[JOINT COMMITTEE PRINT]

DESCRIPTION OF H.R. 5043
(BANKRUPTCY TAX ACT OF 1979)
SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON
SELECT REVENUE MEASURES

OF THE

COMMITTEE ON WAYS AND MEANS
ON SEPTEMBER 27, 1979

PREPARED FOR THE USE OF THE

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INTRODUCTION

This pamphlet has been prepared by the staff of the Joint Committee on Taxation for the public hearing on H.R. 5043, the Bankruptcy Tax Act of 1979, scheduled for September 27, 1979, before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means.

The pamphlet provides background information on the bill, a summary of the major provisions of the bill, and a more detailed description of present law and the provisions of the bill.

I. BACKGROUND

In 1978, the Congress enacted legislation (P.L. 95–598) which significantly revises and modernizes the substantive law of bankruptcy as well as bankruptcy court procedures. P.L. 95–598 repeals the Bankruptcy Act and substitutes a new title 11 in the U.S. Code, completely replacing the former provisions.[1] The new law generally becomes effective for bankruptcy cases commencing on or after October 1, 1979.

H.R. 5043, the Bankruptcy Tax Act of 1979, is intended to update and clarify Federal income tax rules relating to discharge or cancellation of indebtedness, the tax treatment of the bankruptcy estate of an individual debtor, the tax treatment of corporate insolvency reorganizations, and procedural rules relating to assessment and collection of tax liabilities of the debtor and of the bankruptcy estate. Because of the October 1 effective date set by P.L. 95–598 for repeal of the existing Bankruptcy Act (including repeal of provisions governing Federal income tax treatment of debt discharge in bankruptcy), and for implementation of new bankruptcy court procedures, H.R. 5043 would generally be effective for bankruptcy cases commencing on or after October 1, 1979. Present law would continue to apply for bankruptcy cases commenced under the Bankruptcy Act, i.e., prior to October 1, 1979, including Bankruptcy Act cases which are commenced before and continue after that date.

H.R. 5043 has been developed by the staffs on the basis of extensive studies, commentaries, and recommendations for changes in bankruptcy tax rules made over the past six years. This effort to review and modernize bankruptcy tax law began with Congressional establishment of the Commission on the Bankruptcy Laws of the United States and the report issued by the Commission in 1973.[2]

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[1] The 1978 statute did not include a "short title" (although it has been designated by some commentators as the "Bankruptcy Reform Act of 1978"). This pamphlet refers to the 1978 bankruptcy statute as "P.L. 95–598." The existing substantive bankruptcy law, which will be superseded by P.L. 95–598, is referred to as the "Bankruptcy Act."

In this pamphlet, the provisions of title 11 of the U.S. Code which were enacted by P.L. 95–598 are cited as "new 11 U.S. Code § —." References to the "Code" are to the Internal Revenue Code of 1954, as amended.

Bankruptcy cases to which the substantive provisions of P.L. 95–598 will apply—generally, cases commenced on or after October 1, 1979—are referred to in the bill, H.R. 5043, as "title 11 cases."

[2] The present-law Federal income tax rules relating to taxpayers in bankruptcy cases and the Commission's recommendations for legislative changes, together with alternative proposals, are discussed in detail in a series of articles by William T. Plumb, Jr., Esq., entitled "The Tax Recommendations of the Commission on the Bankruptcy Laws." These articles appear at 29 Tax Law Review 227 (1974) (tax effects of debt reduction; insolvency reorganizations); 72 Mich. L. Rev. 935 (1974) (income tax liabilities of the bankruptcy estate and the debtor); and 88 Harv. L. Rev. 1360 (1975) (tax procedures).

The Ways and Means Committee held hearings in 1978 on H.R. 9973 (95th Congress), dealing with Federal income tax aspects of bankruptcy. Subsequent to those hearings and prior to introduction of H.R. 5043, the staffs received further comments from the American Bar Association, Tax Section, Ad Hoc Committee for Bankruptcy Revision; the American Institute of Certified Public Accountants, Bankruptcy Task Force; the Association of the Bar of the City of New York, Committee on Taxation; the New York State Bar Tax Section, Committee on Bankruptcy and Insolvency; the National Bankruptcy Conference, Committee on Tax Matters; the Departments of Treasury and Justice; the Internal Revenue Service; and other groups and individuals.

II. SUMMARY OF H.R. 5043

Tax treatment of discharge of indebtedness

Bankruptcy cases

In P.L. 95–598, the Congress repealed provisions of the Bankruptcy Act governing Federal income tax treatment of debt discharge in bankruptcy, effective for cases instituted on or after October 1, 1979. The bill would provide tax rules in the Internal Revenue Code in replacement of the repealed provisions.

Under the bill, no amount would be included in income by reason of a discharge of indebtedness in a bankruptcy case. Instead, the debt-discharge amount which would be excluded from gross income by virtue of the bill's provisions would be applied to reduce certain of the taxpayer's attributes.

The attribute reduction would be made in the following order: net operating loss carryovers; carryovers of the investment tax credit, WIN credit, and new jobs credit; capital loss carryovers; and asset basis. However, the taxpayer's basis in his assets would not be reduced below his remaining undischarged liabilities. Also under the bill, a reduction in the basis of qualified investment credit property would not result in imposition of any investment credit recapture tax.

Outside bankruptcy—insolvent taxpayers

The bill would provide discharge of indebtedness rules generally similar to those summarized above in the case of insolvent taxpayers whose debts are cancelled outside of bankruptcy, so that the debt-discharge rules will not operate as an incentive or disincentive to commencement of bankruptcy cases.

Outside bankruptcy—solvent taxpayers

In the case of solvent taxpayers, the bill would modify the existing Federal income tax election under which a taxpayer may elect to reduce basis of assets instead of reporting current income from debt cancellation outside of bankruptcy. The bill would require a solvent taxpaper to reduce net operating losses and credits before electing to reduce asset basis in such a case. This provision would achieve a result generally similar to that under the bill for a solvent or insolvent taxpayer whose debts are discharged in bankruptcy.

Equity-for-debt rules

The bill also provides rules relating to corporate indebtedness in order to better coordinate the treatment of discharged debt at the corporate level with treatment at the creditor level. If a corporate debtor issues stock to its creditor for an outstanding security (such as a bond), no income from debt discharge would be realized and no attribute reduction would be required. Thus, no tax consequences at the corporate level would occur with respect to transfers which are generally treated as nonrecognition of gain or loss transactions for the creditors. If a corporate debtor issues stock for other debts (such a debt held by trade creditors or by a lender holding a short-term note), the corporation would be treated as having satisfied the debt with an amount of money equal to the stock's fair market value. To the extent the stock's value is less than the debt discharged, the discharge of indebtedness rules summarized above would apply. This treatment would be consistent with the usual recognition treatment for the creditors (e.g., a bad debt deduction is allowed for trade creditors) and the fact that tax attributes generally arose as a result of incurring such debts.

Loss carryovers

Under the bill, the special limitations on net operating loss carryovers (sec. 382 of the Internal Revenue Code) would not apply to the extent creditors receive stock in exchange for their claims. This exception to the section 382 rules is proposed in light of the attribute reduction provisions of the bill, under which loss carryovers would be reduced in certain cases (as described in the preceding paragraph) where the debtor corporation issues stock for debt.

Bankruptcy estate of an individual

At present, there are no Internal Revenue Code rules specifying whether the bankruptcy estate of a debtor constitutes a taxable entity and, if so, how tax attributes are to be allocated between the estate and the debtor. Under the bill, the bankruptcy estate of an individual is treated as a separate taxable entity in a liquidation or reorganization case under the new bankruptcy statute. Also, the bill provides that no separate taxable entity would be created by commencement of a bankruptcy case in which the debtor is an individual having no assets other than exempt property, an individual in a case under chapter 13 of the new bankruptcy law (adjustment of debts of an individual with regular income), a partnership, or a corporation.

The Federal income tax rules set forth in the bill with respect to the estate of an individual, if treated as a separate taxable entity, include rules for allocation of income and deductions between the debtor and the estate, computation of the estate's taxable income, accounting methods and periods, the treatment of the estate's administrative costs as deductible expenses, carryover of tax attributes between the debtor and the estate, and requirements for filing and disclosure of returns.

Corporate insolvency reorganizations

The bill provides that an insolvency reorganization of a corporation generally would be governed for Federal income tax purposes by the rules applicable to other corporate reorganizations. To coordinate the bill's rules for attribute reduction on discharge of indebtedness, the bill would include insolvency reorganizations within the category of transactions resulting in carryover of tax attributes to a successor corporation.

The bill provides that to the extent stock or other property received in a reorganization is attributable to accrued but unpaid interest, the recipient would treat the value of the property received as interest income.

