Bankrupt Partnerships and Disregarded Entities

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This report analyzes the development of the tax rules applicable to bankrupt partnerships and disregarded entities, and it discusses how in today's environment those tax rules produce results and encourage behaviors that undercut the goals of both bankruptcy policy and revenue collection. It also discusses how those results and behaviors resemble those that existed in the early 1930s and prompted the Depression-era Congresses to rewrite our bankruptcy and tax laws to facilitate the rehabilitation of distressed businesses. The report draws on that history, Congress's long-standing practice of designing the tax law to accommodate bankruptcy policy, and the overriding importance of bankruptcy policy in the broader economic context to argue that the current tax rules applicable to distressed partnerships and disregarded entities should be changed to facilitate the bankruptcy restructuring process. The report also explores some self-help remedies that owners of distressed partnerships and disregarded entities can use to mitigate the harshness of the results produced by the current tax rules.

The authors are deeply grateful to Paul Oosterhuis, Andre LeDuc, Max Miller, Art Rollin, and Jim Sowell for commenting on prior drafts of this report. They thank David Shakow for providing some insight on the legislative process that led to the enactment of the Bankruptcy Tax Act of 1980. They are also thankful for the research assistance of Justin Winerman, Bob Wille, Nick Gianou, Christine Morong, and the staff of the Skadden library, and for the administrative assistance of Jamie Jones-Mikesell, Elisha Mantia, Veronica Michalowski, Michaline Siera, John Irish, and the staff of the Chicago word processing department. As always, the mistakes in this report are those of the authors.

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I. Introduction

Tax lawyers have known for a quarter-century that a bankruptcy restructuring of a partnership can result in a crushing tax burden for the partnership's owners. Yet because of either the eternal optimism of the tax bar or our collective sense of self-preservation, one would be hard-pressed to find a single tax lawyer who has ever looked a client in the eye and said, ''Although a partnership may provide you with enormous flexibility and savings during the good years, a C corporation is preferable because partnerships behave poorly in bankruptcy.''

Unlike their brethren in the tax bar, corporate lawyers seem to assume that every undertaking will end in a disaster that needs to be isolated in a separate limited liability entity. With tax planning based on an assumption of success and corporate planning based on an assumption of failure, legal and tax advisers have grown accustomed to complicated structures involving multiple tiers of limited liability entities that are treated as partnerships or, more recently, disregarded entities (DEs).[1] In

[1]For example, when General Growth Properties Inc., a large shopping center real estate investment trust, filed for bankruptcy on April 16, 2009, the bankruptcy filing listed as debtors more than 275 entities that were designated as limited partnerships (LPs) or limited liability companies. *See* Voluntary Petition of General Growth Properties Inc., filed Apr. 16, 2009 (S.D.N.Y.); *see also* Voluntary Petition of Capmark Financial Group Inc., filed Oct. 25, 2009 (D. Del.) (listing 37 LLCs and LPs); Voluntary Petition of Chrysler LLC, filed Apr. 30, 2009 (S.D.N.Y) (listing 16 LLCs and LPs); Voluntary Petition of Extended Stay Inc., filed

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recent years, tax advisers have witnessed a surge in the use of passthrough entities[2] — a term that, for purposes of this report, encompasses only entities that are classified for tax purposes as partnerships or DEs — and Treasury estimates that more than half of all business income is earned through entities such as partnerships, DEs, and S corporations.[3]

Now that the Great Recession has forced businesses of all types and sizes to address the tax problems presented by distressed passthrough entities, many of us will have to deal in one way or another with two facts. First, bankruptcy of a passthrough entity could trigger a ruinous income tax liability for its owners. Second, those owners will expect their tax advisers to develop techniques to prevent that tax liability from arising.

Those two facts will often interact to prevent the parties from completing a restructuring that achieves all of their goals. Bankruptcy plans that work best from an economic perspective may produce significant tax liabilities for the owners, while alternate techniques that produce favorable tax results for the owners may produce poor economic results for other stakeholders (such as creditors, vendors, and employees). Not surprisingly, the owners of a distressed passthrough entity often elect the path that produces the lowest owner-level tax liability, even if that path produces poor economic results overall.

This brings us to the central point of this report. If we are to restore our national finances, we need to restore our economy. If we are to restore our economy, we need to rehabilitate our distressed business entities — entities that are more likely than ever to be operated in passthrough form. The rehabilitation process often will require a bankruptcy restructuring that restores the economic productivity of the distressed entity. To the extent tax law distorts the process by encouraging the use of techniques that produce favorable tax results for the owners of the distressed passthrough entity and unfavorable economic results for other stakeholders in the entity, the tax law undercuts the goals of both bankruptcy policy and revenue collection.

During the Great Depression, Congress faced a similar situation with corporate bankruptcies. It found that bankruptcy and tax law were forcing distressed businesses into ruinous liquidations. To mitigate the harm created by those liquidations, Congress overhauled the bankruptcy laws to enable more businesses to survive as going concerns, and it modified the tax laws to make the bankruptcy process tax free. Congress believed the country's best interests were served by having the tax law's revenue collection function yield to the rehabilitative function of bankruptcy law.[4] We believe it is in the national interest to continue that approach by revising the tax rules applicable to bankrupt passthrough entities to accommodate the bankruptcy process.

In making the case for change, Section II of this report explores the policy goals underlying bankruptcy law and the manner in which bankruptcy tax policy has developed over the past 90 years. Section III illustrates how the current tax rules applicable to bankrupt passthrough entities produce draconian tax results at the owner level, and it describes how those tax results distort the restructuring process and subvert the goals of both bankruptcy policy and tax collection. Section IV discusses some recommendations that could be adopted to address the problems described in Section III. Finally, Section V explores some alternate techniques that may be used to reduce the problems described in Section III.

II. Policy Background

A. Bankruptcy Policy

In the summer of 1970, Congress created the Commission on the Bankruptcy Laws of the United States.[5] The bankruptcy commission was asked to review and provide recommendations for modernizing the nation's bankruptcy laws, which had not undergone a comprehensive review since the enactment of the Chandler Act in 1938.[6] The Chandler Act made major revisions to the Bankruptcy Act of 1898.[7] After two years of work and

June 15, 2009 (S.D.N.Y.) (listing 57 LLCs and LPs); Voluntary Petition of Sun-Times Media Group Inc., filed Mar. 31, 2009 (D. Del.) (listing 13 LLCs and LPs); Voluntary Petition of Tribune Co., filed Dec. 8, 2008 (D. Del.) (listing 18 LLCs and LPs).

[2]*See, e.g.*, International Association of Commercial Administrators, *2007 Annual Report of the Jurisdictions* (Corporation Service Co. 2007). For example, by December 31, 2006, Delaware had 276,320 active corporations on file (down 22,181 from the previous year) and 455,091 LLCs, LPs, and limited liability partnerships (up 62,910 from the previous year). In 2006, 33,449 new corporations were formed, while a total of 107,523 LLCs, LPs, and LLPs were formed. *See also* Friedman, "The Silent LLC Revolution — The Social Cost of Academic Neglect," 38 *Creighton L. Rev.* 35 (2004) (discussing the increased use of LLCs in all 50 states); *infra* text accompanying notes 179-184 (analyzing government statistics concerning the extent to which U.S. business income is earned through entities such as S corporations, partnerships, and DEs).

[3]Peter R. Merrill, "The Corporate Tax Conundrum," *Tax Notes*, Oct. 8, 2007, p. 174, *Doc 2007-21273, 2007 TNT 196-40*.

[4]*See infra* text accompanying notes 26-44 (discussing the Depression-era amendments to the bankruptcy and tax laws, which were designed to increase economic productivity and aid creditors' recoveries by enabling more distressed businesses to survive as going concerns).

[5]Act of July 24, 1970, P.L. 91-354, 84 Stat. 468. The members of the bankruptcy commission were appointed by the president of the United States, the president of the Senate, the speaker of the House, and the chief justice of the Supreme Court.

[6]William T. Plumb Jr., "The Corporate Tax Conundrum Laws — Reorganizations, Carryovers and the Effects of Debt Reduction," 29 *Tax L. Rev.* 227, 229 (1973) (hereinafter Plumb I).

[7]Bankruptcy Act of 1898, ch. 541, 30 Stat. 544 (repealed 1978). The formal name of the Bankruptcy Act of 1898 was An Act to Establish a Uniform System of Bankruptcy Through the United States. Until the creation of the U.S. Code, statutes were organized merely as statutes at large. Congress began to assemble its legislation into the U.S. Code in 1926. *See* Preface: The Code of the Laws of the United States, 11 U.S.C. at xvii (1977). It was not until 1928 that federal legislation was regularly organized into the U.S. Code. *See* Act of May 29, 1928, ch. 910, 45 Stat. 1007.

hearings, the bankruptcy commission delivered to Congress a detailed report[8] and model legislation,[9] which together formed the basis of the bankruptcy and tax legislation that was adopted later in that decade.

In developing its recommendations, the bankruptcy commission noted that "no coherent, well developed general policy or philosophy has come to the Commission's attention that takes into account the scope of the [Bankruptcy] Act and the experience under it."[10] Thus, in developing recommendations and drafting its model legislation, the bankruptcy commission incorporated several theories on the purpose of bankruptcy law,[11] two of which are particularly relevant to this report. The first is that the purpose of bankruptcy law is to prevent a financial impasse between debtor and creditor from destroying the debtor's economic productivity (the productivity theory). The second is that the law should prevent creditors from reducing the value of one another's claims by pursuing those claims in separate proceedings that result in piecemeal sales of the debtor's assets (the collective action theory).[12]

1. The productivity theory. The productivity theory provides that bankruptcy law exists primarily to convert insolvent, and therefore unproductive, economic units into solvent and productive units that will contribute to the economy as consumers or employers.

Under the productivity theory, once an economic unit becomes insolvent, that unit exists only to serve its creditors. Because it will function without any upside potential of its own, the unit can be expected to perform at the lowest level needed to sustain its day-to-day existence. If the unit is an individual, it will revert to a pauper's existence in which it purchases only the essentials of life, such as shelter, food, and clothing.[13] If the unit is a business entity, it will become a so-called zombie company — the business equivalent of a pauper — that abandons any attempt at growth and directs any (remaining) employees to maintain revenue and reduce costs as much as possible.[14] In both cases, the insolvent unit functions well below its optimum level of productivity, to the detriment of the economy as a whole. As Prof. Nicholas Georgakopoulos has stated:

> Each productive entity is a nexus in the web of economic activity. Every transaction gives rise to consumer and producer surplus. Every transaction accelerates the velocity of money. And every transaction that exchanges product for cash leads to more transactions, more productivity, and consumer and producer surplus. The removal of a productive individual from this economic web has consequences that match Maynard Keynes' notion about the multiplier. *Just as Keynes held that the restoration of economic activity has an effect greater than the spending it requires, so the destruction of an individual's economic activity has an effect greater than the production that does not occur*.[15]

The bankruptcy process restores insolvent units to productivity, thereby benefiting the economy as a whole.[16] For example, a financially distressed individual may extinguish or restructure his liabilities by completing a bankruptcy process under chapter 7 or chapter 13 of the Bankruptcy Code.[17] Similarly, an insolvent business entity may enter bankruptcy proceedings that result in

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[8]H.R. Doc. No. 93-137, pt. I (1973) (hereinafter bankruptcy commission report).

[9]*Id.* pt. II (hereinafter bankruptcy commission proposed legislation).

[10]Bankruptcy commission report, *supra* note 8, at 61.

[11]*Id.* at 61-83; *Local Loan Co. v. Hunt*, 292 U.S. 234 (1934) ("One of the primary purposes of the bankruptcy act is to relieve the honest debtor from the weight of oppressive indebtedness and permit him to start afresh free from the obligations and responsibilities consequent upon business misfortunes" (citations omitted)); *see also* Elizabeth Warren, "Bankruptcy Policy," 54 *U. Chi. L. Rev.* 775, 776 (1987) ("Currently, the policies endorsed to support bankruptcy pronouncements are wide-ranging and, at the extremes, very much in opposition. Despite the critical importance of different policy presumptions, the policy elements underlying most discourses are asserted only obliquely, and they are rarely challenged directly").

[12]Bankruptcy commission report, *supra* note 8, at 75.

[13]Nicholas L. Georgakopoulos, "Bankruptcy Law for Productivity," 37 *Wake Forest L. Rev.* 51, 58 (2002) (citing *Local Loan Co.*, 292 U.S. at 245).

[14]*See, e.g.*, John Murray Brown, "Ireland to Pay €54bn for Banks' Bad Debts and to Spur Lending," *Financial Times*, Sept. 17, 2009, at 5 (detailing the economic problems presented by zombie companies); Lingling Wei and Maurice Tamman, "Fed Frets About Commercial Real Estate," *The Wall Street Journal*, Oct. 7, 2009, at C1; Thomas A. Corfman, "Zombie Fears Stalk Tishman in the Loop," *Crain's Chi. Bus.*, Dec. 7, 2009, at 1.

[15]Georgakopoulos, *supra* note 13, at 64 (emphasis added).

[16]*Id.* at 52 ("The productivity incentives that bankruptcy law creates share a feature. The debtor's financial impasse destroys productivity — either production incentives or outright productive capacity — that would otherwise contribute to social welfare in ways that the debtor does not internalize. Insolvency destroys productivity in various ways and bankruptcy revives it.").

[17]Under an individual chapter 7 bankruptcy, the individual debtor will transfer some of his assets to a bankruptcy estate, and a trustee of the estate will sell those assets and distribute the proceeds to creditors in full repayment of the debtor's dischargeable liabilities. In that area, bankruptcy law provides a balancing act under which specified assets are not subject to the claims of creditors and specified liabilities are not eligible for discharge. For example, all states restrict a creditor's ability to reach some property belonging to individual debtors (so-called exempt property). The Bankruptcy Code permits an individual debtor to assert the exemptions to which he is otherwise entitled under applicable state law. *See* 11 U.S.C. (hereinafter Bankruptcy Code) section 522(b)(3). Also, section 727 of the Bankruptcy Code describes 12 situations in which a debtor will not receive a discharge of indebtedness, most of which stem from dishonesty or improper conduct of the individual debtor. Moreover, section 523 of the Bankruptcy Code describes several debts that are not eligible for discharge under any circumstances. *See, e.g.*, section 523(a)(1).

Under an individual chapter 13 bankruptcy, a court will restructure the individual's liabilities to make them serviceable. *See* Bankruptcy Code sections 1301-1330. To be eligible for chapter 13, an individual must have a regular source of income,

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one of two outcomes. First, the entity may complete a bankruptcy reorganization in which the interests of its prepetition equity holders are fully or partially extinguished and the claims of prepetition creditors are reinstated, extinguished, or satisfied through a transfer of cash, property, or newly issued debt or equity interests in the reorganized entity.[18] Second, the entity may undergo a bankruptcy liquidation in which its assets are sold in an orderly fashion and the sales proceeds are distributed to creditors.[19]

In both the individual and business entity reorganization processes, the bankrupt debtor is given a fresh start that permits it to rejoin the economy as a productive consumer or employer.[20] The business entity liquidation process can also be thought of as a fresh start in that the debtor's assets are redeployed from an incompetent organization to a competent one that can put those assets to more productive use.[21]

2. The collective action theory. According to the collective action theory, the primary goal of bankruptcy law is to create a collection mechanism that allows creditors to satisfy their competing claims in an orderly fashion.[22] The idea behind the theory is that the creditors, as a group, can achieve a greater recovery by participating in a controlled, collective process rather than a process that involves each individual creditor enforcing separate claims against a debtor and perhaps seizing and selling individual assets in piecemeal fashion.[23]

At first blush, it would appear that because it is couched in terms of the orderly collection of debt, the collective action theory is less relevant to an analysis of tax policy than the productivity theory. However, two key proponents of the collective action theory — Profs. Douglas Baird and Thomas Jackson — rely on concepts of economic productivity to support their views on the collective action theory and its role in allocating assets among competing creditors:

> Even in a situation where the bankruptcy process requires that a debtor's assets be sold off to repay creditors, the creditors as a group will enjoy a greater recovery if those assets can be held together and marketed as a going concern rather than being sold off piece by piece. Maintaining the productivity of the creditor's assets enhances the recovery enjoyed by the debtors.[24]

Thus, to the extent the collective action theory supports liquidating a debtor's assets, a key component of the theory rests on the notion that productivity is enhanced by moving those assets from the debtor to a competent purchaser as a going concern. In that sense, the collective action theory furthers the goal of enhancing economic activity, albeit in a different way than that advocated by the productivity theory.[25]

3. Impact of the productivity theory and the collective action theory on the development of modern bankruptcy law. Although the productivity theory and the

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fixed unsecured debts less than $336,900, and fixed secured debts of less than $1,010,650. *See* Bankruptcy Code section 109(e).

Also, a family farmer can reorganize under chapter 12, and an individual may reorganize under chapter 11 in some instances. For various reasons, an individual is most likely to file for protection under either chapter 7 or chapter 13. *See* Sara Murray and Conor Dougherty, "Personal Bankruptcy Filings Rising Fast," *The Wall Street Journal*, Jan. 7, 2010, at A3 (discussing the rise in chapter 7 and chapter 13 filings for individuals).

[18]*See* Bankruptcy Code section 1141.

[19]*Id.* at sections 726, 1112, and 1123(b)(4).

[20]This article uses the term "fresh start" to refer loosely to the bankruptcy debt relief provided to both individuals and business entities. This is consistent with Congress's view that section 108, which permits taxpayers to exclude cancellation of indebtedness (CODI) recognized in a bankruptcy proceeding, advances bankruptcy policy by preserving "the debtor's 'fresh start' after bankruptcy." S. Rep. No. 96-1035 at 10, *as reprinted in* 1980 U.S.S.C.A.N 7017, 7024-7025 (hereinafter Senate report). Profs. Baird and Jackson make the point, however, that the fresh start concept, which prevents pauperism among individuals by eliminating the ability of creditors to impose claims against an individual's post-bankruptcy earnings, technically does not apply to bankrupt business entities. Instead, a bankrupt entity undergoes a reorganization process in which prepetition claims against the entity are either reinstated or converted into new claims against, or equity interests in, the entity. Thus, a business entity, unlike an individual, is not freed from prepetition claims against it. Douglas Baird and Thomas Jackson, "Corporate Reorganizations and the Treatment of Diverse Ownership Interests: A Comment on Adequate Protection of Secured Creditors in Bankruptcy," 51 *U. Chi. L. Rev.* 97, 110 n.45 (1984).

We certainly cannot quarrel with the distinction drawn by Profs. Baird and Jackson. That said, for purposes of analyzing the extent to which the tax rules applicable to bankrupt passthrough entities undercut bankruptcy law and policy, it is appropriate to use the term "fresh start" to refer collectively to debt discharges provided to both individuals and entities. That is because, in each case, the debt discharge serves similar goals — *e.g.*, the orderly payment of creditors, the rehabilitation of the debtor, and the return of the debtor to the economy. To the extent the tax law prevents otherwise willing parties from achieving those goals, the same tax policy issues are implicated. *See* Georgakopoulos, *supra* note 13, at 55 ("The productivity-reviving features of bankruptcy law will be illustrated from several provisions. The most fundamental is the cornerstone of individual bankruptcy in the United States, the fresh start policy. . . . The second illustration is the very existence of the reorganization process. . . . That a reorganization can avoid the

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destruction of productive capacity, of course, explains this fundamental piece of bankruptcy law").

[21]*See infra* text accompanying notes 23-25.

