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DESCRIPTION OF H.R. 5043

(BANKRUPTCY TAX ACT OF 1980)

As Passed the House

LISTED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT GENERALLY

OF THE

COMMITTEE ON FINANCE

ON MAY 30, 1980

PREPARED FOR THE USE OF THE

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BY THE STAFF OF THE

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CONTENTS

	Page
Introduction	1
I. Background	3
II. Summary of H.R. 5043	5
III. Explanation of H.R. 5043	10
A. Tax Treatment of Discharge of Indebtedness	10
B. Rules Relating to Title 11 Cases for Individuals	22
1. Debtor and bankruptcy estate as separate entities	22
2. Debtor's election to close taxable year	23
3. Computation of bankruptcy estate's tax liability	26
4. Computation of individual's tax liability	28
5. Technical amendment	30
6. Effective date	30
C. Corporate Reorganization Provisions	31
D. Miscellaneous Corporate Amendments	39
1. Exception from personal holding company status	39
2. Repeal of special treatment for certain railroad stock redemptions	39
3. Application of section 337 liquidation rule to insolvent corporations	40
4. Estate of individual in bankruptcy as subchapter S shareholder	40
5. Certain transfers to controlled corporations	41
6. Effect of discharge of indebtedness on earnings and profits	42
E. Changes in Tax Procedures	43
1. Coordination with bankruptcy court procedures	43
2. Relief from certain failures to pay tax when due	47
3. Preservation of FUTA credit	48
4. Repeal of deadwood provision	48
5. Technical and conforming amendments	49
6. Effective date for provisions of section 6 of the bill	50
F. Revenue Effect	51

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 1980, scheduled for May 30, 1980, before the Senate Finance Subcommittee on Taxation and Debt Management Generally.

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

(A separate pamphlet describes five Senate bills—S. 2484, S. 2486, S. 2500, S. 2503, and S. 2548—which are also scheduled for the May 30 Subcommittee hearing.)

I. BACKGROUND

H.R. 5043, the Bankruptcy Tax Act of 1980, concerns the Federal income tax aspects of bankruptcy, insolvency, and discharge of indebtedness. The bill passed the House of Representatives on March 24, 1980, by a vote of 324–0, after having been ordered favorably reported by the Ways and Means Committee on March 12, 1980 (House Report No. 96–833).

The bill was developed over the past several years on the basis of extensive hearings, studies, and suggestions as to appropriate tax rules for bankruptcy and related tax issues. 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 that Commission in 1973.[1] That report recommended changes and clarifications in both substantive rules and tax rules of bankruptcy.

In 1978, the 95th Congress enacted legislation (Public Law 95–598) which significantly revised and modernized the substantive law of bankruptcy as well as bankruptcy court procedures. Public Law 95–598 repealed the Bankruptcy Act and substituted a new title 11 in the U.S. Code, completely replacing the former provisions.[2] The new law generally became effective for bankruptcy cases commencing on or after October 1, 1979. H.R. 5043 is intended to complete the process of revising and updating Federal bankruptcy laws by providing rules governing the tax aspects of bankruptcy and related tax issues.

Because of the October 1, 1979 effective date enacted in Public Law 95–598 for repeal of the Bankruptcy Act (including repeal of provisions governing Federal income tax treatment of debt discharge in bankruptcy), and for implementation of new bankruptcy court procedures, provisions of H.R. 5043 applicable with respect to bankruptcy

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[1] 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).

[2] 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 substantive bankruptcy law which is 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 sec.—" References to the "Code" are to the Internal Revenue Code of 1954, as amended.

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

cases 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. Provisions of H.R. 5043 applicable to transactions outside bankruptcy cases (such as discharge of indebtedness of a solvent taxpayer outside bankruptcy) generally would be effective for such transactions occurring after December 31, 1980.

Hearings were held on H.R. 5043 before the Ways and Means Subcommittee on Select Revenue Measures on September 27, 1979.[3] Throughout the development of the bill over the past several years, comments as to the appropriate tax rules in bankruptcy cases and related tax issues have been received from various groups and individuals, including 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 State Bar of California, Tax Section, Bankruptcy Tax Revision Committee; the Departments of Treasury and Justice; and the Internal Revenue Service.

[3] In 1978, the Ways and Means Committee held hearings on H.R. 9973 (95th Congress), concerning Federal income tax aspects of bankruptcy and related issues.

II. SUMMARY OF H.R. 5043

A. Tax Treatment of Discharge of Indebtedness

In Public Law 95–598, Congress repealed provisions of the Bankruptcy Act governing Federal income tax treatment of a discharge of indebtedness in bankruptcy, effective for cases instituted on or after October 1, 1979. The bill would provide tax rules in the Internal Revenue Code applicable to debt discharge in the case of bankrupt or insolvent debtors, and would make related changes to existing Code provisions applicable to debt discharge in the case of solvent debtors outside bankruptcy.

Bankruptcy or insolvency

Under the bill, no amount would be included in income for Federal income tax purposes by reason of a discharge of indebtedness in a bankruptcy case, or outside bankruptcy if the debtor is insolvent. Instead, the amount of discharged debt which would be excluded from gross income by virtue of the bill's provisions (the "debt discharge amount") would be applied to reduce certain tax attributes.

Unless the taxpayer elects first to reduce basis in depreciable assets, the debt discharge amount would be applied to reduce the taxpayer's net operating losses and then certain tax credits and capital loss carryovers. Any excess of the debt discharge amount over the amount of reduction in these attributes would be applied to reduce asset basis (but not below the amount of the taxpayer's remaining undischarged liabilities). Any further remaining debt discharge amount would be disregarded, i.e., would not result in income or have other tax consequences.

The bill would provide that the taxpayer may elect to apply the debt discharge amount first to reduce basis in depreciable property, before applying any remaining amount to reduce net operating losses and then other tax attributes in the order stated in the bill. A debtor making this election could elect to reduce basis in depreciable property below the amount of remaining liabilities (i.e., where the debtor would rather so reduce asset basis than reduce carryovers). To the extent the debtor makes an election to reduce basis in depreciable assets, or reduces basis in assets after reduction in other tax attributes, it is anticipated that Treasury regulations prescribing the order of basis reduction among assets would generally accord with present Treasury regulations which apply in the case of basis reduction under section 270 of the (now repealed) Bankruptcy Act.

To insure that ordinary income treatment eventually would be given to the full amount of basis reduction in depreciable or nondepreciable assets, the bill provides that any gain on a subsequent disposition of reduced-basis assets would be subject to "recapture" under sections 1245 or 1250 of the Internal Revenue Code.

62-647 O - 80 - 2

Outside bankruptcy—solvent taxpayers

The bill would modify the existing Federal income tax election (secs. 108 and 1017 of the Code) under which a solvent taxpayer outside bankruptcy may elect to reduce basis of assets instead of recognizing current income from debt cancellation. Similar to the rules of the bill applicable to bankrupt or insolvent debtors, the bill provides that the election to reduce basis allowed to the solvent debtor outside bankruptcy would require reduction in basis of depreciable assets.

To the extent that the debtor makes an election to reduce basis, it is anticipated that Treasury regulations prescribing the order of basis reduction among the taxpayer's depreciable assets would generally accord with present Treasury regulations under section 1017 of the Code. As in the case of bankrupt or insolvent debtors, the bill provides that any gain on a subsequent disposition of reduced-basis assets would be subject to "recapture" under sections 1245 or 1250 of the Code.

The bill also provides that in the case of a solvent taxpayer outside bankruptcy, a reduction to the purchaser in the amount of a purchase-money debt, by the seller of the property, would be treated for Federal income tax purposes as a purchase price reduction and not as a discharge of indebtedness.

Equity-for-debt rules

The bill also provides rules relating to discharge of indebtedness of corporate debtors (whether or not in a bankruptcy case) 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), there would be no debt discharge amount and no attribute reduction would be required. Thus, no tax consequences at the corporate level would occur with respect to a transaction which is treated generally as a nonrecognition of gain or loss transaction for the creditors.

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 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 would reflect the fact that tax attributes generally arise as a result of incurring debt obligations or expending loan proceeds.

If a value is placed on the stock either (1) by the bankruptcy court in a proceeding in which the Internal Revenue Service had the right to intervene on the valuation issue (including notice of the court hearing on the valuation issue) or (2) in a bankruptcy or similar proceeding or in an out-of-court agreement in which the debtor and creditor had adverse interests in the tax consequences of the valuation, the Revenue Service as well as the debtor and creditor would be bound by the valuation for purposes of the debt discharge rules of the bill and the creditor's bad debt deduction.

In light of these stock-for-debt rules, the bill provides that the special limitations on net operating loss carryovers (sec. 382 of the Internal Revenue Code) generally would not apply to the extent creditors receive stock in exchange for their claims.

The bill also provides that the debt discharge 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.

Other rules concerning debt discharge

In addition, other rules in the bill concerning debt discharge would relate to debt acquired by a related party, discharge of liabilities payment of which would have given rise to deductions, the tax benefit rule of section 111 of the Code, and discharge of a partnership debt. Also, the bill provides (overturning a contrary position of the Internal Revenue Service) that if the basis of investment credit property is reduced by a debt discharge amount, no investment credit recapture would occur by reason of the reduction.

Effective date

The provisions of the bill relating to tax treatment of debt discharge would apply for bankruptcy cases (or receivership, foreclosure, or similar judicial proceedings) commenced on or after October 1, 1979. Present tax law would continue to apply for bankruptcy cases (or receivership, etc. proceedings) commenced prior to October 1, 1979.

In the case of discharge of indebtedness outside bankruptcy cases (or receivership, etc. proceedings), the debt discharge rules of the bill would apply to any discharge of indebtedness occurring after December 31, 1980.

B. Bankruptcy Estate of an Individual

In general

The bill would treat the bankruptcy estate of an individual in a liquidation or reorganization case under the new bankruptcy statute as a separate taxable entity for Federal income tax purposes. 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 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 a bankruptcy estate of an individual which would be treated as a separate taxable entity would 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 of the estate, 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.

Debtor's election to close taxable year

Also, the bill generally would give an individual debtor an election to close his or her taxable year as of the day the bankruptcy case commences. If the election were made, the debtor's Federal income tax liability for the "short" taxable year ending on commencement of the case would become an allowable claim against the bankruptcy estate. If the election were not made, the commencement of the bankruptcy case would not terminate the taxable year of an individual debtor.

Effective date

These provisions of the bill would apply to bankruptcy cases commencing more than 90 days after the date of enactment of the bill.

C. Corporate Reorganizations in Bankruptcy

Expansion of reorganization provisions

The bill would expand the categories of tax-free corporate reorganizations defined in section 368 of the Code to include a new category of "G" reorganizations. This category would include certain transfers of assets pursuant to a court-approved reorganization plan in a bankruptcy case (or in a receivership, foreclosure, or similar proceeding). Accordingly, the bill would terminate the applicability of special rules of current law relating to insolvency reorganizations (secs. 371–374 of the Code).