Also, the corporate nonrecognition tax rules for 12-month liquidations would be extended to cover asset sales which are part of an insolvency liquidation. Under the bill, a corporate debtor generally would not be considered a personal holding company, subject to additional taxes on certain passive income, while in an insolvency reorganization proceeding. The bill provides that the bankruptcy estate of an individual debtor would be considered an eligible shareholder in a subchapter S corporation.

Tax procedural rules

The bill would make various technical changes relating to Internal Revenue Service assessment and collection procedures, to coordinate tax procedural rules with new rules enacted in P.L. 95–598 for determination of tax liabilities in bankruptcy cases.

Effective dates

The provisions of the bill would be effective for bankruptcy cases commenced or or after October 1, 1979, and for receivership, foreclosure, or similar nonbankruptcy judicial proceedings commenced on or after that date. Present tax law would continue to apply for bankruptcy cases, receivership proceedings, etc., commenced prior to October 1, 1979, including such cases or proceedings which were commenced before and continue after that date. In the case of transactions outside of bankruptcy cases, receivership proceedings, etc., the provisions of the bill would apply to such transactions after September 30, 1979.

III. DESCRIPTION OF H.R. 5043

A. Tax Treatment of Discharge of Indebtedness (sec. 2 of the bill)

In P.L. 95-598, the Congress repealed provisions of the Bankruptcy Act governing Federal income tax treatment of debt discharge in bankruptcy, effective for cases instituted on or after October 1, 1979. The bill would provide tax rules in the Internal Revenue Code in replacement of the repealed provisions.

The bill, accommodating tax policy to bankruptcy policy, provides that no income would be realized by reason of debt discharge in a bankruptcy case, and that the debt discharge amount would be applied to reduce the taxpayer's net operating loss carryovers, carryovers of certain credits and of capital losses, and basis in assets. In addition, the bill would provide generally similar discharge of indebtedness rules for taxpayers whose debts are cancelled outside bankruptcy, so that the debt-discharge rules will not operate as an incentive or disincentive to commencement of bankruptcy cases. The bill also provides general rules relating to corporate indebtedness in order to better coordinate the treatment of discharged debt at the corporate level with treatment at the creditor level.

Present law

In general

Under present law, income is realized when indebtedness is forgiven or in other ways cancelled (sec. 61(a)(12) of the Internal Revenue Code). For example, if a corporation issues bonds at par and later repurchases the bonds at less than par, the difference is taxable as income at that time.[1]

There are several exceptions to the general rule of income realization. Under a judicially developed "insolvency exception," no income arises from discharge of indebtedness if the debtor is insolvent both before and after the transaction;[2] and if the transaction leaves the debtor with assets whose value exceeds remaining liabilities, income is realized only to the extent of the excess.[3] Treasury regulations provide that the gratuitous cancellation of a corporation's indebtedness by a shareholder-creditor does not give rise to debt-discharge income to the extent of the principal of the debt since the cancellation amounts to a contribution to capital of the corporation.[4] Some courts have applied this exception even if the corporation had previously deducted the amount owed to the shareholder-creditor.[4a] Under a related exception,

[1] *United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931).

[2] Treas. Regs. § 1.61-12(b)(1); *Dallas Transfer & Terminal Warehouse Co.* v. *Comm'r*, 70 F. 2d 95 (5th Cir. 1934).

[3] *Lakeland Grocery Co*, 36 B.T.A. 289 (1937).

[4] Treas. Regs. § 1.61-12(a).

[4a] *Putoma Corp.* v. *Comm'r*, 66 T.C. 652 (1976), *aff'd*, —— F. 2d —— (5th Cir. 1979).

no income arises from discharge of indebtedness if stock is issued to a creditor in satisfaction of the debt, even if the creditor was previously a shareholder, and even if the stock is worth less than the face amount of obligation satisfied.[5] Further, cancellation of a previously accrued and deducted expense does not give rise to income if the deduction did not result in a reduction of tax (sec. 111). Also, amounts discharged by gift or bequest are not treated as income to the donee creditor (sec. 102).

A debtor who would otherwise be required to report current income from debt cancellation under the preceding rules instead may elect to reduce the basis of his assets in accordance with Treasury regulations (secs. 108 and 1017 of the Code). This income exclusion is available if the discharged indebtedness was incurred by a corporation or by an individual in connection with property used in his trade or business. These provisions were intended to allow the tax on the debt-discharge income to be deferred and collected through lower depreciation deductions for the reduced-basis assets, or greater taxable gains on sale of the assets.

The Internal Revenue Service takes the position that a reduction in the basis of qualified investment credit property resulting from an election under sections 108 and 1017 of the Code is *pro tanto* a disposition of the property the basis of which was reduced, resulting in partial recapture of the investment credit allowed upon its purchase (Rev. Rul. 74–184, 1974–1 C.B. 8).

Bankruptcy proceedings

The Bankruptcy Act contains certain rules relating to the Federal income tax treatment of discharge of indebtedness in bankruptcy proceedings. However, these rules have been repealed by P.L. 95–598 effective for bankruptcy cases instituted on or after October 1, 1979.

Under the existing Bankruptcy Act provisions, no income is recognized on cancellation of indebtedness in an insolvency reorganization (under chapter X).[6] The Act requires the debtor corporation to reduce the basis of its assets by the amount of indebtedness discharged, but not below the fair market value of such assets as of the date the bankruptcy court confirms the reorganization plan.[7] However, under section 372 of the Internal Revenue Code, no basis reduction is required if the corporation's property is transferred to a successor corporation as part of the bankruptcy reorganization.[8]

Similar rules apply in the case of an "arrangement" (under chapter XI), a "real property arrangement" (under chapter XII), and a wage earner's plan (under chapter XIII), except that no basis reduction is

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[5] *Comm'r* v. *Motor Mart Trust*, 156 F. 2d 122 (1st Cir. 1946).

[6] Sec. 268 of the Bankruptcy Act.

[7] Sec. 270 of the Bankruptcy Act.

[8] While under present law no basis reduction is required if a successor corporation is used in the insolvency reorganization, the Code under present law does not permit the carryover of tax attributes, such as net operating losses, from the debtor to the successor corporation (except possibly in certain situations where the reorganization meets the requirements of sec. 368 of the Code, in which case net operating losses may be limited by section 382 of the Code).

required under a wage earner's plan.[9] In addition, in the case of a Bankruptcy Act discharge other than under an insolvency reorganization or an arrangement described above, income is not realized to the extent the general "insolvency exception" applies.[10]

Explanation of provisions

Debt discharge in bankruptcy

Under the bill, no amount would be included in income by reason of discharge of indebtedness in a bankruptcy case. Instead, the debt-discharge amount which would be excluded from gross income by virtue of the bill's provisions would be applied to reduce certain of the taxpayer's tax attributes.

The excluded amount of debt discharge would reduce the taxpayer's tax attributes in the following order:

(1) net operating losses and carryovers;

(2) carryovers of the investment tax credit (other than the ESOP credit), the WIN credit, and the new jobs credit;[11]

(3) capital losses and carryovers; and

(4) the basis of the taxpayer's assets.[12]

The reduction in each category of carryovers would be made in the order of taxable years in which the items would be used up, determined as if the debt-discharge amount were not excluded from income.

Under the bill, the basis of the taxpayer's assets would not be reduced below an amount equal to the remaining, undischarged liabilities. (Thus a sale of all the taxpayer's assets would not result in income tax liability except to the extent the sale proceeds exceeded the amount needed to pay off the remaining liabilities.) Any amount of debt discharge which is left after attribute reduction under these rules would be disregarded, i.e., would not result in income or have other tax consequences.

If the basis of qualified investment credit property is reduced under these rules, no investment credit recapture tax would be incurred, because the reduction would not be considered to be a disposition.

In the case of an individual debtor, any attribute reduction required under the bill generally would apply to the bankruptcy estate if the estate is treated as a separate taxable entity for Federal income tax purposes (see sec. 3 of the bill, discussed at III–B below). If the estate is not treated as a taxable entity, the attribute reduction rules would apply to the individual debtor, except that there would be no reduction of any of the individual's tax attributes arising after commencement of the bankruptcy case, or of the basis of exempt assets (under new 11 U.S. Code § 522).

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[9] Secs. 395, 396, 520, 522, and 679 of the Bankruptcy Act.

[10] Treas. Regs. § 1.61–12(b). See text accompanying notes 2 and 3 of section III–A, *supra*.

[11] These credits would be reduced at the rate of 50 cents on the dollar. This flat-rate reduction avoids the complexity of determining a tax on the "excluded amount" and determining how much of the "excluded amount" is used up by the credits for purposes of determining other reductions.