[22]Baird and Jackson, *supra* note 20, at 100; Thomas H. Jackson, "The Fresh-Start Policy in Bankruptcy Law," 98 *Harv. L. Rev.* 1393, 1395 (1985) ("most of bankruptcy law is concerned not with defining a debtor's right of discharge, but with providing a compulsory and collective system for satisfying the claims of creditors"); Georgakopoulos, *supra* note 13, at 53 ("Without bankruptcy law, creditors would engage individually in actions that are not beneficial to creditors as a group" (citing Baird and Jackson, *supra* note 20)).

[23]Baird and Jackson, *supra* note 20, at 103.

[24]*Id.* at 101.

[25]*See* Georgakopoulos, *supra* note 13, at 53 ("The two goals — solution of the collective action problem and productivity revival — are not in conflict because resolving the collective action problem is an expression of saving productivity, that which would be destroyed by creditors' asset-grabbing.").

collective action theory are sometimes viewed as competing theories of bankruptcy policy, the two theories combined in a way that had a tremendous effect on the evolution of modern bankruptcy law.

''Modern'' bankruptcy law traces its roots to the Depression-era amendments to the Bankruptcy Act of 1898. Before the Great Depression, that act provided a distressed business entity two bankruptcy alternatives: liquidation and equity receivership.[26] In liquidation, the debtor's assets were sold, often piecemeal, to competing bidders. In an equity receivership, a court would appoint a receiver to supervise the operation of the debtor's business and oversee an orderly sale of the debtor's assets, a process that can be thought of simplistically as a slow-motion liquidation.[27] In both cases, the business was sold rather than rehabilitated in the hands of its existing stakeholders.

As more businesses collapsed under the financial stresses of the Great Depression, Congress found that those two processes were inadequate. Liquidations were viewed as destructive to business in general, while receivership was fraught with its own administrative problems.[28] Accordingly, Congress set out to improve the bankruptcy process by creating a mechanism that rehabilitates distressed companies and maintains their existence as going concerns.

Thus, in 1933 Congress amended the Bankruptcy Act of 1898 by adding section 77, permitting distressed railroad companies to engage in bankruptcy reorganizations under which the claims of prepetition debt holders were converted into new debt or equity interests in the reorganized companies.[29] The amendment reflected the generally held belief that shares of stock in a railroad company functioning as a going concern are worth more than the sum of the company's assets, which would include hundreds of miles of easements and railroad track that might be nearly worthless on a piecemeal basis.[30] In Congress's view, liquidation of a railroad company could be expected to destroy value and productivity, while a reorganization that continued the company as a going concern maintained value and restored productivity.

The Bankruptcy Act of 1898 was amended again in 1934, adding new section 77B. That section allowed all companies (not just railroads) to engage in bankruptcy reorganizations.[31] The enactment of section 77B reflected Congress's concern that the liquidity crisis plaguing railroads was also wreaking havoc on the industrial sector in general, forcing companies into destructive liquidations that were harmful to the economy as a whole.[32] Finally, in 1938 the Chandler Act was passed,[33] amending the Bankruptcy Act of 1898 by, among other things, protecting a bankrupt debtor from foreclosure and enhancing debtors' rights.[34]

By allowing distressed companies to engage in reorganizations designed to protect the value of their assets and allow them to continue their existence as going concerns, Congress intended to enhance economic productivity by both increasing creditors' recoveries and

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[26]*See* bankruptcy commission report, *supra* note 8, at 238 (discussing the historical development of the bankruptcy process). For an excellent description of the development of American bankruptcy law from colonial times to 1995, see Charles J. Tabb, ''The History of the Bankruptcy Laws in the United States,'' 3 *Am. Bankr. Inst. L. Rev.* 5 (1995).

[27]Bankruptcy commission report, *supra* note 8, at 238-240.

[28]*Id.* at 238-240; Tabb, *supra* note 26, at 22-23 (discussing the shortcomings of the equity receivership process); Jacob Trieber, ''The Abuses of Receiverships,'' 19 *Yale L.J.* 275, 275 (1910) (''The recklessness with which receivers are sometimes appointed by courts has caused such a widespread feeling of uneasiness among large corporations and commercial houses that the mere threat to apply for a receiver . . . is frequently sufficient to cause the parties threatened . . . to submit to any terms demanded rather than take the chances of having business destroyed by the appointment of a receiver.'').

[29]Act of March 3, 1933, ch. 204, section 1, 47 Stat. 1467, 1474-1482; bankruptcy commission report, *supra* note 8, at 238.

[30]*Cont'l Ill. Bank & Trust Co. v. Chi. Rock Island & Pac. Ry. Co.*, 294 U.S. 648, 671-672 (1935) (A ''railway is a unit; it cannot be divided up and disposed of piecemeal like a stock of goods. It must be sold, if sold at all, as a unit and a going concern.'').

[31]Act of June 7, 1934, ch. 424, section 1, 48 Stat. 911, 912-922.

[32]Plumb I, *supra* note 6, at 237 (discussing how Congress enacted section 77B to provide a substitute for equity receiverships and an alternative to ruinous liquidations); *Claridge Apartments Co. v. Commissioner*, 323 U.S. 141, 149 (1944) (stating that section 77B was enacted to ''encourage the freer use of bankruptcy reorganization in order to avoid unnecessary or premature liquidations''); bankruptcy commission report, *supra* note 8, at 238-242 (discussing the evolution of the bankruptcy reorganization process as an economic policy response to the wave of corporate liquidations that resulted from the Great Depression).

Modern-day commentators generally agree that business liquidations tend to produce less value than business reorganizations, at least in situations when the debtor's assets are not maintained as a going concern. *See* Jackson, *supra* note 22, at 864 (''To the extent that a non-piecemeal bankruptcy process (whether in the form of liquidation or reorganization) is likely to increase the aggregate pool of assets, its substitution for individualistic remedies may be advantageous to the creditors as a group.''). Prof. Georgakopoulos makes the additional point that business liquidations are particularly destructive during times of capital market dislocation, a condition that existed during both the Great Depression and the recent financial crisis:

> The benefit of avoiding auctions is even more pronounced at times of panics and selling cascades. A selling cascade is the result of a sudden price drop combined with forced sales that are triggered by the price drop. The ultimate example occurs in a securities market crash. . . . Reorganizations cannot eliminate cascading sales. Nevertheless, avoiding the forced auctions does avoid aggravating the cascade and fueling the panic.

Georgakopoulos, *supra* note 13, at 77-78.

[33]Chandler Act, ch. 575, 52 Stat. 840 (1938). The formal name of the Chandler Act was An Act to Amend an Act Entitled ''An Act to Establish a Uniform System of Bankruptcy Throughout the United States,'' Approved July 1, 1898, and Acts Amendatory Thereof and Supplementary Thereto; and to Repeal Section 76 Thereof and All Acts and Parts of Acts Inconsistent Therewith. The Chandler Act organized the Bankruptcy Act of 1898 into separate chapters that deal with bankruptcy administration, liquidations, and reorganizations.

[34]Tabb, *supra* note 26, at 29-30.

rehabilitating distressed companies.[35] The expanded bankruptcy reorganization process played an important role in slowing the wave of panic selling that plagued the economy,[36] and it remains a cornerstone of bankruptcy law today.[37]

B. Tax Policy

1. Historical context. Understanding why the bankruptcy tax regime works as it does requires us to explore the development of that regime and the manner in which it was influenced by Congress, the courts, the IRS, and the bankruptcy commission. Unfortunately, the history of today's bankruptcy tax policy is neither concise nor pretty.

a. The early years. Although the Constitution granted Congress the power to enact bankruptcy laws,[38] and bankruptcy procedures date back to the founding of our country,[39] there was no need for federal law to address the income tax consequences of a discharge of indebtedness until the federal income tax became law following the ratification of the 16th Amendment in 1913.[40]

After adoption of the income tax, the Bureau of Internal Revenue issued two authorities — a regulation and an office decision — addressing the treatment of taxpayers that realized income from the cancellation of indebtedness (CODI). The regulation stated that CODI generally was taxable as ordinary income.[41] However, the office decision (I.T. 1564) provided that a ''taxpayer receives no income by virtue of a discharge of indebtedness resulting from an adjudication in bankruptcy.''[42] This provision applied to all types of taxpayers, including partnerships.

b. The Depression era. Following the Depression-era additions of sections 77 and 77B to the Bankruptcy Act of 1898, the scope of I.T. 1564 (and the exclusion of CODI realized in bankruptcy) came into question because the reorganization processes described in sections 77 and 77B of the Bankruptcy Act of 1898 did not require the entry of an adjudication in bankruptcy.[43] Accordingly, the concern arose that a corporation that reorganized under section 77 or section 77B of the Bankruptcy Act of 1898 might be subject to tax on CODI realized in connection with the reorganization because that CODI did not result from an

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[35]Georgakopoulos, *supra* note 13, at 55 (''That a reorganization can avoid the destruction of productive capacity, of course, explains this fundamental piece of bankruptcy law.'').

[36]Samuel L. Bufford, ''What Is Right About Bankruptcy Law and Wrong About Its Critics,'' 72 *Wash. U. L.Q.* 829, 837 (1994):

> Much about the causes of the Great Depression was not understood in early 1933. Congress did understand a piece of it, however. It had watched the banks foreclose on real estate in a down economy, and had watched the banks themselves disappear. . . . Left to their state-law rights, it appeared that the banks had nearly closed down the economy and put a quarter of the nation's workers out of work. Congress passed a law to stop this process. In his last official act, President Herbert Hoover signed the bill that gave us bankruptcy reorganization.

Georgakopoulos, *supra* note 13, at 77-78 (discussing the extent to which bankruptcy reorganizations can mitigate the harm produced by panic selling).

[37]Tabb, *supra* note 26, at 29-30 (''Perhaps most significant, however, was the [Chandler Act's] reworking of the recently enacted reorganization provisions into the form that prevailed for the next forty years.'').

[38]U.S. Const. Art. I, section 8, cl. 4 (granting Congress the power to ''pass uniform laws on the subject of bankruptcies''); Tabb, *supra* note 26, at 12-21 (detailing the development of early U.S. bankruptcy law from the Constitutional Convention through the Civil War).

[39]*See* Tabb, *supra* note 26, at 6-23 (discussing early debt collection procedures in bankruptcy); bankruptcy commission report, *supra* note 8, at 62-63 (noting that debt discharge relief first appeared in the Bankruptcy Act of 1841). While only appearing in this country in 1841, laws granting relief from onerous debts date back to ancient Rome. *See* Georgakopoulos, *supra* note 13, at 56 (tracing the history of the discharge of debts to the Roman law performance of *cessio bonorum*, in which a debtor would cede all his assets to his creditors to avoid servitude or dismemberment).

[40]U.S. Const. Amend. XVI. Although the first income tax was levied in 1861, it was meant only to fund the Civil War and was discontinued after the war. *See* Joseph Thorndike, ''An Army of Officials: The Civil War Bureau of Internal Revenue,'' *Tax Notes*, Dec. 24, 2001, p. 1739, *Doc 2001-31477*, or *2001 TNT 249-39*. When Congress reinstated the income tax in 1894, it was

(Footnote continued in next column.)

immediately challenged and ruled unconstitutional in *Pollock v. Farmers' Loan & Trust Co.*, 157 U.S. 429 (1895).

[41]Reg. 45, Art. 544 (1921). This regulation was not viewed favorably by the courts. As early as 1926, they held that a solvent taxpayer was not subject to tax on CODI recognized when the taxpayer repurchased its outstanding debt at a discount. *See, e.g.*, *Meyers Jewelry Co. v. Commissioner*, 3 B.T.A. 1319 (1926) (''under the circumstances of this appeal . . . the cancellation of the taxpayer's indebtedness does not constitute income''); *Am. Tobacco Co. v. Commissioner*, 20 B.T.A. 586 (1930) (finding that the difference between the price at which bonds are issued and the price at which they are retired does not represent taxable gain). This line of authority was overturned in 1931, when the Supreme Court issued its seminal decision in *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931). In that case, the taxpayer issued bonds at par and later repurchased them at a discount. The Court found that in so doing, the taxpayer freed assets whose net value, before the repurchase, was burdened by the corporation's obligation to repay the bonds at par. This freeing of assets led to an accession of wealth by the taxpayer, which in turn represented taxable gross income. Subsequent cases built on the freeing-of-assets principle, addressing situations in which an insolvent taxpayer satisfied its liabilities at a discount. Applying the theory of *Kirby Lumber*, those courts found that to the extent a taxpayer is insolvent, its assets cannot be freed by the cancellation of the taxpayer's debts, and therefore the taxpayer cannot experience an accession of wealth as a result of that cancellation. *See, e.g.*, *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95 (5th Cir. 1934); *Lakeland Grocery Co. v. Commissioner*, 36 B.T.A. 289 (1937). For a discussion of the early tax treatment of CODI recognized outside the bankruptcy context, see James S. Eustice, ''Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion,'' 14 *Tax L. Rev.* 225, 225 (1959); Stanley Surrey, ''The Revenue Act of 1939 and the Income Tax Treatment of Cancellation of Indebtedness,'' 49 *Yale L.J.* 1153 (1940).

[42]I.T. 1564, II-1 C.B. 59 (1923) (issued under article 50 of the regulations and the authority of the Revenue Act of 1921).

[43]*Cont'l Ill. Bank & Trust Co. v. Chi. Rock Island & Pac. Ry. Co.*, 294 U.S. at 671-672 (indicating that reorganizations undertaken under sections 77 and 77B of the Bankruptcy Act of 1898 were not technically adjudications in bankruptcy).

adjudication in bankruptcy and was therefore ineligible for the exclusion. Moreover, if imposed, that tax would reduce the value of the stock received by creditors in the reorganization, because the incidence of tax would be on the reorganized corporation. That in turn might encourage creditors to force the corporation into a bankruptcy liquidation to allow the CODI to be realized tax free.[44]

In other words, if the government were to impose tax on CODI realized in a corporate bankruptcy reorganization, creditors would be encouraged to force the corporation into a liquidation — exactly what Congress sought to avoid when it added the reorganization provisions to the Bankruptcy Act of 1898. To avoid that result, Congress added section 268 to the Bankruptcy Act of 1898 when it adopted the Chandler Act in 1938. Section 268 provided that ''no income or profit, taxable under any law of the United States or of any State . . . shall, in respect to the adjustment of indebtedness of a debtor in a [reorganization conducted under section 77 or section 77B] be deemed to have been realized by a debtor.''[45] Congress thus chose to exclude CODI from taxable income to prevent a situation in which the imposition of tax might force a debtor into liquidation.

c. From the Great Depression to the bankruptcy commission. In the three decades between the Great Depression and the creation of the bankruptcy commission, the tax treatment of bankrupt taxpayers and transactions occurring in connection with the bankruptcy process developed piecemeal. For example, although many of the tax rules applicable to bankrupt taxpayers were set forth in the Bankruptcy Act of 1898, they were not updated to conform to the tax rules adopted in the Internal Revenue Codes of 1939 and 1954. In many cases, the Bankruptcy Act rules and the IRC-based rules did not work well with various judicial doctrines.[46] Thus, by the time the bankruptcy commission was created in 1970, the tax regime applicable to distressed and bankrupt taxpayers was a hodgepodge of judicial doctrines, statutory provisions, and administrative authorities that provided different and sometimes conflicting tax results for similarly situated taxpayers.[47] The bankruptcy commission was asked to sort through that morass and develop a set of recommendations to replace the existing bankruptcy tax regime in its entirety.

d. The bankruptcy commission report and legislative sausage-making. After two years of work, the bankruptcy commission submitted to Congress its report and proposed legislation, which was intended to supersede the Bankruptcy Act of 1898.[48] Consistent with the congressional mandate to the commission, the proposed legislation contained a comprehensive set of tax provisions intended to apply to all bankrupt taxpayers, regardless of their tax classification and the nature and extent of their indebtedness.[49]

The submission of the bankruptcy commission report and the proposed legislation started a seven-year legislative process that culminated in a revamping of U.S. bankruptcy law. Because of a political turf battle that arose after Congress began deliberations on the proposed legislation, lawmakers decided to develop the core bankruptcy rules — for example, the reorganization process,

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[44]Plumb I, *supra* note 6, at 236 (discussing how the imposition of an income tax on a corporation that completed a reorganization under section 77B of the Bankruptcy Act would ''to an undetermined extent . . . nullify or make impossible the realization of the objects of section 77B [one of which was] to encourage the freer use of bankruptcy reorganization in order to avoid unnecessary and premature liquidations'' (citing *Claridge Apartments*, 323 U.S. at 148-149)); *see also* ''Hearings on H.R. 8046 Before the House Comm. on the Judiciary,'' 75th Cong. 265-267 (1937) (testimony of Charles Banks) (discussing the illogic of imposing a tax on CODI recognized by a bankrupt corporation whose debt is converted into equity; ''it is not logical, because the creditors, as I say, have surrendered something coming to them; and yet the Government comes along and says, 'That is taxable income to the debtor, and you are the successor of the debtor'''); *see also* bankruptcy commission report, *supra* note 8, at 238-242 (discussing the evolution of the bankruptcy reorganization process as an economic policy response to the wave of corporate liquidations that resulted from the Great Depression).

The recognition of CODI was one of two tax rules that frustrated the policy goals underlying the bankruptcy reorganization provisions. The other problem stemmed from the reorganization provisions in the tax code, which were not liberal enough to provide nonrecognition treatment to some types of bankruptcy reorganizations. Plumb I, *supra* note 6, at 236. Congress remedied that problem by amending the tax code to provide for the nonrecognition of gain realized by a transferor corporation in some types of bankruptcy reorganizations. *Id.* (discussing the origin of the bankruptcy reorganization provisions).

[45]Chandler Act, ch. 575, sec. 1, section 268, 52 Stat. 840, 904 (1938). Also, section 276(c)(3) of the Bankruptcy Act of 1898 provided that the CODI exclusion rule set forth in section 268 of that act would apply retroactively to bankruptcy reorganizations that had been completed under section 77B of the Bankruptcy Act of 1898, as amended in 1934.

[46]Plumb I, *supra* note 6, at 260-265.

[47]Eustice, *supra* note 41, at 225 (''One of the murkiest pools of obscurity in the tax law for the past three decades has been the income tax effect to a debtor on the cancellation or modification of his indebtedness. Congress and the courts have been wrestling with a mounting flood of conflicting decisions, technical distinctions, and subtle shadings of statutory interpretation, which has served to create an imposing body of law in this area from the standpoint of volume if nothing else.'').

[48]The lead tax consultant to the bankruptcy commission was the now legendary William T. Plumb Jr. Besides serving on the bankruptcy commission, helping draft the commission's proposed legislation, and helping draft the notes to that legislation, Plumb published four exhaustive law review articles in less than 12 months, each of which dealt with an aspect of the commission's work. *See* Plumb I, *supra* note 6; Plumb, ''The Tax Recommendations of the Commission on the Bankruptcy Laws — Income Tax Liabilities of the Estate and the Debtor,'' 72 *Mich. L. Rev.* 935 (1974) (hereinafter Plumb II); Plumb, ''The Tax Recommendations of the Commission on the Bankruptcy Laws — Priority and Dischargability of Tax Claims,'' 59 *Cornell L. Rev.* 991 (1974); Plumb, ''The Tax Recommendations of the Commission on the Bankruptcy Laws — Tax Procedures,'' 88 *Harv. L. Rev.* 1360 (1975). That contribution to our profession is truly remarkable.