The bill would permit a "G" reorganization to take the form of a triangular reorganization, including a "reverse merger." Also, the bill would allow the acquiring corporation in a "G" reorganization to transfer the acquired assets to a controlled subsidiary. In light of the debt discharge rules of the bill, which would adjust tax attributes of a reorganized corporation to reflect changes in its debt structure, the statutory rule generally governing carryover of tax attributes in corporate reorganizations (sec. 381 of the Code) would apply in the case of a "G" reorganization.

Since "G" reorganizations would be subject to the rules governing the tax treatment of exchanging shareholders and security holders which apply generally to corporate reorganizations, a shareholder or security holder who receives securities in a "G" reorganization with a principal amount exceeding the principal amount of securities surrendered would be taxed on the excess. Also, money or other "boot" property received in a "G" reorganization would be subject to the dividend-equivalence tests which apply to the reorganizations generally.

Property attributable to accrued interest

Under the bill, a creditor exchanging securities in any corporate reorganization described in section 368 of the Code (including a "G" reorganization) would be treated as receiving interest income on the exchange to the extent the creditor receives new securities, stock, or other property attributable to accrued but unpaid interest on the securities surrendered.

Effective date

These provisions of the bill would apply to bankruptcy cases (or receivership, foreclosure, or similar judicial proceedings) commencing on or after October 1, 1979. In addition, the amendments relating to property attributable to accrued interest also would apply to transactions occurring after December 31, 1980 (other than transactions in a proceeding under the Bankruptcy Act or in a receivership, foreclosure, or similar judicial proceeding begun before October 1, 1979).

D. Miscellaneous Corporate Amendments

The bill would make a number of miscellaneous amendments to the Internal Revenue Code relating to corporate tax issues, including the following.

1. PHC status.—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 a bankruptcy case (or receivership, foreclosure, or similar proceeding) commencing on or after October 1, 1979.

2. Liquidation rule.—The corporate nonrecognition tax rules applicable to 12-month liquidations would be extended to cover sales by insolvent corporations of assets, other than assets acquired after commencement of the bankruptcy case, during the entire period from adoption (after commencement of the case) of the plan of liquidation through conclusion of the case. This provision would apply to bankruptcy cases (or receivership, etc. proceedings) commencing on or after October 1, 1979.

3. Subchapter S shareholder.—The bill provides that for bankruptcy cases commencing on or after October 1, 1979, the bankruptcy estate of an individual debtor could be an eligible shareholder in a subchapter S corporation.

4. Section 351 applicability.—Under the bill, transfers to a controlled corporation of indebtedness of the corporation which is not evidenced by a security, or of claims against the corporation for accrued but unpaid interest on indebtedness, would not be covered by the nonrecognition rule of section 351 of the Code. 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 or similar case to the extent the stock or securities received in exchange for the assets were used by the debtor to pay off his debts. The effective date for these provisions would be the same as for the provisions of the bill relating to tax treatment of discharge of indebtedness.

5. Earnings and profits.—The bill provides that to the extent the amount of discharged indebtedness is applied to reduce basis under section 1017 of the Code, such basis-reduction amount would not affect the debtor corporation's earnings and profits. The effective date for this provision would be the same as for the provisions of the bill relating to tax treatment of discharge of indebtedness.

E. Changes in Tax Procedures

The bill would coordinate certain provisions of the Internal Revenue Code with the bankruptcy court procedures enacted in P.L. 95–598. These procedures include the automatic stay on assessment or collection of certain tax claims against the debtor, the automatic stay on institution or continuation by the debtor of deficiency litigation in the U.S. Tax Court, and the authority of the bankruptcy court to lift the stay and permit the debtor's tax liability to be determined by the Tax Court.

III. EXPLANATION OF H.R. 5043

A. Tax Treatment of Discharge of Indebtedness (sec. 2 of the bill and secs. 108, 111, 382, and 1017 of the Code)

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 has issued a $1,000 bond at par which it later repurchases for only $900, thereby increasing its net worth by $100, the corporation realizes $100 of income in the year of repurchase (*United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931)).

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; [1] and if the transaction leaves the debtor with assets whose value exceeds remaining liabilities, income is realized only to the extent of the excess.[2] 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.[3] Some courts have applied this exception even if the corporation had previously deducted the amount owed to the shareholder-creditor.[4] Under a related exception, 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 the 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). A debt cancellation which constitutes a gift or bequest is not treated as income to the donee debtor (sec. 102).

A debtor which would otherwise be required to report current income from debt cancellation under the preceding rules instead may elect to reduce the basis of its 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

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

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

[3] Treas. Regs. § 1.61–12(a).

[4] *Putoma Corp.* v. *Comm'r*, 66 T.C. 652 (1978), *aff'd*, 604 F. 2d 734 (5th Cir. 1979).

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

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 income-exclusion 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 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 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

In general

Under the bill, no amount would be included in income for Federal income tax purposes by reason of a discharge of indebtedness in a bankruptcy case.[11] Instead, the amount of discharged debt which would be excluded from gross income by virtue of the bill's provisions (the "debt discharge amount") would be applied to reduce certain tax attributes.

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[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 secs. 368 and 381 of the Code, in which case net operating losses may be limited by section 382 of the Code).

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

[10] Treas. Regs. § 1.61–12(b). See text accompanying notes 1 and 2.

[11] For purposes of these rules, the term "bankruptcy case" (referred to in the bill as a "title 11 case") means a case under new title 11 of the U.S. Code, but only if the taxpayer is under the jurisdiction of the court in the case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.

Unless the taxpayer elects first to reduce basis of depreciable assets, the debt discharge amount would be applied to 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, the new jobs credit, and the credit for alcohol used as a fuel; [12]

(3) capital losses and carryovers; and

(4) the basis of the taxpayer's assets.

The reduction in each category of carryovers would be made in the order of taxable years in which the items would be used, with the order determined as if the debt discharge amount were not excluded from income.[13] For this purpose, any limitations on the use of credits that are based on the income of the taxpayer would be disregarded.

After reduction of the specified carryovers, any remaining debt discharge amount would be applied to reduce asset basis, but not below the amount of the taxpayer's remaining undischarged liabilities. (Thus, a sale of all the taxpayer's assets immediately after the discharge generally would not result in income tax liability except to the extent the sale proceeds and cash on hand exceed 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.

Election to reduce basis in depreciable property

The bill provides that the taxpayer could elect, in accordance with Treasury regulations, to apply all or a portion of the debt discharge amount first to reduce basis (but not below zero) in depreciable property,[14] before applying any remaining amount to reduce net operating losses and other tax attributes in the order described above. A debtor making this election could elect to reduce basis (but not below zero) in depreciable property below the amount of remaining liabilities (i.e., where the debtor would rather so reduce asset basis than reduce carryovers).

An election first to reduce basis in depreciable property would be made on the taxpayer's return for the year in which the discharge occurs, or at such time as permitted by Treasury regulations. Once

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[12] These credits would be reduced at the rate of 50 cents for each dollar of debt discharge amount. This flat-rate reduction would avoid the complexity of determining a tax on the debt discharge amount and determining how much of the amount would be used up by the credits for purposes of determining other reductions. Except for reductions in credit carryovers, the specified tax attributes would be reduced one dollar for each dollar of debt discharge amount.

[13] 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.

[14] For this purpose, the term "depreciable property" means any property of a character subject to the allowance for depreciation, but only if the basis reduction would reduce the amount of depreciation or amortization which otherwise would be allowable for the period immediately following such reduction. Thus, for example, a lessor could not reduce the basis of leased property where the lessee's obligation in respect of the property will restore to the lessor the loss due to depreciation during the term of the lease, since the lessor cannot take depreciation in respect of that property. See *Harry H. Kem, Jr.*, 51 T.C. 455 (1968), *aff'd*, 432 F.2d 961 (9th Cir. 1970).

made, an election could be revoked by the taxpayer only with the consent of the Internal Revenue Service.

Recapture rule

If the basis of property (whether depreciable or nondepreciable) were reduced pursuant to the rules in the bill, any gain on a subsequent disposition of the property would be subject to "recapture" under section 1245 of the Code or, in the case of realty, under section 1250. The computation of the amount of straight-line depreciation (under sec. 1250(b)) would be determined as if there had been no reduction of basis under section 1017.

Basis reduction—general rules

To the extent a debtor makes an election to reduce basis in depreciable property, or reduces basis in assets after reduction in other attributes, the particular properties the bases of which would be reduced would be determined pursuant to Treasury regulations. It would be anticipated that the order of reduction prescribed in such regulations would generally accord with present Treasury regulations which apply in the case of basis reduction under section 270 of the (now repealed) Bankruptcy Act (Treas. Regs. §§ 1.1016-7 and 1.1016-8).

In order to avoid interaction between basis reduction and reduction of other attributes, the bill provides that the basis reduction would take effect on the first day of the taxable year following the year in which the discharge took place. If basis reduction were required in respect of a discharge of indebtedness in the final year of a bankruptcy estate, the reduction would be made in the basis of assets acquired by the debtor from the estate at the time so acquired.

In a bankruptcy case involving an individual debtor to which new section 1398 of the Code (as added by the bill) would apply, any attribute reduction required under the bill would apply to the attributes of the bankruptcy estate (except for purposes of applying the basis-reduction rules of section 1017 to property transferred by the estate to the individual) and not to those attributes of the individual which arose after commencement of the case. Also, the bill provides that in a bankruptcy case involving an individual debtor, no reduction in basis would be made in the basis of property which the debtor treats as exempt property under new 11 U.S. Code section 522.

Debt discharge outside bankruptcy—insolvent debtors

The bill provides that if a discharge of indebtedness occurs when the taxpayer is insolvent (but is not in a bankruptcy case), the amount of debt discharge would be excluded from gross income up to the amount by which the taxpayer is insolvent,[15] 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 debt discharged which would not be excluded from gross income

[15] The bill defines "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. The bill provides that except pursuant to section 108(a)(1)(B) of the Code (as would be added by the bill), there is to be no insolvency exception from the general rule that gross income includes income from discharge of indebtedness.

(because it exceeds the insolvency amount) would be treated in the same manner as debt cancellation in the case of a wholly solvent taxpayer.

Debt discharge outside bankruptcy—solvent debtors

In the case of a solvent taxpayer outside bankruptcy, the bill would modify 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. Under this modification, only the basis of depreciable property held by the taxpayer could be reduced.[16]

An election to reduce basis in depreciable property would be made on the taxpayer's return for the year in which the discharge occurs, or at such other time as permitted by Treasury regulations. Once made, an election could be revoked by the taxpayer only with the consent of the Internal Revenue Service.

If a taxpayer makes an election to reduce basis in depreciable property, the particular depreciable assets the bases of which are to be reduced (but not below zero) would be determined pursuant to Treasury regulations. It would be anticipated that the order of reduction among depreciable assets of the taxpayer would generally accord with present Treasury regulations (Treas. Regs. §§ 1.1017–1 and 1.1017–2). The bill provides that the basis reduction would take effect on the first day of the taxable year following the year in which the discharge takes place.

To the extent a solvent taxpayer outside bankruptcy does not make an election to reduce basis in depreciable property in lieu of reporting income from debt discharge, or to the extent the debt discharge amount exceeds the maximum reduction which can be made through an election, the excess constitutes income from discharge of indebtedness which, as under present law, constitutes gross income for Federal income tax purposes (sec. 61(a)(12) of the Code; Rev. Rul. 67–200, 1967–1 C.B. 15).