[12] In order to avoid interaction between basis reduction and reduction of other attributes, the bill would provide that the basis reduction is to take effect on the first day of the taxable year following the year in which the discharge took place.

Debt discharge outside bankruptcy

Insolvent taxpayers.—The bill provides that in the case of an insolvent taxpayer whose debts are cancelled outside of bankruptcy, the amount of debt discharge would be excluded from gross income up to the amount by which the taxpayer is insolvent,[13] and that the excluded amount would be applied to reduce tax attributes in the same manner as if the discharge had occurred in a bankruptcy case. Any balance of the debts discharged which is not so excluded from gross income (because it exceeds the insolvency amount) would be treated in the same manner as debt cancellation in the case of a wholly solvent taxpayer.

Solvent taxpayers.—The bill would retain the present rule (secs. 108 and 1017 of the Code) permitting an election to reduce the basis of assets in lieu of reporting income from discharge of indebtedness, subject to several modifications. First, a taxpayer would be required to use up currently any net operating loss or loss carryovers and any credits before electing to exclude any remaining amount of the cancelled debt. (This would achieve a result generally similar to the taxpayer whose debts are discharged in bankruptcy, and generally would not require a solvent taxpayer whose debts are discharged to actually pay tax currently on that income to the extent loss carryovers, credits, and basis are reduced.) Second, the bill would provide that a taxpayer may elect to reduce the basis of an investment in stock in a member of a controlled group of corporations (within the meaning of sec. 1504 of the Code) only if the controlled corporation also elects to reduce the basis of its assets. (This would preclude use of a tax-planning technique intended to postpone indefinitely recognizing income from discharge of indebtedness—rather than deferring recognition until depreciation deductions are taken or the reduced-basis asset is sold [14].)

Additional rules as to debt discharge

Equity-for-debt rules.—The bill would provide rules relating to corporate indebtedness in order to better coordinate the treatment of discharged debt at the corporate level with treatment at the creditor level.

If a corporate debtor issues stock to its creditor for the principal amount of an outstanding security (such as a bond), no income from debt discharge would be realized and no attribute reduction would be

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[13] The bill would define "insolvent" as the excess of liabilities over the fair market value of assets, determined with respect to the taxpayer's assets and liabilities immediately before the debt discharge.

[14] A technique under present law is to have a parent corporation (often a holding company) borrow funds which it contributes to an active subsidiary. If the debt is later repurchased at a discount, the parent then makes an election to reduce the basis of its stock in the subsidiary under section 1017 and reports no income. So long as the stock continues to be held by the parent, no income is recognized, and if the subsidiary later is liquidated into the parent, the basis of the assets in the hands of the parent carries over from their basis in the hands of the subsidiary (sec. 334(b)(1)). This technique thus allows debt-discharge income completely to escape taxation.

required [15]. Thus, no tax consequences at the corporate level would occur with respect to transfers which are treated generally as nonrecognition of gain or loss transactions for the creditor.

If a corporate debtor issues stock for other debts (such as debt held by trade creditors or by a lender holding a short-term note), the corporation would be treated as having satisfied the debt with an amount of money equal to the stock's fair market value. To the extent the stock's value is less than the face amount of the debt discharged, the discharge of indebtedness rules summarized above would apply.[16] This treatment would be consistent with the usual recognition treatment for the creditors (e.g., a bad debt deduction is allowed for trade creditors) and the fact that tax attributes generally arose as a result of incurring such debts.

The bill also would provide that the discharge of indebtedness rules would apply to the extent that the amount of debt transferred to a corporation as a contribution to capital exceeds the shareholder's basis in the debt.[17]

Similar rules would apply in the case of discharge of partnership indebtedness if an equity interest in the partnership is exchanged for a partnership debt, or if partnership debt is contributed by a partner as a contribution to capital.

The equity-for-debt rules in the bill would apply whether the debtor is solvent or insolvent, and whether or not the debtor is in a bankruptcy case.

Tax benefit rule.—The bill would clarify present law by providing that in applying the tax benefit rule of section 111 of the Code in order to determine if the recovery of an item is taxable, a deduction increasing an unexpired carryover would be treated as having produced a reduction in tax.

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[15] For purposes of this rule, the term "security" means an evidence of indebtedness which was issued by a corporate debtor with interest coupons or in registered form (within the meaning of sec. 165(g)(2)(C)) and which constitutes a security for purposes of section 354 of the Code. Thus the term "security" is intended to mean those instruments with respect to which generally no deduction for partially worthless debts could have been allowed under section 166(a)(2) of the Code and with respect to which no loss could be recognized in an exchange under a plan of reorganization by reason of sections 354 or 356 of the Code.

This rule also would apply to an exchange of stock for a security, as so defined, of a predecessor corporation (i.e., a corporation whose attributes carried over under sec. 381 of the Code, as amended by the bill).

[16] For example, assume a corporate debtor borrows $1,000 on a short-term note and later issues $600 worth of stock in cancellation of the note. Under present law, the creditor recognizes a $400 loss, but the corporate debtor neither recognizes income nor must reduce tax attributes. Under the bill, the creditor would recognize a $400 loss (as under present law), and the corporation would be required to apply the $400 debt discharge amount to reduce tax attributes pursuant to the rules discussed in the text above.

[17] For example, assume a corporation accrues and deducts (but does not actually pay) a $1,000 liability to a shareholder-employee as a salary, and the cash-basis employee does not include the $1,000 in income. In a later year the shareholder-employee forgives the debt. Under the bill, the corporation would be required to apply the $1,000 debt discharge amount to reduce tax attributes pursuant to the rules discussed in the text above. On the other hand, if the shareholder-employee were on the accrual basis and had included the salary in income, so that his basis in the debt was $1,000, there would be no debt discharge amount and no attribute reduction would be required.

Related parties.—The bill would provide that an outstanding debt acquired from an unrelated party by a party related to the debtor would, for purposes of determining the debtor's income, be treated as having been acquired by the debtor to the extent provided in regulations issued by the Treasury Department. For this purpose, related parties generally would include businesses under common control (under sec. 414 of the Code) and members of the debtor's family. The definition of "family" for this purpose includes a spouse of the debtor's child or grandchild. This rule is intended to treat a debtor as having its debts discharged if a party related to the debtor purchases outstanding debt of the debtor at a discount, because of the likelihood that the related party will fail to demand payment in full from the debtor.

Lost deductions.—The bill would provide that if the payment of a liability would have given rise to a deduction, the discharge of that liability will not give rise to income or require reduction of tax attributes.

Section 382 exception.—Because the bill contains rules providing for attribute reduction in certain circumstances where a corporation's indebtedness is discharged upon the issuance of stock, no further reduction of attributes would be required under sections 382 and 383 of the Code if stock is issued in exchange for a creditor's claim against the corporation (unless the claim was acquired for the purpose of acquiring the stock). The bill specifically would provide that acquisition of stock for debt in a bankruptcy or similar case would not be treated as an acquisition by purchase in applying section 382(a) of the Code and that the creditors of the debtor corporation would be treated as shareholders in applying the continuity rules of section 382(b).

Partnerships

The bill would provide that any income from the discharge of a partnership debt would be treated as an item of income which is allocated separately to each partner (under sec. 702(a) of the Code). The partner's basis in the partnership would then be increased (under sec. 705) by the amount of the income. The reduction in the partner's share of partnership liabilities would result in a deemed distribution (under sec. 752), in turn resulting in an offsetting reduction of the partner's basis in the partnership (under sec. 733).[18]

If the partner is in a bankruptcy proceeding, is insolvent, or makes an election under section 1017, the debt-discharge amount would be excluded from the partner's income under section 108. If the partner would thereby be required to reduce his basis in the partnership, the partnership would likewise be required to reduce its basis in its assets with respect to that partner (in a manner similar to that which would be required if the partnership had made an election under sec. 754 to adjust basis in the case of a transfer of a partnership interest).

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[18] The effect of these provisions of the bill would be to overturn the contrary rule in *Stackhouse* v. *U.S.*, 441 F. 2d 465 (5th Cir. 1971).

B. Rules Relating to Title 11 Cases for Individuals (sec. 3 of the bill)

Under bankruptcy law, the commencement of a liquidation or reorganization case involving an individual debtor creates an "estate" which consists of property formerly belonging to the debtor. The estate is administered by a trustee for the benefit of creditors, and it may derive its own income and incur expenditures. At the same time, the individual is given a "fresh start"—that is, wages earned by the individual after commencement of such case, exempt assets, and after-acquired property do not pass to the bankruptcy estate, but remain with the individual.