[49]Bankruptcy commission proposed legislation, *supra* note 9, section 7-315.

bankruptcy procedure, priority of claims, and satisfaction of claims — separately from the bankruptcy tax rules.[50]

As it turned out, the legislative package containing the core bankruptcy rules moved through Congress more quickly than the package containing the tax rules. Thus, in 1978 Congress passed, and the president signed, the Bankruptcy Act of 1978 (P.L. 95-598), which evolved into our current Bankruptcy Code.[51]

The Bankruptcy Act of 1978 superseded the Bankruptcy Act of 1898, including the special tax rules adopted as part of the Chandler Act in 1938.[52] In other words, as soon as the Bankruptcy Act of 1978 went into effect, our system provided a wonderful new bankruptcy process for which the tax results, in many cases, could not be predicted.[53] Because tax liabilities necessarily have an adverse effect on the bankruptcy process in general and on creditors in particular,[54] Congress came under pressure to adopt bankruptcy tax legislation before bankrupt entities began to restructure under the Bankruptcy Act of 1978.[55]

In light of those concerns, Congress moved quickly to enact the tax legislation that ultimately became the Bankruptcy Tax Act of 1980 (BTA).[56] Given the manner in which the BTA came to pass, it is not surprising that it omitted some of the tax recommendations made by the bankruptcy commission.[57] That situation prompted Sen. Robert Dole to enter a statement into the record promising that various outstanding bankruptcy tax policy objectives and critical issues would be addressed by Congress ''next year.''[58]

e. Bankrupt partnerships before and after the BTA and the bankruptcy commission recommendations on bankrupt partnerships. For purposes of this report, the history of the taxation of bankrupt partnerships can be divided into two subjects, CODI and asset sale gain, each of which spans two time periods, pre-BTA and post-BTA.

- **Pre-BTA treatment of CODI.** During the years leading up to the Chandler Act, a bankrupt partnership that liquidated or entered receivership did not recognize CODI under I.T. 1564.[59] The Chandler Act extended the CODI nonrecognition rule to CODI realized by partnerships engaged in bankruptcy reorganizations.[60] Those two rules remained in place, in one form or another, through the enactment of the Bankruptcy Act of 1978 or the BTA, as the case may be.[61]
- **Pre-BTA treatment of asset sale gain.** Before the BTA, the treatment of asset sale gain realized by a bankrupt partnership was inconsistent and unclear. In 1931 the Bureau of Internal Revenue ruled that a bankruptcy filing by a partnership did not create a separate taxable entity and that asset sale gain recognized by a bankrupt partnership would pass

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[50]The bill destined to become the Bankruptcy Act of 1978 originally contained several provisions that affected the tax liability of bankrupt business entities and their owners. Those provisions arguably fell under the jurisdiction of the House Ways and Means Committee. *See* Paul H. Asofsky, ''Toward a Bankruptcy Tax Act of 1993,'' 51 *N.Y.U. Ann. Inst. on Fed. Tax'n* section 13.03, at 13-6 (1993) (hereinafter Asofsky I). While this did not bother Rep. Wilbur Mills, chair of the Ways and Means Committee at the time the bill was introduced, it did bother Rep. Al Ullman, who succeeded Mills as committee chair in 1977. Ullman made it clear that he would block floor action on any bill that contained substantive tax provisions and was not referred to the Ways and Means Committee. Accordingly, the tax provisions were removed from the bill that ultimately became the Bankruptcy Act of 1978. *Id.* at 13-6 to 13-7.

[51]Bankruptcy Act of 1978, P.L. 95-598, 92 Stat. 2549. Although the statute does not contain a short title, it is often referred to as the Bankruptcy Reform Act of 1978 or the Bankruptcy Act of 1978. Although enacted in 1978, the act did not take effect until October 1, 1979. For purposes of simplicity, all references to the ''Bankruptcy Code'' are references to the Bankruptcy Code as in effect at the time of this writing.

[52]*Id.* at section 101, 92 Stat. at 2549.

[53]126 *Cong. Rec.* H2053, H2061 (daily ed. Mar. 24, 1980) (statement of Rep. Duncan) (''In 1978, legislation was enacted that significantly amended the federal bankruptcy laws (Public Law 95-598). . . . Separate legislation was required to conform the tax laws to the new bankruptcy law. However, passage of the conforming tax changes was unfortunately delayed.'').

[54]*See supra* text accompanying notes 43-45.

[55]''The Bankruptcy Tax Act of 1980: Hearing Before the Subcomm. on Taxation and Debt Management of the Senate Finance Comm.,'' 96th Cong. 241 (1980) (statement of David J. Shakow, Treasury associate tax legislative counsel) (stating that Treasury believes ''it is very important to have the bill passed expeditiously, so that taxpayers in bankruptcy and practitioners who advise them can plan their transactions with knowledge of what the consequences of those transactions will be'').

[56]Bankruptcy Tax Act of 1980, P.L. 96-589, 94 Stat. 3389.

[57]126 *Cong. Rec.* H2053, H2061 (daily ed. Mar. 24, 1980) (statement of Rep. Butler) (stating that ''the bill has taken positions . . . which are compromises between the position contained in the bill originally and that urged by those in agreement and those in the bankruptcy community'').

[58]126 *Cong. Rec.* S16,490, S16,493 (daily ed. Dec. 13, 1980) (statement of Sen. Dole).

[59]The Bureau of Internal Revenue initially took the position that if a partnership were to realize CODI outside a bankruptcy proceeding, the CODI represented taxable income. Office Decision I.T. 1547, 1923 II-1 C.B. 58. That position was initially rejected, and then modified, by the courts. *See supra* note 41 (discussing the development of CODI-related case law in the 1920s and 1930s).

[60]*See* Victor F. Keen, ''Problems of the Individual Arising From Bankruptcy and Insolvency: As Stockholder, Officer, Partner, and Individual,'' 36 *N.Y.U. Ann. Inst. on Fed. Tax'n* 383, 398 (1979) (discussing the tax rules applicable to bankrupt partnerships that recognize CODI).

[61]*See, e.g.*, reg. section 1.61-12(b) (1979). This regulation was the successor to I.T. 1564 and provided an exclusion from CODI realized by a taxpayer in connection with ''an adjudication in bankruptcy,'' a corporate reorganization, and an arrangement or real property arrangement completed under bankruptcy law. In the case of a bankrupt partnership, that CODI exclusion applied at the entity level, and partners were permitted in some cases to exclude from income the section 731 gain that would otherwise result from the reduction in the partnership's indebtedness. Rev. Rul. 71-301, 1971-2 C.B. 256 (obsoleted by Rev. Rul. 95-21, 1995-1 C.B. 13, *95 TNT 49-13*). Also, the CODI provisions of the Bankruptcy Act of 1898 remained in effect. *See* Bankruptcy Act of 1898 sections 268, 395, and 520 (as amended and in effect before the enactment of the Bankruptcy Act of 1978).

through to its partners.[62] That position was reversed in GCM 24617, which concluded that the estate of a bankrupt partnership under the jurisdiction of a bankruptcy trustee was a separate taxable entity, the income of which was taxable at the estate level and therefore not passed through to the partners.[63] The IRS reiterated that position in Rev. Rul. 68-48.[64] Rev. Rul. 68-48 also made clear that if a bankrupt partnership was operating under the supervision of an equity receiver (rather than a bankruptcy trustee) that had jurisdiction over a portion of the partnership's assets, any asset sale gain recognized in connection with the bankruptcy proceeding would pass through to the partners and would be subject to tax at the partner level.[65] It was unclear how the IRC would treat asset sale gain recognized by a bankrupt partnership under a proceeding that was managed by the partnership as debtor in possession.[66]

The legislation proposed by the bankruptcy commission contained several provisions applicable to bankrupt partnerships, two of which directly addressed the treatment of CODI and asset sale gain realized by a bankrupt partnership. First, the proposed legislation retained the rule under which CODI realized by a bankrupt partnership was excluded from income at the partnership level.[67] Second, the bankruptcy commission recommended that neither the partners nor the estate of a bankrupt partnership recognize any income on the sale of assets that occurred outside the ordinary course of the partnership's business.[68] The second recommendation applied to all bankrupt partnerships, regardless of whether they were operating as debtors-in-possession or under the supervision of a trustee or equity receiver. The second recommendation, if enacted, would have rationalized the inconsistent results produced by Rev. Rul. 68-48.

Those two proposals were not included in the BTA. As a result, a bankrupt partnership is now subject to the following rules:

- **Post-BTA treatment of CODI.** CODI is treated as taxable income,[69] and any CODI realized by a bankrupt partnership is passed through to the partners and subject to tax at the partner level unless the partner qualifies for a section 108 exclusion.[70]
- **Post-BTA treatment of asset sale gain.** The estate of a bankrupt partnership is not treated as a taxable entity separate from the partnership.[71] Thus, unlike under prior law, any asset sale gain recognized by the partnership in connection with a bankruptcy proceeding is passed through (and taxed) to the partners.

Although the BTA made significant changes to the long-established tax regime applicable to bankrupt partnerships, those changes were not accompanied by a comprehensive legislative history. Still, for the reasons discussed in Section IV.A below, those changes did not initially produce the types of problems discussed in Section III of this report.

f. The current state of affairs. Given this history, it is not surprising that our tax code lacks a cohesive, integrated policy approach to the taxation of bankrupt passthrough entities. That said, in order to discuss the direction in which our tax system should move, we first need to understand where we are. For that reason, this part of the report focuses on three tax ground rules that, in the context of bankrupt passthrough entities, combine to create tax results and behaviors that undercut bankruptcy policy. Those ground rules include the tax treatment of CODI, the differences in tax treatment of transactions involving recourse and nonrecourse indebtedness, and the classification of DE-level indebtedness and debt-for-equity exchanges involving DEs. That discussion segues into Section III, which addresses how the tax ground rules create results and encourage behaviors that undercut bankruptcy policy.

2. The current tax treatment of CODI.

a. The CODI exclusions. Section 108(a) contains five CODI exclusions, each of which permits a taxpayer to avoid current recognition of what would otherwise be ordinary taxable CODI.[72] They are the bankruptcy exclusion,[73] the insolvency exclusion,[74] the qualified farm

[62]GCM 8488, X-1 C.B. 270 (1931); Plumb II, *supra* note 48, at 958.

[63]GCM 24617, 1945 C.B. 235.

[64]Rev. Rul. 68-48, 1968-1 C.B. 301. The ruling held that "both ordinary and capital gain income are taxable to the estate of the bankrupt partnership," although it did not elaborate on the reasons the estate (rather than the partners) should bear the tax associated with the partnership's bankruptcy.

[65]*See* Keen, *supra* note 60, at 389-394 (discussing the tax treatment of partnerships operating under the jurisdiction of an equity receiver).

[66]*See* Plumb II, *supra* note 48, at 959-960.

[67]The provisions that enacted this recommendation were included in section 5-104(a) of the bankruptcy commission proposed legislation, which applied to partnerships that liquidated in bankruptcy, and section 7-315(b) of the proposed legislation, which applied to partnerships that reorganized in bankruptcy.

[68]The provisions that enacted this recommendation were included in section 5-104 of the bankruptcy commission proposed legislation, which applied to liquidating bankruptcies, and section 7-315 of the proposed legislation, which applied to bankruptcy reorganizations of bankrupt business entities.

[69]Section 61(a)(12). Unless otherwise noted, all "section" references are to the Internal Revenue Code of 1986, as amended.

[70]Section 108(d)(6).

[71]Section 1399; Senate report, *supra* note 20, at 25-26; Paul H. Asofsky, "Bankrupt Partnerships," at 15-16 (Sept. 14, 1983) (unpublished manuscript on file with the authors; hereinafter Asofsky II).

[72]Section 61(a)(12) (CODI included in income); Rev. Rul. 69-613, 1969-2 C.B. 163.

[73]Section 108(a)(1)(A).

[74]Section 108(a)(1)(B). Under the insolvency exception, a taxpayer may exclude CODI from gross income to the extent the taxpayer is insolvent. A taxpayer is insolvent if the amount of his liabilities exceeds the FMV of his assets. Section 108(d)(3). The insolvency exception is an extension of the Supreme Court's decision in *Kirby Lumber*, which is discussed at note 41 *supra*. The exception was codified when Congress enacted the BTA.

indebtedness (QFI) exclusion,[75] the qualified real property business indebtedness (QRPBI) exclusion,[76] and the qualified principal residence exclusion.[77] Also, section 108(i) permits taxpayers to defer recognition of certain CODI realized in 2009 or 2010.[78]

Although there are five CODI exclusions and one CODI deferral provision, this report focuses only on the bankruptcy exclusion,[79] which allows taxpayers to exclude from income CODI that ''occurs in a title 11 case.''[80] CODI is treated as occurring in a title 11 case only if the CODI results from a debt discharge that was ordered by, or granted under a plan approved by, the court that had jurisdiction over the taxpayer.[81]

The bankruptcy exclusion was added to the code by the BTA[82] and represents a continuation of prior policy. In Congress's view, the bankruptcy exclusion was ''intended to accommodate bankruptcy policy and tax policy'' by enabling a distressed taxpayer to engage in a bankruptcy restructuring process without triggering an immediate tax liability.[83]

b. Attribute reduction and black hole CODI.

i. Background. When Congress enacted the first statutory bankruptcy exclusion in 1938, it decided that the exclusion should operate as an income deferral mechanism rather than a pure exclusion from income. To implement that policy decision, the Chandler Act added section 270 to the Bankruptcy Act of 1898.[84] That provision required a bankrupt taxpayer realizing excluded CODI to reduce the basis of its assets by the amount of excluded CODI. The basis reduction provision was originally suggested by Treasury, which did not want the tax law to permit taxpayers to use borrowed funds to buy depreciable assets, enjoy a tax-free discharge of their repayment obligations, and then continue to receive depreciation deductions for those assets on exit from bankruptcy.[85]

Over the years, policymakers discovered that an unlimited basis reduction mechanism could often prove counterproductive.[86] Accordingly, Congress placed limits on the basis reduction mechanism, which in certain cases, caused the CODI exclusion to act as a true exemption from income rather than a mere income deferral provision.

ii. Attribute reduction in the BTA. When drafting the BTA, Congress retained the attribute reduction concept that existed under prior law. However, it modified that mechanism so that a taxpayer's net operation losses were subjected to the attribute reduction mechanism and were generally the first tax attributes subject to reduction.[87] This change reflects Congress's belief that if a corporation were allowed to exit bankruptcy with its NOLs intact, the NOLs would provide the corporation with a competitive advantage over other corporations that did not resort to the bankruptcy process.[88]

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[75]Section 108(a)(1)(C).

[76]Section 108(a)(1)(D).

[77]Section 108(a)(1)(E).

[78]For a detailed description of the operation of section 108(i), see Richard M. Lipton, ''Deferral of CODI Income: IRS Provides Exclusive Procedures for the Section 108(i) Election,'' 111 *J. Tax'n* 260 (2009); Lipton, ''Recovery Act Allows Deferral of CODI Income — to Elect or Not?'' 110 *J. Tax'n* 260 (2009); New York State Bar Association Tax Section, ''Report on the Cancellation of Indebtedness and AHYDO Rules of Sections 108(i) and 163(e)(5)(F),'' (Apr. 29, 2009), *Doc 2009-9509*, *2009 TNT 80-22*.

[79]This report focuses only on the bankruptcy exclusion for two reasons. First, the QFI exclusion and the QRPBI exclusion are so narrow that they cannot apply to most of the situations described in this report. For example, the QRPBI exclusion shields only CODI recognized on some types of pre-1993 real estate indebtedness and some types of post-1993 real estate acquisition indebtedness. Section 108(c)(3). Moreover, the QRPBI exclusion may not be relied on by C corporations. Section 108(a)(1)(D); Richard M. Lipton, ''Debt Workout Issues for REITs Are Complicated, Whether They Are Debtors or Creditors,'' 111 *J. Tax'n* 158, 165 (2009). Similarly, the QFI exclusion applies only to CODI recognized on some types of indebtedness incurred in the trade or business of farming, but only if the lender satisfies specific requirements. Section 108(g).

Second, although section 108(i) may apply in the bankruptcy context, this report will not focus on the operation of that provision for two reasons. For one, the provision itself applies only to CODI recognized in 2009 or 2010, and the problems described in this report will continue to exist after the sunset of section 108(i). More importantly, section 108(i) is not particularly helpful in the situations analyzed by this report, because we focus on situations in which a bankruptcy restructuring of a passthrough entity could create a tax liability large enough to cause serious financial harm to the owners of the entity. In that context, section 108(i) will merely defer an owner-level financial disaster and is therefore unlikely to be helpful as a planning tool.

[80]Section 108(a)(1)(A).

[81]Section 108(d)(2).

[82]Bankruptcy Tax Act of 1980, P.L. 96-589, section 2(a), 94 Stat. 3389, 3389.

[83]Senate report, *supra* note 20, at 9-10.

[84]Chandler Act, ch. 575, sec. 1, section 270, 52 Stat. 840, 904 (1938).

[85]S. Rep. No. 75-1916, at 7 (1938).

[86]One of the problems presented by the unlimited basis reduction mechanism was that many reorganized companies exited bankruptcy with no asset basis. Eustice, *supra* note 41, at 256. The lack of basis would increase the tax liability of the reorganized company postbankruptcy and create a significant tax liability if the entity were to sell assets. This outcome would encourage bankrupt entities to retain as much debt as possible postbankruptcy, which tended to produce results that undercut bankruptcy policy. *Id.* That situation prompted the Supreme Court to characterize the basis reduction rule as ''a plain blunder, the consequences of which were not foreseen, understood or intended by those who finally gave it the form of law.'' *Claridge Apartments*, 323 U.S. at 151. To reduce the harsh effects of unlimited basis reduction, Congress adopted the ''fair market value floor,'' which provided that the basis of an asset may not be reduced below its FMV. Some viewed that rule as inadequate, and it was replaced by the current liability floor, which is described below. *See* bankruptcy commission report, *supra* note 8, at 289; *see also* Asofsky I, *supra* note 50, at 13-8 to 13-10 (discussing Congress's desire to improve attribute reduction).

[87]Section 108(b).

[88]''The Bankruptcy Tax Act of 1980: Hearing Before the Subcomm. on Select Revenue Measures of the House Ways and Means Comm.,'' 96th Cong. 8 (1979) (statement of Daniel I. Halperin, Treasury deputy assistant secretary for tax legislation)

(Footnote continued on next page.)

iii. Black hole CODI. In designing the attribute reduction mechanism now contained in section 108(b), Congress recognized that a taxpayer may have more CODI than available tax attributes. In that situation the taxpayer has essentially used borrowed funds to generate a pre-restructuring tax benefit that is no longer available for attribute reduction.

In dealing with those situations, Congress faced a difficult choice. First, it could require the taxpayer to report taxable income equal to the excess of CODI over the amount of tax attributes available for reduction, with the understanding that such an approach could jeopardize the successful restructuring of many businesses. Second, Congress could allow the excess to escape taxation, knowing that in some circumstances section 108(a) would operate as a true income exclusion — that is, bankrupt taxpayers would be allowed to receive borrowed funds tax-free, use those funds to generate tax benefits, and then benefit from a tax-free cancellation of their obligation to repay those borrowed funds. Congress chose to facilitate the bankruptcy restructuring process by allowing the excess of CODI over available tax attributes to escape taxation, and in doing so it created what is referred to as black hole CODI.

iv. Sources of black hole CODI. In a perfectly symmetrical system, a taxpayer could not realize an amount of CODI that exceeds the taxpayer's available tax attributes, because every dollar of indebtedness would be represented either by asset basis or attribute carryforwards such as NOLs, capital loss carryforwards, and tax credit carryforwards. In our system, however, black hole CODI can arise from two basic sources — leveraged transactions that produce neither basis nor deductions, and code-based mechanisms that govern the attribute reduction process.