Recapture rule

To insure that ordinary income treatment eventually will be given to the full amount of basis reduction, the bill provides that any gain on a subsequent disposition of reduced-basis property would be subject to "recapture" under section 1245 of the Code or, in the case of realty, under section 1250. The computation of the amount of straight-line depreciation (under sec. 1250(b)) would be determined as if there had been no reduction of basis under section 1017.

Certain reductions as purchase price adjustments

The bill provides that if the seller of specific property reduces the debt of the purchaser which arose out of the purchase, and the reduction to the purchaser does not occur in a bankruptcy case or when the

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[16] The exclusion from gross income under section 108(a) of the Code (as would be amended by the bill) would apply, in the case of a discharge which does not occur in a title 11 case and which does not occur when the taxpayer is insolvent, where the indebtedness discharged is "qualified business indebtedness." The latter term means indebtedness of the taxpayer if both (1) the indebtedness was incurred or assumed by a corporation, or by an individual in connection with property used in his trade or business, and also (2) the taxpayer makes an election to reduce the basis of depreciable assets.

For this purpose, the term "depreciable property" would be defined the same way as in the case of the election by a bankrupt or insolvent taxpayer to reduce the basis of depreciable property (see note 14, *supra*).

purchaser is insolvent, then the reduction to the purchaser of the purchase-money debt would be treated (for both the seller and the buyer) as a purchase price adjustment on that property. This rule would apply only if but for this provision the amount of the reduction would be treated as income from discharge of indebtedness.

This provision would be intended to eliminate disagreements between the Internal Revenue Service and the debtor as to whether in a particular case to which the provision applies the debt reduction should be treated as discharge income or a true price adjustment. If the debt has been transferred by the seller to a third party (whether or not related to the seller), or if the property has been transferred by the buyer to a third party (whether or not related to the buyer), this provision would not apply to determine whether a reduction in the amount of purchase-money debt should be treated as discharge income or a true price adjustment; nor would it apply where the debt is reduced because of factors not involving direct agreements between the buyer and the seller, such as the running of the statute of limitations on enforcement of the obligation.

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. These rules would apply whether the debtor is solvent or insolvent, and whether or not the debtor is in a bankruptcy case.

Securities

Under the bill, if a corporate debtor issues stock to its creditor for the principal amount of an outstanding security (such as a bond), there would be no debt discharge amount, and no attribute reduction would be required. Thus, no tax consequences at the corporate level would occur with respect to a transfer which is treated generally as a nonrecognition of gain or loss transaction for the creditor.

For purposes of this rule, the term "security" would mean 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) of the Code) and which constitutes a security for purposes of section 354 of the Code.[17] Thus, the term "security" would be intended to mean those instruments with repect to which generally no reduction 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.[18]

[17] The bill provides that the stock-for-security exception would apply only if the debt for which the stock is issued constituted a "security" either on October 1, 1979, or if incurred after that date, then at all times after the debt was incurred. Accordingly, the exception in section 108(f)(1)(C) would not apply if non-security debt held by a creditor is transformed (after October 1, 1979) into security debt either directly (through an exchange of the non-security debt for debt in registered form, for example) or indirectly (through a "repayment" that is, as a practical matter, conditioned on reinstitution of the debt in the form of a security).

[18] However, if the creditor holding the security is a bank, the "securities rule" applies under the bill (i.e., there would be no tax consequences to the debtor) even though, unlike other taxpayers, banks are permitted under present law (sec. 582(a) of the Code) to claim a bad debt deduction for a partially worthless security.

The "securities rule" of the bill would not be intended to apply if only a *de minimis* amount of stock is issued for an outstanding security. Thus, the value of the stock received could not be very small when compared to the total amount of the creditor's claim, so that the debt forgiveness rules would not be circumvented by the issuance of token shares to a creditor with no real equity interest in the corporation.

If both stock and other property were issued for a debt evidenced by a security, the stock would be treated as issued for a proportion of the debt equal to its proportion of the value of the total consideration. For example, if $30 cash and $20 worth of stock are issued to cancel a $100 bond, the cash would be treated as satisfying $60 of the debt (resulting in a debt discharge amount of $30 to which the rules of the bill apply), and the stock would be treated as issued for the other $40 of the debt (with no income resulting or attribute reduction required).

Debts other than securities

If a corporate debtor issues stock for other debts (such as debts 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 principal amount of the debt discharged, the discharge of indebtedness rules summarized above would apply.[19]

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 reflects the fact that tax attributes generally arise as a result of incurring debt obligations or expending loan proceeds.

If a value is placed on the stock either (1) by the bankruptcy court in a proceeding in which the Internal Revenue Service had the right to intervene on the valuation issue (including notice of the court hearing on the valuation issue) or (2) in a bankruptcy or similar proceeding or in an out-of-court agreement in which the debtor and creditor had adverse interests in the tax consequences of the valuation, the Revenue Service as well as the debtor and creditor would be bound by the valuation for purposes of tax calculations, including the debt discharge rules of the bill and the creditor's bad debt deduction.

Capital contributions

The bill also provides that the discharge of indebtedness rules would apply to the extent that the amount of debt transferred to a

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[19] 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 must account for a debt discharge amount of $400.

If the corporation is insolvent or in bankruptcy, it must apply the $400 debt discharge amount to reduce tax attributes pursuant to the rules discussed in the text above. If the debtor is a solvent corporation outside bankruptcy, it could elect to reduce basis of depreciable assets by $400 in lieu of recognizing $400 of income in the year of discharge.

corporation as a contribution to capital exceeds the shareholder's basis in the debt.[20] Thus, the discharge of indebtedness rules would apply when a cash-basis taxpayer contributes to the capital of an accrual-basis corporation a debt representing an accrued expense previously deducted by the corporation.[21]

Application of rules

For purposes of the equity-for-debt rules, the bill provides that the term "debtor corporation" would include a successor corporation, and that the stock of a corporation in control of the debtor corporation would be treated as stock of the debtor.[22]

Partnership debt

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.

Other rules concerning debt discharge

No disposition on basis reduction.—If the basis of qualified investment credit property would be reduced by a debt discharge amount under the rules of the bill, no investment credit recapture tax would be incurred, because the reduction would not be considered a disposition. This rule would overturn the position taken by the Internal Revenue Service in Rev. Rul. 74-184, *supra*, in the case of a solvent debtor making an election under sections 108 and 1017 of the Code (as

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[20] For example, assume a corporation accrues and deducts (but does not actually pay) a $1,000 liability to a shareholder-employee as 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 must account for a debt discharge amount of $1,000. If the corporation is insolvent or in bankruptcy, it must apply the $1,000 debt discharge amount to reduce tax attributes pursuant to the rules discussed in the text above. If the debtor is a solvent corporation outside bankruptcy, it could elect to reduce basis of depreciable assets by $1,000 in lieu of recognizing $1,000 of income in the year of discharge.

On the other hand, if the shareholder-employee were on the accrual basis, had included the salary in income, and his or her basis in the debt was still $1,000 at the time of the contribution, there would be no debt discharge amount, and no attribute reduction would be required.

[21] This contribution-to-capital rule would reverse the result reached in *Putoma Corp.* v. *Comm'r*, 66 T.C. 652 (1976), *aff'd*, 601 F.2d 734 (5th cir. 1979). Moreover, it would be intended that the result reached in *Putoma* could not alternatively be sustained on the ground that the shareholder has made a "gift" to the corporation, since it would be intended that there will not be any gift exception in a commercial context (such as a shareholder-corporation relationship) to the general rule that income is realized on discharge of indebtedness.

[22] Thus the stock-for-debt rules of the bill would apply for an exchange by a successor corporation (i.e., a corporation whose attributes carried over under section 381 of the Code, as amended by this bill) of its stock for debt of its predecessor, or an exchange by the debtor of the successor corporation's stock for the debt. Also, these rules would apply where stock of a corporation in control of the debtor corporation or the successor corporation is transferred in the exchange.

would be amended by the bill), and would preclude extension of that position to bankrupt or insolvent debtors.[23]

Indebtedness of taxpayer.—The debt discharge rules of the bill would apply with respect to discharge of any indebtedness for which the taxpayer is liable or subject to which the taxpayer holds property.

Unamortized premium and discount.—The bill provides that the amount taken into account with respect to any discharge of indebtedness would be properly adjusted for unamortized premium and unamortized discount with respect to the indebtedness discharged.[24]

Debt acquired by related party.—The bill provides that, for purposes of determining income of the debtor from discharge of indebtedness, an outstanding debt acquired from an unrelated party by a party related to the debtor would be treated as having been acquired by the debtor to the extent provided in regulations issued by the Treasury Department. For purposes of this rule, a person would be treated as related to the debtor if the person is (1) a member of a controlled group of corporations (as defined for purposes of sec. 414(b) of the Code) of which group the debtor is a member, (2) a trade or business treated as under common control with respect to the debtor (within the meaning of sec. 414(c) of the Code), (3) either a partner in a partnership treated as controlled by the debtor or a controlled partnership with respect to the debtor (within the meaning of sec. 707 (b)(1) of the Code), or (4) a member of the debtor's family or other person bearing a relationship to the debtor specified in section 267(b) of the Code. The definition of "family" for this purpose would also include a spouse of the debtor's child or grandchild. This rule would be intended to treat a debtor as having its debt discharged if a party related to the debtor purchases the debt at a discount (for example, where a parent corporation purchases at a discount debt issued by its subsidiary).[25]

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[23] No inference would be intended, by virtue of adoption of the no-disposition rule of the bill as described in the text above, as to whether the position taken by the Internal Revenue Service in Rev. Rul. 74-184, *supra*, represents a correct interpretation of Federal income tax law prior to the effective date of the bill's no-disposition rule.

A purchase price adjustment (whether or not described in new sec. 108(e)(5) of the Code, as would be added by this bill) would continue to constitute an adjustment for purposes of the investment credit rules of the Code.

[24] This provision of the bill would not be intended to be a change from the rules of current law as to adjustments for unamortized premium and discount.

[25] It would be intended that the Treasury Department has authority to and will issue regulations providing for the following income tax consequences on repayment or capital contribution of debt which had been acquired by a related party subject to the rule of the bill treating the debtor as having acquired the debt.

If the debtor subsequently pays the debt to the related party and the related party recognizes gain on the payment transaction, a deduction equal to the amount of such gain will be allowed to the debtor for the year in which such payment occurs. For example, assume a parent corporation purchases for $900 on the open market a $1,000 bond issued at par by its wholly owned subsidiary. Under the bill, the debtor (the subsidiary) must account for a debt discharge amount of $100 for its taxable year during which the debt was so acquired. In the following year when the debt matures, assume the subsidiary pays its parent the full principal amount ($1,000). The Treasury regulations would provide that the debtor will be allowed a $100 deduction in the year of such payment.