For Federal income tax purposes, it is necessary to determine whether the bankruptcy estate constitutes a taxable entity apart from the individual debtor; and if so, how income, deductions, and credits should be allocated between the estate and the individual debtor, particularly in the year the bankruptcy case commences. At present, there are no Internal Revenue Code rules specifying whether the bankrupcy estate constitutes a taxable entity and, if so, how tax attributes are to be allocated between the estate and the debtor. This results in uncertainty and other problems in determining the Federal income tax liability of the bankruptcy estate and the individual debtor. The provisions of section 3 of the bill, adding new sections 1398 and 1399 to the Internal Revenue Code, would provide the first comprehensive statutory treatment of these issues.

1. Debtor, bankruptcy estate as separate entities

Present law

Under present law, the estate created on commencement of a bankruptcy proceeding with respect to an individual debtor is treated for Federal income tax purposes as a new taxable entity, separate from the individual (Rev. Rul. 72–387, 1972–2 C.B. 632). Accordingly, the trustee must file a tax return (Form 1041) for the bankruptcy estate if the gross income of the estate, for the period beginning with filing of the petition or for any subsequent taxable year, is $600 or more. The taxable income of the estate is computed under subchapter J of the Internal Revenue Code (relating to taxation of decedent's estates and trusts).

The taxable year of the individual debtor is not terminated on commencement of the bankruptcy proceeding. On the individual's return (Form 1040) for the year in which the bankruptcy proceeding commenced, the individual reports all income earned by him or her during the entire year, but does not report any income earned by the bankruptcy estate.[1]

Thus, under present law, income earned by the individual debtor in the year in which the bankruptcy proceeding begins but prior to commencement of the proceeding is taxed to the individual as a post-petition tax liability, even though any moneys arising from the income and any assets which had been purchased with the income (and which the debtor owns at commencement of the proceeding) become part of the bankruptcy estate, available to satisfy claims of creditors. Also under present law, tax attributes of the individual debtor (such as a net operating loss deduction arising out of a business operated as a sole proprietorship) are used by the individual in computing his or her tax liability, and are not available to the estate.

Explanation of provisions

In general.—The bill, like present law, would treat the bankruptcy estate of an individual as a separate taxable entity for Federal income tax purposes (subject to the exceptions discussed below). However, the bill would generally treat the bankruptcy estate as continuing the pre-bankruptcy tax status of the individual debtor, rather than as constituting an entirely new entity. Also, the bill would provide in effect that after commencement of the bankruptcy case, the individual debtor represents a new tax person whose income and deductions are attributable to those items which do not pass to the bankruptcy estate. These changes are intended to better coordinate Federal income tax treatment of the individual debtor and the bankruptcy estate with bankruptcy policy, under which assets of the debtor pass on commencement of the case to the estate for the benefit of creditors, while earnings from services performed by an individual after commencement of a liquidation or reorganization bankruptcy case do not constitute an asset of the estate subject to the claims of creditors.

Exceptions.—The bill would provide two exceptions to separate entity treatment of the bankruptcy estate of an individual. First, under regulations to be issued by the Treasury Department, the estate would not be treated as a taxable entity if the debtor has no assets other than property which may be treated as exempt property under bankruptcy law (prop. Code sec. 1398(b)(1)).[2] In this situation, no assets may pass to the bankruptcy estate from which income could be earned, and hence there is no reason for treating the estate as a taxable entity. Second, if a bankruptcy case involving an individual is commenced but subsequently dismissed by the bankruptcy court, the estate would not be treated as a separate entity (prop. Code sec. 1398 (b)(2)). In this situation, where the bankruptcy proceeding does not run to completion, it is appropriate to treat the debtor's tax status as if no proceeding had been brought.

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[1] The rationale for treating the individual debtor and the bankruptcy estate as separate entities is that the individual may obtain new assets or earn wages after transfer of the pre-bankruptcy property to the trustee and thus derive income independent of that derived by the trustee from the transferred assets.

[2] In this pamphlet, provisions of the Internal Revenue Code which would be added by section 3 of the bill are cited as "prop. Code—".

Scope of rules.—The separate entity rules under the bill (prop. Code sec. 1398) would apply only if a bankruptcy case involving an individual debtor is brought under chapter 7 (liquidation) or chapter 11 (reorganization) of title 11 of the U.S. Code, as codified by P.L. 95–598. Thus no separate taxable entity would be created on commencement of a case under chapter 13 of title 11 (adjustment of debts of an individual with regular income). In a chapter 13 case, both future earnings of the debtor and exempt property may be used to make payments to creditors, and hence the bankruptcy law does not create the same dichotomy between after-acquired assets of the individual debtor and assets of the bankruptcy estate as in chapter 7 or chapter 11 cases.

Under the bill, no taxable entity would result from commencement of a bankruptcy case involving a partnership or corporation. This provision (prop. Code sec. 1399) would overturn current Internal Revenue Service practice as to partnerships, under which the estate of a partnership in bankruptcy is treated as a taxable entity (Rev. Rul. 68–48, 1968–1 C.B. 301), but is the same as present law with respect to commencement of a bankruptcy case involving a corporation.

Detailed discussion.—The following is a more detailed discussion of the provisions of section 3 of the bill as applicable where the bankruptcy estate of an individual debtor would be treated as a taxable entity.

2. Computation of bankruptcy estate's tax liability

Gross income

Under the bill, the gross income of the bankruptcy estate of an individual for its first taxable year would consist of (1) all gross income of the individual debtor which the debtor had received during that year but prior to commencement of the bankruptcy case, (2) any gross income of the debtor for the remainder of that year which under bankruptcy law constitutes property of the bankruptcy estate, and (3) the gross income of the estate for the remainder of that year, i.e., the gross income earned by the estate beginning on and after the date the case commenced (prop. Code sec. 1398(e)(1)).The first taxable year of the bankruptcy estate would be the same as the taxable year of the individual—in almost all instances, the calendar year (prop. Code sec. 1398(d)(1)).

For each subsequent taxable year the estate is in existence, its gross income would consist of (1) the gross income of the estate for such year plus (2) any gross income of the debtor for such year which under bankruptcy law constitutes property of the estate (prop. Code sec. 1398(e)(1)).

Deductions, credits

In general, the bankruptcy estate would succeed to all deductions and credits to which the individual debtor would have been entitled for the year in which the bankruptcy case commenced but prior to commencement of the case (prop. Code sec. 1398(e)(3)). For example, in its first taxable year the bankruptcy estate would be entitled to claim itemized deductions for medical expenses, interest, taxes, charitable contributions, casualty losses, and employee expenses that the debtor had paid in that year prior to commencement of the bankruptcy case. Similarly, the estate would claim on its return other deductions or credits—such as deductions for bad debts, section 162 trade or business expenses, and section 212 income production expenses, and the investment tax credit—to which the debtor would have been entitled for the portion of the year ending with commencement of the case.[3] However, the debtor would retain (and the estate could not claim) his or her deduction for personal exemptions (sec. 151 of the Code) and any earned income credit (sec. 43 of the Code).

Attribute carryover

Since the bankruptcy estate would be treated as a continuation of the individual debtor's pre-bankruptcy tax status, the estate would succeed to the following income tax attributes of the debtor (determined as of the beginning of the taxable year in which the case commenced):

(*a*) net operating loss carryovers;
(*b*) capital loss carryovers;
(*c*) credit carryovers;
(*d*) charitable contribution carryovers;
(*e*) recovery exclusions (under sec. 111 of the Code);
(*f*) the debtor's basis in and holding period for, and the character in the debtor's hands of, any asset acquired (other than by sale or exchange) from the debtor;
(*g*) the debtor's method of accounting; and
(*h*) other tax attributes, to the extent provided by regulations (prop. Code sec. 1398(g)).

Administrative expenses

Under present law, it is unclear in certain circumstances whether administrative and related expenses of the bankruptcy estate are deductible by the estate (see Rev. Rul. 68–48, 1968–1 C.B. 301). The bill provides (prop. Code sec. 1398(h)(1)) that the estate could deduct (a) any administrative expense allowed under new 11 U.S. Code sec. 503 and (b) any fee or charge assessed against the estate under 28 U.S.C., chapter 123 (court fees and costs). Such deductions would be allowed whether or not considered trade or business expenses or investment expenses, but subject to disallowance under other provisions of the Internal Revenue Code, such as sections 263 (capital expenditures) or 265 (expenses relating to tax-exempt interest).

Under present law, any deduction otherwise available for administrative or related expenses may be lost, since no carryover deduction is permitted for expenses not incurred in a trade or business. The trustee often cannot pay administrative expenses until the end of the bankruptcy proceeding; unless considered trade or business expenses, the unused amount cannot be carried back and deducted against income of the bankruptcy estate received in earlier years.