First, black hole CODI can result from transactions such as leveraged recapitalizations, leveraged redemptions, and leveraged buyouts. In each case, a taxpayer, usually a corporation, will incur indebtedness to fund a transfer of cash to the entity's current or former owners. Because the borrowed funds were not used to acquire a corporate-level asset or fund a corporate-level expense, the borrowing cannot create a corporate-level tax attribute that is available for attribute reduction.[89]

Second, black hole CODI can result from a pair of code provisions that govern the attribute reduction process.

- **The liability floor.** The liability floor rule, set forth in section 1017(b)(2), states that when determining the extent to which the basis of property must be reduced as a result of section 108(b), the basis of the taxpayer's assets may not be reduced below the amount of the taxpayer's liabilities. Congress adopted the liability floor to prevent the attribute reduction process from giving rise to taxable gain, which might prevent a taxpayer from repaying its post-bankruptcy debts.[90]
- **Timing of attribute reduction.** The attribute reduction mandated by section 108(b) does not occur until the first day of the first tax year following the year in which the related CODI is realized.[91] Thus, if a taxpayer realizes excluded CODI and asset sale gain during the same tax year, it may use all available tax attributes — including NOLs — to offset that gain. In other words, the attribute reduction rule permits a bankrupt taxpayer to use its NOLs to offset asset sale gain recognized in connection with a bankruptcy restructuring even though the use of those NOLs may cause section 108(a) to act as a true income exclusion rather than a deferral provision.[92]

c. Application of section 108 to different types of business entities. For a corporation, the section 108 exclusions apply at the entity level, meaning that the status of the entity's shareholders as bankrupt or insolvent is irrelevant. This rule applies even if the corporation has made an election under subchapter S.[93]

("bankruptcy is intended to give debtors a fresh start, not a head start"); Plumb I, *supra* note 6, at 278 ("the right to a fresh start does not require that the bankrupt be given a head start by being permitted to offset future earnings with depreciation or other deductions reflecting obligations which were incurred for previous benefits but where discharged in [bankruptcy]").

[89]*See* David M. Einhorn et al., "Critical Federal Income Tax Issues Relating to Corporate Restructurings," 847 *PLI/Tax* 857, 865 (2008) ("In the case of a [leveraged buyout], for example, debt may be incurred to finance payments to shareholders, without any corporate attributes being created thereby. (In effect, the potential corporate tax benefits associated with the borrowed funds disappear when those funds are distributed.) In those cases, attribute reduction may be regarded as either ineffective because there are no attributes to reduce or excessive").

[90]Senate report, *supra* note 20, at 13.

[91]Section 108(b)(4)(A); reg. section 1.1017-1(a).

[92]For example, assume that Corp. XY files for bankruptcy protection when it owns two assets: Asset 1 and Asset 2. Asset 1 has a tax basis of $0 and an FMV of $100. Asset 2 has a tax basis of $10 and an FMV of $100. Corp. XY has two debts on its books, Debt 1 and Debt 2, each of which has an outstanding principal amount of $300. XY has an NOL of $100. XY completes a bankruptcy restructuring in which the following steps take place: (1) Asset 1 is sold to a third party in exchange for $100; (2) the proceeds of the Asset 1 sale are used to retire all $300 of Debt 1, which generates CODI of $200; and (3) Debt 2 is converted into new common stock of XY that is worth $40 and a new XY note in the face amount of $10, which generates CODI of $250.

In this case, XY's income items will consist of $100 of gain on the sale of Asset 1 and $450 of CODI. Because attribute reduction does not occur until the first day of the first tax year after the year in which XY recognizes its CODI, XY may use its $100 NOL to fully offset the $100 of gain recognized on the sale of Asset 1. This means that when it comes time for XY to perform attribution reduction, it will have no attributes available for reduction, because its NOL will have been reduced to $0 by virtue of the sale of Asset 1, and the $10 of basis in Asset 2 cannot be reduced because of the existence of the new $10 note that was issued in repayment of Debt 2. In this case, the timing of attribute reduction, coupled with the liability floor, enables XY to receive a full exclusion of all $450 of CODI recognized in connection with its bankruptcy restructuring.

[93]Section 108(d)(7)(A).

As discussed above, for a partnership, the section 108 exclusions apply at the partner level.[94] This means that if a partnership files for bankruptcy and realizes CODI, the partners cannot exclude that CODI from gross income unless the partners themselves are either bankrupt or eligible for one of the other section 108 exclusions.[95]

In a situation in which a DE files for bankruptcy but its owner does not, it would appear from a technical reading of section 108 that any CODI realized by the owner as a result of the cancellation of DE indebtedness is ineligible for the bankruptcy exclusion. That is because, technically speaking, the owner is not itself under the jurisdiction of a bankruptcy court.[96] Still, some argue that because a DE's debt is treated as debt of the owner for tax purposes, a bankruptcy discharge of DE debt is treated as a bankruptcy discharge of the owner's debt for tax purposes. Under this theory, CODI realized by a bankrupt DE would be eligible for the bankruptcy exclusion.[97] The government is aware that some taxpayers are taking this position, and Treasury officials (speaking in their individual capacities and not as representatives of the government) have indicated publicly that the government intends to issue guidance indicating that the position is incorrect. Until that guidance is issued, however, one can expect taxpayers to take that position, especially if the alternative is an owner-level bankruptcy proceeding that is induced by a tax liability triggered by a DE-level bankruptcy proceeding.[98] This report will assume that section 108 applies in the same manner to both partnerships and DEs, meaning that in a bankruptcy restructuring of a DE, the section 108 exclusions apply at the owner level.

3. Transactions involving recourse and nonrecourse debt. Transactions that result in the satisfaction of secured debt can produce different tax results depending on whether the secured debt is recourse or nonrecourse for tax purposes. Although the distinction between transactions that satisfy recourse debt and those that satisfy nonrecourse debt affects all types of taxpayers both in and out of bankruptcy, that distinction is particularly important to distressed passthrough entities. There are three reasons for this.

First, the classification of debt as recourse or nonrecourse may determine whether a transaction that satisfies that debt generates CODI, which is eligible for exclusion under section 108, or gain, which cannot be excluded under that provision. Second, for a passthrough entity that is an obligor on multiple debts, some of which are recourse and some of which are nonrecourse, differences between the tax treatment of transactions that satisfy recourse debt and transactions that satisfy nonrecourse debt will affect the tax exposure, and therefore the behavior, of the owners in different ways. Third, there is no primary authority that provides clear guidance on whether indebtedness of a DE is recourse or nonrecourse. The uncertainty created by that absence of authority can also affect the behavior of the direct and indirect owners of a bankrupt DE, thereby distorting the bankruptcy process.

As a preliminary matter, if a lender simply agrees to reduce the principal amount of indebtedness, the reduction triggers CODI regardless of whether the debt is recourse or nonrecourse.[99] This means that the differences between the treatment of recourse and nonrecourse debt arise only when the borrower either transfers property to a lender in repayment of the debt or sells property to a third party and uses the sales proceeds to retire the debt. Those differences are summarized below.

- **Transfer of property subject to nonrecourse indebtedness.** If a taxpayer transfers property subject to, or in full satisfaction of, the nonrecourse debt that encumbers the property, the taxpayer is treated as having sold or exchanged the property for an amount equal to the outstanding principal of that nonrecourse debt.[100] The taxpayer recognizes gain or loss depending on the relationship between the tax basis of the property and the principal amount of the nonrecourse debt.[101] The transfer does not result in CODI even if the principal amount of the

[94]Section 108(d)(6).

[95]*See* James B. Sowell, "Debt Workouts: The Partnership and the Partners," 871 *PLI/Tax* 817, 840 (2009); Linda Z. Swartz, "Partnership Bankruptcy Tax Issues," 871 *PLI/Tax* 1091, 1134 (2009).

[96]*But see Gracia v. Commissioner*, T.C. Memo. 2004-147, *Doc 2004-12996, 2004 TNT 121-15*. In that case, a bankruptcy court discharged a partner's obligation to guarantee the debts of a bankrupt partnership. Because the court discharging the partnership's debt said that it was exercising its jurisdiction over the partner, the Tax Court found that the partner could exclude the partnership-level CODI under the bankruptcy exclusion. *See also Price v. Commissioner*, T.C. Memo. 2004-149, *Doc 2004-12995, 2004 TNT 121-14* (same); *Mirarchi v. Commissioner*, T.C. Memo. 2004-148, *Doc 2004-12997, 2004 TNT 121-16* (same); *Est. of Martinez v. Commissioner*, T.C. Memo. 2004-150, *Doc 2004-12994, 2004 TNT 121-13* (same).

[97]*See* Alice Abreu, "Paradise Kept: A Rule-Based Approach to the Analysis of Transactions Involving Disregarded Entities," 59 *SMU L. Rev.* 491, 536 (2006) ("Some solvent corporations are apparently taking the position that Section 108(a) applies to the cancellation of indebtedness income of LLCs in which they are the single member. . . . [T]he taxpayer's argument would be that although the taxpayer — the corporate owner of the LLC — has not itself been discharged in bankruptcy, the debts discharged in bankruptcy are, for federal tax purposes, its debts (the debts of the taxpayer/owner) because for federal tax purposes the LLC does not exist as a separate entity. Furthermore, the taxpayer/owner is the only person who could be treated as being before the bankruptcy court, as required by [section] 108(d)(2), because for federal tax purposes the LLC does not exist as a separate entity." (footnotes omitted)).

[98]*Cf.* Peter C. Canellos, "Tax and Bankruptcy Policies in the Chapter 11 Context," 609 *PLI/Comm* 273, 280 (1992) ("The complexity of corporate tax rules encourages aggressive positions on the part of taxpayers.").

(Footnote continued in next column.)

[99]*See, e.g.*, reg. section 1.61-12(a); Rev. Rul. 91-31, 1991-1 C.B. 19 (holding that a reduction of the principal amount of a nonrecourse debt results in CODI even when the principal amount of the debt is greater than the FMV of the encumbered property).

[100]Reg. section 1.1001-2(c), Example 7; *Crane v. Commissioner*, 331 U.S. 1 (1947); *Tufts v. Commissioner*, 461 U.S. 300 (1983).

[101]Reg. section 1.1001-2(c), Example 7.

nonrecourse debt exceeds the fair market value of the encumbered property.[102]

- **Transfer of property subject to recourse indebtedness.** If a taxpayer either transfers property and uses the proceeds to satisfy a recourse debt or transfers property to a lender in full satisfaction of a recourse debt, the transaction is bifurcated into two components. In the first component, the taxpayer is treated as selling the property for its FMV and will recognize gain or loss depending on the relationship between the tax basis of the property and its FMV.[103] If the FMV of the property exceeds its tax basis, the taxpayer will recognize taxable gain that cannot be excluded from income under section 108 even if the taxpayer is in bankruptcy.[104] In the second component, the taxpayer is treated as satisfying the recourse debt for an amount equal to the FMV of the transferred property.[105] If the amount of the recourse debt exceeds the FMV of the property, the taxpayer will realize CODI that may be excluded from income under section 108.[106]

Those differences in tax treatment stem from two Supreme Court decisions — *Crane v. Commissioner*[107] and *Tufts v. Commissioner*[108] — that involve property sales outside the bankruptcy process. In *Crane*, the taxpayer sold property that was subject to an amount of nonrecourse indebtedness that did not exceed the property's FMV. The Court held that the amount realized by the taxpayer included the principal amount of the nonrecourse debt to which the property was subject. In reaching that holding, the Court relied on two factors. First, the Court believed it would be absurd not to include the amount of nonrecourse debt in the taxpayer's basis in the property, because doing so would materially understate the taxpayer's depreciation deductions for the property. Second, and more importantly, the Court concluded that the taxpayer obtained an economic benefit when the purchaser took the property subject to the nonrecourse debt, because the value of the property exceeded the principal amount of that debt. Given that line of reasoning, the *Crane* Court, in its famous footnote 37, left open the question whether its holding would apply to a transfer of property subject to a nonrecourse debt that exceeded its FMV.

The question raised by footnote 37 bounced around the lower courts for several decades[109] before the Supreme Court finally addressed it in 1983, when it issued its opinion in *Tufts*. There the Court held that when a taxpayer transfers a property that is subject to a nonrecourse debt that exceeds the property's FMV, the taxpayer's amount realized is equal to the principal amount of that debt. That opinion has been heavily criticized over the years, beginning with the concurring opinion filed by Justice O'Connor.[110] She made the point that a taxpayer who acquires a property using the proceeds of a nonrecourse borrowing and then transfers that property when the principal amount of the borrowing exceeds the FMV of the property has experienced CODI in an amount equal to that excess. The thrust of her argument is that a taxpayer who transfers property subject to a nonrecourse debt that exceeds the FMV of the property has engaged in a two-step transaction in which the taxpayer: (1) sold the property for its actual FMV; and (2) used the FMV sales proceeds to retire the nonrecourse debt at a discount. In her view, taxing the transaction that way would properly reflect that the property declined in value, triggering a loss to the taxpayer, and that the taxpayer repaid a debt at a discount. Although Justice O'Connor believed that in an ideal world, the tax treatment of the transaction would reflect that economic reality, she would not impose that result by way of judicial opinion, because doing so would overturn 60 years of common law, IRS ruling practice, and a newly issued regulation.[111] In other words, although Justice O'Connor was not persuaded by the reasoning of the majority opinion, she believed the only way to resolve the issue is through a change in the code or regulations. That view did not, however, stop a steady stream of commentators from criticizing the majority opinion and calling for a change in law.[112]

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[102]*Id.*; *see* William L. Raby, "Bifurcation and Excess Debt," *Tax Notes*, Jan. 10, 1994, p. 211, *Doc 94-377*, or *94 TNT 3-47*.

[103]*See* reg. section 1.1001-2(c), Example 8. Despite the regulation and the example, courts have on occasion treated a transfer of property subject to a recourse debt as an integrated sale transaction in which the amount of the recourse debt is treated as the amount realized. *Chilingirian v. Commissioner*, 918 F.2d 1251 (6th Cir. 1990) (finding that the entire amount of a recourse debt should be included in the amount realized on disposition of the underlying property); *see also In re A.J. Lane & Co., Inc.*, 133 B.R. 264 (Bankr. D. Mass. 1991). These cases would seem to be irreconcilable with the regulation.

[104]Reg. section 1.1001-2(c), Example 8; Sowell, *supra* note 95, at 824-826.

[105]Reg. section 1.1001-2(c), Example 8.

[106]*Id.*

[107]*Crane*, 331 U.S. 1.

[108]*Tufts*, 461 U.S. 300.

[109]*See, e.g.*, *Woodsam Assocs. Inc.*, 16 T.C. 649 (1951), *aff'd*, 198 F.2d 357 (2d Cir. 1952); *Estate of Delman v. Commissioner*, 73 T.C. 15 (1979).

[110]*Tufts*, 461 U.S. at 318-319.

[111]*Id.* at 319-320.

[112]Canellos, *supra* note 98, at 291-292 (discussing the "confusion reflected in the disparate and illogical treatment of recourse vs nonrecourse" indebtedness); Asofsky I, *supra* note 50, at 13-58 to 13-60 (criticizing the *Tufts* opinion as contrary to common sense); Diane M. Anderson, "Federal Income Tax Treatment of Nonrecourse Debt," 82 *Colum. L. Rev.* 1498, 1511-1530 (1982) (criticizing *Crane* as stating that the "fact remains that the repayment of nonrecourse debt is contingent on the continued high value of the property"); Glenn E. Coven, "Limiting Losses Attributable to Nonrecourse Debt: A Defense of the Traditional System Against the At-Risk Concept," 74 *Cal. L. Rev.* 41, 76 (1986) ("The *Tufts* decision is economically unjustifiable, for it permits taxpayers to convert ordinary income into capital gains"); John F. Coverdale, "Text as Limit: A Plea for a Decent Respect for the Tax Code," 71 *Tul. L. Rev.* 1501, 1555-1556 (1997) ("In an arm's-length transaction like that in *Tufts*, the taxpayer cannot be said to have received for the property cash or other property in excess of the fair market value of the property sold"); Susan M. Halliday and Theodore P. Manno, "Death of a

(Footnote continued on next page.)

Given that CODI can be excluded from gross income under some circumstances, whereas gains cannot be excluded from gross income under those same circumstances,[113] it is not surprising that taxpayers eligible to rely on a CODI exclusion have tried to develop transactions that purport to characterize as CODI the income realized on a disposition of property subject to nonrecourse indebtedness. In many instances, the courts have rejected those efforts.[114] As a result, financially distressed taxpayers who own properties subject to nonrecourse debt often find that a successful bankruptcy restructuring may produce significant taxable and nonexcludable income.

4. The classification of DE debt and debt-for-equity exchanges involving DEs.

a. The classification of DE debt as recourse or nonrecourse. The process of classifying a debt as recourse or nonrecourse begins with an analysis of the lender's rights. If a debt is secured by collateral and the lender may seek recourse only against that collateral, the debt is nonrecourse for tax purposes regardless of whether the borrower is a DE.

The classification of debt as recourse or nonrecourse becomes much more difficult when the borrower is a DE that provides its sole owner with limited liability (for example, a state law limited liability company or similar foreign entity)[115] and the lender may seek recourse against all of the assets owned by the DE. The classification process in that case is harder because, for contract law purposes, the debt is recourse in the sense that in a bankruptcy of the DE, the DE might be forced to sell or transfer all its assets to satisfy the debt. For tax purposes, however, the debt appears to be nonrecourse for two reasons. First, a purchaser cannot buy the owner's interest in the DE without also indirectly inheriting the DE's liabilities. Second, the owner of the DE is not liable for the DE's debts.

In theory, DE debt must be classified for tax purposes in one of two ways: recourse or nonrecourse. Given that tax lawyers are a creative bunch, it should come as no surprise that the question whether DE debt is recourse or nonrecourse has three potential answers: recourse, nonrecourse, and "it depends."

Those who conclude that a recourse debt of a DE is classified for tax purposes as nonrecourse debt of the DE's sole owner rely on a number of analogous authorities but, in the end, base their conclusion on two facts: The debt of the DE is treated for tax purposes as debt of the owner, and the creditor of the DE can seek recourse only against the DE's assets. Therefore, the DE-level debt must be classified for tax purposes as nonrecourse debt of the owner that is secured by the DE's assets.[116]

Footnote: A Current View of *Crane* and the Road to *Tufts*," 36 *S.C. L. Rev.* 403, 441-442 (1985) ("In *Tufts*, the Supreme Court chose not to adopt a powerful weapon against tax shelters").

[113]*See supra* text accompanying notes 72-90 (discussing rules under which CODI may be excluded from gross income).