If a related party transfers to a corporation as a contribution to capital debt issued by the corporation and the debtor corporation thereby has a debt dis-

"Lost" deductions.—The bill provides that if the payment of a liability would have given rise to a deduction, the discharge of that liability would not give rise to income or require reduction of tax attributes. For example, assume a cash-basis taxpayer owes $1,000 to its cash-basis employee as salary and has not actually paid such amount. If later the employee forgives the debt (whether or not as a contribution to capital, then the discharge would not give rise to income or require any reduction of tax attributes.

Section 382 exception.—Because the bill would contain 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 were acquired for the purpose of acquiring the stock).[26] The bill specifically provides 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) to a reorganization under section 368(a)(1)(G) of the Code (as added by this bill).

It is expected that the Treasury regulations defining a consolidated return change of ownership would be amended to conform with the amendment made by this bill to section 382 of the Code.

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 would be treated as having produced a reduction in tax if the deduction increased a carryover that had not expired at the end of the taxable year in which the recovery occurs. Thus, if an accrual-basis taxpayer incurs a deductible obligation to pay rent in 1980, and that obligation is forgiven in 1981, the rent deduction would be treated as having produced a reduction in tax even if it had entered into the calculation of a net operating loss that had not expired at the end of 1981 but had not been used as of that time.

Partnerships

The bill would provide that the rules of exclusion from gross income and reduction of tax attributes in section 108 of the Code (as amended by the bill) are to be applied at the partner level and not at

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charge amount pursuant to the rules of the bill, a deduction equal to the debt discharge amount will be allowed to the debtor for the year in which the capital contribution is made. For example, assume a parent corporation purchases for $900 on the open market a $1,000 bond issued at par by its wholly owned subsidiary. Under the bill, the debtor (the subsidiary) must account for a debt discharge amount of $100 for its taxable year during which the debt was so acquired. In the following year, assume the parent transfers the debt to its subsidiary as a contribution to capital (i.e., forgives the debt). The Treasury regulations would provide that the amount treated as a debt discharge amount under the capital contribution rules of the bill ($100 in the example given) will be reduced by the debt discharge amount previously taken into account by the subsidiary ($100).

[26] For example, any claim purchased after it had become evident that the claim would have to be satisfied primarily with stock could be considered to have been acquired for the purpose of acquiring the stock.

the partnership level.[27] Accordingly, income from discharge of a partnership debt would not be excludable at the partnership level under amended section 108. Instead, such income would be treated as an item of income which is allocated separately to each partner pursuant to section 702(a) of the Code.

This allocation of an amount of debt discharge income to a partner results in that partner's basis in the partnership being increased by such amount (sec. 705). At the same time, the reduction in the partner's share of partnership liabilities caused by the debt discharge results in a deemed distribution (under sec. 752), in turn resulting in a reduction (under sec. 733) of the partner's basis in the partnership. The section 733 basis reduction, which offsets the section 705 basis increase, would be separate from any basis reduction pursuant to the attribute-reduction rules of the bill.

The tax treatment of the amount of discharged partnership debt which is allocated as an income item to a particular partner would depend on whether that partner is in a bankruptcy case, is insolvent (but not in a bankruptcy case), or is solvent (and not in a bankruptcy case). For example, if the particular partner were bankrupt or insolvent, the debt discharge amount would be excluded from gross income pursuant to amended section 108 and would be applied to reduce the partner's net operating losses and other tax attributes, unless the partner elects to apply the amount first to reduce basis in depreciable assets. If the particular partner were solvent (and not in a bankruptcy case), the amount allocated to that partner would be included in that partner's gross income except to the extent the partner elects to reduce basis of depreciable assets.

The bill would provide that, in connection with these attribute-reduction rules, a partner's interest in a partnership is to be treated as depreciable property to the extent of such partner's proportionate interest in the depreciable property held by the partnership. The bill also would provide that if a partner reduces his basis in the partnership under section 1017 of the Code by reason of the debt discharge rules of the bill, the partnership must make a corresponding reduction in the basis of the partnership property with respect to such partner (in a manner similar to that which would be required if the partnership had made an election under section 754 to adjust basis in the case of a transfer of a partnership interest).[28]

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

[28] For example, assume that a partnership is the debtor in a bankruptcy case which began March 1, 1981, and that in the bankruptcy case a partnership liability in the amount of $30,000 is discharged. The partnership has three partners. The three partners have equal distributive shares of partnership income and loss items under section 702(a) of the Code. Partner A is the debtor in a bankruptcy case; partner B is insolvent (by more than $10,000), but is not a debtor in a bankruptcy case; and partner C is solvent, and is not a debtor in a bankruptcy case.

Under section 705 of the Code, each partner's basis in the partnership is increased by $10,000, i.e., his distributive share of the income of the partnership. (The $30,000 debt discharge amount constitutes income of the partnership for this purpose, inasmuch as the income exclusion rules of amended sec. 108 would not apply at the partnership level.) However, also by virtue of present law, each partner's basis in the partnership is decreased by the same amount secs. 752 and 753 of the Code). Thus, there is no net change in each partner's

Technical amendments

The bill would amend section 703(b) of the Code, relating to elections of a partnership, to provide that any election under sections 108(b)(5) or 108(d)(4) of the Code (as would be amended by the bill) with respect to income from discharge of indebtedness is to be made by each partner separately and not by the partnership. Section 118(c) of the Code, relating to cross references, would be amended to add a reference to the rules of the bill on capital contributions of indebtedness. Section 1032(b) of the Code, relating to basis, would be amended to add a cross reference to the stock-for-debt rules of the bill.

Effective date

The amendments to the Internal Revenue Code made by section 2 of the bill would apply to transactions in a bankruptcy case if the case commenced on or after October 1, 1979; to transactions in a receivership, foreclosure, or similar proceeding if the proceeding commenced on or after October 1, 1979; and to other transactions which occur after December 31, 1980 (except that the provisions of section 2 would not apply to any transactions in proceedings under the Bankruptcy Act or in a receivership, foreclosure, or similar proceeding which proceeding began before October 1, 1979, even if such transaction occurs after December 31, 1980).

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basis in the partnership resulting from discharge of the partnership indebtedness except by operation at the partner level of the rules of sections 108 and 1017 of the Code (as would be amended by the bill).

In the case of bankrupt partner A, the $10,000 debt discharge amount must be applied to reduce net operating losses and other tax attributes as would be specified in the bill, unless A elects first to reduce the basis of depreciable assets. The same tax treatment would apply in the case of insolvent partner B. In the case of solvent partner C, such partner could elect to reduce basis in depreciable assets in lieu of recognizing $10,000 of income from discharge of indebtedness.

If A, B, or C elects to reduce basis in depreciable assets, such partner could be permitted, under the Treasury regulations, to reduce his basis in his partnership interest (to the extent of his share of partnership depreciable property), because the bill would treat that interest as depreciable property. If a partner does so reduce basis in his interest in the partnership, the bill also would require that the partnership must make a corresponding reduction in the basis of the partnership property with respect to such partner (in a manner similar to that which would be required if the partnership had made an election under section 754 to adjust basis in the case of a transfer of a partnership interest).

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B. Rules Relating to Title 11 Cases for Individuals (sec. 3 of the bill; new secs. 1398 and 1399 and secs. 6012 and 6103 of the Code)

Effect of bankruptcy law

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 bankruptcy estate generally 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 the case and after-acquired property do not become part of the bankruptcy estate, but belong to the individual, and certain property may be set aside as exempt.

Explanation of provisions

1. Debtor and bankruptcy estate as separate entities

Present law

For Federal income tax purposes, the estate created on commencement of a bankruptcy proceeding with respect to an individual debtor is treated 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 year of the individual debtor is not terminated on commencement of the bankruptcy proceeding. On the individual's return (Form 1040 or 1040A) for the year in which the bankruptcy proceeding commenced, the individual reports all income earned by him or her during the entire year (including income earned by the individual before commencement of the proceeding, even though any assets derived from such income pass to the bankruptcy estate), but does not report any income earned by the bankruptcy estate.

General provisions of bill

The bill, like present law, would treat the bankruptcy estate of an individual as a separate taxable entity for Federal income tax purposes. The separate entity rules under the bill (new Code sec. 1398) [1] would apply 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 amended by P.L. 95–598. No separate taxable entity would be created on commencement of a case under

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

chapter 13 of new 11 U.S. Code (adjustment of debts of an individual with regular income).[2]

Exception

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 (new Code sec. 1398(b)(1)). In this situation, where the bankruptcy case does not run to completion, it would be appropriate to treat the debtor's tax status as if no proceeding had been brought.[3]

Partnerships, corporations

The bill provides that no taxable entity would result from commencement of a bankruptcy case involving a partnership or corporation. This rule (new Code sec. 1399) would reverse 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 would be the same as present law with respect to commencement of a bankruptcy case involving a corporation (Treas. Reg. § 1.641(b)-2(b)).

Accordingly, the bankruptcy trustee of a partnership in a bankruptcy case would be required to file annual information returns (under section 6031 of the Code) for the partnership. Also, the bankruptcy trustee of a corporation in a bankruptcy case, as under present law, would be required to file annual income tax returns and pay corporate income tax for the corporation (sec. 6012 (b)(3) of the Code; Rev. Rul. 79-120, 1979-1 C.B. 382).

2. *Debtor's election to close taxable year*

In general

The bill would give an individual debtor an election to close his or her taxable year as of the day before the date on which the bankruptcy case commences (the "commencement date"). If the election were made, the debtor's taxable year which otherwise would include the commencement date would be divided into two "short" taxable years of less than 12 months. The first such year would end on the day

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[2] The rationale for generally 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. In a chapter 13 case, however, 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.

For purposes of the separate entity rules under new Code section 1398, a partnership would not be treated as an individual. The interest in a partnership of a debtor who is an individual would be taken into account under new Code section 1398 in the same manner as any other interest of the debtor (new Code sec. 1398(b)(2)).

[3] If the estate is not treated as a separate entity because the bankruptcy case was dismissed, the debtor would include on his or her return(s), for the year(s) the estate was in existence, any gross income, deductions, or credits which otherwise would be tax items of the estate. The estate, although temporarily in existence under bankruptcy law prior to dismissal of the case, would not constitute a taxable entity for Federal income tax purposes.

before the commencement date; the second such year would begin on the commencement date (new Code sec. 1398(d)(3)(A)). If the election were not made, the commencement of the bankruptcy case would not affect the taxable year of an individual debtor (new Code sec. 1398(d)(2)).

As a result of the debtor's making the election, his or her Federal income tax liability for the first short taxable year would become (under bankruptcy law) an allowable claim against the bankruptcy estate as a claim arising before bankruptcy. Accordingly, any tax liability for that year would be collectible from the estate, depending on the availability of estate assets to pay debts of that priority. Inasmuch as any such tax liability for an electing debtor's first short taxable year would not be dischargeable, the individual debtor would remain liable for any amount not collected out of the bankruptcy estate (new 11 U.S. Code sec. 523(a)(1)). If the debtor does not make the election, no part of the debtor's tax liability from the year in which the bankruptcy case commences would be collectible from the estate, but would be collectible directly from the individual debtor.

If the election were made, the debtor would be required to annualize his or her taxable income for each short taxable year in the same manner as if a change of annual accounting period had been made (new Code sec. 1398(d)(3)(F)).

