corporation context. *Id.* at 710 n.10. The S corporation loophole does not apply to partnerships because § 108(d)(6) provides that the § 108 rules apply at the partner level, not at the partnership level. Unlike the S corporation shareholder, the partner in an insolvent partnership is entitled to exclude COD income under § 108(a)(1)(B) only if the partner is insolvent. Lipton, *supra* note 34, at 134 n.3. Because the Supreme Court did not specifically adopt or reject the interpretation of § 108(b)(4)(A) made by the Third Circuit in *Farley* (that the attribute reduction is to occur in the year following the year of discharge, rather than in the year of discharge after determining the tax for the year of discharge), the Supreme Court’s decision in *Gitlitz* does not aid in determining whether the reduction occurs before or after carrying back a net operating losses to years prior to the discharge.

36. *Farley*, 202 F.3d at 205-06.

37. 121 S.Ct. at 709.

38. *Id.* (emphasis in original, citation omitted).

39. *Id.* (emphasis added).

section 108(b)(4)(A). For purposes of basis reduction, section 1017(a) provides that the amount of unrecognized discharge of indebtedness income that is to be applied to reduce basis “shall be applied in reduction of the basis of any property held by the taxpayer **at the beginning of the taxable year following the taxable year in which the discharge occurs.**”⁴⁰ Did the Supreme Court mean by its off-hand comment that the section 108(b)(4)(A) net operating loss attribute reduction is to take place in the year following discharge as section 1017(a) requires for basis reduction, or did it merely mean that both the net operating loss attribute reduction and the basis reduction would take place after the pass-through of discharge of indebtedness income to S corporation shareholders? The answer is uncertain.

In applying section 108(b)(4)(A) to a net operating loss carryback, it is difficult to ignore the very different language used by Congress in sections 108(b)(4)(A) and 1017(a).⁴¹ The difference in language can be rationally explained by Congress’ desire to prevent the carryback of net operating losses to years prior to the year of discharge before the attribute reduction is made. It appears that none of the courts that considered the S corporation issue had the net operating loss carryback question in mind when they wrote their opinions.

Because the net operating loss carryback results in a refund of the prior years’ taxes (requiring a formal claim for refund) rather than an adjustment to the taxes owing for the year of discharge,⁴² only a skilled linguistic contortionist could interpret section 108(b)(4)(A) to allow the carryback before the attribute reduction takes place. The carryback simply does not result in the determination of the taxes imposed for the taxable year of discharge. Under a plain interpretation of the language, the attribute reduction should reduce the carryback. Thus, in many bankruptcy cases, the postponement of deductions to the year of plan confirmation will in many cases eliminate the potential benefit of a net operating loss carryback due to the reduction in attributes required by the discharge of indebtedness rules.

2. Phantom Income Does Not Always Result in a Net Operating Loss.—The net operating loss carryback rules only apply if there is, in fact, a net operating loss to carry back. If the debtor has income in both year one and year two, the deductions properly attributed to year one but postponed until

40. § 1017(a).

41. § 108(b)(4)(A) provides “the reductions described in paragraph (2) shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge.” § 1017(a) provides that the discharge of indebtedness income which is excluded from recognition and is to be applied to reduce basis “shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs.”

42. See *supra* note 24.

confirmation of the plan of reorganization in year two will be used to reduce year two income before constituting a net operating loss. For example, suppose that a debtor had both \$20x of income in years one and two, and \$10x of deductible expenses in each year which, absent the bankruptcy restrictions, would have been paid and deducted in years one and two. Due to the deferral required by the bankruptcy rules, instead of having \$10x of taxable income in years one and two, the debtor would have \$20x of taxable income in year one and no taxable income in year two. No carryback would result in year two, because the deductions properly attributable to year one were used to offset year two income.

The value of the deductions in year two may be very different from the value of the deductions in year one for several reasons. First, the debtor would likely be in a higher tax bracket in year one than in year two due to the deferred deductions. In the example above, the debtor could be pushed into a higher tax bracket in year two due to the extra \$10x of taxable income, while the savings of \$10x in year two may result in a lower tax bracket benefit. The debtor's year two income may be substantially reduced due to scaled down operations, further reducing the applicable year two bracket and the value of the deferred year one deduction. Second, there could be differences in tax rates between years one and two. Finally, lower capital gains rates may also increase the tax cost of the phantom income. The postponement of deductions properly attributed to year one would be used to reduce year two capital gains before constituting a net operating loss.⁴³ In many bankruptcy cases, including most liquidation cases, capital gains are incurred at the end of the case when assets are liquidated. The value of the deduction to reduce ordinary income in year one may be significantly higher than the value of the deduction in year two to reduce capital gains, because capital gains are taxed at much more favorable marginal rates than is ordinary income.⁴⁴

In summary, while the net operating loss carryback, when it applies, could mitigate the distortion caused by the bankruptcy restrictions on payment of creditor claims, it does not provide a bankable solution to the phantom income problem. In all cases, the debtor suffers a one-year time value of money loss by paying excess taxes for year one which are refunded for year two. In many bankruptcy cases, the carryback will be eliminated in the year the plan of

43. A net operating loss is defined as "the excess of the deductions allowed by this chapter over the gross income." § 172(c). Capital gains are included in gross income. § 61(a)(3) (gains from "dealings in property" are included in "gross income").

44. For individuals, the highest marginal tax rate on capital gains is 20%, while the highest marginal tax rate on ordinary income is 39.6%. §§ 1(h)(1)(E), 1(a). For all individuals, applicable capital gains rates will be lower than taxpayer's marginal rate on ordinary income. § 1(h)(1)(A). Corporations do not receive preferential rates on capital gains. See § 11. Therefore, it is irrelevant to a corporation whether the deferred expenses offset ordinary income or capital gains.

reorganization is confirmed by the reduction required by the discharge of indebtedness rules. Finally, where the debtor has sufficient income in year two to utilize the deductions so that they are not carried back, the value of the deductions may be significantly less than the value of the deductions would have been in year one, due to differences in the taxpayer's applicable marginal tax rates and the unfavorable use of the year one deductions to offset year two capital gains rather than year one ordinary income.

B. The DSF and QSF Rules Provide Only Limited Relief from Accounting Method Distortion in Bankruptcy

DSFs were created by Congress in 1988⁴⁵ to relieve some of the hardships caused by the hybrid accrual method accounting system created by Congress with the enactment of section 461(h) in 1984.⁴⁶ In order to understand the need for DSFs and the significant expansion made by the Treasury in the QSF regulations, it is necessary to understand the history of the hybrid tax accounting system created by section 461(h).

1. *The History of Deductions Under the Accrual Method of Accounting.*—Prior to 1916, income taxes in the United States were generally based on the cash method of accounting, although some accrual method accounting principles were allowed in 1913 for inventory accounting.⁴⁷ In 1916, Congress first expressly permitted accrual method tax accounting for taxpayers who used the accrual method for keeping their financial books. This act specifically allowed reserves for liabilities accrued but not yet due. In 1919, Congress added the predecessor of current sections 446(a) and (b), which allowed taxpayers to consistently use the method of accounting that they used in keeping their financial books, as long as the method employed correctly reflected income.⁴⁸ This is the same basic statutory standard used today under section 446.

45. Section 468B, (providing for the use of DSFs, was enacted in the Technical and Miscellaneous Revenue Act of 1988, §§ 1018(f)(4)(A)-(B), 26 U.S.C. § 468B). Pub. L. No. 100-647. According to the Joint Committee on Taxation, the provision was enacted to allow accrual method taxpayers under limited circumstances to deduct payments made to a DSF even though the payments would not otherwise qualify for a deduction under § 461(h) because they were not made directly to the creditor. See Joint Committee on Taxation, Explanation Of Technical Corrections To The Tax Reform Act Of 1984 And Other Recent Tax Legislation, JCS-11-87 (Part 1 Of 17 Parts) (May 13, 1987).

46. Section 461(h) was created in the Deficit Reduction Act of 1984, § 91, 26 U.S.C. § 461(h).

47. The early history of income tax accounting methods was summarized by the Solicitor General in *United States v. Anderson*, 269 U.S. 422, 423-25 (1926).

48. *Id.*

The Supreme Court first considered the problems of accrual method tax accounting in *United States v. Anderson*.⁴⁹ In *Anderson*, a munitions manufacturer kept its books and reported its taxes under the accrual method. The manufacturer deducted a munitions excise tax, which it had paid in 1917, from its 1917 income. The government argued that under the accrual method employed by the manufacturer in accounting for all other items of income and expense, the taxes should have been deducted in 1916, because the taxes were computed on 1916 sales. The issue in the case was when the excise taxes “accrued.” In deciding that the excise taxes accrued in 1916, the Supreme Court announced what has become known as the “all events” test for accrual of income and expenses – a test which would be used without substantial change for the next 60 years:

[I]n advance of the assessment of a tax, all the events may occur which fix the amount of the [excise] tax and determine the liability of the taxpayer to pay it. In this respect, for purposes of accounting and of ascertaining true income for a given accounting period, the munitions tax here in question did not stand on any different footing than other accrued expenses appearing on appellee’s books.⁵⁰

There were few statutory changes in accrual method rules between 1919 and 1985. While the sections were renumbered, the basic rules were (1) section 446(a), which allows a taxpayer to use the method of accounting regularly used in computing income on the taxpayer’s books, (2) section 446(b), which allows the commissioner to reject a method of accounting which does not clearly reflect income, and (3) section 461(a), which allows the taxpayer to take a deduction in the proper tax year under the taxpayer’s method of accounting used to compute taxable income.

2. The Time Value of Money Problem.—Under a strict interpretation of the “all events test,” a structured settlement would be deductible at its face amount, even though the payments may be made over a long period of time without stated interest. The “all events test” ignores the time value of money – both income and expenses are recognized when accrued, rather than when received or paid. When interest which could be earned on the money is taken into account, the discounted present value of this stream of payments would be significantly less than the arithmetic sum of the payments.

The first important case to recognize the potential for present-value abuse by accrual method taxpayers was *Mooney Aircraft, Inc. v. United States*.⁵¹

49. *Id.*

50. *Id.* at 441.

51. 420 F.2d 400 (5th Cir. 1969).

In *Mooney*, an aircraft manufacturer sold its aircraft together with so-called “Mooney Bonds” redeemable for \$1,000 upon retirement of the aircraft. The manufacturer sought to deduct the entire \$1,000 redemption price of the bonds upon issuance, arguing that under the “all events” test the liability had accrued, and the amount of the liability could then be determined with reasonable certainty. The Court agreed with the manufacturer that the “all events” test had been satisfied because the fact and amount of the liability were known, only the timing of the liability was uncertain. But the Court also accepted the government’s argument that the manufacturer’s method of accounting for the bonds did not “clearly reflect income” within the meaning of section 446(b), because the manufacturer would not be called upon to redeem the bonds for many years. The Court reasoned that it would be unfair to allow a current deduction for a liability that would not be paid for many years, especially in light of the risk that Mooney’s future obligation might never be paid due to insolvency.⁵² Therefore, the court did not allow the manufacturer to deduct any portion of the bond liability until the year of actual payment.