[114]*See 2925 Briarpark Ltd. v. Commissioner*, 163 F.3d 313 (5th Cir. 1999). In that case, a partnership purportedly sold land to a third party for less than the face amount of the nonrecourse debt that encumbered the land and then transferred the sales proceeds to the creditor in full repayment of the debt. The taxpayer argued that since it was discharging the debt with cash less than the principal amount of the debt, the transaction resulted in CODI. The court disagreed. It found that the transaction was a sale and that any debt agreement was "intertwined" with the terms of the sale. Thus, the transaction as a whole was the functional equivalent of a sale or exchange of the land. *See also* FSA 200135002 (Apr. 10, 2001), *Doc 2001-22902, 2001 TNT 171-12* (following the reasoning of *Briarpark*); *Sands v. Commissioner*, T.C. Memo. 1997-146, *Doc 97-8241, 97 TNT 55-8* (finding a sale or exchange when the sale of property and the discharge of debt were part of one settlement), *aff'd sub nom. Murphy v. Commissioner*, 163 F.3d 618 (2d Cir. 1998), *Doc 98-23262, 98 TNT 155-6*. *But see Gershkowitz v. Commissioner*, 88 T.C. 984 (1987) (treating a discharge of nonrecourse indebtedness and a sale of property as separate transactions). However, James B. Sowell has argued that "a different result would seem to follow where property is sold to a third party subject to debt and the debt is modified (including a reduction in principal) in connection with the transfer" because "Treas. Reg. section 1.1274-5(b)(1) treats a modification of the debt instrument undertaken in connection with the sale or exchange as occurring in a transaction that is separate from the sale or exchange." *See* Sowell, "Debt Workouts: The Partnership and the Partners," at *5-6 (publication pending 2010, manuscript on file with the authors).

Further complicating matters is *Fulton Gold Corp. v. Commissioner*, 31 B.T.A. 519 (1934), in which the court held that the satisfaction of a nonrecourse mortgage for less than the full principal amount resulted in a reduction in the basis of the property securing the mortgage, and not CODI. Taxpayers have tried to rely on the case to argue that a reduction in the principal amount of a nonrecourse debt results in a reduction of the basis of the property securing the debt. Richard M. Lipton, "IRS Adopts Inconsistent Positions on Nonrecourse Debt in Loan Workouts," 77 *J. Tax'n* 196 (1992). However, the IRS has always disagreed with the holding in *Fulton Gold*, and following the Supreme Court's decision in *Tufts*, it seems unlikely that *Fulton Gold* is still valid law. Michael G. Frankel, "Real Estate Workouts — A Step-by-Step Analysis," 871 *PLI/Tax* 997, 1015-1016 (2009); *see also* Canellos, *supra* note 98, at 291-292.

[115]As discussed above, this report uses the term "DE" to refer only to disregarded entities that provide their owners with limited liability. It is possible to form a DE that provides its sole owner with unlimited liability. For example, a person can form a state law limited partnership in which the person functions as the sole general partner and a DE of the person functions as the limited partner. In that situation, a recourse debt of the limited partnership would be a recourse debt of the owner as a result of the owner's status as general partner. *See* reg. section 1.752-2(a). This type of structure would be highly unusual in practice.

[116]Terence Cuff, "Indebtedness of a Disregarded Entity," 81 *Taxes* 303, 340 (Mar. 2003) (noting that while unclear, a DE's debt may be nonrecourse because its owner is not personally liable for the debt under state law); Philip B. Wright, "Disregarded Entities Issues and Opportunities," 703 *PLI/Tax* 61, 84-85 (2006) (noting that the assumption of recourse liabilities by a DE may cause the liabilities to be treated as nonrecourse); *see also* FSA 200135002. In that field service advice, the IRS found that debt the parties characterized as a "limited recourse loan" was nonrecourse for tax purposes, even though the lender had recourse to "almost everything" the debtor owned. *Id.* ("the rights of a creditor with respect to a limited recourse loan are not as great as the rights of a creditor with respect to a recourse loan. In this case, [the lender] could not have, for example, attached assets of [the debtor] that were not specifically mentioned in the

(Footnote continued on next page.)

Those who conclude that a recourse debt of a DE is classified for tax purposes as recourse debt of the DE's sole owner likewise rely on a number of analogous authorities and, in the end, base their conclusion on two facts: (1) unless the lender has limited its recovery to a specific asset owned by the DE, it can seek recourse against all assets of the DE, even those that are acquired after the date the loan is made; and (2) a loan that permits the lender to seek recourse against a pool of assets that may change over time should be classified for tax purposes as recourse.[117]

Those who conclude that the debt of a DE may be recourse or nonrecourse depending on the circumstances are simply throwing their hands in the air and asserting that recourse debt is like pornography — they know it when they see it.[118]

b. Classification of debt-for-equity exchanges involving DEs. Wrapped up in the discussion of the classification of DE debt as recourse or nonrecourse is a closely related question: When a distressed DE is converted into a partnership consisting of the DE's owner and one or more DE creditors, how much income or gain, if any, does the DE's owner recognize?

Example 1: Individual A owns DE-1. DE-1's sole asset is Asset 1, which is a non-real-estate capital asset that DE-1 has held for more than one year. DE-1 owes $150 to Bank. The liability is recourse to all of DE-1's assets. A has no obligation to satisfy that liability or to contribute additional proceeds to DE-1. Asset 1 has a tax basis of $100 and an FMV of $50. DE-1 files for bankruptcy. In connection with the bankruptcy process, the parties agree to restructure DE-1 as follows: (1) DE-1 will be converted into Partnership 1, the members of which will be A and Bank; (2) Bank's $150 liability will be canceled in its entirety; (3) Bank will receive equity in Partnership 1 that provides a capital account of $50 and a profits interest of 90 percent; and (4) A will receive, in exchange for his future services, equity in Partnership 1 that has a capital account of $0 and a profits entitlement of 10 percent.

Although this transaction can be classified in many ways, the following two paradigms would seem the most probable:

- **The full assets-over paradigm.** Under the full assets-over paradigm, the parties would be treated as if (1) A transferred Asset 1 to Bank in full repayment of the $150 liability; and (2) Bank and A formed Partnership 1, with Bank contributing Asset 1 in exchange for a capital and profits interest and A receiving a profits interest.

Loan Agreement. Accordingly, the loan was nonrecourse for purposes of Treas. Reg. section 1.1001-2''). Analogously, even the recourse debt of a DE with significant operating assets may be considered nonrecourse to its owner, since the creditor would never have recourse to all the assets of the owner.

[117]Marc D. Teitelbaum, ''A Disregarded Entity Must Be Taken Into Account,'' 773 *PLI/Tax* 9, 39 (2007) (noting that a DE could be treated as a division of its owner, so that debt that was recourse to the DE would be recourse to its single member); Cuff, *supra* note 116, at 339 (stating that a court might find the debt to be recourse debt since ''the foreclosure itself does not technically end the [DE]'s liability''); *see also* LTR 200315001 (Sept. 19, 2002), *Doc 2003-9291*, *2003 TNT 71-17*) (Corp. X engaged in an F reorganization under which 100 percent of the stock of X was transferred to a newly formed corporation (Newco), and X converted into LLC status under state law and became a DE of Newco; *ruled* that the recourse debt of X will not have undergone a ''significant modification'' for purposes of reg. section 1.1001-3 since the creditors' state law rights against X will not change); LTR 200630002 (Apr. 24, 2006), *Doc 2006-15342*, *2006 TNT 157-46* (same); LTR 200709013 (Nov. 22, 2006), *Doc 2007-5483*, *2007 TNT 43-32* (similar; conversion of corporate subsidiary into DE and then a partnership). Because a change in the nature of indebtedness from recourse to nonrecourse is generally considered a significant modification under reg. section 1.1001-3, these letter rulings could be read to suggest that debt that is recourse to a DE will be treated as recourse debt of the DE's owner for tax purposes. However, the emphasis that reg. section 1.1001-3 places on state law rights, and the fact that the state law rights were unaffected by the tax conversion, could temper that argument. For further discussion of these rulings, see Debra J. Bennett, '''To Be or Not to Be, That Is the Question': Disregarded Entities and Debt Modification,'' 81 *Taxes* 9 (Dec. 2003); James M. Peaslee, ''Modifications of Nondebt Financial Instruments as Deemed Exchanges,'' *Tax Notes*, Apr. 29, 2002, p. 737, *Doc 2002-10327*, or *2002 TNT 83-25*; Jasper L. Cummings, Jr., ''The Disregarded Entity Is and Isn't (Disregarded),'' *Tax Notes*, May 5, 2003, p. 743, *Doc 2003-11183*, or *2003 TNT 87-31*.

[118]*See Jacobellis v. Ohio*, 378 U.S. 184 (1964). This point can be illustrated by comparing the following two fact patterns:

Fact Pattern 1. Corp. X forms DE-1 to acquire Blackacre. DE-1 borrows money from Bank. The loan is secured by Blackacre, but Bank may seek recourse against any other asset owned by DE-1. Bank is a non-economic member of DE-1 and has the right to veto any transfer of X's interest in DE-1 or DE-1's interest in Blackacre. Throughout the life of the loan, DE-1's sole asset consists of Blackacre.

(Footnote continued in next column.)

Fact Pattern 2. Corp. Y owns three DEs, each of which operates 100 grocery stores under a brand name that is unique to that DE. DE-2 operates 100 stores under brand name 2. DE-2 owns the stores and maintains its own workforce, inventory, and payroll. To finance its inventory purchases and payroll, DE-2 enters into a revolving credit facility with Bank. The credit facility is unsecured, and Bank may seek recourse against any and all assets of DE-2 regardless of when the assets are acquired. No other person executes a guarantee or similar obligation for the credit facility. Aside from customary covenants in the credit agreement, Bank has no management or veto rights for Y's interest in DE-2. It is anticipated that DE-2's inventory will turn over daily and that DE-2 is likely to sell existing stores and purchase new ones over time.

The loan in Fact Pattern 1 looks like a classic nonrecourse real estate loan, because Bank can seek recourse only against Blackacre, and X cannot sell DE-1 or cause DE-1 to sell Blackacre without either repaying the debt owed to Bank or ensuring (with the Bank's consent) that the purchaser takes Blackacre subject to the debt. The loan in Fact Pattern 2 looks like a classic recourse trade credit arrangement, because the borrower (DE-2) is constantly buying and selling the assets (*i.e.*, inventory) that Bank will rely on for repayment of the loan. Also, Buyer may sell existing stores and buy new stores, thereby materially changing the asset pool against which Bank may seek recourse. Those two fact patterns admittedly represent the extremes on the spectrum between ''recourse'' DE debts that look like nonrecourse loans and ''recourse'' DE debts that look like true recourse loans. In real life, classification is much more difficult because most cases lie between the two extremes.

- **The partnership formation paradigm.** Under the partnership formation paradigm, the parties would be treated as if (1) A contributed Asset 1 to Partnership 1 in exchange for his partnership interest; and (2) Bank contributed the $150 note to Partnership 1 in exchange for its partnership interest.

Despite the importance of tax to the bankruptcy restructuring process, there is little guidance on the tax classification of debt-for-equity exchanges involving DEs. The most relevant guidance is Rev. Rul. 99-5,[119] which addresses two situations in which a DE is converted into a partnership. In situation 1, individual A owns a disregarded LLC and sells 50 percent of its ownership interest in the LLC to a third party in exchange for cash. In situation 2, individual A owns a disregarded LLC, and a third party contributes cash to the LLC in exchange for a 50 percent interest; the LLC then uses that cash in its business. In each situation, the third party's acquisition of a 50 percent interest in the LLC converts the LLC from a DE to a partnership.

The IRS ruled that the transaction in situation 1 is treated as if A sold a 50 percent interest in the LLC's assets to the third party in a fully taxable transaction, and A and the third party contributed their 50 percent interests in those assets to a new partnership in a section 721 contribution. The IRS ruled that the transaction in situation 2 is treated as a single section 721 transaction in which A and the third party formed a new partnership, with A contributing the LLC's assets and the third party contributing cash. The transaction in situation 2 did not result in gain or loss to A. The critical difference between situation 1 and situation 2 was A's receipt of cash.

The application of Rev. Rul. 99-5 to Example 1 is unclear, because one can rely on Rev. Rul. 99-5 to make credible arguments in support of both the full assets-over paradigm and the partnership formation paradigm. Thus, one could argue that the transaction in Example 1 should be analyzed under the full assets-over paradigm, because the bankruptcy court order that confirms the DE-1 restructuring plan will likely result in the complete cancellation of A's prepetition equity interest in DE-1, and because Bank's interest in Partnership 1 will represent all of the initial capital. Under this view, A would be treated as transferring 100 percent of the interests in DE-1 to Bank in full repayment of the $150 liability, and as receiving a profits interest in newly formed Partnership 1.[120] The main driver of A's tax liability will be the characterization of DE-1's liability as recourse or nonrecourse.

However, one could argue that the transaction in Example 1 should be analyzed under the partnership formation paradigm because, when the dust settles, DE-1 will have converted from DE status to partnership status, A will continue as an equity owner in the entity formerly known as DE-1, and A will not receive any cash or other consideration as a result of that transaction.

When the uncertainty surrounding the classification of a debt-for-equity exchange is combined with the uncertainty surrounding the classification of DE debt as recourse or nonrecourse, the result is the matrix illustrated on the next page.

In situations when a DE is owned by a parent entity, the parties can reduce some of this uncertainty by having the parent entity issue its own equity to Bank in partial repayment of the DE's debt. That transaction would clearly be treated as a debt-for-equity exchange at the parent level, which would create CODI, depending on the value of the equity, regardless of the classification of the DE debt as recourse or nonrecourse. If the parent cannot issue its own equity or if the DE is owned by an individual, the parties must deal with uncertainty when evaluating the type of debt-for-equity exchange described in Example 1.

c. The effect of uncertainty. The classification of DE debt as recourse or nonrecourse and the classification of debt-for-equity exchanges involving DEs could be the sole focus of a report.[121] For our purposes, however, as illustrated in Section III below, there are three take-aways from this part of the discussion. First, both the classification of DE debt as recourse or nonrecourse and the classification of debt-for-equity exchanges involving DEs are, in many real-life cases, uncertain. Second, this is an area in which tax results have a strong influence on behavior, and if taxpayers are faced with significant uncertainty, they may be encouraged to follow the route that provides the highest probability of the lowest tax liability. Third, to the extent that route is different from the route that would have been followed in the absence of either taxes or uncertainty relating to taxes, the tax system has distorted the bankruptcy restructuring process, thereby undercutting bankruptcy policy.

III. Policy Issues

A. Basic Issues

The tax problems created by a distressed passthrough entity and the extent to which those problems create policy issues — that is, results or behaviors that impede the goals of bankruptcy policy — vary depending on several factors. They include the entity's status as a DE or partnership,[122] the character of the entity's liabilities as

[119]Rev. Rul. 99-5, 1999-1 C.B. 434, *Doc 1999-2045*, *1999 TNT 10-6*.

[120]*See* New York State Bar Association (NYSBA) Tax Section, "Report on Proposed Regulations Under Sections 108(e)(8) and 721" (June 29, 2009), *Doc 2009-14635*, *2009 TNT 122-75* ("we would exempt from the application of Section 721 a transfer of an interest in a pass-through entity to a creditor if the pass-through entity, immediately before the debt-for-equity exchange, is a disregarded entity for federal income tax purposes and becomes a partnership by reason of such transfer. That transaction should be treated as a transfer of an undivided

(Footnote continued in next column.)

interest in the assets of the pass-through entity's owner, and gain or loss should be recognized upon such exchange").

[121]*See, e.g.*, Cuff, *supra* note 116; Teitelbaum, *supra* note 117; Wright, *supra* note 116; Abreu, *supra* note 97.

[122]As discussed above, although practitioners use the term "passthrough entity" to refer to many types of entities — including DEs, partnerships, grantor trusts, S corporations, complex trusts, regulated investment companies, REITs, controlled foreign corporations, and passive foreign investment

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	Full Assets-Over Paradigm	Partnership Formation Paradigm
DE-1 Debt Is Recourse	A recognizes a $50 long-term capital loss and $100 of CODI.[a] A does not recognize gain on receipt of his interest in Partnership 1 and takes a zero basis in that interest.[b]	A recognizes $100 of CODI.[c] A does not recognize gain or loss on the receipt of his interest in Partnership 1 and takes a $50 basis in that interest.[d]
DE-1 Debt Is Nonrecourse	A recognizes a $50 long-term capital gain and does not recognize any CODI.[e] A does not recognize gain on receipt of his interest in Partnership 1 and takes a zero basis in that interest.[f]	A recognizes $100 of CODI.[g] A does not recognize gain or loss on receipt of his interest in Partnership 1 and takes a $50 basis in that interest.[h]

[a]Reg. section 1.1001-2(a)(2); reg. section 1.1001-2(c), ex. 8. In this case, A would be treated as: (i) selling Asset 1 for $50 and recognizing a $50 long-term capital loss ($100 tax basis minus $50 FMV); and (ii) using $50 of value to retire a $150 debt, producing $100 of CODI.
[b]*See* Notice 2005-43, 2005-1 C.B. 1221, *Doc 2005-11236, 2005 TNT 98-37*; Rev. Proc. 2001-43, 2001-2 C.B. 191, *Doc 2001-20855, 2001 TNT 150-11*; Rev. Proc. 93-27, 1993-2 C.B. 343, *Doc 93-6562, 93 TNT 123-7*; *see also* Glenn E. Mincey et al., "Rev. Proc. 2001-43, Section 83(b), and Unvested Profits Interests — the Final Facet of Diamond?" 95 *J. Tax'n* 205 (2001); Terence Floyd Cuff, "Some Basic Issues in Drafting Real Estate Partnership and LLC Agreements," 863 *PLI/Tax* 463 (2009).
[c]Section 108(e)(8)(B); prop. reg. section 1.108-8(a); *see also* Sowell, *supra* note 95, at 859-861; Swartz, *supra* note 95, at 1150.
[d]The calculation of A's basis in the partnership formation paradigm is conceptually odd. On the formation of Partnership 1, A would take an initial tax basis in his partnership interest of $100 ($100 basis in Asset 1, reduced by the $150 liability, and increased by the $150 liability). *See* section 752. A nanosecond later, Bank will contribute its $150 note to Partnership 1 in exchange for its Partnership 1 interest in a transaction that generates CODI of $100. This means that A's basis in his Partnership 1 interest would be increased from $100 to $200 to reflect the allocation of CODI to A, and then decreased from $200 to $50 to reflect the discharge of the $150 liability.
[e]Reg. section 1.1001-2(a)(1); reg. section 1.1001-2(c), ex. 7.
[f]*See infra* note 122 in text.
[g]Section 108(e)(8)(B); prop. reg. section 1.108-8(a); *see also* Sowell, *supra* note 95, at 859-861; Swartz, *supra* note 95, at 1150.
[h]*See infra* note 124 in text.

recourse or nonrecourse for tax purposes, the source of the entity's income and any related CODI resulting from a restructuring of the entity, and the extent to which the entity's liabilities exceed the tax bases of its assets. While those factors can combine to create a multitude of unique situations and corresponding policy issues, the basic point of this report — that the tax rules applicable to bankrupt passthrough entities lead to results and behaviors that undercut bankruptcy policy — can be illustrated using a simple example, a complex example, and a variation on the complex example. All the examples in this report assume that the participants are subject to tax at the highest federal statutory income tax rates[123] and that the items described in the example are the only items reportable on the participants' returns for the applicable years.

B. The Simple Example

The simple example involves an individual who forms a wholly owned holding company to conduct a non-real-estate, non-farming business through its own wholly owned operating company.

Example 2: Individual A decides to enter business as a sole proprietor. To protect himself from the potential liabilities associated with the business, A forms Holdco and contributes $25 to the entity. Holdco forms Opco and contributes to it the $25 received from A. Opco borrows $150 from Bank and uses the proceeds in the course of its business. Bank can seek recourse against all of Opco's assets to obtain repayment of the loan. In year 6 Opco becomes distressed and files for bankruptcy. At that time, the principal owed to Bank is $150, and the assets of Opco (which qualify as section 1231 assets) have a tax basis of $100 and an FMV of $50. During the bankruptcy case, Bank agrees to accept 100 percent of the outstanding equity of Opco in full repayment of the $150 loan. A owns $8 of liquid assets such as stocks and securities. A also owns a number of illiquid assets such as residential real estate, undeveloped land, and interests in private investment funds. A has no personal liabilities. On the advice of both corporate and tax counsel, Holdco and Opco were formed as LLCs, and each entity is a DE of A.