To alleviate this problem, the bill provides that any amount of the deduction for administrative, etc., expenses not used in the current

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[3] The language of prop. Code sec. 1398(e)(3) as it appears in H.R. 5043 as introduced could be construed more narrowly than intended and explained in the text above, and accordingly will be revised in later versions of the bill.

year could be carried back by the estate three years (but only to a taxable year of the estate) and forward seven years (prop. Code sec. 1398(h)(2)). These carryovers would be "stacked" after the section 172 net operating loss deductions for the particular year.

Character of expenditures

Under present law, payment of certain expenses or debts by the trustee may not be treated as deductible if the trustee does not actually operate the debtor's trade or business. To alleviate this problem, the bill would provide that an amount paid or incurred by the bankruptcy estate would be deductible or creditable by the estate to the same extent as the same item would have been deductible or creditable by the debtor had the debtor remained in the same trades, businesses, or activities after the case commenced as before and had the debtor paid or incurred such amount (prop. Code sec. 1398(e)(4)).

Carryback of estate's NOLs

If the bankruptcy estate itself incurs a net operating loss (apart from losses passing to the estate from the individual debtor), the bill provides that the bankruptcy estate could carry back its net operating losses not only to previous taxable years of the estate, but also to taxable years of the individual prior to the year in which the case commenced (prop. Code sec. 1398(j)(2)). Similarly, the bill would allow the bankruptcy estate to carry back excess credits, such as the investment tax credit, to pre-bankruptcy taxable years of the individual debtor.[4]

Tax rate schedule, etc.

Except as otherwise provided in prop. Code section 1398, the taxable income of the bankruptcy estate would be computed in the same manner as in the case of an individual. The estate would be allowed a deduction of $1,000 under section 151 of the Code as its personal exemption. Under the bill, the zero bracket amount for the estate would be $1,700, and the tax rate schedule applicable to the estate would be that for married individuals filing separate returns (prop. Code sec. 1398(c)).

Change of accounting period

The estate would be permitted to change its annual accounting period (taxable year) one time without obtaining approval of the Internal Revenue Service as otherwise required under section 442 of the Code (prop. Code sec. 1398(j)(1)). This rule would permit the trustee to effect an early closing of the estate's taxable year prior to the expected termination of the estate, and then to submit a return for such "short year" for an expedited determination of tax liability pursuant to new 11 U.S. Code § 505.

Returns of estate

Under the bill, the trustee would be required to file a Federal income tax return on behalf of the bankruptcy estate for any year in which the estate's gross income exceeds $2,700 (sec. 3(b) of the bill), and to pay the estate's tax liability due for that year (prop. Code sec. 1398(c)(1)).

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[4] The right of the estate to carry back its net operating loss deduction or excess credits to offset the individual debtor's pre-bankruptcy income would be consistent with treating the bankruptcy estate as a continuation of the individual's pre-bankruptcy tax status.

Disclosure of returns

The bill provides that the estate's Federal income tax return would, upon written request, be open to inspection by or disclosure to the individual debtor. Such disclosure is necessary so that the debtor could properly determine any amount of tax attributes to which the debtor succeeds on termination of the estate.

No-disposition rule

Under the bill, a transfer (other than by sale or exchange) of assets from the bankruptcy estate to the individual debtor on termination of the estate would not be treated as a transfer giving rise to recognition of gain or loss, recapture of deductions or credits, or acceleration of income or deductions (prop. Code sec. 1398(f)(2)).

3. Computation of individual's tax liability

Gross income

For the year in which the bankruptcy case commenced or a later year while the bankruptcy estate remains in existence, the debtor would not include in his or her return (or in a joint return with the debtor's spouse) income earned by the debtor but treated as gross income of the bankruptcy estate under the provisions of the bill described above (prop. Code sec. 1398(e)(2)). The provisions of the bill that treat such income items as gross income of the estate rather than of the individual would override any otherwise applicable "assignment of income" principles of tax law. Except for such income items which are included in the gross income of the estate, the individual would determine his or her gross income as if no bankruptcy case had been commenced.

Deductions, credits

The deductions or credits otherwise available to an individual debtor but allocated to the bankruptcy estate under the provisions of the bill summarized above could not be used by the individual. However, even in the year the bankruptcy petition is filed, the individual debtor would remain entitled to or eligible for, as if no bankruptcy case had commenced, the deductions for personal exemptions (sec. 151 of the Code), the earned income credit (sec. 43 of the Code), head of household or surviving spouse status, and joint return filing.

No-disposition rule

Under the bill, a transfer (other than by sale or exchange) of assets from the individual debtor to the bankruptcy estate would not be treated as a transfer giving rise to recognition of gain or loss, recapture of deductions or credits, or acceleration of income or deductions (prop. Code sec. 1398(f)). For example, such a transfer of an installment obligation would not be treated as a disposition giving rise to acceleration of gain under section 453(d) of the Code.

Carryback of net operating loss

The bill provides that an individual debtor could not carry back, to a year that preceded the year in which the case was commenced, any net operating loss or credit carryback from a taxable year ending after commencement of the bankruptcy case (prop. Code sec. 1398(j)(2)(B)). As noted above, the bill would permit the bankruptcy estate to carry back its net operating loss deduction to offset the pre-bankruptcy income of the individual debtor.

Income averaging

Under the bill, an individual debtor would continue to be eligible for income averaging. Because income earned by the debtor prior to commencement of the case would be included in gross income of the bankruptcy estate as described above, the individual would include only part of his or her actual earnings in gross income for the year in which the case is commenced. In order to adjust for the effect of this rule, the bill provides that the debtor's base period income for the year in which the case commenced would be annualized (prop. Code sec. 1398(j)(3)).

Attribute carryover

On termination of the bankruptcy estate, the debtor would succeed to the following tax attributes of the estate:

(*a*) net operating loss carryovers;
(*b*) capital loss carryovers;
(*c*) credit carryovers;
(*d*) charitable contribution carryovers;
(*e*) recovery exclusions (under sec. 111 of the Code);
(*f*) the estate's basis in and holding period for, and the character in the estate's hands of, any asset acquired (other than by sale or exchange) from the estate; and
(*g*) other tax attributes, to the extent provided by Treasury regulations (prop. Code sec. 1398(i)).

Any carryover that passes to the individual debtor from the bankruptcy estate could be carried forward by the individual—i.e., could be used in the year in which he or she succeeds to the carryover and in later years, but could not be carried back to prior years of the debtor.[5] The unused attributes of the estate to which the debtor succeeds would include both attributes which originally had passed to the estate from the debtor and also attributes generated by the estate.

Disclosure of returns

In cases where the bankruptcy estate of an individual debtor is treated as a taxable entity, any Federal income tax return of the debtor for the taxable year in which the bankruptcy case commenced or preceding years would, upon written request, be open to inspection by or disclosure to the trustee of the bankruptcy estate. (This disclosure is necessary so that the trustee properly may report income items and deductions of the debtor under the rules summarized above, may deter-

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[5] The rule that any attribute carryover from the estate could only be carried forward by the individual debtor will be made explicit in later versions of the bill.

As noted above, the bill would provide (prop. Code sec. 1398(h)(1)) a special deduction to the estate for its administrative and related expenses, and would permit a three-year carryback and seven-year carryforward by the estate of any amount not used in the year incurred. If any amount of such deduction still remains unused, it would not carry over to the debtor.

mine attribute carryovers to the estate, and may carry back deductions to preceding years of the debtor.) In an involuntary case, however, no disclosure to the trustee could be made prior to the time the bankruptcy court has entered an order for relief unless that court finds that such disclosure is appropriate for purposes of determining whether an order for relief should be entered (sec. 3(c) of the bill.)

Also under the bill, prior year returns of the debtor in any bankruptcy case would be open, upon written request, to inspection by or disclosure to the trustee, but only if the Internal Revenue Service finds that such trustee, in his fiduciary capacity, has a material interest which would be affected by information contained in the return.

C. Corporate Reorganization Provisions (sec. 4 of the bill)

Present law

Definition of reorganization

Under present Federal income tax law, an insolvent corporation which transfers all or part of its assets, pursuant to a court order in a proceeding under chapter X of the Bankruptcy Act or in a receivership, foreclosure, or similar proceeding, to another corporation organized or utilized to effectuate a court-approved plan may qualify for tax-free reorganization treatment under special rules relating to insolvency reorganizations (secs. 371–374 of the Code). These special rules for insolvency reorganizations, however, generally allow less flexibility in structuring tax-free reorganizations, do not permit carryover of tax attributes to the transferee corporation, and otherwise differ in important respects from the general reorganization rules.