Although the *Mooney* court was correct in concluding that the deduction of the full \$1,000 redemption price of the bond at issuance did not accurately reflect income, the position adopted by the court – disallowing the deduction until payment – is subject to the same criticism. To correctly analyze any deferred payment problem, it is necessary to properly separate the investment component of the transaction involving imputed interest.

In the *Mooney* case, the purchaser of the aircraft bought more than just an aircraft. The purchaser bought both an aircraft and a bond. As a matter of economics, seller did not give the bond away for free – the cost to seller of the bond (and possibly a profit component as well) was included in the purchase price.

A bond is evidence of a loan – the purchaser pays the issuer money in return for the issuer’s promise to repay a greater sum upon maturity (in the case of *Mooney* upon retirement of the aircraft).⁵³ If instead of lumping the two transactions together, the seller in *Mooney* had sold the aircraft for a lower price without the bond, and in a separate document had borrowed the discounted present value of the bond in return for a promise to pay the face amount of the

52. *Id.* at 410.

53. The *Mooney* court used the term “bond” in its colloquial sense to mean a document evidencing an obligation to pay a specific amount at a specific time or upon the occurrence of a particular event. See § 171(d) (defining “bond” for purposes of § 171 as a “bond, debenture, note or certifice or other evidence of indebtedness. . . .”); § 150(a)(1) (“bond” includes “any obligation.”) The Encyclopaedia Britannica, defines a bond as follows: “in finance, a loan contract issued by local, state, and national governments and by private corporations specifying an obligation to return borrowed funds.” 2 Encyclopaedia Britannica 354 (15th ed. 1987).

bond upon retirement of the aircraft, the economics of the transaction would be apparent. In *Mooney*, the seller should have been taxed on the segregated amount received for the aircraft, and should have been allowed to receive the loan proceeds tax free, since they would have to be repaid upon the obligation's maturity.⁵⁴ Then each year the issuer would be entitled to a deduction for the accrued interest on the bond.⁵⁵ In the final year of redemption, the total of the accrued interest owing on the bond and the purchase price of the bond would equal the \$1,000 redemption payment.⁵⁶ Thus, the seller/issuer would have received an exclusion from income for the discounted present value of the bond at the time of issuance, and would receive interest deductions each year until the maturity of the bond. No deduction would be available upon payment of the bond at maturity.

For the accrual method taxpayer, the value of the initial exclusion and the annual deductions would significantly exceed the value of the final redemption payment, because the taxpayer would be able to obtain a return on the tax savings from the exclusion and the deductions in the applicable years. The Court's solution of allowing a deduction only in the year of payment improperly deprives an accrual method taxpayer of the earnings on the properly matched deductions. In *Mooney*, both the taxpayer's proposed method of deducting the full future value of the obligation now, and the Court's method of allowing a deduction only at the time of payment, distort the economically correct method of accounting for the transaction.

54. See e.g., *Commissioner v. Tufts*, 461 U.S. 300, 307 (1983) (stating that "when a taxpayer receives a loan, he incurs an obligation to repay that loan at some future date. Because of this obligation, the loan proceeds do not qualify as income to the taxpayer. When he fulfills the obligation, the repayment of the loan likewise has no effect on his tax liability.")

55. Under current law, if the issuance of the bond was properly viewed in its economic sense as a loan, the bond would be an "original issue discount" obligation because the discounted present value of the bond would be less than the redemption amount of the bond. § 1273(a)(1). The issuer would be allowed a deduction under § 163(e) for the accrued daily portion of the original issue discount. See also § 1272(a)(3) (discussing the method for calculating daily interest on original issue discount obligation); Regs. § 1.461-4(e) (stating that "in the case of interest, economic performance occurs as the interest cost economically accrues in accordance with the principles of relevant provisions of the Code."). However, if instead of viewing the bond as a loan, the bond were to be treated as a "rebate, refund or similar payment" connected to the sale of the aircraft, then a deduction would be available to the issuer only upon payment of the obligation. Regs. § 1.461-4(g)(3). Therefore, the characterization of the transaction (and very likely the form of the transaction) may result in very different tax consequences.

56. This is a function of mathematics. The original issue discount rules compute the daily amount of interest based on the yield to maturity of the instrument, using the adjusted issue price as the present value of the instrument and the redemption price at maturity as the future value. § 1272(a)(3)(A); Regs. § 1.1272-1(b)(i). The difference between the present and future values is the amount of interest that accrues under the instrument.

When interest rates rose to double-digit heights in the late 1970s and early 1980s, Congress recognized the need to statutorily address the crack in the accrual method system identified by the *Mooney* court. The House Report on what would later become section 461(h) states: “the rules relating to the time for accrual of a deduction by a taxpayer using the accrual method of accounting should be changed to take into account the time value of money.”⁵⁷

Congress’ concern that accrual method taxpayers would attempt to take advantage of the potential time value of money loophole in the accrual method was well founded. For example, in 1980, the Ford Motor Company entered into 20 structured settlements of product liability tort claims for payouts totaling \$24,477,699 over as long as 58 years. Ford paid only \$4,424,587 for annuities to cover all of the payments required under the settlement terms, yet attempted to deduct on its 1980 return the entire \$24,477,699 future liability. The Tax Court found that, if allowed, the tax savings from the deduction would more than offset the entire cost of the annuities, allowing Ford to make a net after-tax profit on the settlement of its tort liabilities.

The case was heard by the Tax Court in 1994, nine years after the enactment of section 461(h), but was decided under the law in effect in 1980 before the enactment of section 461(h). Ford argued that the “all events” test was met, and that therefore there was no basis for the court to disallow the entire deduction. Like the *Mooney* court, the Tax Court and the Sixth Circuit agreed with Ford that the “all events” test had been met, but they also agreed with the government that the accrual method as applied to these settlements did not “clearly reflect income” as required by section 446(b). Unlike the *Mooney* court, however, the Court in the *Ford Motor Company* case determined that Ford would be required to use a judicially-created hybrid accounting system, under which Ford was allowed to deduct the amount paid for the annuities (which represented the discounted present value of the settlement payments), and was allowed not to recognize income as the annuities were paid and the payments remitted to the tort claimants.⁵⁸

The accounting system created by the Court in *Ford Motor Company* was a thoughtful approach to the problem. The Court reached the correct economic result, even though its methodology was erroneous. The correct way to analyze a structured settlement like that in *Ford Motor*, is to separate the tort settlement from the investment aspects of the structured payout. As a matter of economics, Ford agreed to pay the victim the discounted present value of the structured settlement in satisfaction of its tort liability for the current year. Ford should have been indifferent to structuring the transaction as a structured payout

57. H.R. Rep. No. 98-432, pt. 2 at 1254 (1984).

58. *Ford Motor Company v. Commissioner*, 71 F.3d 209, 217 (6th Cir. 1995), aff’d 102 T.C. 87 (1994).

funded with annuities, or as a direct payment to the victim for the cost of the annuities.⁵⁹ If Ford had made this settlement payment in cash, it would have been entitled to deduct the payment at the time of payment.⁶⁰

The tort victim, however, wanted structured payments rather than a lump sum payment at settlement. In essence, the victim lent Ford the present value of the tort settlement in return for Ford's promise to make future structured payments. The future payments included unstated imputed interest. Commentators are in general agreement that the proper way to analyze a structured settlement as a matter of economics is as a cash settlement from the tortfeasor to the victim of the discounted present value of the structured settlement, followed by a loan of the present value from the victim to the tortfeasor in return for the structured payments.⁶¹ There is disagreement, however, on how the transaction should be taxed.⁶²

59. This assumes, of course, that it would not be able to accelerate its deductions for future imputed interest, as it sought in the *Ford Motor* case.

60. The all events test would be met because the liability had accrued (the fact and amount of the liability were determined). Even under the current rules, economic performance under § 461(h)(2)(C) is met with respect to tort claims upon payment.

61. Mary Louise Fellows, *A Comprehensive Attack on Tax Deferral*, 88 Mich. L. Rev. 722, 795 (1990) ("A deferred payment agreement, such as a deferred tort settlement, is economically equivalent to the parties entering into two agreements: (1) the payment of damages to compensate the victim for losses and (2) the victim loaning the tortfeasor the amount of damages to be repaid at some specified date"); Daniel I. Halperin, *Interest in Disguise: Taxing the "Time Value of Money"*, 95 Yale L.J. 506, 526 (1986) ("The 1984 legislation, however, defers the entire deduction until payment. As we have seen, this approach is equivalent to allowing a deduction for the present value of the liability in . . . the year of settlement, and thus effectively denies the [tortfeasor] a deduction for interest.").

62. In an influential article, Professor Halperin argued that it was appropriate to deny the tortfeasor a deduction for imputed interest on a structured settlement because the tort victim might not have to recognize income resulting from the imputed interest. "Congress, however, has recently enacted legislation that specifically exempts the recipient of a deferred tort settlement from taxation of any component due to interest. Limitations on the deductions allowed to [the tortfeasor] can be seen as a way of subjecting her to tax on income accruing for the benefit of the patient, who would otherwise avoid tax on this investment income." Halperin, at 526. See also, Fellows, at 795 ("The thrust of Halperin's argument regarding the proper treatment of a deferred tort settlement pertains to the borrowing component. He reasons that Code rules excluding the interest income from the loan from the victim's tax base explains why section 461(h) denies the tortfeasor a deduction for the interest cost by postponing the deduction for damages until payment." The theory behind these arguments is that tax treatment between the parties should be parallel so as not to deprive the Treasury of revenue. Other commentators reject Professor Halperin's thesis that the distortion of the accrual method for one taxpayer is fair because of a possible counter-matched distortion to the taxpayer on the other side of the transaction. See e.g., Donald W. Kiefer, *The Tax Treatment Of A "Reverse Investment"*, 26 Tax Notes 925 (1985); Emil M. Sunley, *Observations on the Appropriate Tax Treatment of Future Costs*, 22 Tax Notes 719 (1984). These philosophical debates are beyond the scope of this paper. It is important to keep in mind, however, that the deferral of properly matched deductions for financing costs until the year of payment would deter tortfeasors from entering into structured

Viewed from an economic perspective, an accrual method taxpayer should receive a deduction at the time of settlement for the discounted present value of the settlement, should be deemed to borrow back the settlement payment from the victim in return for the structured loan payout, and should be entitled to deduct the imputed interest on the deemed loan as it economically accrues.⁶³

The tortfeasor's purchase of an annuity with the loan proceeds should be viewed as a separate investment transaction. As with any investment, the tortfeasor would be required to recognize as income the interest earned on the annuity.⁶⁴ Since the interest accrued under the terms of the structured settlement and the interest earned on the annuity contract would be the same amount each year (because the annuity matched the structured settlement payouts), and would thus offset each other on tortfeasor's tax return, the Court in *Ford Motor* reached the economically correct result by excluding the annuity earnings from income and disallowing deductions for the imputed interest on the structured loan payout. While reaching the correct economic result, the Court cited no legal basis for excluding interest earned on the annuity. The Court's ruling in *Ford Motor* was limited to the abusive situation before them. The Court did not attempt to fashion a system that would apply generally to all structured tort settlements.⁶⁵

3. Congress Enacts Section 461(h) to Prevent Accrual Method Taxpayers from Structuring Transactions to Take Advantage of the Time Value of Money.—In contrast to the limited approach taken by the Court in *Ford Motor*, Congress took a meat ax to the time value of money problem. In 1984, Congress enacted section 461(h), which imposes on an accrual method taxpayer the concept of “economic performance” in addition to the “all events” test before

settlements – which in many cases are created at the request of the victim for legitimate non-tax reasons, such as planning for future medical or personal care. DSFs and QSFs were created to mitigate the effects of the deferral without allowing the tortfeasor to recover a windfall.