Availability of election

The election provided under the bill would be available in cases to which new section 1398 of the Code applies. Accordingly, the election would be available to an individual debtor in a bankruptcy case under chapter 7 (liquidation) or chapter 11 (reorganization) of title 11 of the U.S. Code, as amended by Public Law 95-598, except where such case is commenced but subsequently dismissed by the bankruptcy court. Also, the bill provides that the election would not be available to a debtor who has no assets other than property which he or she may treat as exempt property under new 11 U.S. Code section 522 (new Code sec. 1398 (d)(3)(C)). In the latter instance, since there would be no assets in the bankruptcy estate out of which the debtor's tax liability for the period prior to the commencement date could be collected, there is no reason to authorize termination of the taxable year.

Due date, manner of election

The election must be made on or before the 15th day of the fourth month following the commencement date—i.e., by the date on which a return would be due for the first short taxable year if the election were made, determined without regard to any extension for filing such return. For example, if the bankruptcy case commences on March 10, the election must be made by July 15 of that year. The election would be made in such manner as prescribed by Treasury regulations, but the election would not be conditioned on approval of the Internal Revenue Service, as under section 442 of the Code. The election, once made, would be irrevocable (new Code sec. 1398(d)(3)(D)).

Spousal election

If the debtor making the election was married on the date the bankruptcy case involving him or her commenced, the debtor's spouse could join in the election to close the taxable year, but only if the debtor and the spouse file a joint return for the first short taxable year (new Code sec. 1398(d)(3)(B)). The filing of a joint return for the first short taxable year would not require the debtor and the spouse to file a joint return for the second short taxable year.

If during the same year a bankruptcy case involving the debtor's spouse were commenced, the spouse could elect to terminate his or her then taxable year as of the day before the commencement date, whether or not the spouse previously had joined in the debtor's election. If the spouse previously had joined in the debtor's election, or if the debtor had not made an election, the debtor could join in the spouse's election. But if the debtor had made an election and the spouse had not joined in the debtor's election, the debtor could not join in the spouse's election, inasmuch as the debtor and the spouse, having different taxable years, could not file a joint return for a year ending with the spouse's commencement date (sec. 6013 of the Code).

Illustrative example

The rules relating to spousal elections under the bill would be illustrated by the following example.

Assume that husband and wife are calendar-year taxpayers, that a bankruptcy case involving only the husband commences on March 1, 1982, and that a bankruptcy case involving only the wife commences on October 1, 1982.

If the husband does not make an election, his taxable year would not be affected; i.e., it does not terminate on February 28. If the husband does make an election, his first short taxable year would be January 1 through February 28; his second short taxable year would begin March 1. The wife could join in the husband's election, but only if they file a joint return for the taxable year January 1 through February 28.

The wife could elect to terminate her then taxable year on September 30. If the husband had not made an election, or if the wife had not joined in the husband's election, she would have (if she made the election) two taxable years in 1982—the first from January 1 through September 30, and the second from October 1 through December 31. If the husband had not made an election to terminate his taxable year on February 28, the husband could join in an election by his wife, but only if they file a joint return for the taxable year January 1 through September 30. If the husband had made an election but the wife had not joined in the husband's election, the husband could not join in an election by the wife to terminate her taxable year on September 30, since they could not file a joint return for such year.

If the husband had made the election and the wife had joined in it, she would have two additional taxable years with respect to her 1982 income and deductions (if she makes the election relating to her own bankruptcy case)—the second short taxable year would be March 1 through September 30, and the third short taxable year would be October 1 through December 31. The husband could join in the wife's election if they file a joint return for the second short taxable year. If the husband does so join in the wife's election, they could file joint returns for the short taxable year ending December 31, but would not be required to do so.

3. Computation of bankruptcy estate's tax liability

Gross income, deductions, credits

Under the bill, the gross income of the bankruptcy estate of an individual would consist of (1) any gross income of the individual debtor realized after the commencement of the case which under bankruptcy law (new 11 U.S. Code) constitutes property of the bankruptcy estate, and (2) the gross income of the estate beginning on and after the date the case commenced (new Code sec. 1398(e)(1)). The deductions and credits of the bankruptcy estate would consist of (1) any item of deduction or credit of the debtor that is properly associated with gross income of the debtor which would be treated (under new Code sec. 1398(e)(1)) as gross income of the estate and (2) the deductions and credits of the estate (new Code sec. 1398(e)(3)).

Taxable year

The first taxable year of the estate would end on the same day as the taxable year of the debtor which includes the commencement date (new Code sec. 1398(d)(1)).

Attribute carryover

The estate would succeed to the following income tax attributes of the debtor (determined as of the first day of the debtor's taxable year in which the case commences):

(*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 Treasury regulations (new Code sec. 1398(g)). For example, the regulations could allow the estate the benefit of section 1341 of the Code if the estate repays income which the debtor received under claim of right.

Character of expenditures

Under present law, it is not clear whether certain expenses or debts paid by the trustee are deductible if the trustee does not actually operate the debtor's trade or business (and if such expenses are not incurred in a new trade or business of the estate.) To alleviate this problem, the bill would provide that an amount paid or incurred by the bankruptcy estate is deductible or creditable by the estate to the same extent as that item would be 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. The same test would be applied to determine whether amounts paid by the estate constitute wages for purposes of Federal employment taxes (new Code sec. 1398(e)(4)).

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 would provide (new 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. Code, ch. 123 (court fees and costs). Such deductions would be available whether or not considered trade or business expenses or investment expenses, but would be subject to disallowance under other provisions of the Internal Revenue Code, such as sections 263 (capital expenditures), 265 (expenses relating to tax-exempt interest), or 275 (certain taxes).

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 would provide that any amount of the new deduction for administrative, etc. expenses not used in the current year could be carried back by the estate three years (but only to a taxable year of the estate) and forward seven years (new Code sec. 1398(h)(2)). These carryovers would be "stacked" after the net operating loss deductions (allowed by sec. 172 of the Code) for the particular year. An administrative, etc. expense which would be deductible solely under new Code sec. 1398(h)(1), or a carryover deduction for such expense, would be allowable only to the estate (new Code sec. 1398(h)(2)(D)).

Carryback of estate's net operating losses

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 (new 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.

Tax rate schedule, etc.

Except as otherwise provided in new 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 and the tax rate schedule applicable to the estate would be the same as for married individuals filing separate returns (new Code sec. 1398(c)). The estate would not be eligible for income averaging.

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 is $2,700 or more (sec. 3(b) of the bill and new sec. 6012(a)(9) of the Code), and to pay the estate's tax liability due for that year (new Code sec. 1398(c)(1)). No return need be filed and no income tax would be due if gross income for the year is less than $2,700.

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 (new 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 sec. 505.

Disclosure of returns

The bill would provide that the estate's Federal income tax return would be open (upon written request) to inspection by or disclosure to the individual debtor (sec. 3(c) of the bill and amended sec. 6103(e) of the Code). Such disclosure would be necessary so that the debtor could properly determine any amount of tax attributes to which the debtor would succeed on termination of the bankruptcy estate.

No-disposition rule

Under the bill, a transfer (other than by sale or exchange) of an asset 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 (new Code sec. 1398(f)(2)).

4. *Computation of individual's tax liability*

Gross income, deductions, credits

If any item of gross income of the debtor realized after commencement of the bankruptcy case would be treated under new Code section 1398(e)(1) as gross income of the bankruptcy estate (because under bankruptcy law such income constitutes property of the estate), that item would not be included by the debtor as gross income on his or her return or a joint return with the debtor's spouse (new Code sec. 1398(e)(2)).

This provision of the bill, treating such income items as gross income of the estate rather than of the individual, would be intended to override otherwise applicable "assignment of income" principles of tax law. For example, if the estate were entitled under bankruptcy law to a salary payment earned by the debtor before the case commences but paid after that date, the amount of the payment would be included in the estate's gross income and is not to be included in the debtor's gross income.

If any item of deduction or credit of the debtor would be treated under new Code section 1398(e)(3) as a deduction or credit of the bankruptcy estate (because such item is properly associated with gross income of the debtor which would be treated as gross income of the estate), that item would not be allowable to the debtor as a deduction or credit on his or her return or a joint return with the debtor's spouse (new Code section 1398(e)(3)). This rule would insure that no particular item of deduction or credit can be allowable to both the debtor and the estate.

No-disposition rule

Under the bill, a transfer (other than by sale or exchange) of an asset 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 (new Code sec. 1398(f)(1)). 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 would provide that an individual debtor cannot 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 (new 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.

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 [4]; and
(*g*) other tax attributes, to the extent provided by Treasury regulations (new Code sec. 1398(i)).

Disclosure of returns

In a bankruptcy case to which new Code section 1398 would apply (determined without regard to whether the case is dismissed), the Federal income tax returns of the debtor for the taxable year in which the bankruptcy case commenced and preceding years would be open (upon written request) to inspection by or disclosure to the trustee of the bankruptcy estate. (This disclosure would be necessary so that the trustee properly may determine attribute carryovers to the estate and may carry back deductions to preceding years of the debtor.) In an involuntary case, however, no such 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

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[4] In a bankruptcy case to which new Code sec. 1398 would apply, any attribute reduction under section 2 of the bill would apply to tax attributes of the bankruptcy estate (except for purposes of applying the basis-reduction rules of section 1017 to property transferred by the estate to the individual) and not to those attributes of the individual which arose after commencement of the case. Also, the bill would provide that in a bankruptcy case involving an individual debtor, no reduction in basis is to be made in the basis of property which the debtor treats as exempt property under new 11 U.S. Code section 522. The tax attributes to the estate, as so reduced, would carry over (to the extent unused on termination of the estate) to the individual debtor pursuant to new Code sec. 1398(i).

purposes of determining whether an order for relief should be entered (sec. 3(c) of the bill and amended sec. 6103(e) of the Code).

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

5. Technical amendment

Section 443(c) of the Code, relating to cross references, would be amended by adding a cross reference to new Code section 1398(d)(3)(E), with respect to returns for a period of less than 12 months in the case of a debtor's election to terminate a taxable year.

6. Effective date

The amendments made by section 3 of the bill would apply to bankruptcy cases commencing more than 90 days after the date of enactment of the bill.

C. Corporate Reorganization Provisions (sec. 4 of the bill and secs. 354, 355, 357, 368, and 381 of the Code)

Present law

Definition of reorganization

A transfer of all or part of a corporation's 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 Internal Revenue Code).

These special rules for insolvency reorganizations generally allow less flexibility in structuring tax-free transactions than the rules applicable to corporate reorganizations as defined in section 368 of the Code. Also, the special rules for insolvency reorganizations do not permit carryover of tax attributes to the transferee corporation, and otherwise differ in important respects from the general reorganization rules.[1] While some reorganizations under chapter X of the Bankruptcy Act may be able to qualify for nonrecognition treatment under section 368, other chapter X reorganizations may be able to qualify only under the special rules of sections 371–374 and not under the general reorganization rules of section 368.

Triangular reorganizations

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of sections 371–374 of the Code, the stock or securities used to acquire the assets of the corporation in bankruptcy must be the acquiring corporation's own stock or securities. This limitation generally precludes corporations in bankruptcy 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 under the general rules of section 368.