Triangular reorganizations

In order for an insolvency reorganization to qualify for nonrecognition treatment, the stock or securities used to acquire the assets of the insolvent corporation must be the acquiring corporation's own stock or securities. This limitation generally precludes insolvent corporations from engaging in so-called triangular reorganizations, where the acquired corporation is acquired for stock of the parent of the acquiring corporation. By contrast, tax-free triangular reorganizations generally are permitted for other corporations.

Transfer to controlled subsidiary

In the case of an insolvency reorganization, it is not clear under present law whether and to what extent the acquiring corporation may transfer assets received into a controlled subsidiary. In the case of other corporate reorganizations, the statute expressly defines the situations where transfers to subsidiaries are permitted (sec. 368 (a) (2) (C) of the Code).

Carryover of tax attributes

Also, in the case of an insolvency reorganization, it is not clear to what extent attributes (such as net operating losses) of the insolvent corporation may carry over to the surviving corporation. In the case of other corporate reorganizations, however, specific statutory rules permit carryover of tax attributes to the surviving corporation (sec. 381 of the Code).

"Continuity of interest" rule

It is also not clear under present law to what extent creditors of a debtor corporation who exchange their claims for stock may be considered to have "stepped into the shoes" of former shareholders for purposes of satisfying the nonstatutory "continuity of interest" rule.[1]

"Principal amount" rule

Under corporate reorganizations, generally the exchange of stock or securities in one corporation for those of another corporation in a reorganization is not tax-free to the extent the principal amount of the securities received exceeds the principal amount of the securities surrendered (secs. 354(a)(2)(B) and 356(d)(2) of the Code). This rule does not apply under current law to insolvency reorganizations under sections 371–374 of the Code.

Treatment of accrued interest

Under present law, a claim for unpaid interest is treated as an integral part of the security to which it relates, so that the surrender of the security together with the claim for unpaid interest is treated only as the surrender of a security. Thus, the nonrecognition provisions apply to an exchange of a security with accrued but unpaid interest, although the unpaid interest would have been taxable as ordinary income if paid separately.[1a]

Explanation of provisions

Section 4 of the bill generally would conform the rules governing insolvency reorganizations with the existing rules applicable to other corporate reorganizations.

Definition of reorganization

The bill would add insolvency reorganizations as a new category "G" under the general definition of tax-free reorganizations (sec. 368(a)(1) of the Code), and would repeal the special tax rules (secs. 371–374) now applicable only to insolvency reorganizations.[2] The new "G" category would include certain transfers of assets pursuant to a court-approved reorganization plan in a bankruptcy case under new title 11 of the U.S. Code, or in a receivership, foreclosure, or similar judicial proceeding.[3] An insolvency reorganization qualifying as a "G" reorganization would not have to meet certain requirements imposed for qualification under other categories of section 368 tax-free reorganizations, such as the requirement under section 368(a)(1)(C) that only stock be received in exchange for assets.

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[1] Generally, the courts have found the "continuity of interest" test satisfied if the creditors' interests were transformed into proprietary interests prior to the reorganization (*e.g., Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942)).

[1a] *Carman* v. *Comm'r*, 189 F. 2d 363 (2nd Cir. 1951); Rev. Rul. 59–98, 1959–1 C.B. 76.

[2] The rules governing tax-free exchanges under the final system plan for ConRail, set forth in sec. 374(c) of the Code, would not be changed by the bill.

[3] The definition of a receivership, foreclosure, or similar proceeding would be the same as under present law (sec. 371 of the Code). For purposes of this pamphlet, the term "insolvency reorganization" (which is used in present sections 371–374 of the Code) is used to describe reorganizations qualifying under proposed section 368(a)(1)(G), even though solvent corporations as well as insolvent corporations in bankruptcy cases, etc. may be subject to the new rules.

Triangular reorganizations

The bill would permit a corporation to acquire a debtor corporation in an insolvency reorganization in exchange for stock of the parent of the acquiring corporation rather than for its own stock.

In addition, because certain creditors of the debtor corporation would be treated as its shareholders immediately before the reorganization for purposes of section 368 of the Code, such corporations would be able to engage in so-called "reverse merger" triangular reorganizations in which the subsidiary of an acquiring corporation is merged into the debtor corporation.

Transfer to controlled subsidiary

The bill would permit a corporation which acquires the assets of a debtor corporation in an insolvency reorganization to transfer the acquired assets to a controlled subsidiary without endangering the tax-free status of the reorganization. This provision would put insolvency reorganizations on a similar footing with other types of reorganizations and would eliminate the present law uncertainty as to whether such transfers to subsidiaries are permitted.

Carryover of tax attributes

Under the bill, the statutory rule generally governing carryover of tax attributes in corporate reorganizations (sec. 381) also would apply in the case of an insolvency reorganization. This would eliminate the present uncertainty as to the availability of carryovers of tax attributes in insolvency reorganizations.[4]

"Continuity of interest" rule

Under the bill, the requirement that "continuity of interest" must be satisfied in order to qualify as a reorganization could be met by treating the creditors as shareholders where the shareholders receive no consideration for their stock. (However, since a secured creditor is unlikely to be willing to take stock for his secured debt, a secured creditor not receiving stock would not be counted as a creditor for purposes of determining whether continuity is established.) Short-term creditors who receive stock for their claims would count under the bill toward satisfying the continuity of interest rule, but any gain or loss realized by such creditors would be recognized for income tax purposes.

"Principal amount" rule

Under the bill, insolvency reorganizations would be subject to the rules governing the tax treatment of exchanging shareholders and security holders which apply to other corporate reorganizations. Accordingly, a shareholder or security holder who receives securities with a face amount exceeding the face amount of securities surrendered would be taxed on the excess. Also, "boot" would be subject to the general dividend-equivalence test of section 356 of the Code.

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[4] Special rules relating to limitations on net operating loss carryovers under section 382 of the Code are discussed in section III–A of this pamphlet.

Treatment of accrued interest

Under the bill, a creditor exchanging securities in a corporate reorganization (including an insolvency reorganization) would be treated as receiving interest income on the exchange to the extent the security holder receives new securities, stock, or any other property for accrued but unpaid interest on the securities surrendered. This provision, which would overturn the so-called *Carmen* rule,[5] would apply whether or not the exchanging security holder would otherwise recognize gain on the exchange. Under this provision, a security holder which had previously accrued the interest as income could recognize a loss to the extent the interest is not paid in the exchange.

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[5] See note 1a, *supra*.

D. Miscellaneous Corporate Amendments (sec. 5 of the bill)

1. Exception from personal holding company status

Present law

Under present law, a corporation in a bankruptcy or insolvency proceeding may become subject to the personal holding company tax on certain passive income (sec. 541 of the Internal Revenue Code) if its assets are converted to investments which produce passive income before the corporation is liquidated.

Explanation of provision

Section 5(c) of the bill provides that a corporation subject to court jurisdiction in a bankruptcy case or insolvency proceeding would not be considered a personal holding company. This exception would not be available, however, if a major purpose of the corporation in commencing or pursuing the proceeding is avoidance of the personal holding company tax.

2. Application of 12-month liquidation rule

Present law

Under present law, a corporation which sells its assets and liquidates in a distribution to shareholders within 12 months after adopting a plan of liquidation generally does not recognize gain or loss on the sales (sec. 337 of the Internal Revenue Code). The Internal Revenue Service has ruled that this provision does not apply if, as in the case of an insolvency proceeding, the assets are transferred to creditors instead of to shareholders (Rev. Rul. 56–387, 1956–2 C.B. 189).

Explanation of provision

Section 5(c) of the bill would allow a corporation in a bankruptcy case or similar proceeding to sell its assets tax-free under the 12-month liquidation rule, although the assets are transferred to its creditors rather than to shareholders, provided the liquidation otherwise satisfies the requirements of section 337 of the Code. The 12-month period would begin when the court approves the plan of liquidation.

3. Estate of individual in bankruptcy as subchapter S shareholder

Present law

Under present law, only individuals, estates, and certain trusts are permitted to be shareholders of subchapter S corporations (sec. 1371 of the Internal Revenue Code). Failure to satisfy this rule disqualifies the election of the corporation under subchapter S.

The Internal Revenue Service holds that an "estate" for subchapter S purposes includes only the estate of a decedent and not the estate of an individual in bankruptcy (Rev. Rul. 66–266, 1966–2 C.B. 356).

Accordingly, the Revenue Service also has held that the filing of a voluntary petition in bankruptcy by a shareholder terminates the subchapter S election as of the beginning of the taxable year in which the petition is filed (Rev. Rul 74–9, 1974–1 C.B. 241). However, the U.S. Tax Court has held that the filing of a petition seeking financial rehabilitation of a debtor under the debt arrangement provisions of the Bankruptcy Act does not create a new entity apart from the debtor and does not cause the termination of a subchapter S election.[1]

Explanation of provision

Section 5(d) of the bill would permit the bankruptcy estate of an individual to be a shareholder of a subchapter S corporation.