In this case, the classification of the debt owed by Opco to Bank will determine whether Opco's bankruptcy will result in a potentially crushing tax liability for A.

- If the $150 debt is classified as a nonrecourse liability, A reports $50 of long-term capital gain, on which he owes a tax of $7.50.[124] That tax liability destroys A's liquid net worth, but he is able to avoid bankruptcy and retain his illiquid assets.
- If the $150 loan is treated as a recourse obligation, A reports CODI of $100, which is offset by an ordinary

companies — this report will focus exclusively on the tax issues confronting distressed partnerships and DEs and will use the term "passthrough entity" to refer only to partnerships and DEs.

[123]As of this writing, the highest corporate statutory rate is 35 percent, and the highest individual rates are 35 percent for ordinary income and 15 percent for capital gains. Sections 1(h)(1)(C), 1(i)(2), and 11(b). For simplicity, state and local taxes are not considered.

[124]If the $150 debt is classified as nonrecourse, A will be treated as selling the assets of Opco for $150 (the outstanding loan balance). Because those assets have a tax basis of $100, A will report $50 of long-term capital gain in connection with the bankruptcy and thereby incur a tax liability of $7.50. This assumes that the assets of Opco are capital assets or section 1231 assets and are not otherwise subject to recapture. To the extent those assets are ineligible for that treatment, the income recognized by A will be ordinary in nature and subject to tax at a higher statutory rate.

loss of $50. That produces net ordinary income of $50, on which A owes tax of $17.50.[125] A tax liability of $17.50 is more than twice the value of A's liquid assets, and it could force A into the very type of bankruptcy proceeding he was trying to avoid when he formed Holdco and Opco to conduct his business. It bears mentioning that the CODI realized in the Opco bankruptcy would be excluded from A's income to the extent A is insolvent under the insolvency exclusion.[126] The way the numbers work out, A cannot rely on the insolvency exclusion if his illiquid assets are worth $92 or more, and the insolvency exclusion does not prevent the destruction of A's liquid net worth unless his illiquid assets are worth $14.85 or less.[127] Somewhere between $14.85 and $92 lies a breakpoint at which the tax liability attributable to the Opco bankruptcy will force A into bankruptcy even if A can rely on the insolvency exclusion to exclude a portion of the CODI realized in the Opco bankruptcy. Given the inherent uncertainties associated with the valuation of illiquid assets, it may be extremely difficult for A to determine whether, and to what extent, the insolvency exclusion will shield him from a tax liability that will force him into bankruptcy.

The effect of the distinction between recourse and nonrecourse indebtedness on the owner of a DE is not limited to individual owners. For example, if Holdco is a C corporation in a position to file for bankruptcy jointly with Opco, the parties will prefer that the $150 liability be classified as a recourse obligation. In that case, the CODI realized in the Opco bankruptcy will be excluded from gross income under the bankruptcy exclusion, and any loss recognized in connection with the restructuring will be subject to attribute reduction.

If, however, the $150 loan is classified as a nonrecourse obligation, Holdco is treated as selling Opco's assets in a taxable transaction that results in a long-term capital gain of $50. If Holdco is a C corporation, that tax liability is treated as an administrative expense that must be satisfied in full in order for Holdco to complete a chapter 11 bankruptcy process. If Holdco lacks either the cash or tax attributes (for example, NOLs) to satisfy or eliminate that tax liability, it will have to engage in a chapter 7 liquidation process that could lead to the forced sale of any other assets owned by Holdco. Any tax due in connection with the liquidation will go unpaid to the extent that Holdco lacks the funds to pay the tax.[128]

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[125]If the $150 liability is classified as recourse, the bankruptcy restructuring of Opco is bifurcated for tax purposes and treated as two separate transactions. In the first transaction, A is treated as selling the assets of Opco for their $50 FMV in a transaction that generates a $50 loss ($100 tax basis minus $50 FMV). Assuming those assets are eligible for treatment under section 1231, that loss is ordinary. Section 1231(a)(2). In the second transaction, A is treated as satisfying the $150 recourse debt with $50 of assets in a transaction that generates $100 of CODI. If the loss recognized by A on the sale component of the transaction is eligible for ordinary treatment under section 1231, A can use the $50 ordinary loss to partially offset the $100 of CODI, yielding a net ordinary income inclusion of $50. To the extent that section 1231 does not apply, that loss is capital in nature and, in a real-world scenario, is unavailable to offset the ordinary CODI. Section 1211(b) (an individual taxpayer may use capital losses only to offset capital gains and $3,000 of ordinary income); section 1211(a) (a corporate taxpayer may only use capital losses to offset capital gains). If the entire loss recognized on the asset sale component of the Opco bankruptcy is classified as capital, A recognizes net CODI of $100, the tax on which is $35.

[126]*See supra* note 74 (discussing the application of the insolvency exclusion); Rev. Rul. 92-53, 1992-2 C.B. 48 (in which a taxpayer owns property subject to a nonrecourse liability and recognizes CODI on the reduction of the principal amount of that liability, and the amount of that nonrecourse liability may be treated as a personal liability of the taxpayer for purposes of applying the insolvency exclusion to that CODI); *see also* Sowell, *supra* note 95, at 842.

[127]To rely on the insolvency exclusion, A would have to prove that the $150 Opco liability exceeded the aggregate FMV of the Opco assets, A's liquid assets, and A's illiquid assets. Because Opco's assets are worth $50 and A's liquid assets are worth $8, A will be unable to rely on the insolvency exception if his illiquid assets are worth $92 or more.

Those numbers tell only half the story, however. A's liquid net worth is $8, which means that he cannot realize more than $22.85 of taxable CODI without destroying his liquid net worth. A will realize $22.85 of taxable CODI if his illiquid assets are worth $14.85. In that situation, A would be insolvent by $77.15, which is the excess of the $150 Opco liability over the sum of (1) the Opco assets ($50), (2) A's liquid assets ($8), and (3) A's illiquid assets ($14.85). On those facts, of the $100 of CODI produced in the Opco bankruptcy, $77.15 would be excluded under the insolvency exclusion, and $22.85 would be taxable. Section 108(d)(3). The amount of non-excluded (*i.e.*, fully taxable) CODI recognized by A will increase dollar-for-dollar as the value of the illiquid assets increases and the extent of A's insolvency decreases. At some point, the tax liability imposed

(Footnote continued in next column.)

on the non-excluded portion of the CODI recognized in connection with the Opco bankruptcy will force A into bankruptcy.

[128]The extent to which tax liabilities are satisfied in a bankruptcy proceeding depends on the nature of the transactions that gave rise to the tax liability and the nature of the bankruptcy process being undertaken. Generally speaking, when a business entity files for bankruptcy, the nature and value of the consideration received by its creditors depends in part on whether the bankruptcy proceedings occur under chapter 7 or chapter 11 of the Bankruptcy Code.

Chapter 11 provides for two types of restructuring transactions: reorganizations and liquidations. Bankruptcy Code section 1123(a) and (b)(4). In a chapter 11 reorganization, the claims of prepetition creditors may be reinstated, paid in full, or satisfied through an issuance of debt or equity in the reorganized debtor. In a chapter 11 liquidation, the assets of the debtor are sold off, typically through the use of one or more court-approved bidding processes, and the sales proceeds are distributed to creditors.

If a taxpayer files for bankruptcy under chapter 11, it must generally satisfy all of its administrative expenses before exiting bankruptcy. Bankruptcy Code section 1129(a)(9)(A) (second-priority administrative expenses and some other postpetition claims must be paid in full in cash on the plan's effective date). Federal income tax liabilities attributable to operations or transactions, including asset sales, that occur during the course of bankruptcy proceedings are treated as administrative expenses. Bankruptcy Code section 507(a)(2) and (8). If a taxpayer does not have sufficient funds to fully satisfy all of its administrative

(Footnote continued on next page.)

If Holdco is an S corporation, the results are mixed. If the $150 liability is classified as recourse for tax purposes and Holdco files for bankruptcy jointly with Opco, the CODI recognized in the bankruptcy is excluded from gross income at the Holdco level, and any loss recognized in connection with the bankruptcy is subject to attribute reduction.[129] In that case, the bankruptcy restructuring is tax neutral to A. If, however, the $150 liability is treated as nonrecourse, Holdco is treated as selling the assets of Opco in a taxable transaction that results in a long-term capital gain of $50. That gain is passed through to A, where it produces a tax liability of $7.50. Once again, that tax liability destroys A's liquid net worth, but he is able to avoid bankruptcy and retain his illiquid assets.

Example 2 illustrates how in a bankruptcy of Opco, the classification of Opco's debt as recourse or nonrecourse determines whether that bankruptcy results in a substantial tax liability on A. In that example, the lender's behavior is predetermined — it will seize 100 percent of the equity of Opco in full payment of Opco's $150 liability. The only uncertainty is the extent to which the tax liability triggered by the Opco bankruptcy will ruin A.

In real life, however, the situation will be much more fluid. The distressed entity, its owners, and its creditors are likely to consider several different restructuring alternatives depending on their views of the entity, its business, and the owners' willingness to contribute additional funds to the entity. The parties will likely find that the restructuring transaction that makes the most business sense may have to be scrapped in favor of the transaction that makes the most tax sense.

C. The Complex Example

1. The complex fact pattern.

Example 3: Ten years ago, several individuals decided to form and operate Business X, a non-real-estate, nonfarming operation, using a typical Holdco/Opco structure. Under that structure, each owner has held an equity interest in Holdco, Holdco has been the sole owner of Opco, Holdco's sole asset has been its Opco interest, and Opco has held all of the assets used in Business X.

Over the years, Opco had a solid operating history. Seven years ago, Opco borrowed $4,500 from Bank under a seven-year note. Opco used some of the borrowed funds in the conduct of Business X and distributed some of them to Holdco, which in turn distributed them to its owners. Some of those distributions were made in full or partial redemption of the interests of one or more owners. The $4,500 note is recourse to all of Opco's assets (for example, goodwill, intellectual property, inventory, and equipment). To strengthen Bank's position as creditor, Holdco guaranteed the $4,500 note and pledged its Opco interest as collateral for the guarantee. None of the owners of Holdco bear personal liability for the $4,500 note.

Last year Opco's business began to deteriorate because of macroeconomic factors beyond its control, but its business model remains viable on a long-term basis. Today Opco's assets have a gross FMV of $1,500 on a going concern basis and a gross FMV of $900 on a liquidation basis. Opco's basis in its assets is $3,000, and its only liability is the $4,500 note. Opco does not have enough cash to repay the $4,500 note at its upcoming maturity date, and Opco cannot refinance the $4,500 note with a new loan. Bank has tried to market the $4,500 note to investors, but has been unable to find a buyer.

All of Holdco's equity is currently owned by three individuals: A, B, and C. None of the Holdco owners are bankrupt. Each has $200 of available liquid net worth, all of which can be deployed in the Opco business. The balance of each owner's net worth is represented by illiquid assets, such as residential real estate and minority interests in private investment funds and privately held companies.

Bank recognizes that it will achieve a greater recovery on the $4,500 note if Opco continues as a going concern, and the owners would rather continue Business X than have it auctioned off in liquidation. In light of those views, the parties agree to a proposed restructuring under the following terms: (1) the existing Holdco equity held by A, B, and C will be written off as worthless; (2) A, B, and C each will contribute $200 to Holdco in exchange for newly issued 5 percent equity interests in Holdco; (3) Holdco will contribute to Opco the $600 that it receives from A, B, and C; (4) Bank will exchange the $4,500 note for a new 10-year $1,000 Opco note and a newly issued 85 percent equity interest in Holdco; and (5) Opco will continue to operate Business X.

Following the restructuring, Opco will have $2,100 of assets, consisting of business assets worth $1,500 and cash of $600, and Opco's sole liability will be the $1,000 note. Accordingly, the aggregate value of Holdco's outstanding equity will be $1,100. The newly issued 5 percent equity interests in Holdco held by A, B, and C

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expenses, it is considered administratively insolvent. Bankruptcy Code section 1129(a)(9)(A). When a debtor is administratively insolvent, a plan of reorganization cannot be confirmed without agreement from all of the administrative claimants. In that situation, the bankruptcy court is likely to convert the case into a chapter 7 liquidation. *See* Bankruptcy Code sections 1112(b)(1), 1112(b)(4), and 1129(a)(9)(A).

In a chapter 7 liquidation, the taxpayer's assets are sold off and the proceeds are used to repay creditors in order of priority. Bankruptcy Code sections 507(a) and 726(a)(1). To the extent that the taxpayer does not possess sufficient funds to satisfy its administrative expenses, those expenses will never be paid. *See, e.g., In re Lochmiller Indus., Inc.*, 178 B.R. 241 (Bankr. C.D. Cal. 1995).

Thus, for a C corporation that sells assets in a bankruptcy liquidation, it is entirely possible that the government will be unable to collect the tax due in connection with that sale. *See* Mark S. Wallace, "Is a Midstream Abandonment of Property by a Bankruptcy Trustee Taxable to the Estate?" 77 *J. Tax'n* 26, 27 (1992) ("If the bankruptcy estate is administratively insolvent, the taxing authority will be unable to collect the tax in full from the estate"); Christopher Woll, "Post Bruno's Bankruptcy Planning: An Analysis of Taxable Emergence Structures," 4 *DePaul Bus. & Com. L.J.* 277, 279 (2006); John C. Hart and Nancy Mehlman, "Restructuring the Bankrupt Corporation," 848 *PLI/Tax* 705, 743-45 (2008).

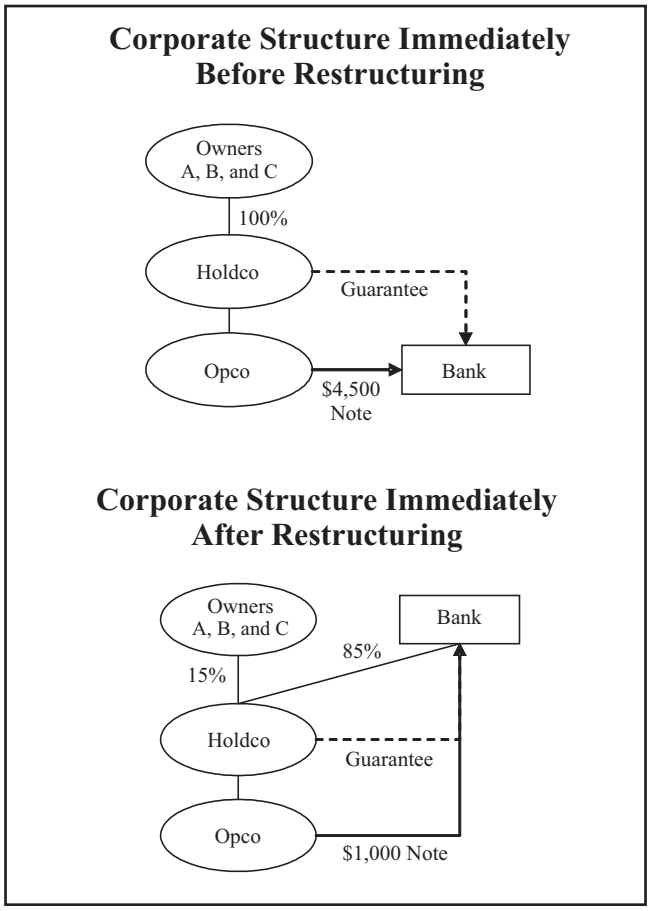
[129]Section 108(d)(7) (attribute reduction generally occurs at the S corporation level); reg. section 1.108-7(e), Example 5 (some suspended losses of an S corporation shareholder are treated as deemed NOLs that are eligible for attribute reduction).

will be worth $55 each, and Bank's newly issued 85 percent equity interest in Holdco will be worth $935.

Thus, as a result of the proposed restructuring, Bank will recover $1,935 of value — equity worth $935 and the $1,000 note, which is presumed to have an issue price and FMV of $1,000.[130] This means that Holdco/Opco will realize $2,565 of CODI, which represents the excess of the $4,500 note over the $1,935 of consideration transferred to Bank in repayment of that note.[131]

Under the proposed restructuring, Opco will retain 70 percent of its workforce. Under a liquidation scenario, it is likely that 95 percent of Opco's workforce would be terminated.

The following diagram illustrates the pre-restructuring and post-restructuring corporate structure of Holdco/Opco:



As discussed below, the tax consequences of the proposed restructuring will differ greatly depending on the tax classification of Holdco. To illustrate the effect of those differences, Section III.c.ii analyzes the tax results that will arise if Holdco is classified as a corporation, while Section III.c.iii analyzes the tax effects that will arise if Holdco is a tax partnership. Because Opco exists to enhance Bank's rights, this report assumes that regardless of Holdco's tax classification, Opco is classified as a DE of Holdco.

2. Tax consequences if Holdco had been classified as a corporation. If the owners had classified Holdco as either a C corporation or an S corporation, the parties could complete the proposed restructuring under two scenarios that will not trigger an immediate owner-level tax and presumably will not affect the owners' behavior.[132]

Under the first scenario, the parties will complete the restructuring under a prepackaged bankruptcy process in which Holdco and Opco both file for bankruptcy protection.[133] In that event, the $2,565 of CODI realized by Holdco will be excluded from income under the bankruptcy exclusion. Also, although the law is unclear, each owner may be able to report a worthless stock deduction for its prepetition equity interest in Holdco.[134] Finally,

[130]*See* sections 1273(b)(4) and 1274; Swartz, *supra* note 95, at 1118-1119.

[131]Section 108(e)(8) and (e)(10).

[132]If Holdco had been classified as an S corporation, the issuance of Holdco stock to Bank would result in the termination of Holdco's S corporation status. Sections 1361(b)(1)(B) and 1362(d)(2). In that case, the parties might consider having Bank acquire an 85 percent equity interest in Opco rather than an 85 percent equity interest in Holdco. That structure would convert Opco into a partnership and maintain Holdco's status as an S corporation. As discussed above, the tax classification and consequences of that type of debt-for-equity exchange are unclear. *See supra* text accompanying notes 114-120 and notes a-h (discussing the tax classification and consequences of debt-for-equity exchange transactions involving DEs).

[133]Prepackaged restructurings (prepacks) are completely negotiated, documented, and voted on by creditors and equity holders before the filing of the chapter 11 case. *See* Timothy R. Pohl and Rena M. Samole, "Out of Court Restructurings and Prepackaged Plans," 867 *PLI/Comm* 295 (2004). The advantages of a prepack include avoiding costs and expenses associated with a typical chapter 11 restructuring, the administrative burdens and risks associated with a traditional chapter 11 case, and business deterioration. *Id.*; *see also* Deryck A. Palmer and Jessica L. Fink, "Prepackaged and Prearranged Chapter 11 Case Process," 921 *PLI/Comm* 581 (2010); Nancy L. Lazar and James I. McClammy, "Recent Developments in the Law of Prepackaged Bankruptcy Plans," 820 *PLI/Comm* 309 (2001).