63. See *supra* note 61.

64. See § 1272(a)(1). It is worth noting that the original issue discount rules do not apply to certain annuities governed by § 72. § 1275(a)(1)(B). However, the special annuity rules in § 72 only apply to annuities held by natural persons. § 72(u)(1)(A). Because the *Ford Motor* Company is a corporation and not a natural person, the special annuity exceptions to the original issue discount rules would not apply, and Ford would, under existing law, have to recognize as income accrued interest under the annuity contract.

65. In rejecting Ford's argument that, by enacting § 461(h), Congress recognized the right of taxpayers to deduct the full amount of future tort payments at the time of settlement, the *Ford Motor* Court stated: “Section 461(h) was a Congressional effort to remedy an accounting distortion by placing *all* accrual method taxpayers on the cash method of accounting for tort liabilities, regardless of the length of the payout period and without any consideration of whether accrual of an expense in an earlier year would distort income. Its enactment does not preclude the Commissioner from applying the clear reflection standard of Section 446(b) on a case-by-case basis to taxpayers in tax years prior to 1984.” *Id.* at 214.

a deduction is allowed.⁶⁶ The most significant change brought about by the new economic performance rules was the imposition of a cash-method deduction system for accrual method taxpayers with respect to workers' compensation and tort claims. Under section 461(h)(2)(C), workers' compensation and tort claims can only be deducted when actually paid **to the creditor**.⁶⁷ The Treasury has made it clear that payment to a third party, including payment to a trust, escrow, court administered fund, or any other arrangement, does not constitute payment to the creditor unless the creditor is required to recognize the payment as income.⁶⁸ Similarly, the debtor cannot deduct the cost of an annuity contract purchased to fund a structured settlement, unless the annuity contract is transferred to (and presumably taxable at the time of transfer to) the creditor.⁶⁹

4. Congress Enacts Section 468B to Provide a Method for Structuring Tort Settlements.—To mitigate the harshness of the rule preventing accrual method taxpayers from deducting liabilities for structured tort settlements prior to receipt by the tort claimant, in 1986 Congress added section 468B to provide for designated settlement funds (“DSFs”).⁷⁰

Section 468B allows an accrual method taxpayer to deduct payments made to a DSF to satisfy present and future tort liabilities for personal injury, death, and property damage.⁷¹ The DSF must be established by Court order, it must completely extinguish the taxpayer's tort liability (preventing use of a DSF for contested claims),⁷² it must be administered by persons who are independent

66. § 461(h)(1); Deficit Reduction Act of 1984, § 91, 26 U.S.C. § 461(h)(1).

67. § 461(h)(2)(C). The statute provides: “If the liability of the taxpayer requires a **payment to another person** and – (i) arises under any workers' compensation act, or (ii) arises out of any tort, economic performance occurs as the payments **to such person** are made.” § 461(h)(2)(C) (emphasis added). Thus, the statute appears to require a direct payment to the creditor before a deduction can be taken.

68. Regs. § 1.461-4(g)(1)(i).

69. Regs. § 1.461-4(g)(1)(ii)(B).

70. Technical and Miscellaneous Revenue Act of 1988, §§ 1018(f)(4)(A)-(B), 26 U.S.C. § 468B; Joint Committee on Taxation, Explanation Of Technical Corrections To The Tax Reform Act Of 1984 And Other Recent Tax Legislation, JCS-11-87 (Part 1 Of 17 Parts) (May 13, 1987) (“The 1984 Act provides that liabilities are not treated as incurred prior to the time when economic performance occurs. In the case of the taxpayer's liability to another person, arising under any workers compensation act or any tort, economic performance occurs as payments to such person are made, except to the extent provided in regulations. It is unclear whether an irrevocable payment to a court ordered settlement fund, which extinguishes the tort liability of the taxpayer to a person (or class of persons), constitutes economic performance under that Act. . . . The Act clarifies that under certain limited circumstances, an irrevocable payment to a court-ordered settlement fund that extinguishes tort liability of the payor (the “taxpayer”) constitutes economic performance with respect to such liability. This provision applies only to qualified payments made to a designated settlement fund.”)

71. § 468B(d)(2)(D).

72. § 468B(e).

of the taxpayer, and the taxpayer may hold no beneficial interest in the income or corpus of the fund.⁷³ The taxpayer must also elect to treat the trust or escrow as a designated settlement fund.⁷⁴ The fund is treated as a corporation, but is taxed on its taxable income at the maximum rates under section 1(e) rather than under section 11.⁷⁵

The language of the statute suggests that Congress intended DSFs to rule the field. Section 468B(f) provides that, except as otherwise allowed by regulations, a DSF is the exclusive method for accrual method taxpayers to obtain a deduction for payments made to a fund to resolve or satisfy personal injury, death or property damage claims.⁷⁶ However, due to the limited scope of DSFs,⁷⁷ that dominance was short lived.

In connection with the enactment of section 468B, Congress gave the Treasury broad authority to prescribe regulations providing for the taxation of escrow accounts, settlement funds or other "similar funds."⁷⁸ In 1992, the Treasury responded to criticism regarding section 461(h) by promulgating regulations for the establishment of Qualified Settlement Funds ("QSF").⁷⁹

Like DSFs, QSFs must be established by a government or court order. While broader than the DSF statute, the QSF regulations also limit the types of liabilities for which a QSF can be used. A QSF is limited to environmental liabilities, tort liabilities, breach of contract liabilities,⁸⁰ liabilities for other "violations of law," and other liabilities allowed by the Commissioner in revenue

73. § 468B(d)(2)(E).

74. § 468B(d)(2)(F).

75. § 468B(b)(1).

76. § 468B(f).

77. The most important limit was the requirement that the liability be uncontested. § 468B(e). The limitation to "personal injury, death and property damage" claims was also significantly expanded by the Treasury in the QSF regulations, as discussed *infra*. See *supra* notes 81-82.

78. § 468B(g).

79. Regs. § 1.468B-1 et seq. Like a DSF, a QSF is taxed as a separate entity at the highest rates applicable under § 1(e). Regs. § 1.468B-2(a). A QSF must use a calendar year and the accrual method of accounting. Regs. § 1.468B-2(j). If property is transferred to a QSF, the transferor must recognize gain or loss under § 1001. Regs. § 1.468B-3(a)(1). The Treasury has proposed new regulations to allow an election for DSFs and QSFs to be taxed as grantor trusts rather than as separately taxed corporations at the highest bracket rates. Prop. Regs. § 1.468B-1(k).

80. The QSF regulations were designed to use the same language for qualified claims as used in the regulations under § 461(h). Compare Regs. § 1.461-4(g)(2) (stating a "tort, breach of contract or violation of law.") with Regs. § 1.468B-1(c)(2)(ii) (same). The regulations under § 461(h) make it clear that the term "breach of contract" refers only to incidental, consequential or liquidated damages. Regs. § 1.461-4(g)(2) (stating that "[a] liability to make payments for services, property, or other consideration under a contract is not a liability arising out of a breach of that contract unless the payments are in the nature of incidental, consequential, or liquidated damages. . . .").

rulings or procedures.⁸¹ DSFs are more limited, permitting only “personal injury, death or property damage” liabilities.⁸²

The broader definition of tort claims in the QSF regulations is greatly expanded by allowing a QSF to be used for both contested and uncontested liabilities.⁸³ In responding to public comments concerning the proposed QSF regulations, the Treasury made it clear that a contested liability fund satisfies the “resolve and satisfy” requirement of the final QSF regulations.⁸⁴

However, certain liabilities are excluded from QSF qualification. Liabilities for workers’ compensation and self-insured health plans,⁸⁵ product warranty obligations,⁸⁶ and other liabilities designated by the Commissioner in a revenue ruling or procedure, are excluded.⁸⁷

5. The Treasury Prohibits the Use of a QSF to Pay Bankruptcy Trade Claims.—Most importantly for this article, a liability to “general trade creditors or debtholders that relates to a title 11 or similar case or workout” is excluded from QSF eligibility.⁸⁸ The Treasury has given no meaningful explanation for its decision to exclude bankruptcy trade debt and other general liabilities from QSF eligibility. In the preamble to the regulations, the Treasury gives the following reason for its decision to preclude the use of a QSF to satisfy general trade claims in bankruptcy:

The proposed regulations invited comments regarding the extent to which qualified settlement funds should be available for the claims of general creditors and security holders in bankruptcy. Generally, commentators stated that the qualified settlement fund rules should not be imposed in the bankruptcy context. Some commentators recommended that the qualified settlement fund rules be applied to a bankruptcy fund on an elective basis. **The Service and the Treasury Department have concluded that the application of the regulations should not be elective.** The final regulations exclude claims of general trade creditors and debtholders that relate to the title 11 or similar case, or to a workout. However, qualified settlement fund treatment remains available for other liabilities such as tort liabilities

81. Regs. § 1.468B-1(c)(1).

82. § 468B(d)(2)(D).

83. Regs. § 1.468-1(c)(2).

84. Preamble to Regs. § 1.468B-1 Qualified Settlement Funds, Public Comments, T.D. 8459, 57 Fed. Reg. 60983 (12/18/92).

85. Regs. § 1.468B-1(g)(1).

86. Regs. § 1.468B-1(g)(2).

87. Regs. § 1.468B-1(g)(4).

88. Regs. § 1.468B-1(g)(3).

irrespective of whether the liability, for example, relates to a title 11 case. For instance, if a corporation is a defendant in a class action involving a tort liability and subsequently files a petition for bankruptcy, the defendant's bankruptcy will not affect the qualified settlement fund treatment of a fund, account or trust established to resolve or satisfy the tort liability.⁸⁹

The Treasury's only stated basis for limiting the use of QSFs to solve bankruptcy distortion – that the QSF regulations would somehow become elective – does not make sense.⁹⁰ The creation of a segregated fund to pay claims is always elective. Someone has to elect to create the fund device in the first place. The tax treatment of the device once elected may be mandatory. But the device itself is always elective. Allowing bankruptcy debtors to elect to use the fund device, with Bankruptcy Court approval, is no different than allowing anyone else to elect to use the fund device for a permitted purpose.

The Treasury's apparent concern that, without the limitation, the QSF device would be "imposed" on debtors in bankruptcy appears unfounded. Even without the limitation, it would be inconsistent with the general scheme of bankruptcy estate taxation to automatically treat a bankruptcy estate as a QSF. Under section 1398, the bankruptcy estate of an individual debtor under Chapters 7 and 11 is treated as a separate taxable entity from the debtor, but remains owned by the debtor. No separate taxable entity is created for partnerships and corporations.⁹¹ The separate estate is taxed at individual rates, not at estate rates.⁹² The Service's apparent concern with the automatic application of QSFs to bankruptcy estates is inconsistent with the specific rules governing bankruptcy taxation and thus appears entirely unfounded.