4. Certain transfers to controlled corporations

Present law

Under present law, if property is transferred to a corporation controlled by the transferor, no gain or loss is recognized on the transfer (sec. 351 of the Internal Revenue Code). For this purpose, property includes (1) indebtedness of the transferee corporation not evidenced by a security,[2] and (2) a claim for accrued interest on indebtedness of the transferee corporation.[3]

Explanation of provision

Section 5(a) of the bill would provide that for purposes of the rule providing for nonrecognition of gain or loss on certain transfers of property to a controlled corporation, (1) indebtedness of the corporation which is not evidenced by a security and (2) claims against the corporation for accrued but unpaid interest on indebtedness are not to be treated as "property." Accordingly, the nonrecognition rule of section 351 of the Code would not apply on the transfer of such assets to a controlled corporation.

Also, the nonrecognition rule would not apply in the case of a transfer to a controlled corporation of the assets of a debtor in a bankruptcy case or insolvency proceeding to the extent the stock or securities received in exchange for the assets are used by the debtor to pay off his debts. This rule is designed to prevent the incorporation by a debtor of high basis, low-value assets where a transfer of the assets directly to the creditors followed by a transfer by the creditors to a controlled corporation would result in a fair market value basis to the corporation.

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[1] *CHM Company*, 68 T. C. 31 (1977).

[2] *Alexander F. Duncan*, 9 T.C. 468 (1947), acq. 1948–2 C.B. 2; Rev. Rul. 77–81, 1977–1 C.B. 97.

[3] See *Carman* v. *Comm'r*, 189 F.2d 363 (2d Cir. 1951).

5. Effect of discharge of indebtedness on earnings and profits

Present law

Under present law, the effect of discharge of indebtedness upon the earnings and profits of a corporation in a bankruptcy proceeding is unclear.[4]

Explanation of provision

Section 5(f) of the bill would provide that cancellation of indebtedness income, including amounts excluded from gross income pursuant to section 108 of the Code (as amended by this bill), increases the earnings and profits of a corporation (or reduces a deficit) except to the extent basis in assets is reduced under section 1017 of the Code.

6. Repeal of special treatment for certain railroad redemptions

Present law

Present law provides that any distribution in redemption of stock issued by a railroad corporation pursuant to a reorganization plan under section 77 of the Bankruptcy Act gives rise to capital gain, even if under the general redemption distribution tests the stockholder would realize ordinary income (sec. 302(b)(4) of the Internal Revenue Code).

Explanation of provision

Section 5(b) of the bill would repeal the special rule giving automatic capital gain treatment in the case of redemptions of certain stock issued by railroad corporations in bankruptcy.

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[4] In the case of *Meyer* v. *Comm'r*, 383 F.2d 883 (8th Cir. 1967), the Eighth Circuit held that earnings and profits did not arise where indebtedness was discharged under the Bankruptcy Act. The Internal Revenue Service has announced that it will not follow the *Meyer* decision to the extent that the amount of debt discharged exceeds the reduction in basis of the taxpayer's assets (Rev. Rul. 75-515, 1975-2 C.B. 117).

E. Changes in Tax Procedures (sec. 6 of the bill)

1. Coordination with bankruptcy court procedures

Present law (Bankruptcy Act)

In the case of an individual debtor, the commencement of a bankruptcy proceeding creates an estate, consisting of all assets of the individual other than exempt property and certain assets acquired after the proceeding begins, which is under control of the bankruptcy court. The assets of the bankruptcy estate are not subject to levy by the Internal Revenue Service for the debtor's prepetition income tax liabilities, and generally can be reached only through the Service's filing of a proof of claim in the bankruptcy court.

The bankruptcy court has jurisdiction to determine the debtor's liability for any unpaid tax, whether or not assessed, unless the liability was adjudicated prior to bankruptcy by a court of competent jurisdiction (sec. 2a(2A) of the Bankruptcy Act). Under present law, a determination by the bankruptcy court of a prepetition tax liability of an individual debtor is binding on the Internal Revenue Service and on the trustee of the bankruptcy estate, but might not bind the debtor personally unless the debtor individually invokes the bankruptcy court's jurisdiction. That is, the bankruptcy court's decision, subject to the exception noted, generally would not settle the personal liability of an individual debtor for the amount, if any, of prepetition nondischargeable tax claims which are not satisfied out of the assets of the bankruptcy estate. Accordingly, even where the bankruptcy court rules in favor of the Revenue Service with respect to a nondischargeable tax claim, the debtor may be able to force the Service to relitigate the issue if the claim cannot be satisfied out of estate assets.

Effect on Tax Court jurisdiction

Under present Federal income tax law (sec. 6871 of the Code), the Internal Revenue Service is authorized, on institution of a bankruptcy proceeding, to assess any income tax liabilities against the debtor. The Service is not required to follow the normal procedure under which a deficiency notice is issued to the taxpayer and the taxpayer may challenge an asserted income tax liability in the U.S. Tax Court without payment of the tax. Even if a statutory deficiency notice had been issued and the time for filing a Tax Court case had not expired, the debtor is barred after commencement of the bankruptcy proceeding from litigation in the Tax Court, i.e., from litigating without payment of the asserted tax liability. Present law likewise provides that any portion of a claim for nondischargeable taxes allowed in a bankruptcy proceeding but not satisfied out of assets in the estate shall be paid by the taxpayer after termination of the bankruptcy proceeding (sec. 6873 of the Code).

Thus, under present law, the U.S. Tax Court loses jurisdiction to determine the debtor's personal liability for prepetition taxes unless a Tax Court case had been filed prior to the bankruptcy proceeding. Accordingly, unless the debtor can invoke the jurisdiction of the bankruptcy court and that court makes a determination, the debtor is precluded from prepayment review of an asserted income tax liability. The debtor's only recourse is to pay the tax and then contest the issue through the refund claim procedure of the Internal Revenue Service and subsequent refund litigation in the U.S. District Court or U.S. Court of Claims.

If a notice of deficiency had been issued and a Tax Court case filed prior to institution of the bankruptcy proceeding, but the Tax Court had not reached a decision as to the debtor's income tax liability, both the bankruptcy court and the Tax Court have jurisdiction under present law to determine the tax liability issue. A decision by the Tax Court would not necessarily bind the estate of the bankrupt, unless the trustee had intervened in the Tax Court litigation. A decision by the bankruptcy court might not necessarily bind the individual debtor, unless the debtor individually had invoked the bankruptcy court's jurisdiction.

Thus, under present law, in certain circumstances there may be duplicative litigation of the debtor's tax liability; in other circumstances, the debtor may be precluded from obtaining prepayment review of prepetition tax liabilities.

New bankruptcy statute (P.L. 95–598)

New 11 U.S. Code section 505(a) continues the jurisdiction of the bankruptcy court to determine liability for a tax deficiency, regardless of whether it has been assessed, unless it has been adjudicated by a court of competent jurisdiction prior to filing of the bankruptcy petition.[1] The new law, effective for bankruptcy cases commenced on or after October 1, 1979, also seeks to resolve the problems of present law mentioned above by giving the bankruptcy court, in effect, the authority to determine whether the tax liability issue should be decided in the bankruptcy court or in the U.S. Tax Court.

Under new 11 U.S. Code sec. 362(a)(8), commencement of a bankruptcy case triggers an automatic stay of institution or continuation of any U.S. Tax Court proceeding to challenge an asserted tax deficiency of the debtor. Also under the new law, assessment or collection of a prepetition tax claim against the debtor is automatically stayed by commencement of the bankruptcy case (sec. 362(a)(6)).[2] Unless

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[1] Under present law, the trustee of a bankruptcy estate must proceed in courts other than the bankruptcy court to seek a refund of Federal taxes paid by the debtor. While the trustee succeeds to any right to refund for tax overpayments, present law gives the bankruptcy court jurisdiction only to allow claims against the bankruptcy estate, and not to enforce claims against third parties.

New 11 U.S. Code sec. 505(a) expands the jurisdiction of the bankruptcy court to include determination of refund claims. To invoke the bankruptcy court's jurisdiction, the trustee must file an administrative claim for refund with the Internal Revenue Service. If the claim is denied or if 120 days elapse without IRS action, the court has jurisdiction to determine the refund issue.

[2] The stay does not preclude the Internal Revenue Service from issuing a deficiency notice during the bankruptcy case (sec. 362(b)(8) of new 11 U.S. Code).

the stay is lifted by the bankruptcy court, or a discharge is granted or denied, the stay continues until termination of the bankruptcy case (sec. 362(c)).