[134]*Delk v. Commissioner*, 113 F.3d 984 (9th Cir. 1997), *Doc 97-12848*, *97 TNT 90-11* (the taxpayer owned stock in a corporation that filed for bankruptcy; as part of the bankruptcy restructuring, the taxpayer's prepetition equity interest was canceled and the taxpayer contributed new cash to the corporation in exchange for a new equity interest; *held*, that the taxpayer was entitled to a worthless stock deduction for the prepetition equity interest that was canceled in connection with the bankruptcy restructuring); *see also Lawson v. Commissioner*, 42 B.T.A. 1103 (1940) (stock held to be worthless stock when the stockholders received nothing in the plan of reorganization). If the former shareholders are entitled to some right because of their status as former shareholders, the canceled shares may not be worthless. *See Coleman v. Commissioner*, 31 B.T.A. 319 (1934) (no worthless stock deduction when individuals whose shares were canceled were given warrants to buy new shares in the reorganized company); *United Gas Improvement Co. v. Commissioner*, 47 B.T.A. 715 (1942) (no worthless deduction when principal shareholder exchanged old common stock and preferred stock for new common shares); *In re Steffen*, 305 B.R. 369 (Bankr. M.D. Fla. 2004) (no worthless stock deduction because

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subject to the liability floor, Holdco/Opco will be required to reduce tax attributes by the amount of excluded CODI.[135] To the extent the excluded CODI exceeds the available tax attributes of Holdco/Opco, the excess will be treated as black hole CODI that escapes taxation altogether.[136]

Under the second scenario, the parties will complete the restructuring out of court. Although the law is unclear, Holdco's guarantee of the $4,500 note should render Holdco insolvent for purposes of the insolvency exclusion.[137] In that case, the $2,565 of CODI realized by Holdco will be excluded from income,[138] and Holdco will be subject to the same attribute reduction rules described above. It is unclear whether the owners will receive a worthless stock deduction for their pre-restructuring equity interests in Holdco. Obviously, if the parties are uncertain about the applicability of the insolvency exclusion or require a higher level of comfort on the worthless stock deduction, they will lean toward the prepackaged bankruptcy rather than an out-of-court restructuring.

Thus, if Holdco were a corporation (either C or S), the tax law would help facilitate the restructuring by waiving, or at least deferring, the tax liability that might otherwise result from the CODI triggered in the restructuring. To illustrate the wisdom behind that approach, it is helpful to analyze what would happen if CODI were not excludable from income.

If CODI were not excluded from income and Holdco had been classified as a C corporation, the proposed restructuring could generate a tax liability of as much as $898 at the Holdco level (calculated as the 35 percent corporate income tax imposed on $2,565 of CODI).[139] Depending on the circumstances, that Holdco-level tax liability could fundamentally alter the economic profile of the transaction and the owners' willingness to participate in the restructuring.

For instance, to complete a restructuring in which Holdco's only post-restructuring liability is the $1,000 note and the owners retain a collective 15 percent interest worth a total of $165, the owners would have to contribute to Holdco as much as $898 of additional cash to enable Holdco to satisfy the tax liability attributable to the non-excludable CODI. Assuming the owners lack sufficient extra funds to contribute to Holdco (and that additional third-party financing is unavailable), it might be impossible to structure a transaction that results in both the solvency of Holdco/Opco and the satisfaction of the tax liability attributable to the $2,565 of CODI.

In that case, the parties' only choice would be to place Holdco/Opco into a bankruptcy liquidation proceeding in which it would either (1) sell its assets for $900 and transfer $900 to Bank in full repayment of the $4,500 note, or (2) transfer its assets to Bank in full repayment of the $4,500 note. In either case, Holdco reports at least $1,500 of income or gain in connection with the liquidation.[140] Unless Holdco has sufficient NOL, capital loss, or tax credit carryforwards, it will not have enough money to pay the tax imposed on that income or gain. Consequently, the tax liability triggered on the liquidation of Holdco and cancellation of the $4,500 note would in many situations go unpaid.[141]

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the holders of canceled stock were still entitled to receive potential distributions, if any, from a stock trust).

[135]*See supra* text accompanying notes 84-92.

[136]*Id*.

[137]*See Merkel v. Commissioner*, 192 F.3d 844 (9th Cir. 1999), *Doc 1999-30468*, *1999 TNT 182-7*. In that case, the Ninth Circuit found that if a taxpayer is more likely than not to be called on to satisfy a liability, the entire amount of the liability is included in the taxpayer's calculation of insolvency. However, in dissent, Judge O'Scannlain argued that the calculation of insolvency should include all liabilities, discounted by the probability of the liability's occurrence. Thus, while the more likely than not test holds sway in the Ninth Circuit, there is no guarantee other circuits would not adopt Judge O'Scannlain's method for calculating a taxpayer's insolvency. *See* Richard M. Lipton, "Murky Test for Insolvency in *Merkel* Continues to Cause Problems," 91 *J. Tax'n* 372 (1999).

[138]Immediately before the transaction, Holdco's liabilities ($4,500) exceeded the FMV of its assets ($1,500) by a total of $3,000. Accordingly, all of the CODI recognized in connection with the proposed restructuring would be excluded from income. Section 108(a)(1)(B).

[139]In some cases, a bankrupt C corporation will have sufficient tax attributes to offset the CODI that would be recognized in connection with the type of bankruptcy restructuring described in Example 3. In many real-world situations, however, there is often a disconnect between the maximum amount of CODI that a bankrupt C corporation may recognize and the amount of tax attributes that would be available to offset that CODI if it were includable in income. That disconnect can arise

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for a number of reasons. For example, a C corporation may have significant capital losses or capital loss carryforwards, which cannot be used to offset ordinary CODI. Section 1211(a). Also, if a taxpayer borrowed money to fund so-called *INDOPCO* expenses, which must be capitalized but cannot be amortized, the taxpayer's indebtedness may exceed its loss carryforwards. Reg. section 1.263(a)-5. Finally, if a taxpayer incurred debt in connection with a leveraged redemption, leveraged recapitalization, or leveraged buyout, it will likely have indebtedness that exceeds its loss carryforwards. *See* Einhorn, *supra* note 89, at 865.

[140]If the $4,500 note were treated as a nonrecourse liability for tax purposes, Holdco would report $1,500 of gain on the sale of the Opco assets ($4,500 amount realized minus $3,000 tax basis). *See supra* text accompanying notes 100-102 (discussing the tax treatment of transactions in which property is transferred in payment of or subject to nonrecourse debt). If the $4,500 note were treated as a recourse liability for tax purposes, Holdco would be treated as selling the Opco assets for $900 and using that $900 to repay the $4,500 note. As a result, Holdco would report a loss of $2,100 on the sale or deemed sale of Opco assets ($3,000 tax basis minus $900 amount realized) and $3,600 of CODI on the repayment of the $4,500 note ($4,500 principal minus $900 repayment amount), for a net income inclusion of no less than $1,500. *See supra* text accompanying notes 103-106 (discussing the tax treatment of transactions in which property is transferred in payment of or subject to recourse debt). In that situation, to the extent that the loss recognized on the sale of the Opco assets was classified as capital, those losses could not be used to offset the ordinary CODI. In that case, the net income inclusion would increase dollar-for-dollar by the amount of unusable capital loss.

[141]*See supra* note 128 (discussing the extent to which an income tax liability generated in connection with a liquidating bankruptcy may go unpaid).

In the end, were it not for the exclusion of CODI from gross income, Holdco/Opco might be forced to liquidate. In that situation, all the parties related to Holdco/Opco would lose. Bank would receive a smaller recovery in a liquidation than in the proposed restructuring — $900 versus $1,935.[142] Moreover, the employees of Holdco/Opco would be more likely to keep their jobs in a restructuring scenario, and Holdco/Opco's suppliers and vendors likely would do better under a restructuring as well.[143] Also, the owners of Holdco/Opco are given the opportunity to invest their remaining $600 of liquid assets in the Holdco/Opco business in exchange for a continuing equity interest in the business, an option likely unavailable in a liquidation.

Finally, although it is difficult to predict with any certainty, the government would likely be better off if Holdco/Opco completes a restructuring that enables it to retain a large portion of its operations, workforce, and vendor relationships, thereby generating more tax revenue.[144] If nothing else, the government would not have to pay unemployment benefits for displaced workers, nor would it forgo the income and payroll tax payments that those displaced workers would otherwise produce. At the very least, the government would not be expected to lose money as a result of the bankruptcy exclusion, because even if that exclusion did not exist, any tax liability generated on the liquidation of Holdco/Opco might never be collected.

In the end, by waiving a tax liability that might never be collected, the code has assisted the parties in restoring Holdco/Opco to productivity and preventing the destruction of value (and presumably jobs and economic activity) that would occur in connection with a liquidation. Thus, in the context of Example 3 (in which Holdco is structured as a corporation), the code has provided for the restoration of productivity and preservation of value — the key goals of bankruptcy policy — by compromising some basic principles of income recognition and taxation. This was one of the key policy goals that led to the Depression-era amendments to the Bankruptcy Act of 1898 and the enactment of the BTA in 1980.[145] However, as discussed below, the code takes a completely different — and in our view unwarranted — approach in situations in which Holdco is a partnership.

3. Tax consequences if Holdco had been classified as a partnership. If the parties had classified Holdco as a partnership, they would likely find that a bankruptcy of Holdco or Opco results in a significant tax liability for the owners. To quantify that liability, we must add an assumption about each owner's tax basis in his Holdco interest and the amount of the $4,500 note allocated to each owner under section 752. For purposes of simplicity, we assume that each owner's outside basis in his Holdco interest is $2,500, which represents $1,000 of contributed capital or allocated but undistributed income, plus one-third of the $4,500 note allocated under section 752.

Under the proposed restructuring, each owner will report $855 of CODI, the tax on which is $299 at the 35 percent rate.[146] As discussed above, that owner-level tax

[142]*See supra* text accompanying notes 32-36 (discussing the extent to which creditors may be adversely affected by a liquidation process).

[143]*Cf.* Grant Newton and Paul Wertheim, ''An Examination of the Effect of the Repeal of the Stock-for-Debt Exception,'' *Tax Notes*, Nov. 8, 1993, p. 729, *93 TNT 233-17* (''In many cases, a liquidation would not result in re-employment of the troubled company's workforce in the same industry. One only need look to recent failed reorganizations in the furniture industry, the retail industry, the manufacturing industry, and the airline industry, among others, to appreciate the magnitude and severity of the problem. The large majority of employees of these firms became displaced workers, forced to seek re-employment in other industries. Thus, repeal of the stock-for-debt exception, by forcing many reorganized companies into complete liquidation, could lead to significant loss of jobs.'').

[144]Robin E. Phelan and William M. Sharp, ''Kick 'Em While They're Down — a Taxation and Bankruptcy Critique of the Technical and Policy Aspects of the Bankruptcy Tax Act of 1980,'' 35 *Sw. L.J.* 833, 877 (1981) (A ''successful bankruptcy reorganization gives creditors and other interested parties an opportunity to supply additional goods and services to the rehabilitated debtor, permits the debtor to continue the long-term employment of those individuals in need of steady work, and provides the Service and other taxing authorities with a continuing economic entity that presumably will generate profits in the future and pay taxes upon those profits. *In the aggregate, these potential future taxes should far exceed those taxes resulting from a bankruptcy liquidation in which the debtor meets its demise due to an overly burdensome tax law*.'' (emphasis added)); American Bar Association Section of Taxation, ''Report of the Section 108 Real Estate and Partnership Task Force,'' 46 *Tax Law.* 209, 216 (1992-1993) (hereinafter the ABA report) (''rehabilitated business debtors will presumably create jobs and a greater tax base. With the fresh start policy in the predominant role, tax policy is left in the subservient and limited position of providing the tax operating rules and preventing abuse of the system'').

[145]*See supra* text accompanying notes 43-58.

[146]It could be said that the allocation of $855 of ordinary CODI to an owner will be offset over time because immediately after the restructuring, each owner would have an outside basis in his Holdco interest of $1,855. That amount represents each owner's pre-restructuring outside tax basis of $2,500, increased by the allocation of $855 of CODI, and decreased by the $1,500 of debt that was previously allocated to each owner. Section 752(b). As a practical matter, however, that outside basis will likely be of little use to an owner. For example, although the additional outside basis could be used to support the allocation of deductions from Holdco to an owner, the owner would likely receive little benefit from those allocations, because the owner's post-restructuring interest in Holdco would be only 5 percent. Further, although the additional outside basis could trigger a capital loss on a current or future sale or liquidation of Holdco, that capital loss can be used only to offset other capital gain income that the owner happens to have in the year in which the liquidation occurs, plus a minimal amount of ordinary income. Section 1211(b). Unused capital losses can be carried forward to subsequent tax years, subject again to those limitations. Section 1212(b).

For purposes of simplicity, this report assumes that all CODI recognized by a partnership is allocated among the partners pro rata in accordance with their percentage interests. In reality, the allocation of CODI among the partners of a bankrupt partnership can be quite complex. *See* James B. Sowell, ''Allocation of COD Income in Partnership Workouts,'' 26 *Tax Mgmt. Real Est.*

(Footnote continued on next page.)

liability cannot be reduced by the bankruptcy exclusion, because the bankruptcy exclusion applies at the partner level and the owners of Holdco are not bankrupt.[147] Also, each owner will experience significant uncertainty in attempting to exclude his share of CODI under the insolvency exclusion. First, although an owner could present a strong argument that Rev. Rul. 92-53 permits him to treat his allocable portion of the $4,500 note as a personal liability for purposes of determining whether he is insolvent, that argument is not supported by primary authority.[148] Second, and perhaps more importantly, an owner can rely on the insolvency exclusion only to the extent that the amount of his personal liabilities exceeds the FMV of all of his assets. Given the inherent difficulty in valuing the illiquid assets that each owner holds outside Holdco, an owner may never be certain whether, or to what extent, the insolvency exclusion shields him from the tax consequences of the proposed restructuring.[149]

Thus, if Holdco is a partnership, pursuing the restructuring described above will present the owners with two choices. First, they could proceed with the restructuring with the understanding that it will generate a $299 tax liability that can be satisfied only through the sale of illiquid assets, potentially at fire sale prices.[150] Second, the owners could proceed with the restructuring and attempt to rely on the insolvency exclusion even though the technical and factual arguments in support of the insolvency exclusion are uncertain. Either way, the owners must confront the very real possibility that the restructuring will destroy their net worth, both liquid and illiquid. Obviously, in this situation the tax system encourages the owners to choose a restructuring that is different from the one outlined above. Unfortunately, none of the readily available alternate restructuring techniques advance either the owners' business goals or the goals of bankruptcy policy.

Under one alternate technique, the owners might cause Holdco to transfer its Opco interest to Bank in satisfaction of the $4,500 note. Immediately after that transfer, Holdco would liquidate in a transaction in which the owners receive no consideration. Bank would then liquidate Business X, receiving $900 in the process. The tax consequences of that transaction to the owners will depend on the tax classification of the $4,500 note.

- If the $4,500 note is nonrecourse, each owner will report a long-term capital loss of $1,000 in connection with the transfer of Opco and the liquidation of Holdco, assuming that Opco's assets are section 1231 assets and that recapture rules are not a concern.[151] Although that capital loss would be of little value, the owners would not owe any tax as a result of the transaction.
- If the $4,500 note is treated as a recourse liability, each owner will realize net CODI of $500 in connection with the transfer of Opco and the liquidation of Holdco, assuming that Opco's assets are section 1231 assets.[152] Unless the insolvency exclusion applies, each owner would owe a tax of $175 (at the 35

J. 23 (2010) (discussing the allocation of CODI among the partners of a partnership); Swartz, *supra* note 95, at 1138-1142. Those complexities do not, however, affect the central point of this report, that the allocation of CODI to the partners of a bankrupt partnership can encourage those partners to adopt techniques or behaviors that undercut bankruptcy policy.

[147]*But see Gracia* and related cases, *supra* note 96.

[148]In Rev. Rul. 92-53, 1992-2 C.B. 48, the IRS ruled that when a taxpayer owns property subject to a nonrecourse liability and recognizes CODI on the reduction of the principal amount of that liability, the amount of that nonrecourse liability may be treated as a personal liability of the taxpayer for purposes of applying the insolvency exclusion. In that case, an owner of Holdco would have to argue that for purposes of determining the extent to which the insolvency exclusion applies, his portion of the $4,500 note must be treated as a personal liability. *See* Sowell, *supra* note 95, at 842.

[149]*See supra* text accompanying notes 125-127 (discussing the application of the insolvency exclusion in the context of Example 2).

[150]The only potentially good news here is that the sale process may establish valuation marks for the illiquid assets that are low enough to render an owner insolvent for purposes of the insolvency exclusion (assuming that the exclusion is available as a technical matter).

[151]The $1,000 long-term capital loss represents a netting of the inside gain recognized by Holdco on the transfer of Opco against the outside loss recognized by the owners on the liquidation of Holdco. Holdco would recognize a $1,500 capital gain on the transfer of Opco interests to Bank, which represents the excess of the $4,500 note balance over Opco's $3,000 tax basis in its assets. That $1,500 of gain would be allocated one-third to each owner. Also, each owner's outside basis in his Holdco interest would be (1) increased from $2,500 to $3,000 to reflect the allocation of capital gain, and (2) decreased from $3,000 to $1,500 to reflect the repayment of the $4,500 note and the loss of the section 752 debt allocation associated with that note. Accordingly, when Holdco liquidates, each owner would report a long-term capital loss of $1,500. Sections 731(a)(2), 736(b). That $1,500 long-term capital loss would offset the $500 capital gain allocated to each owner on the transfer of Opco, producing a net long-term capital loss of $1,000. To the extent that a transfer of Opco interests produces ordinary income at the Holdco level, the allocation of that ordinary income could not be offset with the outside capital loss recognized by each owner on the liquidation of Holdco.

[152]The $500 net CODI number represents the excess of $1,200 of CODI allocated to each owner for the transfer of Opco's assets to Bank over the $700 of ordinary loss allocated to each owner for that transfer. The netting of ordinary asset sale loss against ordinary CODI results from the fact that if the Opco liabilities were treated as recourse for tax purposes, the transfer of Opco to Bank in full repayment of the $4,500 note would be bifurcated into two separate transactions. In the first transaction, Holdco would be treated as selling assets with a basis of $3,000 and an FMV of $900, which produces a $2,100 loss, of which $700 would be allocated to each owner. Assuming section 1231 applies, that loss would be ordinary. In the second transaction, Holdco would be treated as repaying the $4,500 note with assets worth $900, producing $3,600 of CODI, of which $1,200 would be allocated to each owner. In evaluating the tax liability of an alternate transaction, it is critical to bear in mind that to the extent the loss recognized on the sale of Opco assets is capital in nature, that loss will not be available to offset CODI, and the amount of ordinary income produced by the alternate transaction would increase.

(Footnote continued on next page.)

percent rate) on that net CODI. That liability will not force the owners into bankruptcy, but it will destroy a significant portion of their liquid net worth.