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[1] Under present law, it is not clear to what extent creditors of an insolvent corporation who receive stock in exchange for their claims may be considered to have "stepped into the shoes" of former shareholders for purposes of satisfying the nonstatutory "continuity of interest" rule, under which the owners of the acquired corporation must continue to have a proprietary interest in the acquiring corporation. 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); Treas. Reg. § 1.371–1(a)(4)). It is unclear whether affirmative steps by the creditors are required or whether mere receipt of stock is sufficient.

Transfer to controlled subsidiary

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of sections 371–374 of the Code, 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

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of sections 371–374 of the Code, court cases have held that attributes (such as net operating losses) of the corporation in bankruptcy do not carry over to the new 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).

"Principal amount" rule; "boot" test

In a corporate reorganization, generally the exchange of stock or securities of one corporation for those of another corporation is not tax-free to the extent the principal amount of the securities received exceeds the principal amount of the securities surrendered, or to the extent of the principal amount of the securities received if no securities are surrendered (secs. 354(a)(2)(B) and 356(d)(2) of the Code). Also, "boot" (money or property other than stock and securities permitted to be received without recognition of gain) received in a corporate reorganization is subject to the dividend-equivalence test of section 356 of the Code. These rules do not apply under present law to insolvency reorganizations qualifying only 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.[2]

Explanation of provisions

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

Definition of reorganization

In general

The bill would add a new category—"G" reorganizations—to the general Code definition of tax-free reorganizations (sec. 368(a)(1)).

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

The new 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 proceeding [3] in a Federal or State court.[4]

The special tax rules (secs. 371–374) now applicable to insolvency reorganizations would continue to apply only to bankruptcy proceedings commenced prior to October 1, 1979, except that the bill would not terminate the applicability of the rules in sections 374(c) and 374(e) of the Code governing tax-free exchanges under the final system plan for ConRail.

In order to facilitate the rehabilitation of corporate debtors in bankruptcy, etc., these provisions are designed to eliminate many requirements which have effectively precluded financially troubled companies from utilizing the generally applicable tax-free reorganization provisions of present law. To achieve this purpose, the new "G" reorganization provision would not require compliance with State merger laws (as in category "A" reorganizations), would not require that the financially distressed corporation receive solely stock of the acquiring corporation in exchange for its assets (category "C"), and would not require that the former shareholders of the financially distressed corporation control the corporation which receives the assets (category "D").

The "G" reorganization provision added by the bill would require the transfer of assets by a corporation in a bankruptcy or similar case, and the distribution (in pursuance of the court-approved reorganization plan) of stock or securities of the acquiring corporation in a transaction which qualifies under section 354, 355, or 356 of the Code. This distribution requirement is designed to assure that either substantially all of the assets of the financially troubled corporation, or assets which consist of an active business under the tests of section 355, are transferred to the acquiring corporation.

"Substantially all" test

The "substantially all" test in the "G" reorganization provision is to be interpreted in light of the underlying intent in adding the new "G" category, namely, to facilitate the reorganization of companies in bankruptcy or similar cases for rehabilitative purposes. Accordingly, it would be intended that facts and circumstances relevant to this intent, such as the insolvent corporation's need to pay off creditors or to sell assets or divisions to raise cash, are to be taken into account in determining whether a transaction qualifies as a "G" reorganization. For example, a transaction would not be precluded from satisfying the "substantially all" test for purposes of the new "G" category merely because, prior to a transfer to the acquiring corporation, pay-

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[3] For this purpose, the definition of a receivership, foreclosure, or similar proceeding would be the same as under present section 371 of the Code.

[4] Under the bill, asset transfers in a receivership, foreclosure, or similar proceeding involving a financial institution (to which section 585 or 593 of the Code applies) before a Federal or State agency would be treated in the same manner as transfers in such a proceeding before a court. Thus, for example, asset transfers in a receivership proceeding under 12 U.S.C. sec. 1729 involving a savings and loan association could qualify as a "G" reorganization.

ments to creditors and asset sales were made in order to leave the debtor with more manageable operating assets to continue in business.[5]

Relation to other provisions

A transaction which qualifies as a "G" reorganization would not be treated as also qualifying as a liquidation under section 332, an incorporation under section 351, or a reorganization under another category of section 368(a)(1) of the Code.[6]

A transaction in a bankruptcy or similar case which does not satisfy the requirements of new category "G" would not thereby be precluded from qualifying as a tax-free reorganization under one of the other categories of section 368(a)(1). For example, an acquisition of the stock of a company in bankruptcy, or a recapitalization of such a company, which transactions are not covered by the new "G" category, could qualify for nonrecognition treatment under sections 368(a)(1)(B) or (E), respectively.

Continuity of interest rules

The "continuity of interest" requirement which the courts and the Treasury have long imposed as a prerequisite for nonrecognition treatment for a corporate reorganization must be met in order to satisfy the requirements of new category "G". Only reorganizations—as distinguished from liquidations in bankruptcy and sales of property to either new or old interests supplying new capital and discharging the obligations of the debtor corporation—could qualify for tax-free treatment.

It is expected that the courts and the Treasury would apply to "G" reorganizations continuity-of-interest rules which take into account the modification by P.L. 95–598 of the "absolute priority" rule. As a result of that modification, shareholders or junior creditors, who might previously have been excluded, may now retain an interest in the reorganized corporation.

For example, if an insolvent corporation's assets are transferred to a second corporation in a bankruptcy case, the most senior class of creditor to receive stock, together with all equal and junior classes (including shareholders who receive any consideration for their stock), should generally be considered the proprietors of the insolvent corporation for "continuity" purposes. However, if the shareholders receive consideration other than stock of the acquiring corporation, the transaction should be examined to determine if it represents a purchase rather than a reorganization.

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[5] Because the stated intent for adding the new "G" category is not relevant to interpreting the "substantially all" test in the case of other reorganization categories, the comments in the text as to the appropriate interpretation of the "substantially all" test in the context of a "G" reorganization would not be intended to apply to, or in any way to affect interpretations under present law of, the 'substantially all" test for other reorganization categories.

[6] However, if a transfer qualifying as a "G" reorganization also meets the requirements of section 351 or qualifies as a reorganization under section 368(a)(1)(D) of the Code, the "excess liability" rule of section 357(c) would apply if any former shareholder of the transferor corporation receives consideration for his stock, but would not apply if no former shareholder of the transferor corporation receives any consideration for his stock (i.e., if the corporation is insolvent). This rule would parallel present law, under which insolvency reorganizations under sections 371 or 374 are excluded from the application of section 357(c).

Thus, short-term creditors who receive stock for their claims may be counted toward satisfying the continuity of interest rule, although any gain or loss realized by such creditors will be recognized for income tax purposes.

Triangular reorganizations

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

In addition, the bill would permit the acquisition in the form of a "reverse merger" of an insolvent corporation (i.e., where no former shareholder of the surviving corporation receives any consideration for his stock) in a bankruptcy or similar case if the former creditors of the surviving corporation exchange their claims for voting stock of the controlling corporation which has a value equal to at least 80 percent of the value of the debt of the surviving corporation.

Transfer to controlled subsidiary

The bill would permit a corporation which acquires substantially all the assets of a debtor corporation in a "G" reorganization to transfer the acquired assets to a controlled subsidary without endangering the tax-free status of the reorganization. This provision would place "G" reorganizations on a similar footing with other categories of reorganizations.

Carryover of tax attributes

Under the bill, the statutory rule generally governing carryover of tax attributes in corporate reorganizations (sec. 381 of the Code) would also apply in the case of a "G" reorganization. This would eliminate the so-called "clean slate" doctrine and would reflect the fact that adjustments may be made to a reorganized corporation's tax attributes under the rules in section 2 of the bill.[7]

"Principal amount" rule; "boot" test

Under the bill, "G" reorganizations would be subject to the rules governing the tax treatment of exchanging shareholders and security holders which apply to other corporate reorganizations. Accordingly, an exchanging shareholder or security holder of the debtor company who receives securities with a principal amount exceeding the principal amount of securities surrendered would be taxable on the excess, and an exchanging shareholder or security holder who surrenders no securities would be taxed on the principal amount of any securities received. Also, any "boot" received would be subject to the general dividend-equivalence test of section 356 of the Code.

Treatment of accrued interest

Under the bill, a creditor exchanging securities in any corporate reorganization described in section 368 of the Code (including a "G"

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[7] 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. It is anticipated that the amount carried over under section 381 of the Code would be adjusted to take into account any amount of debt discharge income which the corporation realized after the close of the taxable year by delaying the discharge of its debts.

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 attributable to accrued but unpaid interest (including accrued original issue discount) on the securities surrendered. This provision, which would reverse the so-called *Carman* rule,[8] would apply whether or not the exchanging security holder realizes gain on the exchange overall. Under this provision, a security holder which had previously accrued the interest (including original issue discount) as income could recognize a loss to the extent the interest is not paid in the exchange.

If the plan of reorganization allocates the value of the stock or other property received by the creditor between the principal amount of the creditor's security and the accrued interest, both the corporate debtor and the creditor would be required to utilize that allocation for Federal income tax purposes.[9] However, if the value of the stock or other property received by the creditor exceeds the principal amount of the security, the amount allocated to the security could not exceed such principal amount until an amount has been allocated to interest equal to the full amount of the accrued interest.

Example

The reorganization provisions of the bill may be illustrated in part by the following example.

Assume that Corporation A is in a bankruptcy case commenced after October 1, 1979. Immediately prior to a transfer under a plan of reorganization, A's assets have an adjusted basis of $75,000 and a fair market value of $100.000. A has a net operating loss carryover of $200,000. A has outstanding bonds of $100,000 (on which there is no accrued but unpaid interest) and trade debts of $100,000.

Under the plan of reorganization, A is to transfer all its assets to Corporation B in exchange for $100,000 of B stock. Corporation A will

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[8] See note 2, *supra*.

[9] For example, assume that a corporation, pursuant to a plan of reorganization, transfers stock with a value of $55 to its creditor in exchange for the creditor's $100 security with $10 accrued interest. Also assume that, under the terms of the plan, the $55 stock is exchanged for the principal of the debt and no portion of the stock is transferred for the interest claim. In this situation, (1) the security holder would not have any interest income on the exchange (or could deduct $10 if that amount previously had been accrued by the creditor as interest income), and (2) the corporation would have a debt discharge amount of $10, with the tax consequences as determined in section 2 of the bill (except that there would be no debt-discharge amount if either the corporation had not previously deducted the accrued interest or else the prior deduction had not resulted in a "tax benefit" under sec. 111 of the Code).

On the other hand, if the reorganization plan first allocates the stock to accrued interest and the remainder to principal, then (1) the security holder would have $10 of interest income (unless that amount had previously been accrued by the creditor as income) and (2) the corporation would not have any debt discharge amount (since the stock was exchanged for a security).

If the stock is allocated proportionately to principal and accrued interest, then (1) the security holder would have $5 of interest income (unless that amount had previously been accrued by the creditor as income), and (2) the corporation's debt discharge amount would be $5, with the tax consequences as determined in section 2 of the bill (except that there would be no debt discharge amount if either the corporation had not previously deducted the accrued interest or else the prior deduction had not resulted in a "tax benefit" under section 111 of the Code).

distribute the stock, in exchange for their claims against A, one-half to the security holders and one-half to the trade creditors. A's shareholders will receive nothing.