The new statute authorizes the bankruptcy judge to lift the stay and permit the debtor to institute a Tax Court case (if a notice of deficiency has been issued and the period for filing such case has not expired) or to continue a pending Tax Court case involving the debtor's tax liability (new 11 U.S. Code sec. 362(d)). The bankruptcy court, for example, could lift the stay if the debtor seeks to litigate in the Tax Court and the trustee wishes to intervene in that proceeding. In such a case, the merits of the tax controversy will be determined by the Tax Court, and the Tax Court's decision will bind both the individual debtor as to any taxes which are nondischargeable and the intervenor trustee as to the tax claim against the estate. However, if the bankruptcy court does not lift the automatic stay, but instead itself determines the tax issue and (at the request of the IRS or of the debtor) determines the debtor's personal liability for a nondischargeable tax, then the bankruptcy court's decision will bind both the individual debtor and the estate as well as the government.[3]

Explanation of provisions

Sections 6(a), 6(b), 6(c), 6(d), and 6(g) of the bill would coordinate certain provisions of the Internal Revenue Code with the bankruptcy court procedures enacted in P.L. 95–598.

Assessment, collection limitations

Section 6(a) of the bill would provide that if the automatic stay under new 11 U.S. Code section 362(a)(6) precludes the Internal Revenue Service from assessment or collection of tax, the running of the period of limitations is suspended, for assessment, for the duration of the stay and for 60 days thereafter; and for collection, during the period of the stay and for six months thereafter.

Tax Court petition

Section 6(b) of the bill would provide that if the stay under section 362(a)(8) of new 11 U.S. Code precludes a debtor from filing a petition in the U.S. Tax Court after receipt of a deficiency notice, the running of the normal 90-day period for filing the petition would be suspended during the stay and for 60 days thereafter. Also, the bill would clarify that the filing of a proof of claim, the filing of request for payment, or other action taken by the Internal Revenue Service in the bankruptcy case would not be treated as prohibited under section 6213(a) of the Code (relating to certain restrictions generally applicable to assessment of a tax deficiency).

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[3] 124 Cong. Rec. H–11,111 (daily ed. Sept. 28, 1978) (remarks of Mr. Edwards). In the case of a corporate debtor, the commencement of a bankruptcy proceeding does not create a separate taxable entity, and (unlike in the case of an individual debtor) the debtor corporation is considered to be personally before the bankruptcy court. Accordingly, a decision by the bankruptcy court as to the corporate debtor's prepetition income tax liability is binding on the corporation, which cannot thereafter institute a Tax Court case to relitigate the issue. However, under P.L. 95–598, the bankruptcy judge is authorized to lift the automatic stay under new 11 U.S. Code sec. 362 and permit the tax issue to be determined in the U.S. Tax Court (if a case involving the issue is already pending in that Court, or if a deficiency notice has been issued and the period for filing such case has not expired).

ax Court intervention

Section 6(c) of the bill would provide that the trustee of the bank-ıptcy estate of a debtor may intervene, as a matter of right, on ·half of the estate in any proceeding before the U.S. Tax Court › which the debtor is a party. This provision would apply where the ınkruptcy judge lifts the automatic stay under section 362 of new 11 [.S. Code so that the debtor's prepetition tax liability can be deter-ıined in the Tax Court.

mmediate assessment

Section 6(g) of the bill would generally repeal the present provision uthorizing the Internal Revenue Service to immediately assess ertain prepetition tax deficiencies of the debtor on institution of bank-uptcy proceedings. However, the Internal Revenue Service would ave the authority to make an immediate assessment (1) of tax imposed n the bankruptcy estate of an individual debtor, or (2) of tax imposed n a debtor if liability for such tax has become res judicata against he debtor pursuant to a bankruptcy court determination.

These two exceptions reflect situations in which there is no need o require the Internal Revenue Service to follow the normal de-iciency notice procedure. In the case of taxes imposed on the bank-uptcy estate of an individual (i.e., where the estate is treated as a eparate taxable entity), the estate's tax liability is determined by he bankruptcy court and cannot be litigated in the U.S. Tax Court. n the case where an individual debtor's personal liability for non-lischargeable tax claims has been litigated in the bankruptcy court, ınd under the doctrine of res judicata the debtor would be precluded rom relitigating the issue in any other court, no purpose would be erved by requiring issuance of a deficiency notice prior to assess-nent. For the same reason, the bill would permit immediate assess-nent of a corporate debtor's tax liabilities once the bankruptcy court as made a determination which has become res judicata.

To the extent immediate assessment authority is retained (i.e., in eceivership proceedings and in the two situations just described), he bill would expand the category of taxes which can be so assessed o include taxes under Internal Revenue Code chapters 41 (public harities), 42 (private foundations and black lung benefit trusts), 43 (qualified pension, etc., plans), and 44 (real estate investment trusts).

Cross references

Section 6(d) of the bill would add cross references in sections 6212, 6512, 6532, and 7430 of the Code to new 11 U.S. Code section 505 (relating to jurisdiction of the bankruptcy court).

2. Relief from certain failures to pay tax when due

Present law

The Internal Revenue Code (secs. 6651, 6654, and 6655) imposes penalties for failure timely to pay certain taxes, unless the taxpayer can establish that the failure was due to reasonable cause and not due to willful neglect. Under bankruptcy rules, a debtor or trustee of a bankruptcy estate may be precluded from timely paying certain taxes after commencement of the bankruptcy proceedings.

Explanation of provision

Section 6(e) of the bill would relieve the debtor or trustee fron penalties which might otherwise be imposed for failure timely to pa; certain taxes to the extent that bankruptcy proceedings preclude pay ment of such taxes when due. In the case of a tax incurred by th estate, the relief would be granted if the failure occurred pursuant t a court order finding probable insufficiency of funds to pay such taxes In the case of a tax incurred by the debtor before commencement o the bankruptcy case, the relief provision of the bill would apply i either the bankruptcy petition was filed before the tax return due date or the date for imposing the penalty occurred after commencement o the bankruptcy case. These rules would not, however, prevent liability for penalties for failure timely to pay or deposit any employment tax required to be withheld by the debtor or trustee.

3. Preservation of FUTA credit

Present law

Present law provides a credit against the Federal unemployment tax imposed on an employer for amounts paid by the employer into State unemployment compensation funds; the credit is limited to a percentage of the Federal tax liability (sec. 3302 of the Internal Revenue Code). A reduction in the otherwise allowable credit is required in the case of late contributions to a State fund (sec. 3302(a)(3) of the Code). Because of the pendency of bankruptcy proceedings, the trustee of a bankruptcy estate may be precluded from making timely payment (on behalf of the debtor) of contributions to State unemployment compensation funds.

Explanation of provision

Section 6(f) of the bill would provide that no reduction in the credit against the FUTA tax is to be made if the failure to make timely contributions to State unemployment compensation funds was without fault of the trustee on account of bankruptcy proceedings.

4. Repeal of deadwood provision

Present law

Section 1018 of the Internal Revenue Code provides certain basis adjustment rules which apply if, in a proceeding under section 77B of the Bankruptcy Act, indebtedness was cancelled in pursuance of a plan of reorganization consummated by adjustment of the capital or debt structure of the insolvent corporation, and the bankruptcy proceeding concluded before September 22, 1938.

Explanation of provision

Section 6(h) of the bill would repeal section 1018 of the Internal Revenue Code.

5. Technical and conforming amendments

Section 6(i) of the bill would make technical and conforming amendments to various sections of the Internal Revenue Code, principally to substitute references to new title 11 of the U.S. Code in place of references to the Bankruptcy Act.

F. Effective Dates (sec. 7 of the bill)

The provisions of the bill would apply to transactions in bankruptcy cases under title 11 of the U.S. Code as codified by P.L. 95–598—that is, in bankruptcy cases commenced on or after October 1, 1979. Present tax law would continue to apply for bankruptcy proceedings commenced under the Bankruptcy Act, i.e., prior to October 1, 1979, including Bankruptcy Act proceedings which were commenced before and continue after that date.

The provisions of the bill would also apply to transactions in receivership, foreclosure, or similar nonbankruptcy judicial proceedings begun after September 30, 1979. Present law would continue to apply to receivership, foreclosure, or similar nonbankruptcy judicial proceedings (as defined in sec. 371 or 374 of the Internal Revenue Code) begun prior to October 1, 1979, including such proceedings which were commenced before and continue after that date.

In the case of any transaction which is not in a bankruptcy case (either under existing or new bankruptcy law) or in a receivership, foreclosure, or similar proceeding (as defined in sec. 371 or 374 of the Code), the provisions of the bill would apply to transactions occurring after September 30, 1979.