Moreover, a bankruptcy estate would not meet the general requirements of a QSF. For example, a QSF cannot be used for the operation of a business. According to the preamble to the section 468B regulations:

89. Preamble to Regs. § 1.468B-1 Qualified Settlement Funds, Public Comments, T.D. 8459, 57 Fed. Reg. 60983 (12/18/92) (emphasis added).

90. The Treasury's concern about an election may relate not to the QSF itself but to the possibility that the debtor would abuse the benefits of the QSF by transferring assets to the fund in excess of the true amount of claims in an attempt to obtain an inappropriate deferral of taxes, or would attempt to obtain deductions for non-deductible liabilities by manipulating the contributions to the fund. As is discussed in Part VI, *infra*, safeguards are needed to assure that the transfers to the fund are not excessive, and that deductions are limited to the properly allocable portion of the contributions to the fund which constitute deductible liabilities. In addition, because the Bankruptcy Court would not permit any fund transfers unless all similarly-situated creditors are treated the same way, the rules for funding a QSF should follow the bankruptcy rules requiring equality of treatment for similar claims.

91. § 1399.

92. Compare § 1398(c) (bankruptcy estate taxed at individual rates); Regs. § 1.468B-2(a) (QSF taxed at rates under § 1(e)).

Commentators requested that a qualified settlement fund be allowed to deduct all expenses incurred in operating a trade or business, including its distributive share of partnership expenses. The Service and the Treasury Department believe that the operation of a trade or business is inconsistent with the general nature of a qualified settlement fund. Therefore, the final regulations do not adopt the suggested modification.⁹³

The Regulations could easily protect against abuse by limiting the use of the QSF to specially created and segregated trusts approved by the Bankruptcy Court, established to set aside excess funds earmarked for payment of claims upon plan confirmation. Thus, the Treasury has failed to articulate a meaningful reason for precluding bankruptcy debtors from using QSFs to resolve and satisfy general bankruptcy claims during the period that claim payments are prohibited by the bankruptcy laws.

6. Section 468B Funds Were Not Designed to Benefit Cash Method Taxpayers.—Another major question is whether the QSF regulations allow a deduction for cash method taxpayers who make payments to a QSF. Because QSFs arose out of an attempt to mitigate the harshness on accrual method taxpayers of the “economic performance” requirements in section 461(h), the benefit of a QSF is simply that the payments to the fund constitute “economic performance” within the meaning of section 461(h).⁹⁴ Accrual method taxpayers can thus deduct payments to a QSF if the “all events test” is otherwise met at the time of payment,⁹⁵ so long as the QSF is properly established.⁹⁶

However, both the “all events test” and the “economic performance test” are irrelevant to the cash method taxpayer.⁹⁷ Although the “economic

93. Preamble to Regs. § 1.468B-1 Qualified Settlement Funds, Public Comments, T.D. 8459, 57 F. R. 60983 (12/18/92).

94. Regs. § 1.468B-3(c).

95. See Regs. § 1.461-1(a)(2) (stating traditional rule allowing deduction by accrual method taxpayer when “all events” test is met).

96. A transfer to a QSF does not constitute “economic performance” if the transferor has an unrestricted right to obtain a refund of the funds transferred. The Treasury Regulations provide that qualified transfers to a QSF constitute “economic performance” within the meaning of § 461(h) unless: (1) the transferor has an unrestricted right to obtain a refund without the agreement of an independent or adverse party (including a Court), or (2) the refund right is based on an event that is certain to occur. See Regs. § 1.468B-3(c)(2)(A) and (B). A properly created QSF will provide for the return of the funds to the transferor only on the resolution of the contest.

97. Section 461(h)(1) provides that “all events” test not treated as met until “economic performance” occurs. The “all events” test applies only under the accrual and not the cash method. Compare Regs. § 1.461-1(a)(1) (cash method deductions allowed upon payment), Regs. § 1.461-1(a)(2) (accrual method deductions allowed when “all events” test met). Thus, economic performance is irrelevant to a cash method taxpayer.

performance” requirements have the effect of putting an accrual method taxpayer on the cash method for purposes of the enumerated liabilities, the QSF regulations by their own terms do no more than to put the accrual method taxpayer back on the regular accrual method in connection with payments to a QSF. This is no help to a cash method taxpayer.

The only authority concerning the effect of the QSF regulations on cash method taxpayers is contained in an example in Treasury Regulations section 1.468B-3(g). In the example, a cash method taxpayer transfers \$1 million to a QSF to satisfy securities law claims. The regulation recognizes that the “economic performance” rules do not apply to the cash method taxpayer. “Therefore, whether, when and to what extent Individual A [the taxpayer] can deduct the transfer is determined under applicable provisions of the Internal Revenue Code, such as sections 162 and 461.”⁹⁸ Nothing in sections 162 or 461 provide any help in determining whether a transfer to a QSF by a tax method taxpayer constitutes a deductible payment. The Treasury was likely incorporating the general rules governing deductions by cash method taxpayers.

The general rule is that cash method deductions are only allowed when a payment discharging the debtor’s liability is made to the creditor, unless an earlier deduction is specifically authorized by statute or regulation. In *Sebring v. Commissioner*,⁹⁹ a cash method bail bondsman sought to deduct payments made to a fund to secure the bondsman’s obligation to indemnify the surety on the bail bonds issued by the surety. The court held that the payments to the fund are a reserve for future liabilities, not payment of a current liability, and therefore not deductible. The Court noted that deductions for reserves are only allowed when specifically permitted by statute, such as deductions to contested liability funds under section 461(f). According to the Court:

[I]f payments to reserves for contested liabilities are deductible only as prescribed by special statutory provision, it would seem a fortiori that payments made in respect of liabilities that do not exist are not deductible. Indeed, the case law has long followed the principle that a contribution to a reserve for future liabilities is not deductible; only actual payment out of the reserve to satisfy a definite liability can give rise to a deductible expense.¹⁰⁰

The *Sebring* court cited the longstanding rule of *Commercial Liquidation Co. v. Commissioner*,¹⁰¹ in which the court denied a deduction for a collection agency’s payments to a reserve fund held by a surety to protect against

98. Regs. § 1.468B-3(g).

99. 93 T.C. 220 (1989).

100. *Id.* at 225.

101. 16 B.T.A. 559 (1929).

contingent liabilities. The *Sebring* court also cited the Fifth Circuit's opinion in *Hradesky v. Commissioner*,¹⁰² which held that a cash basis taxpayer could not deduct a payment made into an escrow to satisfy unpaid real estate taxes until the taxes are paid from the escrow to discharge the taxpayer's liability. The rules for cash method deductions for payments to reserve funds thus mirror the rules for deductions for payments to trusts by accrual method taxpayers¹⁰³ – unless the payment discharges the taxpayer's underlying liability, the payment is not deductible.¹⁰⁴ Thus, the reference in the regulations to the general rules governing cash method deductions suggests that no deduction would be available for a cash method taxpayer's payments to a QSF, because under the cash method no deduction is allowed for fund payments unless the taxpayer's underlying liability to the creditor is discharged as a result of the transfer.

In conclusion, there are two main reasons that the existing QSF regulations do not provide a clear mechanism for solving the accounting method distortion that occurs in a bankruptcy case when the debtor has the ability and desire to segregate funds for the payment of creditor claims. First, with respect to both accrual and cash method taxpayers, a QSF cannot be used by its specific terms to satisfy ordinary trade debt and most other non-tort claims. It would be difficult to obtain Bankruptcy Court approval for establishing a pre-confirmation fund for the payment of certain tort claims without establishing an equivalent fund for the payment of non-tort trade claims. The Bankruptcy Court would be concerned that the transfer to the fund for the benefit of certain creditors could result in disparate treatment of similarly-situated creditors, violating the cardinal rule of equal treatment for similar claims.¹⁰⁵

102. 540 F.2d 821 (5th Cir. 1976).

103. See discussion, Part IV, *infra*.

104. There is also a significant limitation on the deductibility of refundable payments made to reserve funds which may be used to benefit the taxpayer in future tax years. The Supreme Court in *Commissioner v. Lincoln Sav. & Loan Ass'n.*, 403 U.S. 345 (1971), held that a savings and loan association could not deduct mandatory reserve payments made to the Federal Savings and Loan Insurance Corporation ("FSLIC"), which were credited along with earnings to the savings and loan association's account, and were refundable if the institution ceased operating. The Court held that the payments to the fund constituted a capital investment rather than a deductible expense because the reserve fund would continue to benefit the institution in future years. The Court would allow a deduction only when the amounts in the reserve fund were applied to a non-refundable general fund for the payment of the FSLIC's current expenses and liabilities. See *id.* at 358-59.

105. The principle of equality of distribution runs throughout the Bankruptcy Code. With respect to a plan of reorganization that has not been accepted by all classes of creditors, the so-called "cramdown" provisions specifically require the Court to find that the plan does not discriminate unfairly in the treatment of creditors. See 11 U.S.C. § 1129(b)(1) (2000). With respect to a plan of reorganization that has been accepted by all classes of creditors, the rules forbidding discrimination are implied. The plan of reorganization must provide that all claims in the same class be treated the same way, unless the claimant agrees to less favorable

Second, it is unclear whether (and, if so, how) the QSF regulations would provide any assistance to cash method taxpayers who are the ones most directly affected by the phantom income problem. Indeed, the reference to the general rules of cash method deductions suggest that no deduction would be available for payments made by cash method taxpayers to a QSF.

The existing QSF regulations could only be used in a limited way by accrual method taxpayers seeking deductions for funds segregated to pay tort liabilities, if the debtor could convince a Bankruptcy Court that the segregation would not favor the tort and creditors at the expense of the debtor's other creditors. Outside of this limited circumstance, the existing QSF regulations do little to mitigate the distortion caused by the bankruptcy prohibition on payment of pre-petition creditor claims prior to plan confirmation.

III. CONTESTED LIABILITY FUNDS PROVIDE ONLY LIMITED RELIEF FROM PHANTOM INCOME IN BANKRUPTCY

Early cases held that accrual method taxpayers could not deduct the payment of contested liabilities. In *Dixie Pine Products Company v. Commissioner*,¹⁰⁶ the State of Mississippi asserted that the taxpayer owed a gasoline use tax on a solvent used in its manufacturing business. After paying the tax for several years, the taxpayer obtained a determination from the Mississippi Supreme Court that the gasoline tax could not be imposed on the use of the solvent. After the Mississippi Supreme Court's determination but before the lower court entered an injunction, the taxpayer deducted from its federal income taxes the "accrued" but unpaid state gasoline taxes, which were disputed. On remand, the State and the taxpayer stipulated to the disallowance of future gasoline taxes, so that the amounts that had been accrued would not ever have to be paid. Upon entry of a judgment on the stipulation, the taxpayer recognized as income the accrued but unpaid gasoline taxes which had been deducted earlier.