The transaction would qualify as a reorganization under new section 368(a)(1)(G) of the Code, since all the creditors are here treated as proprietors for continuity of interest purposes. Thus, A would recognize no gain or loss on the transfer of its assets to B (sec. 361). B's basis in the assets would be $75,000 (sec. 362), and B would succeed to A's net operating loss carryover (sec. 381).

Under the bill, the distribution of B stock to A's security holders would not result in income from discharge of indebtedness or require attribute reduction. On the distribution of B stock to A's trade creditors, A would exclude from gross income the debt discharge amount of $50,000—i.e., the difference between the $100,000 debt held by nonsecurity creditors and the $50,000 worth of stock given for such debt. A could elect to reduce the basis of its depreciable assets transferred to B by all or part of the $50,000 debt discharge amount; to the extent the election were not made, the debt discharge amount would reduce A's net operating loss carryover by the remainder of the debt discharge amount. Assuming that A's creditors did not acquire their claims for purposes of acquiring stock, there would be no reduction of A's net operating loss carryover under section 382.

Assume the same facts as above except that B also transfers $10,000 in cash, which is distributed by A to its creditors. Although A would otherwise recognize gain on the receipt of boot in an exchange involving appreciated property, the distribution by A of the $10,000 cash to those creditors having a proprietary interest in the corporation's assets for continuity of interest purposes would prevent A from recognizing any gain (sec. 361(b)(1)(A)).[10]

Technical and conforming amendments

Section 4(h) of the bill would make technical and conforming amendments to the Internal Revenue Code.

1. Amendment of section 354(b).—Paragraphs (1) and (2) of section 354(b) of the Code, relating to exception to general rule on exchanges of stock and securities in certain reorganizations, would be amended by adding references to new subparagraph "G" of section 368(a)(1).

2. Amendment of section 357(c)(2).—Section 357(c)(2) of the Code, providing exceptions to the general rule with respect to liabilities in excess of basis on transfers to controlled corporations, would be amended to add an exception for any exchange pursuant to a plan of reorganization under new category "G" of section 368(a)(1) if no former shareholder of the transferor corporation receives any consideration for his stock.[11]

3. Amendment of section 368(a)(1).—A conforming amendment would be made to section 368(a)(1) of the Code to take into account the addition of new category "G" reorganizations.

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[10] See sec. 371(a)(2)(A) of the Code and Treas. Reg. § 1.371-1(b) for a similar rule relating to distribution of boot to creditors in an insolvency reorganization under present law.

[11] See note 6, *supra*.

4. *Amendment of section 368(b)*.—Section 368(b) of the Code, defining "party to a reorganization", would be amended to include references to new category "G" reorganizations.

5. *Technical change*.—A change would be made in the table of sections for part IV of subchapter C of chapter 1 of the Code.

Effective date

The amendments made by section 4 of the bill would apply to bankruptcy cases commencing on or after October 1, 1979, and to receivership, foreclosure, or similar judicial proceedings begun on or after that date.

In addition, the amendments made by section 4(e) of the bill, relating to exchanges of property for accrued interest, also would apply to transactions occurring after December 31, 1980, other than transactions in a proceeding under the Bankruptcy Act or in a receivership, foreclosure, or similar judicial proceeding begun before October 1, 1979.

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

1. Exception from personal holding company status (sec. 5(a) of the bill and sec. 542 of the Code)

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

Under this provision, a corporation subject to court jurisdiction in a bankruptcy or similar case [1] would not be considered a personal holding company. This exception would not be available, however, if a major purpose in commencing or continuing the proceeding is avoidance of the personal holding company tax.

Effective date

The amendment made by this provision would apply to bankruptcy cases commenced on or after October 1, 1979 and to similar cases commenced on or after that date.

2. Repeal of special treatment for certain railroad stock redemptions (sec. 5(b) of the bill and sec. 302 of the Code)

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 Code).

Explanation of provision

This provision would repeal the special rule giving automatic capital gain treatment in the case of redemptions of certain stock issued by railroad corporations in bankruptcy.

Effective date

The amendment made by this provision would apply to a redemption of stock issued after September 30, 1979 (other than stock issued pursuant to a plan of reorganization approved on or before that date).

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[1] The terms "bankruptcy case" and "similar case" refer, respectively, to (1) cases under new 11 U.S. Code (i.e., bankruptcy cases commenced on or after October 1, 1979) and (2) receivership, foreclosure, or similar proceedings in a Federal or State court (or, in the case of a financial institution, a Federal or State agency).

3. Application of section 337 liquidation rule to insolvent corporations (sec. 5(c) of the bill and sec. 337 of the Code)

Present law

Under present law, a corporation which adopts a plan of liquidation and within 12 months thereafter liquidates in a distribution to shareholders generally does not recognize gain or loss on sales within that period (sec. 337 of the 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 on liquidation to creditors rather than to shareholders (Rev. Rul. 56–387, 1956–2 C.B. 189).

Explanation of provision

This provision would allow an insolvent corporation (i.e., where no shareholder of the corporation receives any consideration for his stock) in a bankruptcy or similar case [2] to sell certain of its assets tax-free where the corporation, after the case commences, adopts a plan of complete liquidation and, upon the liquidation, all of the corporation's assets are transferred to its creditors within the nonrecognition period.[3] The period for nonrecognition would begin on the date of adoption (after commencement of the case) of a plan of liquidation and ends on the date the case terminates. This provision would not apply to assets acquired on or after the date of adopting the liquidation plan, other than to inventory sold in bulk.

Effective date

This provision would apply to bankruptcy cases commencing on or after October 1, 1979 and to similar cases commencing on or after that date.

4. Estate of individual in bankruptcy as subchapter S shareholder (sec. 5(d) of the bill and sec. 1371 of the Code)

Present law

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

The Internal Revenue Service has ruled 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 ruled 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 Selection.[4]

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[2] See note 1, *supra*.

[3] A liquidating solvent corporation in a bankruptcy or similar case could make tax-free sales during the 12-month nonrecognition period of present law (sec. 337).

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

Explanation of provision

Under the bill, the bankruptcy estate of an individual would be allowed as an eligible shareholder in a subchapter S corporation. Thus, a corporation's subchapter S election would not be terminated because of commencement of a bankruptcy case involving an individual who is a shareholder in the corporation. In addition, the bankruptcy estate of an individual which owns stock in a corporation could consent to an election under subchapter S made by the corporation after commencement of the bankruptcy case.

Effective date

The amendment made by this provision would apply to bankruptcy cases commenced on or after October 1, 1979.

5. Certain transfers to controlled corporations (sec. 5(e) of the bill and sec. 351 of the Code)

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 Code). For this purpose, property includes (1) indebtedness of the transferee corporation not evidenced by a security [5] and (2) a claim for accrued interest on indebtedness of the transferee corporation.[6]

Explanation of provision

Under the provision, transfers to a controlled corporation of indebtedness of the corporation which is not evidenced by a security, or of claims against the corporation for accrued but unpaid interest on indebtedness, would not be covered by the nonrecognition rule of section 351 of the Code.

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 or simliar case [7] to the extent the stock or securities received in exchange for the assets are used by the debtor to pay off his debts. Accordingly, gain or loss would be recognized to the debtor upon the debtor's transfer of assets to the controlled corporation if the stock is then transferred to creditors pursuant to a plan approved in a bankruptcy or similar case. (If less than all the stock is transferred to creditors, a proportionate share of gain or loss would be recognized.) Since the basis of the stock received is adjusted for any gain or loss recognized, the amount recognized on the transfer of the stock to the creditors would reflect any amount recognized on the incorporation transfer.

Thus, the sum total of income or loss to the debtor in the two transfers would be the same as if the assets had been transferred directly to the creditors. However, the basis of the assets in the hands of the corporation also would be adjusted by any gain or loss recognized on the

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

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

[7] See note 1, *supra*.

transfer to the corporation, thus reducing any "built-in" loss on assets which had depreciated in value.[8]

Effective date

The effective date for this provision would be the same as for section 2 of the bill, relating to income from discharge of indebtedness.

6. Effect of discharge of indebtedness on earnings and profits (sec. 5(f) of the bill and sec. 312 of the Code)

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.[9]

Explanation of provision

The bill would provide that to the extent that income from discharge of indebtedness (including an amount excluded from gross income pursuant to section 108 of the Code, as amended by this bill) is applied to reduce basis under section 1017 of the Code, such basis-reduction amount does not affect the debtor corporation's earnings and profits (although reduced depreciation deductions or increased gains on sales of reduced-basis assets would affect earnings and profits in the years such deductions are taken or sales made). Otherwise, discharge of indebtedness income, including amounts excluded from gross income (pursuant to section 108 of the Code, as would be amended by this bill), increases the earnings and profits of the corporation (or reduces a deficit).

Effective date

The effective date for this provision would be the same as for section 2 of the bill, relating to income from discharge of indebtedness.

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[8] This rule does not apply to a transfer under a plan of reorganization, since no gain or loss is recognized by reason of section 361 of the Code.

[9] 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 (secs. 6(a), (b), (c), (d), and (g) of the bill and secs. 6213, 6503, 6871, and 7464 of the Code)

Procedures under Bankruptcy Act

Bankruptcy court jurisdiction

In the case of an individual debtor, the commencement of a bankruptcy proceeding creates an estate, which is under control of the bankruptcy court. This estate consists of all assets of the individual other than exempt property and certain assets acquired after the proceeding begins. 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). In proceedings under the Bankruptcy Act [1] 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 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, if 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 fully paid out of estate assets.

Effect on Tax Court jurisdiction

Under present Federal income tax law (sec. 6871 of the Code) as applicable to Bankruptcy Act proceedings, the Internal Revenue Service is authorized, on institution of a bankruptcy proceeding, immediately 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 petition had not expired before commencement of the bankruptcy proceeding, the debtor still is barred from contesting the asserted liability in the Tax Court (i.e., from litigating without first paying the disputed amount) if the Revenue Service exercises its immediate assessment authority. Present income tax law likewise

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[1] The Bankruptcy Act was repealed by P.L. 95–598, effective for bankruptcy cases commencing on or after October 1, 1979, but remains in effect for bankruptcy proceedings commenced prior to that date.

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).

Under the law applicable to Bankruptcy Act proceedings, the U.S. Tax Court thus 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 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 the law applicable to Bankruptcy Act proceedings, in certain circumstances there may be duplicative litigation concerning 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.[2] The new law, effective for bankruptcy cases commenced on or after October 1, 1979, also seeks to resolve the problems 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 section 362(a)(8), commencement of a bankruptcy case triggers an automatic stay of institution or continuation of any U.S. Tax Court proceedings to challenge an asserted tax de-

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[2] Under the law applicable to Bankruptcy Act proceedings, 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, the bankruptcy court has 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 debtor had not done so prior to commencement of the bankruptcy case). If a claim filed by the trustee is denied or if 120 days elapse without action by the Internal Revenue Service, the court has jurisdiction to determine the refund issue.

ficiency 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)).[3] Unless 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 decides the tax issue and (at the request of the Revenue Service 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.