The Supreme Court held broadly that the "all events" test is not met in connection with a contested liability, whether paid or not, and therefore no deduction should have been allowed:

treatment. See 11 U.S.C. § 1123(a)(4) (2000). While there is some leeway in the Bankruptcy Code for separately classifying similar claims, Bankruptcy Courts generally will not permit separate treatment of claims having similar priority. As stated by the leading bankruptcy treatise: "One of the cardinal principles underlying bankruptcy law is equality of treatment of similarly situated creditors." 7 Matthew Bender, *Collier on Bankruptcy*, ¶ 1122.03 (15th ed. revised, 2000). See e.g., *In re Granada Wines, Inc.*, 748 F.2d 42 (1st Cir. 1984) (The general rule regarding classification is that "all creditors of equal rank with claims against the same property should be placed in the same class."), quoting *In re Los Angeles Land and Investments, Ltd.*, 282 F. Supp. 448, 453 (1968), *aff'd*, 447 F.2d 1366 (9th Cir. 1971) and *In re Scherk*, 152 F.2d 747 (10th Cir. 1945).

106. 320 U.S. 516 (1944).

It has long been held that in order to truly reflect the income of a given year, all the events must occur in that year which fix the amount and the fact of the taxpayer's liability for items of indebtedness deducted though not paid; and this cannot be the case where the liability is contingent and is contested by the taxpayer. Here the taxpayer was strenuously contesting liability in the courts and, at the same time, deducting the amount of the tax, on the theory that the state's exaction constituted a fixed and certain liability. This it could not do. It must, in the circumstances, await the event of the state court litigation and might claim a deduction only for the taxable year in which its liability for the tax was finally adjudicated.¹⁰⁷

In *United States v. Consolidated Edison Company*,¹⁰⁸ the Supreme Court re-affirmed the *Dixie Pine Products* decision in a case involving actual payment of a contested liability. *Consolidated Edison* paid property taxes under protest, and sued to recover the overpayments. The Court held that no income tax deduction would be allowed until the contest was finally determined, at which time *Consolidated Edison* could deduct the amount which had been properly paid. Similarly, since the amount paid was not deductible, *Consolidated Edison* did not have to recognize as income the portion of the taxes which were refunded.

A. Creation of Contested Liability Funds

In 1964, Congress enacted section 461(f) to allow the deduction of contested liabilities that have been paid.¹⁰⁹ Section 461(f) also allows both cash and accrual method taxpayers, in the year that the taxpayer transfers money or other property in satisfaction of a contested liability, to deduct a payment if, but for the contest, a deduction would be allowed for the year of transfer.¹¹⁰

The statute requires only a "transfer of money or property to provide for the satisfaction of the asserted liability."¹¹¹ Unlike the economic performance rules applicable to tort claims under section 461(h)(2)(A), the contested liability statute does not require a direct payment to the creditor before a deduction can be taken. However, the Treasury Regulations promulgated under section 461(f) allow a deduction only if payment is made to the creditor, to a trust or escrow pursuant to a written agreement with the creditor, or pursuant to a court or governmental order.¹¹²

107. Id. at 519.

108. 366 U.S. 380 (1961).

109. Revenue Act of 1964, Pub. L. No. 88-272, 78 Stat. 19 (1964).

110. § 461(f).

111. § 461(f)(2).

112. Regs. § 1.461-2(c)(1).

B. The Signature Requirement for Contested Liability Funds

The language in the Treasury Regulation suggests that the creditor must actually sign an agreement before the debtor can deduct the payment of a contested liability which is not made directly to the creditor or pursuant to a court order. This language has spawned a number of conflicting opinions, in which some courts have virtually ignored the language of the regulation.

Two courts have denied deductions where the creditor did not sign the trust agreement. The only court to fully accept the language of the regulation is *Rosenthal v. United States*.¹¹³ The case arose out of a partnership dispute. The partnership, which was controlled by one of the partners, refused to pay the other partner's expenses. The partnership set funds aside in a trust to cover the claims asserted by the other partner, and deducted the fund payments. The Court held that section 1.461-2(c)(1) of the Treasury Regulations requires the signature of the claimant. Since the claimant was unaware of the trust and did not sign the trust agreement, the deductions were not allowable.

The court in *Poirier & McLane Corp. v. Commissioner*,¹¹⁴ also disallowed a deduction for payments to a secret trust for the benefit of the claimants, but did not accept the Treasury Regulation wholesale. In *Poirier*, a construction contractor was sued for trespass by the owners of an apartment building on adjoining land who claimed that the construction damaged the foundation of their apartment building.¹¹⁵ The contractor established a secret trust to cover the asserted trespass claims.¹¹⁶ The claimants were not aware of the creation of the trust.¹¹⁷ The litigation was resolved without any significant liability by the contractor, and the funds were returned by the trust to the contractor.¹¹⁸ The Tax Court allowed the deduction because the funds were transferred beyond the taxpayer's control.¹¹⁹ On appeal, however, the Second Circuit disallowed the deduction, emphasizing that a contrary conclusion would give the taxpayer complete control over the timing of the deposit and deduction, which would not be related to the accrual of the liability.¹²⁰ It is unclear how the *Poirer* court would have ruled if the creditors had been aware of the trust but had not been signatories to the trust agreement, or if the timing of contributions was not solely within the taxpayer's control.

113. 11 Cl. Ct. 165 (1986).

114. 547 F.2d 161 (2d Cir. 1976).

115. *Id.* at 163.

116. *Id.*

117. *Id.* at 165.

118. *Id.* at 163.

119. 63. T.C. 570 (1975).

120. 547 F.2d 161 (2d Cir. 1976).

The Ninth Circuit held in *Consolidated Freightways, Inc. v. Commissioner*,¹²¹ that payments made on account of potential future liabilities that had not arisen are not deductible.¹²² A trucking company sought to deduct payments made to a liability bonding company. The trucking company was self-insured for liability, but was required to post a bond with the Interstate Commerce Commission to assure payment to potential tort claimants.¹²³ In order to obtain the bond, the trucking company was required to post a security deposit with the bonding company.¹²⁴ The amount of the security deposit was determined by the agreement of the taxpayer and the bonding company, based on their joint estimate of the liability and did not match the amount of asserted liabilities.¹²⁵ Because the transfers for security could exceed the amount of all asserted liabilities (which would open the door for unlimited tax deferral),¹²⁶ and because the purpose of the transfers was to protect the bonding company rather than to provide for the satisfaction of tort liabilities, the court denied a deduction for the payments.¹²⁷

The remaining courts to consider the issue have not followed either the language or the manifest intent of the regulation. In *Chem Aero, Inc. v. United States*,¹²⁸ the Ninth Circuit allowed a defendant, who had posted a bond to obtain a stay pending appeal,¹²⁹ to deduct the value of collateral transferred to the bonding company to secure the defendants' indemnity obligations to the bonding company.¹³⁰ The court held that the transfer limitations in section 1.461-2(c)(1) of the Treasury Regulations only stated a general rule, and that the court was free to make exceptions to the general rule where the funds were placed beyond the taxpayer's control for the satisfaction of an asserted liability.¹³¹ The *Chem Aero* court distinguished the *Poirier* case on the grounds that the creditor in *Chem Aero* knew of the posting of the bond, while the *Poirier* transfer was to a secret trust.¹³² However, there was in fact no evidence in *Chem Aero* that the

121. 708 F.2d 1385 (9th Cir. 1983).

122. *Id.* at 1394.

123. *Id.*

124. *Id.*

125. *Id.*

126. *Id.* at 1394.

127. *Id.*

128. 694 F.2d 196 (9th Cir. 1982).

129. *Id.* at 197.

130. *Id.* at 197; 200.

131. *Id.* at 198. ("The italicized phrase 'in general' [in Regs. § 1.461-2(c)(1)] preceding the listed methods of transfer, suggests that they are merely illustrative, not all-inclusive. The regulation demands only that in order for money or other property to be beyond the control of a taxpayer, the taxpayer must relinquish all authority over such money or other property.")

132. *Id.* at 198-99.

creditor knew of the transfer of security to the bonding company, which was the basis for the deduction.

Similarly, in *Varied Invs., Inc. v. United States*,¹³³ the taxpayer deducted payments to a bonding company to secure an appeal bond.¹³⁴ The Eighth Circuit rejected the language of the regulation requiring the claimant to be a party to the trust, holding that “[a] claimant’s assent can be inferred when the claimant is the beneficiary of a trust or escrow because such arrangements in effect carry the same power of enforcement.”¹³⁵ The Court also distinguished *Poirier* on the grounds that the timing of the appeal bond was mandated by Court rules, and was thus not within the taxpayer’s discretion.¹³⁶

In a memorandum opinion, the Tax Court in *Edison Bros. Stores v. Commissioner*,¹³⁷ purporting to follow the Eighth Circuit’s opinion in *Varied*,¹³⁸ rejected the *Poirier* analysis entirely, allowing deductions for payments made to a secret trust for the benefit of a claimant.¹³⁹ *Edison Bros. Stores* involved a trust established without the knowledge of the United States¹⁴⁰ to cover potential contested liabilities for non-rubber footwear import duties. Even though the taxpayer had complete control over the timing of the transfers, and even though the beneficiary of the trust lacked knowledge of the trust,¹⁴¹ the court allowed the deduction under section 461(f) for payments made to the trust because there was no showing that the petitioner engaged in tax abuse by its use of the trust.¹⁴²

In *Chernin v. United States*,¹⁴³ the Court held that a judicial garnishment, and a subsequent agreement to deposit funds in a trust account, were the equivalent of a section 461(f) fund. The taxpayer had appropriated more than \$1 million from his employer, which he claimed were bonus payments owing to him.¹⁴⁴ When his employer learned about the appropriation, the employer sued the taxpayer for embezzlement and garnished the funds.¹⁴⁵ Ultimately, the jury determined that the taxpayer was entitled to the funds and had been wrongly terminated.¹⁴⁶ In allowing a deduction, the Court attempted to distinguish section 1.461-2(c)(1) of the Treasury Regulations as follows:

133. 31 F.3d 651 (8th Cir. 1994).

134. *Id.* at 652.

135. *Id.* at 655.

136. *Id.* at 654.

137. 69 T.C.M. (CCH) 2897, 1995 T.C. Memo. Lexis 263 (1995).

138. 1995 T.C. Memo. Lexis 263 at 5.

139. *Id.* at 4, 9.

140. *Id.* at 9.

141. *Id.*

142. *Id.* at 17.

143. 149 F.3d 805 (8th Cir. 1998).

144. *Id.* at 807.

145. *Id.*

146. *Id.*

Section 461(f) is silent on the mechanics of the transfer requirement. And, in such situations, deference is generally accorded the interpretation of the agency charged with enforcing the statute. *See, e.g., Commissioner v. South Texas Lumber Co.*, 333 U.S. 496, 501, 92 L. Ed. 831, 68 S. Ct. 695 (1948) (stating that Treasury Regulations in particular are entitled to deference as administrative interpretations of a statute). We agree and substantively do give deference to the existing regulation. Yet, this is not the end of the matter. The subtitle to the regulation explicitly begins, “[in] general.” Treas. Reg. 1.461-2(c)(1). Both this circuit and the Ninth Circuit have reflected on the nomenclature preceding the regulation and reasoned that the provision thereby offers only an illustrative, rather than exhaustive, list of events that should be considered “transfers” for purposes of section 461(f)(2).¹⁴⁷

In a recent field service advisory, the Service cites with approval both *Chem Aero*, and *Edison Brothers Stores* for the proposition that a transfer which is made beyond the control of the taxpayer is sufficient, even though the creditor has not signed an agreement.¹⁴⁸

Thus, while the cases are far from consistent with each other, the more recent cases have not followed the letter of the Treasury Regulations. As long as the transfer is made to cover specific liabilities, and the amount of the transfer is not subject to manipulation, the more recent cases have allowed a deduction even though the creditor was not a party to the agreement.

C. Limiting the Use of Contested Liability Funds by Accrual Method Taxpayers

In 1984, Congress made an important amendment to section 461(f), which has received little comment but would appear to significantly limit an accrual method taxpayer’s ability to deduct contested liabilities which are not paid to the claimant. The amendment provides that both the “all events” test and the “economic performance” test must still be met before an accrual method taxpayer can deduct a contested liability. The statute now requires that, “but for the fact that the asserted liability is contested, a deduction would be allowed for the taxable year of the transfer (or for another taxable year) **determined after application of subsection (h).**”¹⁴⁹ It was this emphasized language that was added in 1984.¹⁵⁰

147. 149 F.3d at 810.

148. Field Serv. Adv. No. 200106005 (2001).

149. § 461(f)(4) (emphasis added).

150. Deficit Reduction Act of 1984, see *supra* note 46.

Section 461(h)(2)(C) provides that “economic performance” is not met in connection with a tort claim until payment is made **to the creditor**. Since section 461(f)(4) allows a deduction for contested liabilities only if all of the requirements of section 461(h) are met, and section 461(h) in turn requires a direct payment to the creditor, any payment to a trust would not appear to meet the technical requirements of the statute—unless, of course, another provision of the Code or regulations would establish “economic performance” prior to the time specified in section 461(h).

The only relevant exception to the “economic performance” rules contained in section 461(h)(2)(C) relating to contested tort claims is the DSF/QSF rules. Therefore, the current statute appears to require an accrual method taxpayer to comply with the QSF regulations in order to deduct a contested liability which is not paid directly to the creditor.

The regulations support this technical interpretation. Treasury Regulations section 1.461-4(g)(1)(i) provides that “economic performance occurs when, and to the extent that, payment is made to the person to which the liability is owed. Thus . . . economic performance does not occur as the taxpayer makes payments in connection with such a liability to any other person, including a trust, escrow account, court-administered fund, or any similar arrangement, unless the payments constitute payment to the person to which the liability is owed under paragraph (g)(1)(ii)(B) of this section.” Regulations section 1.416-4(g)(1)(ii)(B) of the Treasury Regulations provides that the transfer constitutes a payment only if the payee would have to recognize income upon receipt of the payment if the payee were on the cash method. The statute and the regulations thus appear to prohibit accrual method taxpayers from deducting payments to a contested liability fund unless the fund meets the stringent DSF/QSF requirements.

The technical reading of the amendment would prevent the use of a contested liability fund for payments which do not qualify for DSF/QSF treatment. For example, even with court approval, an accrual method taxpayer could not deduct payments to a contested liability fund for the satisfaction of contested breach of contract claims for general damages.¹⁵¹ This has significant implications for bankruptcy cases, both because it would limit the accrual method taxpayer’s ability to address the pre-confirmation distortion problem which is the subject of this article, and also would perpetuate the distortion by preventing deductions for funds required to be held back under a plan of reorganization until the resolution of a contest.¹⁵²

151. See *supra* note 80.

152. In order to meet the requirements for plan confirmation, the plan proponent must provide for equal treatment of disputed claims in the event they are ultimately allowed by the Court. Therefore, most reorganization plans with which the author is familiar provide that the distribution which would be owing to a disputed claimant if the claim were to be allowed in full

D. *The Maxus Energy Trust*

The one court to consider the issue has rejected the technical reading of section 461(f)(4). In *Maxus Energy Corporation v. United States*,¹⁵³ the manufacturer of Agent Orange entered into a class action settlement calling for the payment of slightly less than \$22 million to a trust for the benefit of the class upon court approval of the settlement.¹⁵⁴ The manufacturer had the right to back out of the settlement prior to the hearing on approval if it believed that too many class members opted out of the settlement.¹⁵⁵ The deadline to withdraw was July 19, 1984.¹⁵⁶ The settlement was approved by the Court on January 7, 1985.¹⁵⁷ The settlement fund was not eligible to be treated as a DSF because many of the class members' claims were disputed.¹⁵⁸

The government argued that the payment to the settlement fund was not deductible because the fund did not qualify as a DSF and the payment was not made directly to the claimants as required by section 461(h)(2)(C).¹⁵⁹ According to the government, the only exception to the rule forbidding deductions for tort settlements not paid directly to the claimant is a qualified payment to a DSF.¹⁶⁰

The court disagreed with the government's argument. The court first held that the DSF rules were entirely inapplicable, because the issue before the Court concerned contested liabilities and the DSF statute only applied to uncontested liabilities.¹⁶¹ The Court did not consider the effect of the new QSF regulations, which permit contested liabilities. Because the opinion is based on the inapplicability of DSFs to contested liabilities, it is unclear whether the opinion

will be held in a reserve account pending the resolution of the dispute. A cash method taxpayer would be able to deduct payments to a disputed claims fund established in conformity with § 461(f). However, under this technical interpretation of the amendment to § 461(f)(4), an accrual method debtor would not be able to deduct payments to a disputed claims reserve account because the payments have not been made to the creditors. While the accrual method debtor could deduct such payments if made to a QSF, payments on account of liabilities for general breach of contract are not "qualified payments" and thus would not constitute "economic performance." See Regs. § 1.468B-1(c)(2)(ii) (limiting QSF use for tort, breach of contract or violation of law liabilities); Regs. § 1.461-4(g)(2)(i) (providing that "breach of contract" damages means incidental, consequential or liquidated damages, not direct "liability to make payments for services, property or other consideration provided under the contract").

153. 31 F. 3d 1135 (Fed Cir. 1994).

154. *Id.* at 1137.

155. *Id.*

156. *Id.*

157. *Id.*

158. *Id.* at 1144. The Court did not discuss the QSF regulations which had not been enacted at the time of the settlement (although they had been enacted by the time of the hearing).

159. *Id.* at 1144.

160. *Id.*

161. *Id.* at 1144.

would survive given the expanded QSF rules. The Court also seems to have missed the thrust of the government's argument. The government was not arguing that the liabilities were eligible for DSF treatment. Rather, the government was arguing that the only exception to the direct creditor payment rule is a DSF, and that exception did not apply to *Maxus Energy*.¹⁶² Without an applicable exception, the general rule would have prevented the deduction. This portion of the opinion seems of dubious validity.

Second, however, the court held that upon entry of the judgment approving the settlement, the claims of the class were merged into the settlement fund.¹⁶³ Thus, the fund became the "person" entitled to the payment under section 461(h)(2)(C), and the payment by the manufacturer to the fund constituted a direct payment to the "person" entitled to be paid.¹⁶⁴ This argument is on a much more firm footing than the court's first argument.

The merger theory of *Maxus Energy* should apply equally to a cash-method taxpayer, since the "economic performance" rule of section 461(h)(2)(C) applicable to tort claims is, in essence, the same as the cash-method rule – a deduction is not available until actual payment of the claim.

It is unclear whether *Maxus Energy* is still good law after the QSF regulations. The QSF regulations provide that a fund set up for disputed payments under section 461(f) will be treated as a QSF if it meets the requirements for a QSF.¹⁶⁵ The settlement fund created in *Maxus Energy* would likely qualify as a QSF, and thus, would likely be taxed as a QSF.

The more interesting question for this article is whether the *Maxus Energy* theory could be used to set up a fund for contested liabilities that would not qualify for QSF treatment, such as trade and warranty liabilities. The preamble to the new (1999) proposed section 468B regulations suggest that additional room exists for section 461(f) disputed payment funds:

The proposed regulations provide rules relating to the taxation of amounts transferred to an escrowee, trustee, or court in connection with a contested liability within the meaning of section 461(f) (i.e. a transfer to a "461(f) fund"). Commentators provided numerous comments concerning the proposed regulations. After reviewing these comments, the Service and the Treasury Department believe it is appropriate to address economic performance for 461(f) funds after final guidance is provided concerning funds under section 468B. Therefore, the final regulations reserve the treatment of 461(f) funds.¹⁶⁶

162. Id.

163. Id. at 1144-45.

164. Id. at 1145.

165. Regs. § 1.468B-1(b).

166. Prop. Regs. § 468B (Reg. § 209619-93) (2/1/99).

The final regulations under section 461(f) do indeed reserve space for future regulations dealing with “payments to other funds or persons that constitute economic performance.”¹⁶⁷ Thus, the section 461(f) regulations and the new proposed section 468B regulations appear to recognize that additional vehicles will need to be considered for contested liability funds. Until this area of the law is settled, *Maxus Energy* may still be alive in the cracks of the QSF regulations.

The next section considers the possible use of a *Maxus Energy* or general trust to avoid the distortion resulting from the restriction on bankruptcy payments prior to plan confirmation.

IV. THE “GRANTOR TRUST” RULES IMPOSE AN ADDITIONAL LIMITATION ON USING TRUSTS TO AVOID ACCOUNTING METHOD DISTORTION IN BANKRUPTCY

One possibility for solving the gross mismatch between revenues and expenses in bankruptcy cases would be for the debtor to establish a trust for the benefit of creditors without relying on any specific statutory or regulatory authorization. For example, if the debtor could deduct payments made in year one to a general trust account established for the benefit of trade creditors, it could avoid the accounting method distortion caused by the restriction on creditor payments in bankruptcy.

The “grantor trust” rules contained in sections 671-679, however, would likely prevent a deduction for payments to a general trust account. It seems axiomatic that if the trust is treated as owned by the debtor under the grantor trust rules, a payment to the trust would not be deductible any more than a deposit into the debtor’s own bank account.

In order to avoid being characterized as a grantor trust, the debtor would have to retain no reversionary interest,¹⁶⁸ no power to control the beneficial enjoyment of the trust corpus,¹⁶⁹ no forbidden administrative powers,¹⁷⁰ no powers of revocation,¹⁷¹ and no retained interest in the income or corpus of the trust.¹⁷² The regulations contain an additional requirement to avoid grantor trust status. According to section 1.677(a)-1(d) of the Treasury Regulations, in order to avoid being characterized as a grantor trust, the income from the trust cannot

167. Regs. § 1.461-6(c).

168. § 673.

169. § 674.

170. § 675.

171. § 676.