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, as described above. These procedures include the automatic stay on assessment or collection of certain tax claims against the debtor, the automatic stay on institution or continuation by the debtor of deficiency litigation in the U.S. Tax Court, and the authority of the bankruptcy court to lift the stay and permit the debtor's tax liability to be determined by the Tax Court.

Immediate assessment

General rule

Section 6(g) of the bill generally would repeal the present rule (in sec. 6871(a) of the Code) authorizing the Internal Revenue Service to assess certain prepetition tax deficiencies of the debtor immediately

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[3] The stay does not preclude the Internal Revenue Service from issuing a deficiency notice during the bankruptcy case (new 11 U.S. Code sec. 362(b)(8)). government.[4]

[4] 124 Cong. Rec. H–11,111 (daily ed. Sept. 28, 1978) (remarks of Mr. Edwards); 124 Cong. Rec.. S–17,427 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini). 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).

on institution of bankruptcy proceedings. Accordingly, if the bankruptcy court lifts the automatic stay under new 11 U.S. Code section 362(a)(8), the debtor would not be precluded from filing a petition (if timely) in the Tax Court to challenge an asserted prebankruptcy tax deficiency.

Exceptions

The bill would authorize the Revenue Service to make an immediate assessment (1) of tax imposed on the bankruptcy estate of an individual debtor, or (2) of tax imposed on a debtor if liability for such tax has become res judicata against the debtor pursuant to a bankruptcy court determination.

These two exceptions reflect bankruptcy situations in which there is no need to require the Revenue Service to follow the normal deficiency notice procedure. In the case of taxes imposed on the bankruptcy estate of an individual (i.e., where the estate is treated as a separate taxable entity), the estate's own tax liability is determined by the bankruptcy court and cannot be litigated in the Tax Court. In the case where an individual debtor's personal liability for nondischargeable tax claims has been litigated in the bankruptcy court, and under the doctrine of res judicata the debtor would be precluded from relitigating the issue in any court, no purpose would be served by requiring issuance of a deficiency notice prior to assessment. For the same reason, the bill would permit immediate assessment of a corporate debtor's tax liabilities once the bankruptcy court has made a determination which is res judicata.

Conforming rules

The bill also would amend section 6871 of the Code to delete the prohibition in current law on filing a Tax Court petition after commencement of a bankruptcy proceeding. This change likewise would conform to the provisions of P.L. 95–598 which stay the debtor, on commencement of a bankruptcy case, from instituting a Tax Court proceeding to challenge an asserted tax deficiency, but authorize 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). Also, the bill would restate the rule of present law that claims for certain tax deficiencies, etc. may be presented for adjudication before the bankruptcy court, notwithstanding the pendency of any Tax Court proceedings for redetermination of the deficiency.

Receiverships

The bill would not modify the present law rules in section 6871 of the Code relating to receivership proceedings. To the extent immediate assessment authority is retained for receivership proceedings, and for the two bankruptcy situations described above, the bill would expand the category of taxes which could be so assessed to include taxes under Internal Revenue Code chapters 41 (public charities), 42 (private foundations and black lung benefit trusts), 43 (qualified pension, etc., plans), and 44 (real estate investment trusts).

Collection

Section 6(g) of the bill also would amend section 6873(a) of the Code to delete the rule that any portion of a claim for nondischargeable taxes allowed in a bankruptcy case but not satisfied out of assets in the estate must be paid by the taxpayer upon notice and demand by the Internal Revenue Service after termination of the bankruptcy case. (No change would be made in section 6873 with respect to payment of claims for taxes allowed in a receivership proceeding.) As described above, if the bankruptcy court has made a determination of the debtor's tax liability which (under the doctrine of res judicata) precludes the debtor from relitigating the issue in any other court, the Revenue Service could make an immediate assessment of such liability without issuing a deficiency notice. Thereafter, the provisions of the Code relating to collection of assessed taxes would apply.

Tax Court petition

Section 6(b) of the bill would provide that if the stay under new 11 U.S. Code section 362(a)(8) 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 is 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 (such as a request that the court determine the personal liability of an individual debtor for a nondischargeable tax) is not to be treated as prohibited under section 6213(a) of the Code (relating to certain restrictions generally applicable to assessment of a tax deficiency).

Tax Court intervention

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

Assessment and 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.

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 (sec. 6(e) of the bill and new sec. 6658 of the Code.)

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 the 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 the trustee from penalties which otherwise might be applicable under sections 6651, 6654, or 6655 of the Code for failure timely to pay certain taxes, with respect to a period during which a bankruptcy case is pending, to the extent that the bankruptcy case precludes payment of such taxes when due.[5]

In the case of a tax incurred by the estate, the relief would be granted if the failure occurs pursuant to a court order finding probable insufficiency of funds to pay such taxes. In the case of a tax incurred by the debtor before commencement of the bankruptcy case, the relief provision of the bill would apply if either the bankruptcy petition is filed before the tax return due date, or the date for imposing the penalty occurs after commencement of the bankruptcy case.

These relief rules would not, however, apply with respect to 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 (sec. 6(f) of the bill and sec. 3302 of the Code)

Present law

Present law provides a credit against the Federal unemployment tax imposed on an employer for amounts paid by the employer into a State unemployment compensation fund (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).

Explanation of provision

Section 6(f) of the bill would amend section 3302(a) of the Code to provide that there is no reduction in the credit against the FUTA tax if the failure to make timely contributions to a State unemployment compensation fund, with respect to wages paid by the trustee of a bankruptcy estate, is without fault of the trustee on account of the bankruptcy case.

4. Repeal of deadwood provision (sec. 6(h) of the bill and sec. 1018 of the Code)

Present law

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

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[5] No inference would be intended, by virtue of adoption of the rules in section 6(e) of the bill, that under present law such penalties should be imposed where a debtor or the trustee of a bankruptcy estate is precluded from timely paying such taxes by virtue of bankruptcy proceedings.

Explanation of provision

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

5. Technical and conforming amendments (sec. 6(i) of the bill)

Section 6(i) of the bill would make technical and conforming amendments to the Internal Revenue Code, principally to substitute references to bankruptcy cases under new title 11 of the U.S. Code for references to bankruptcy proceedings under the now-repealed Bankruptcy Act.

1. Amendment of section 128(a).—In section 128(a) of the Code, relating to cross references to other Acts, the reference to the Bankruptcy Act would be deleted.

2. Amendment of section 354(c).—Section 354(c) of the Code, relating to exchanges of stock and securities in certain railroad reorganizations, would be amended to substitute a reference to plans of reorganization confirmed under new 11 U.S. Code section 1173, for a reference to plans approved by the Interstate Commerce Commission under section 77 of the Bankruptcy Act.

3. Amendment of section 422(c).—Section 422(c)(5) of the Code relating to certain transfers by insolvent individuals of stock acquired pursuant to exercise of a qualified stock option, would be amended by substituting a reference to new 11 U.S. Code for a reference to the Bankruptcy Act.

4. Amendment of section 1023.—Section 1023 of the Code, relating to cross references, would be amended by deleting a cross reference to the Bankruptcy Act.

5. Amendment of section 6012(b).—Section 6012(b)(3) of the Code, relating to returns made by receivers, trustees, and assignees for corporations, would be amended by substituting a reference to a trustee in a bankruptcy case under new 11 U.S. Code for a reference to a trustee in a bankruptcy proceeding (under the Bankruptcy Act).

6. Amendment of section 6036.—Section 6036 of the Code, relating to notice of qualification as executor or receiver, would be amended by substituting a reference to a trustee in a bankruptcy case under new 11 U.S. Code for a reference to a trustee in a bankruptcy proceeding (under the Bankruptcy Act).

7. Amendment of section 6155(b).—Section 6155(b)(2) of the Code, relating to cross references, would be amended by deleting the reference to section 6873 of the Code with respect to bankruptcy proceedings (under the Bankruptcy Act).

8. Amendment of section 6161(c).—Section 6161(c) of the Code, relating to extension of time for payment of tax claims in bankruptcy or receivership proceedings, would be amended by substituting references to bankruptcy cases under new 11 U.S. Code for references to bankruptcy proceedings (under the Bankruptcy Act).

9. Amendment of section 6216(1).—Section 6216(1), relating to cross references, would be amended by deleting a reference to subchapter B of chapter 70 of the Code with respect to bankruptcy procedures.

10. Amendment of section 6326.—Section 6326 of the Code, relating to cross references, would be amended by deleting references to the Bankruptcy Act and adding references to new 11 U.S. Code.

11. Amendment of section 6503(i).—Section 6503(i)(2), relating to cross references, would be amended by deleting a reference to subchapter C of chapter 70 of the Code with respect to suspension of running of period of limitation in a bankruptcy proceeding (under the Bankruptcy Act).

12. Amendment of section 6872.—Section 6872 of the Code, relating to suspension of period on assessment, would be amended by substituting a reference to a bankruptcy case under new 11 U.S. Code for a reference to a bankruptcy proceeding under the Bankruptcy Act.

13. Amendment of section 7430.—Section 7430 of the Code, relating to cross references, would be amended by deleting references to the Bankruptcy Act and adding references to new 11 U.S. Code.

14. Amendment of section 7508(d).—Section 7508(d)(1) of the Code, relating to time for performing certain acts postponed by reason of service in combat zone, would be amended by substituting a reference to bankruptcy cases under new 11 U.S. Code for a reference to bankruptcy proceedings (under the Bankruptcy Act).

6. Effective date for provisions of section 6 of the bill

The provisions of section 6 of the bill (relating to changes in tax procedures) would be effective October 1, 1979, except that such provisions would not apply to any Bankruptcy Act proceeding commenced before October 1, 1979.

F. Revenue Effect

The revenue effect of the provisions of the bill, other than of those provisions of section 2 (tax treatment of discharge of indebtedness) which apply to solvent taxpayers outside bankruptcy, cannot be estimated with precision. However, it is estimated that the provisions of section 2 other than those applicable to solvent taxpayers outside bankruptcy would result in some revenue gain; that the provisions of section 3 (rules relating to title 11 cases for individuals) and of section 6 (changes in tax procedures) would have a negligible revenue effect; and that the provisions of section 4 and 5 (corporate reorganization provisions and miscellaneous corporate amendments) would result in some revenue loss.

It is not expected that these revenue effects would be significant during the next few fiscal years. This is because the provisions of the bill generally would apply only to bankruptcy cases or similar court proceedings beginning on or after October 1, 1979, to transactions occurring more than 90 days after the date of enactment, or to transactions occurring after December 31, 1980; because it can take considerable time for completion of bankruptcy cases or similar proceedings and of corporate insolvency reorganizations; and because the debt discharge rules of the bill generally would affect revenues in years subsequent to the year in which the debt discharge occurs.

It is estimated that those provisions of section 2 of the bill which apply to solvent taxpayers outside bankruptcy, and which would modify the election under sections 108 and 1017 of the Code to reduce basis of assets in lieu of recognizing income from discharge of indebtedness, would increase tax revenues by less than $5 million annually.

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