172. § 677.

be used to “discharge”¹⁷³ the grantor’s legal obligations. “Under section 677 a grantor is, in general, treated as the owner of a portion of a trust whose income is, or in the discretion of the grantor or a non-adverse party, or both, may be applied in discharge of a legal obligation of the grantor. . . .”¹⁷⁴ The regulations

173. The use of the word “discharge” in this regulation caused one author to suggest that a trust established under a plan of reorganization to liquidate all of the debtor’s assets and make pro-rata payments to creditors should not be treated as a grantor trust because a debtor who proposes a liquidation plan is not entitled to a Chapter 11 discharge. John D. Howard, *The Taxation of Liquidating Trusts, Escrows and Settlement Funds in Chapter 11 Bankruptcy Cases*, 64 Am. Bankr. L.J. 403 (1990) (stating that “[f]rom a bankruptcy standpoint, however, trust income will not be used to “discharge” a legal obligation of the grantors because the consolidated debtors are not entitled to and should not receive a Chapter 11 discharge. . . . Thus, it can be argued that the liquidating trust in *Holywell* does not qualify as a grantor trust under either the Internal Revenue Code or the regulations.”) It appears that the author confused the concept of a Chapter 11 discharge (which involves the discharge of debts not to be paid under the plan) with the discharge of debts that occurs as a matter of state law upon payment. Indeed, taken in a vacuum, the correct analysis is the opposite of the one hypothesized by the author. If the debtor does not receive a bankruptcy discharge and remains liable for the debts, then the payments from the trust will discharge the debtor’s liabilities. Under these facts, the trust would be treated as a grantor trust. On the other hand, if the debtor receives a bankruptcy discharge, then payments from a trust created by the plan of reorganization would not serve to discharge the debtor’s liability, because that liability has already been discharged by the confirmation order. See 11 U.S.C. § 1141(d)(1)(A). The language of the grantor trust regulation deals with the discharge or satisfaction of an obligation that occurs as a matter of law upon payment, not the bankruptcy discharge. The regulations are simply applying the theory of established cases like *Old Colony Trust Co. v. Commissioner of Internal Revenue*, 279 U.S. 716 (1929), to grantor trusts by recognizing that a grantor retains an interest in the income of a trust when that income can be used to satisfy the grantor’s obligations. For tax purposes, the satisfaction of the grantor’s obligations is treated as a transfer from the trust to the grantor, followed by a subsequent payment by the grantor to the creditor. *Douglas v. Willcuts*, 296 U.S. 1 (1935) (“The transaction is regarded ‘as being the same in substance as if the money had been paid to the taxpayer and he had transmitted it to his creditor.’”) The Supreme Court in *In re Holywell Corp.*, 503 U.S. 47 (1992), without any real analysis, held that a liquidating trust created under a plan of reorganization for the sole benefit of creditors did not constitute a grantor trust of the debtor, because the trust was not created or funded by the debtor. According to the Supreme Court, the debtor “himself did not contribute anything to the trust, and we thus fail to see how the respondents can characterize him as the grantor.” *Id.* at 57. The Court did not analyze the grantor trust issues in any further detail. The key issue in determining whether a trust created under a plan of reorganization will be treated as a grantor trust is not whether the debtor receives a general discharge. Rather, the key issue is whether the plan provides that the claims of creditors will be transferred from being a personal liability of the debtor to being an *in rem* liability of the fund, as in *Maxus Energy*, 31 F. 3d 1135 (Fed Cir. 1994). Section 1141(a) of the Bankruptcy Code provides that the terms of a confirmed plan of reorganization bind creditors. This is true whether or not the debtor receives a discharge under § 1141(d)(1)(A) of the Bankruptcy Code. Thus, if the confirmed plan transfers the liability to a trust, and the debtor retains no reversionary interest in the trust, the payments from the trust will not be used to discharge the debtor’s liability to the creditor because that personal liability was already substituted for the *in rem* liability of the trust.

174. Regs. § 1.677(a)-1(d).

provide that the distribution to the grantor may be actual or constructive.¹⁷⁵ If the income of the trust can be used without the consent of an adverse party to satisfy a liability of the grantor, then the grantor is treated as in constructive receipt of the income, and will be treated as the owner of the trust.¹⁷⁶

A. When Payments to a Trust are Deductible as Ordinary Business Expenses

In a series of administrative rulings, the Service has applied these grantor trust principals to determine whether payments made to a fund for the benefit of third party claimants are deductible.

In Revenue Ruling 85-158,¹⁷⁷ the Service held that a trust created by a commodities futures exchange clearing house, the principal and interest of which was used as security for the exchange's indemnity obligations on futures contracts, was a grantor trust because the payments from the fund would discharge the exchange's indemnity obligations. Thus payments by the exchange to the trust were not deductible.

On the other hand, in a series of private letter rulings arising out of trusts set up by stock and commodity exchanges to provide financial assistance to customers who incurred losses as a result of insolvent exchange members, the Service allowed the exchanges to deduct payments to the fund where the exchanges that created the funds were not legally liable for the customer claims.¹⁷⁸ The funds were established to increase investor confidence, not to satisfy the exchange's own liability. The payment by the funds would not discharge the exchange's liability because the exchange had no liability to begin with. Therefore, the payments to the fund were deductible because the trusts were not "grantor trusts."

The court in *Johnson v. Commissioner*¹⁷⁹ used the grantor trust rules to reject an automobile dealer's attempt to exclude from income a portion of the proceeds received from the sale of a vehicle service contract which were transferred to a fund to secure the dealer's future obligations under the service contract. Finding the fund to be a grantor trust because payments from the fund would reduce the dealer's liability and because the dealer held a reversion, the court denied the exclusion for the portion of the purchase price transferred to the grantor trust, and also held that the income from the trust was taxable to the dealer.

175. Regs. § 1.677(a)-1(c).

176. Regs. § 1.677(a)-1(d).

177. 1985-2 C.B. 175 (1985).

178. Priv. Ltr. Rul. No. 6407145030A, Priv. Ltr. Rul. No. 6707186030A, Priv. Ltr. Rul. No. 6905071230A, Priv. Ltr. Rul. No. 7012291000A and 1994 F.S.A. Lexis 41.

179. 108 T.C. 448 (1997), aff'd in part rev'd in part, 184 F.3d 786 (8th Cir. 1999).

Likewise, in *Anesthesia Service Medical Group, Inc. v. Commissioner*,¹⁸⁰ the court held that a medical group could not deduct payments to a trust for the benefit of potential future malpractice claimants. The trust was created in lieu of medical malpractice insurance, and provided that the funds in the trust could never revert to the medical group – any funds remaining in the trust at the conclusion of the trust would be donated to charity. Nevertheless, the court held that the payments to the trust were not deductible because any distributions by the trust to tort claimants would be used to discharge the medical group's malpractice liability and thus constituted a grantor retained interest.

In summary, if the grantor remains liable on the creditors' claims after the transfer to the trust, the trust will be treated as a grantor trust and no deduction will be allowed. In order for there to be a possibility of a deduction, the transfer to the trust must completely satisfy the grantor's obligation to the creditor for the amount of the transfer.¹⁸¹ Moreover, because there must be no possibility of a reversion, the trust could not be used for contested liabilities. Short of an order transferring the liability for the claimants' uncontested claims from the debtor to the fund (as in *Maxus Energy*), the trust will likely be treated as a grantor trust and any deduction disallowed.

At least in theory, the requirement that the debtor's liability be discharged upon transfer to the fund could be addressed using the theory of the *Maxus Energy* case to create a fund, with Bankruptcy Court approval, for the payment of trade claims. The Bankruptcy Court has broad equitable power under section 105 of the Bankruptcy Code to issue orders necessary or appropriate to carry out the bankruptcy laws. However, it would be extremely difficult to convince a bankruptcy judge to wade through uncharted tax waters by authorizing such a trust.¹⁸² A *Maxus Energy* trust requires the complete transfer

180. 85 T.C. 1031 (1985).

181. While § 677 focuses on the potential for the trustor to benefit from the income of the trust, similar rules apply to trust corpus. See § 673 (providing that a grantor is treated as the owner of a trust if there is a possibility of reversion); § 674 (providing that a grantor is treated as owner of a trust if the grantor retains power to control beneficial enjoyment of income or corpus); § 676 (providing that a grantor is treated as owner of a trust if the grantor retains power to revoke transfer to trust). The same constructive receipt rules should apply to corpus as apply to income. Therefore, an attempt by a debtor to take a deduction for payments to a trust fashioned in such a way that the corpus would be used to satisfy the trustor's creditor claims but the income would be paid to some third party should be treated as a grantor trust, because the corpus is subject to reversion or revocation.

182. There are no reported cases in which a bankruptcy debtor sought authority to create and fund a trust for the payment of certain creditor claims after plan confirmation for the purpose of avoiding phantom income. On the other hand, Bankruptcy Courts are familiar with the creation of liquidating trusts. However, liquidating trusts exist for an entirely different purpose than a trust designed to hold cash for distribution to creditors upon plan confirmation. A liquidating trust is designed to hold non-financial assets for orderly liquidation after plan confirmation. Regs. § 301.7701-4(d). In order to be taxed as a liquidating trust, the trust cannot

of the debtor's personal liability to the trust. The *Maxus Energy* court had jurisdiction to effectuate the release and transfer in connection with approval of the class action settlement, in which the class members had the due process right to "opt out" of the settlement. In all probability a bankruptcy judge would refuse to consider such extraordinary action outside of a plan of reorganization, where the statutory guidelines for confirmation are in place. Bankruptcy Courts have been loathe to approve de facto reorganization plans outside of the formal plan confirmation process.¹⁸³

V. SUMMARY OF ANALYSIS AND RECOMMENDATION FOR REFORM

Phantom income is a serious problem in bankruptcy cases. Bankruptcy laws designed to assure ratable distributions to creditors force the debtor to defer paying claims, resulting in phantom income which is taxed to the debtor but earmarked for the payment of creditor claims upon confirmation of the debtor's reorganization plan. The problem affects both cash and accrual method taxpayers with respect to those liabilities that cannot be deducted until paid. Because bankruptcy laws prevent the debtor from arranging its own affairs in such a way as to minimize its taxes, some relief from the phantom income problem is in order.

The only automatic error correction device applicable to the phantom income problem is the net operating loss carryback. The carryback rules provide relief only in ideal circumstances. The rules do not apply when the debtor has sufficient income in the year of plan confirmation to offset the operating loss. Yet, the value of the deduction in the year of confirmation may be significantly less than the value of the deduction in the appropriate year due to the time value of money, and the possibility of creeping rate brackets, differing tax rates, and the reduction of more favorably taxed capital gains rather than ordinary income. Moreover, the discharge of indebtedness rules require any surviving net operating

exist any longer than is reasonable to complete the liquidation of the assets, and cannot hold liquid assets like marketable securities, cash or cash equivalents in excess of a reasonable amount to meet trust expenses and contingent liabilities. Rev. Proc. 94-45, 1994-2 C.B. 684 (1994) (setting forth the requirements for an advance ruling that a trust will be taxed as a liquidating trust.). A liquidating trust is thus not designed to hold cash prior to confirmation of a plan for the purpose of avoiding phantom income.

183. See e.g., In re *Lionel Corp.*, 722 F.2d 1063 (2nd Cir. 1983) (requiring good faith business reason for sale of assets outside of plan); In re *Braniff Airways, Inc.*, 700 F.2d 935 (5th Cir. 1983) (refusing to approve transfer of substantially all assets outside of plan of reorganization); In re *Continental Airlines, Inc.*, 780 F.2d 1223, 1227 (5th Cir. 1986) (refusing to authorize debtor to enter into leases which constituted "creeping reorganization plan" outside requirements for plan confirmation); In re *First South Sav. Assn.*, 820 F.2d 700, n.15 (5th Cir. 1987) (denying proposed financing because it would "significantly effect the terms of any plan that may be proposed in the future.")

losses to be reduced by the amount of unrecognized discharge of indebtedness income occurring upon plan confirmation before being carried back to earlier years. Thus, the net operating loss carryback rules do not provide a reliable device for correcting the phantom income problem in bankruptcy cases.

There are also inadequate methods for the debtor to avoid phantom income through careful tax planning. The DSF and QSF rules likely only benefit accrual method taxpayers, and are limited to tort claims (and specifically exclude bankruptcy trade claims). Likewise contested liability funds can only be used for contested liabilities, and apparently only by cash method taxpayers (unless the more stringent QSF rules are complied with). A general trust could only be used if the transfer to the trust extinguished the debtor's liability to the creditor, as in *Maxus Energy*. Each of the potential funds or trusts has specific limitations which prevent generalized use in bankruptcy to avoid phantom income.

Although in theory the various trusts could be used in combination by some debtors to eliminate some phantom income in bankruptcy, in the real world it would be nearly impossible to convince a Bankruptcy Court to allow special trust fund deposits for certain creditors without providing similar protections for all creditors. Since none of the potential trust devices would permit a deduction for the full panoply of creditor claims, the existing devices provide no real shelter for bankruptcy debtors facing the problem of phantom income.

The Code or the regulations should be amended to permit bankruptcy debtors to establish a single trust for the payment of all types of pre-petition creditor claims upon confirmation of a plan of reorganization. The trust should pay income taxes on its income in the same manner as a QSF or DSF. The trust should be established only with the approval of the Bankruptcy Court, after notice to the Internal Revenue Service and an opportunity for a hearing. The debtor should be required to show that, but for the bankruptcy restrictions on the payment of pre-petition claims prior to plan confirmation, the debtor would in the ordinary course of business use the assets to be contributed to the trust to pay creditor claims (or to reserve for contested creditor claims). The trust assets should be segregated in a separate account under the control of an independent trustee or the Court. The amount set aside in the trust should be limited to the amount of the claims of the legitimate claims creditors, and any contested claims exceeding a threshold value should be estimated by the Court for the purposes of being included in the trust.

The debtor should be specifically allowed to deduct the appropriate portion of the payments to the trust. The amount of the deduction should depend on the amount that would be deductible if the contribution to the trust constituted a distribution to creditors under the liquidation provisions of Chapter 7 of the

Bankruptcy Code at the time the contribution to the trust is made.¹⁸⁴ An allocation of the contributions to the trust between claims is necessary for several reasons. First, a deduction would not be available for payment for some of the debtor's liabilities, such as principal loan repayments¹⁸⁵ or consumer purchases,¹⁸⁶ while payment of other liabilities would be deductible. Without an allocation, the debtor could pick and choose to fund only those liabilities that would be deductible. This would distort the debtor's true financial picture because the debtor is required in bankruptcy to treat all creditors having the same priority in the same way.¹⁸⁷ The phantom income distortion is caused by the debtor's inability to make payments during the bankruptcy case until confirmation of a reorganization plan. That distortion should be cured by allowing the debtor to take appropriate deductions for payments made to the trust which would have been deductible if the debtor were permitted to make those same payments directly to creditors. Since all creditors in bankruptcy must be paid pro rata according to the priority of their claims,¹⁸⁸ a deduction should be

184. Chapter 7 is the so-called "straight bankruptcy" provision of the Bankruptcy Code. It provides for the liquidation of the debtor's assets under the supervision of a court-appointed trustee, and the payment of claims in accordance with the rules established by Congress for bankruptcy liquidations in § 726 of the Bankruptcy Code. See 11 U.S.C. § 701 (appointment of interim trustee); *Id.* § 704 (duty of trustee to collect and reduce to money property of estate and close estate as expeditiously as is compatible with the best interests of parties in interest); *Id.* § 726 (distribution rules). It is appropriate to use the Chapter 7 distribution scheme for the hypothetical interim distribution to creditors for two reasons. First, it is the scheme that would apply if the case were to be converted from Chapter 11 to Chapter 7 upon the debtor's inability to confirm or effectuate a plan of reorganization. See 11 U.S.C. § 1112(b). Second, the Chapter 7 distribution scheme is incorporated into the Chapter 11 plan confirmation requirements through the best interests of creditors test in § 1129(a)(7)(ii) of the Bankruptcy Code. The best interests of creditors test prevents confirmation of a Chapter 11 reorganization plan without the express vote of each creditor unless the plan proponent can prove that each creditor will receive under the plan at least the amount that such creditor would receive in a liquidation under Chapter 7. This fundamental test is designed to assure that all creditors who do not specifically accept the plan are at least as well off as they would be in a Chapter 7 liquidation. Therefore, the hypothetical interim distribution will be allocated in accordance with the procedure required both in the event of a conversion or for meeting the fundamental best interests of creditors test at plan confirmation.

185. *Commissioner v. Tufts*, 461 U.S. 300 (1982) (stating that "[w]hen a taxpayer receives a loan, he incurs an obligation to repay the loan at some future date. Because of this obligation, the loan proceeds do not qualify as income to the taxpayer. When he fulfills the obligation, the repayment of the loan likewise has no effect on his tax liability.")

186. § 262(a).

187. See 11 U.S.C. § 726(b) (providing that distribution in Chapter 7 liquidation pro rata to creditors holding claims of the same priority); *Id.* § 1123(a)(4) (requiring same treatment for all claims in the same class in Chapter 11 plan); see also *supra* note 105.

188. Section 726 of the Bankruptcy Code contains the applicable Chapter 7 distribution rules. These rules require claims entitled to priority to be paid in the order specified in § 507 of the Bankruptcy Code before the claims of general unsecured creditors are paid.

allowed only for the portion of the payments that would have been deductible if the payments were made directly to the creditors.

Second, appropriate adjustments must be made for the claims of secured creditors. In a Chapter 7 case, fully secured creditors would be entitled to distributions only from the proceeds of their collateral, and would have an entitlement to those proceeds before other creditors. A fully secured creditor would not be entitled to any payment from the debtor's other funds in a Chapter 7 liquidation. Therefore, if cash collateral¹⁸⁹ is contributed to the trust, it should be separately accounted for and properly allocated first on account of the secured creditor's claim (and if multiple secured creditors on account of the secured creditors' claims according to their state-law priority) with any excess allocated to the payment of the claims of other creditors according to the Chapter 7 priority rules. If no cash collateral is contributed to the trust, then no portion of the trust funds would be allocated to the claims of fully secured creditors.

The claims of under-secured creditors who have full recourse¹⁹⁰ are treated as two separate claims under the Bankruptcy Code – a secured claim for the amount of the debt up to the value of the security, and an unsecured claim for the amount of the debt exceeding the value of the security.¹⁹¹ The secured portion of the claim should be treated in the same manner as a fully secured creditor, and the unsecured portion of the claim should be treated as a general unsecured claim. Creditors holding non-recourse under-secured claims would be treated in the same manner as fully secured creditors and excluded from treatment in the trust, since they would not have the right to participate in distributions of the debtor's other assets.¹⁹²

Claims of the same class are paid pro-rata in accordance with the amounts of the claims. 11 U.S.C. § 726(b).

189. Cash collateral is defined in § 363(a) of the Bankruptcy Code as cash in which both the estate and a secured creditor have an interest. It includes the proceeds from the sale of the lender's collateral to the extent the lender's security interest extends to such proceeds.

190. Under applicable non-bankruptcy law, the debtor is personally liable for the claims of secured creditors who have full recourse, and is not personally liable for non-recourse secured claims. The Debtor's liability for non-recourse claims is *in rem* only against the security for the loan.

191. 11 U.S.C. § 506(a).

192. Chapter 11 contains special rules for a non-recourse secured creditor to be treated as a recourse creditor if the collateral is to be retained by the debtor rather than sold. 11 U.S.C. § 1111(b). The creditor, in turn, has the right to elect to be treated as a fully secured creditor and not receive distributions as an unsecured creditor. *Id.* § 1111(b)(2). These rules create peculiar strategic issues that must be considered by secured creditors in connection with the proposed treatment of the particular secured claim in connection with a specific proposed plan of reorganization. Since these special rules only apply in connection with confirmation of a reorganization plan, and since the debtor always has the ability to avoid liability for the deficiency claim of a non-recourse creditor by disposing of the property, the deficiency claim of a non-recourse creditor should not be an eligible claim under the bankruptcy claims trust.

Finally, any applicable priorities should be honored. If payments were made to creditors under Chapter 7, claimants holding higher priority claims would be entitled to full payment before any distribution is made to claimants holding lower priority claims.¹⁹³

These basic rules can be illustrated with a simple example. Suppose a cash-method debtor contributes \$300x to a creditor trust at a time when the debtor owes \$100x in priority tax claims, \$50x on unsecured loans, \$200x on a recourse loan secured by real property valued at \$150x, and \$300x in ordinary business expenses. In a Chapter 7 liquidation, the first \$100x would be used to pay the priority claims. The \$200x balance would be allocated to the remaining unsecured claims pro-rata.

	Priority Tax Claims	Unsecured Loans	Recourse Loan Deficiency	Business Expenses	Total
Claim Amount	\$100x	\$50x	\$50x	\$300x	\$500x
Allocation of Contribution to Trust	\$100x	\$25x	\$25x	\$150x	\$300x
Deductions Allowed	\$100x			\$150x	\$250x

Because both of the loan repayments would not be deductible, the debtor would be allowed to deduct only the allocable share of the contribution for priority tax claims and business expenses.

Tax adjustments will be required if any claims covered by the fund are ultimately disallowed. The portion of the trust representing amounts attributable to the disallowed claim must be treated as recovered by the debtor in the year of disallowance, whether withdrawn from the trust or not. The character of the disallowed claim would determine the appropriate tax treatment. If the disallowed claim relates to a loan, the debtor would have discharge of indebtedness income subject to non-recognition under section 108(a)(1)(A). If the disallowed claim represents amounts previously deducted, income would be recognized in the year of recovery under the tax benefit rule.¹⁹⁴ In the event that funds in the trust are used to pay different obligations upon plan confirmation than originally designated (such as administrative expenses in an insolvent bankruptcy estate),

193. 11 U.S.C. § 726.

194. The tax benefit rule requires the inclusion in income of amounts recovered which were beneficially deducted in a prior year. *Hillsboro National Bank v. Commissioner and United States v. Bliss Dairy, Inc.*, 460 U.S. 370 (1983); § 111(a) (providing exception to judicially-created tax benefit rule for recovery of amounts deducted in a prior year which did not reduce the taxpayer's taxes in the prior year).

appropriate adjustments would be required for deductions taken for amounts which are not ultimately paid (resulting in taxable income), and for payments actually made which are subject to deduction (resulting in additional deductions).

Distributions from the trust should only be allowed under specific limited circumstances. Prior to plan confirmation, distributions should be allowed only upon final disallowance of a disputed claim. If the case is converted to Chapter 7, the funds should be available for distribution in accordance with the priorities established for Chapter 7 distribution. Any appropriate tax adjustments would be required for payments to parties different than originally designated. Upon plan confirmation, distributions would be made in accordance with the plan. If the plan permits the use of the trust funds for any purpose other than to pay the designated claims, appropriate tax adjustments would be required. These provisions would assure that the fundamental purposes of bankruptcy are served without exposing the debtor to adverse tax consequences.