Although this form of restructuring may produce either no tax liability or a significantly smaller tax liability than the originally proposed restructuring, it also poses two significant concerns. First, it produces suboptimal economic results for every stakeholder in the Holdco/Opco business. The owners would rather continue the Opco business, and Bank would prefer a restructuring in which Opco continues as a going concern. The technique destroys value and jobs at Opco and, potentially, other businesses (for example, vendors) that rely on a functioning Opco for their commercial activities. The government's tax receipts are likely to be lower as a result of the loss of productivity and value at Opco.[153] And as employees of Opco are forced into unemployment, the government will lose tax revenue from them and incur additional costs such as unemployment benefits.[154]

The second concern is that the tax treatment of this alternate transaction is uncertain, because the recourse-nonrecourse classification of the $4,500 note is unclear. As discussed above, the primary cause of uncertainty is that the terms of the $4,500 note permit Bank to seek recourse against all of the assets of Opco, and the guarantee and pledge permit Bank to seek recourse against all of the assets of Holdco, all of which seem to be indicative of a recourse note. However, the $4,500 note was issued by a DE and guaranteed by an LLC, the sole asset of which is its DE interest — a structure that tends to make the $4,500 note look nonrecourse in nature.[155] This uncertainty may be particularly troublesome because if the $4,500 note is classified as recourse for tax purposes, each owner will have to surrender $175 in tax unless the owner is able to rely on the insolvency exclusion to avoid recognizing taxable CODI, a proposition that is itself uncertain. Although a $175 tax liability will not force an owner into bankruptcy, it will destroy a significant portion of his liquid net worth, and the uncertainty surrounding that liability will likely affect the owner's behavior until the running of the statute of limitations.[156]

As they think through their options, the owners might find that they cannot live with the lingering risk presented by the uncertainties surrounding the classification of the $4,500 note and the application of the insolvency exclusion. In that event, the owners might adopt another, increasingly common alternate technique — "extend and pretend."[157] Under this technique, the parties would extend the maturity of the $4,500 note for some period.[158]

It also bears mentioning that regardless of the character of the loss generated on the transfer of Opco assets, each owner would report a long-term capital loss of $1,500 on the liquidation of Holdco. That is because, in connection with the alternate transaction, each owner's outside basis in his Holdco interest would be (1) increased from $2,500 to $3,700 to account for the allocation of CODI, and (2) decreased from $3,700 to $1,500 to account for (x) the allocation of the $700 loss recognized on the transfer of Opco and (y) the repayment of the $4,500 note, of which $1,500 had been allocated to each owner under section 752. Because each owner would have a $1,500 outside basis in Holdco at the time of its liquidation, each owner would recognize a $1,500 long-term capital loss on that liquidation. Sections 731(a)(2), 736(b). As discussed above, that long-term capital loss would be unavailable to offset the allocation of ordinary CODI.

[153]*See supra* note 144 (discussing the extent to which a rehabilitated business will add to the government's tax collections).

[154]*See supra* text accompanying notes 32-35 (discussing the extent to which bankruptcy liquidations tend to be less efficient for all stakeholders, including employees, vendors, and the government).

[155]*See supra* text accompanying notes 115-118 (discussing the difficulties inherent in classifying DE debt as recourse or nonrecourse for tax purposes).

[156]Under the facts of Example 3, if the owners wanted certainty about the treatment of the alternate transaction, they could restructure that transaction as a transfer of Holdco interests to Bank for no consideration. In that case, each owner would be treated as selling a partnership interest with an outside basis of $2,500 in exchange for a deemed cash payment of $1,500, which represents each partner's share of the $4,500 note. *See* section 752(d). In that scenario, each partner would recognize a long-term capital loss of $1,000. That is the same net result produced by the transaction in which Holdco transferred its Opco interest to Bank in full payment of the $4,500 note and then liquidated.

In many real-life situations, however, parties will find that a transfer of DE interests by a partnership will produce different tax or economic results than a transfer of partnership interests by the partners. The differences can arise from a number of factors. For example, generally speaking, a partner cannot recognize an ordinary loss on the liquidation of a partnership even if the partnership would recognize an ordinary loss on the sale of its assets. Also, if the partnership owns other assets that are unrelated to the distressed DE, those assets will have to be distributed to the partners before the partnership interests can be transferred to a lender. Such a distribution may alter the partners' outside bases in their partnership interests in unexpected ways, which may produce unexpected differences in tax results. Similarly, the distribution of assets by the partnership may require third-party consents or transfer tax payments, which may prove too cumbersome.

[157]Wei and Tamman, *supra* note 14 ("These days, many U.S. banks have adopted a policy of extending loans when they come due even if they wouldn't make those loans now. In some cases, values of the underlying property have fallen below the amount of the loan. 'There's been an extend-and-pretend philosophy by banks to forestall hits to their balance sheets that might occur,' says Patrick Phillips, new chief executive of the Urban Land Institute, a real-estate industry group"); Daniel Thomas, "Vacant Possessions," *Fin. Times*, Dec. 7, 2009, at 8 ("Various phrases have been coined to describe the trend — 'a rolling loan gathers no loss' quickly became cliché — but bankers warn that such maneouvres are not a long-term solution when the need is to reduce exposure to the sector. One banker says that institutions are kicking the can down the road pretty far but 'this is ultimately just delaying the problem in hope that the world will be a better place.'").

[158]This assumes that the issue price of the $4,500 note will remain $4,500. *See* reg. section 1.1001-3 (providing rules that determine whether a modification is a "significant modification" that results in a deemed exchange transaction); section 108(e)(10) (when a borrower exchanges an "old" debt for a "new" debt, the borrower recognizes CODI if the issue price of

(Footnote continued on next page.)

Depending on the circumstances, the owners might contribute a minimal amount of additional funds to Opco (through Holdco) to provide working capital. Opco would then do its best to get by, with a view toward an eventual sale or restructuring transaction that provides better results in the future.

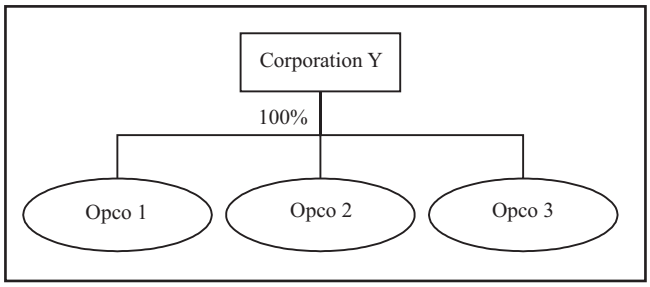
The extend-and-pretend strategy has its benefits. The owners remain involved in the Opco business and do not suffer a current tax liability, and Bank does not suffer the immediate destruction of the value of its collateral. Unfortunately, a side effect of the extend-and-pretend strategy is that Opco will likely reduce its payroll and other operating expenses in order to increase the cash flow available to service the $4,500 note. In fact, until the Opco business recovers its strength, servicing the $4,500 note will be the sole purpose for which Opco exists, and the company will be under constant pressure to increase its debt service payments by cutting costs. In other words, Opco will become a zombie company. If the Opco business does not improve, the extend-and-pretend strategy will simply have postponed the day of reckoning on the $4,500 note.

In sum, if the parties had classified Holdco as a C corporation or an S corporation, the decline in the Opco business could be addressed through a restructuring transaction that achieves the goals of bankruptcy policy — that is, the restoration of productivity at Holdco/Opco and the preservation of the value of Business X — without subjecting the owners of Holdco to a significant tax liability. If, however, the parties were unfortunate enough to have classified Holdco as a partnership, the tax law forces the owners to make a Hobson's choice — save Business X and potentially ruin their personal finances, or pursue an alternate technique that requires either the liquidation of Business X or the conversion of Opco into a zombie company. Each of those outcomes violates one of the fundamental policies underlying bankruptcy law (or at least induces the parties to behave in a way that undercuts those policies). In the end, the tax rules encourage the owners to engage in techniques that sacrifice value, productivity, or both. This is the same type of situation that prompted Congress to rewrite the bankruptcy laws in 1933 and 1934 and the bankruptcy and tax laws in 1938.[159]

D. A Variation on the Complex Example

This section explores an everyday variation on the complex example to illustrate the point that the tax law's ability to encourage behavior contrary to bankruptcy policy is not limited to passthrough entities owned by individuals.

Example 4: Corp. Y is a C corporation holding company that operates three lines of business: Businesses 1, 2, and 3. To insulate each business from the liabilities of each of the other businesses, Y uses a separate operating company to conduct each line of business: Opcos 1, 2, and 3. To minimize the tax compliance costs associated with the filing of consolidated returns, Y's tax director classified each Opco as a DE. Opco 1 and Opco 2 are successful, but Opco 3 incurs debts that require a bankruptcy restructuring that would generate significant CODI. The parties believe that a bankruptcy restructuring will return Opco 3 to productivity and that the restructuring will preserve more value and productivity than a liquidation of Opco 3.



As soon as Y's representatives begin the bankruptcy planning process, they will find that Y's status as a C corporation does not shield Y, Opco 1, or Opco 2 from the tax consequences of the Opco 3 bankruptcy. That is because any CODI realized in a bankruptcy restructuring of Opco 3 will be included in Y's gross income unless Y itself is bankrupt or another CODI exclusion is available. Assuming that Y is not bankrupt and no other CODI exclusion is available, Y must either use its own tax attributes (for example, NOLs or credit carryforwards) or pay a 35 percent income tax on the CODI realized in the Opco 3 bankruptcy.[160]

If the tax liability imposed on Y as a result of the Opco 3 bankruptcy is sufficiently onerous, Y will be forced to consider alternate structures such as a sale of Opco 3 for

the new debt is less than the adjusted issue price of the old debt); section 1273(b) (providing rules for determining the issue price of a debt instrument); section 1274 (issue price for nontraded debt instrument with qualified stated interest is the stated principal amount). For a thorough discussion of these issues, see also Linda Z. Swartz, ''Debt Exchanges,'' 859 *PLI/Tax* 159 (2009); Stuart J. Goldring, ''Modifying Debt and Its Consequences,'' 847 *PLI/Tax* 727 (2008).

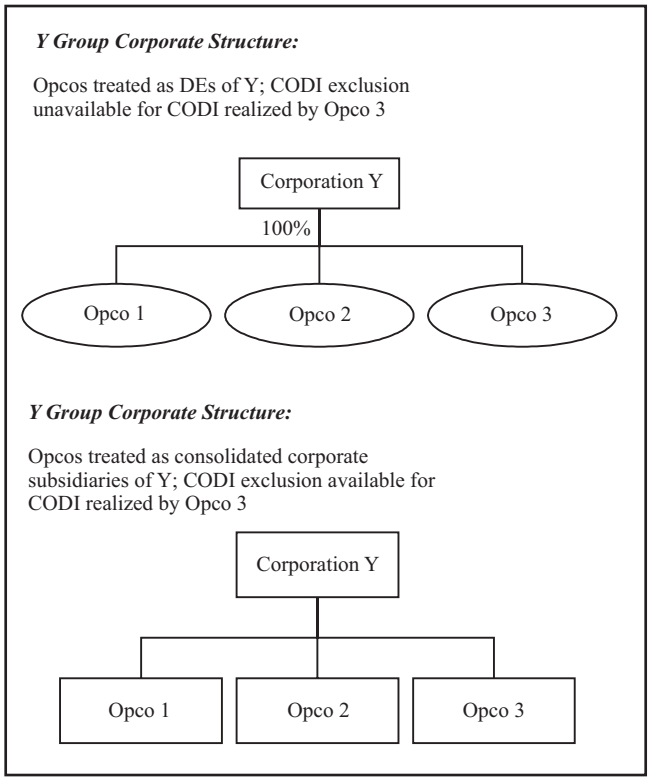
[159]*See supra* text accompanying notes 13-21 (discussing the bankruptcy policy goal of restoring the economic productivity of distressed businesses); *supra* note 144 (discussing the extent to which the tax code can enhance tax collections on a long-term basis by making the bankruptcy restructuring process tax-free).

[160]As discussed at *supra* note 139, Y may lack sufficient tax attributes to offset the CODI recognized on the bankruptcy restructuring of Opco 3. For example, Y's loss carryforwards may be capital in nature, which means they cannot be used to offset ordinary CODI. Section 1211(a). Also, all or a portion of the deductions generated by Opco 3 may have been used to offset income generated by Opco 1 or Opco 2. Further, Y may have incurred *INDOPCO* expenses, which must be capitalized but cannot be amortized, or it may have used borrowed funds to complete a redemption, recapitalization, or leveraged buyout. *See* reg. section 1.263(a)-5; Einhorn et al., *supra* note 89, at 865. In any of those cases, there will be a mismatch between the amount of CODI recognized by Y on the bankruptcy restructuring of Opco 3 and the amount of tax attributes that may be used to offset that CODI.

nominal consideration (and hopefully a lower tax liability)[161] or a negotiated extension of Opco 3's debts in an extend-and-pretend scenario. If both of those solutions are unpalatable, Y may consider filing for bankruptcy jointly with Opco 3, which would enable Y to exclude from income any CODI realized in an Opco 3 restructuring. If, however, a bankruptcy filing at the Y level triggers defaults under other debt instruments to which Y, Opco 1, and Opco 2 are a party, this solution may plunge the entire group into bankruptcy — exactly what Y was trying to avoid when it segregated its three lines of business into separate operating companies.

Thus, despite its status as a C corporation, Y finds itself in the same position and facing the same set of suboptimal choices as individual A in Example 2 and the individual owners of Holdco in Example 3.

The truly unfortunate aspect of Y's situation is that the adverse tax consequences generated by the Opco 3 bankruptcy may have been avoided if Y's tax director had been willing to accept the compliance costs and other burdens associated with the consolidated return regime. In that case, Y would have classified each of the three operating companies as a C corporation, and each operating company would have joined with Y in filing a consolidated return. The consolidated return regime would have provided Y with tax treatment that, during the good times, is quite similar to the tax treatment Y would have received if the operating companies had been classified as DEs.[162] More importantly, the consolidated return regime would have provided far superior tax results during the bad times. In that event, the tax consequences of the Opco 3 bankruptcy would be determined at the Opco 3 level, since Opco 3 would be classified as a stand-alone C corporation for purposes of applying the bankruptcy exclusion.[163] Thus, any CODI resulting from the Opco 3 bankruptcy would be eligible for exclusion under section 108.[164] In other words, in analyzing the effects of an Opco 3 bankruptcy from the perspective of Y's business people and shareholders, the deciding factor between a bankruptcy that produces a potentially catastrophic tax liability at the Y level and a bankruptcy that produces little or no tax liability is the shape of objects on a tax department structure chart:



IV. Recommendations

A. Preliminary Questions

Before discussing potential changes to the code, a preliminary question should be addressed: Is our current system really broken, or are the authors simply unhappy with the results? An answer to that question involves two separate arguments, one grounded in bankruptcy policy and the other in pure tax policy.

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[161]For example, if Y has unused capital loss carryforwards, it could take the position that Opco 3's debts are nonrecourse for tax purposes and that any gain recognized on the transfer of Opco 3 to a third party, to the extent attributable to noninventory assets, is capital gain (subject to recapture rules). In that case, Y could use its capital loss carryforwards to offset the gain recognized on the transfer of Opco 3. Because of restrictions on the use of capital losses, Y could not use capital loss carryforwards to offset CODI recognized in connection with a restructuring of Opco 3. Section 1211(a).

[162]*See* reg. section 1.1502-13(a)(6)(i); Andrew J. Dubroff et al., *Federal Income Taxation of Corporations Filing Consolidated Returns*, section 31.01[1] (2d ed. 2009).

[163]Reg. section 1.1502-28(a)(1); Dubroff et al., *supra* note 162, at section 74.04[4].

[164]Reg. section 1.1502-28(a)(1). The application of the bankruptcy exclusion at the Opco 3 level is not cost free to the Y group, because the attribute reduction process would apply to the entire Y group. Reg. section 1.1502-28(a)(4). Thus, the tax attributes of Opco 3 would be reduced to account for any CODI recognized in connection with the bankruptcy restructuring. Reg. section 1.1502-28(a)(1), (b)(1)(i). To the extent that Opco 3's tax attributes are lower than the recognized CODI, Y would be required to reduce its own tax attributes, including its consolidated NOL and loss carryforwards and, if necessary, its basis in

(Footnote continued in next column.)

the stock of Opco 1 and Opco 2. Reg. section 1.1502-28(a)(4), (c), Example 1. If Y's basis in the stock of Opco 1 and Opco 2 were reduced, Opco 1 and Opco 2 would be treated as having recognized excluded CODI and must perform attribute reduction for their own tax attributes. Reg. section 1.1502-28(a)(3)(ii). Finally, if any of the CODI recognized in connection with the Opco 3 restructuring results in black hole CODI, Y would be required to recognize any excess loss account (ELA) inherent in its Opco 3 stock. Reg. section 1.1502-19(c)(1)(iii)(B). Generally, an ELA would arise if the sum of (1) the aggregate amount of deductions recognized at the Opco 3 level and the aggregate amount of distributions made by Opco 3 to Y, exceeded (2) the sum of Y's initial tax basis in its Opco 3 stock, the aggregate capital contributions made by Y to Opco 3, and the aggregate amount of net income earned by Opco 3 since its inclusion in the Y group. Dubroff et al., *supra* note 162, at section 52.04.

1. Bankruptcy policy. In thinking about the extent to which the bankruptcy policy goal of rehabilitating distressed businesses and restoring their economic productivity should drive changes to the tax rules for bankrupt passthrough entities, it is helpful to frame the discussion with three facts. First, as discussed in Section III, in many everyday situations the tax rules applicable to bankrupt passthrough entities obstruct the bankruptcy process by threatening to impose potentially crushing tax liabilities on the owners of those entities. That, in turn, prompts those owners to pursue alternate techniques that produce lower tax liabilities. As a result, the tax rules for bankrupt passthrough entities can produce the same types of outcomes and behaviors that prompted Congress to rewrite our bankruptcy laws in 1933 and 1934 and our bankruptcy and tax laws in 1938.[165] Second, those results run counter to the government's long-standing practice of molding the tax law to facilitate the bankruptcy process. Third, the record suggests that Congress never intended to produce the results and behaviors described in Section III, at least in the context of operating businesses conducted in passthrough form.

As discussed in Section II, Congress has long recognized the importance of the bankruptcy process to our economy,[166] and it has consistently indicated that the code's revenue collection function must yield to the rehabilitative goals of bankruptcy policy. Congress made that point clear when it added the first statutory CODI exclusion to the Bankruptcy Act of 1898, and it reiterated that point in the legislative history to the BTA, when it emphasized that the bankruptcy tax provisions are designed ''to accommodate bankruptcy policy and tax policy'' by ensuring ''that a debtor coming out of bankruptcy . . . is not burdened with an immediate tax liability.''[167]

With that history acting as prelude to the BTA, it would seem odd for the 96th Congress to suddenly create a new tax system that encourages the owners of distressed passthrough entities to behave like it is 1933. It would seem even odder for that Congress to make such a dramatic policy shift with no discussion in the legislative history, especially considering that one of its goals in enacting the BTA was to accommodate bankruptcy policy.

To reconcile Congress's stated intent in enacting the BTA with the BTA's partnership rules as they operate today, one must consider those rules in the context of the tax law and commercial practice that existed when the BTA was enacted. Although we can never know exactly why Congress adopted the BTA's partnership rules, we do know that those rules were drafted against a backdrop that no longer exists.

When the BTA was adopted, LLCs (as a practical matter) did not exist, and a bankruptcy of a general or limited partnership could be expected to render its general partners bankrupt or insolvent.[168] Also, a solvent partner could rely on the qualified business indebtedness (QBI) exclusion, or perhaps the partnership debt-for-equity theory, to exclude the CODI realized on the restructuring of a bankrupt partnership.[169] Finally and most importantly, because personal income tax rates

[165]*See supra* text accompanying notes 26-45 (discussing the development of bankruptcy and tax policy during the Great Depression and the efforts made by Congress to prevent ruinous corporate liquidations).

[166]Bankruptcy commission report, *supra* note 8, at 71 (''The functions performed by the bankruptcy process are essential to the success of the open credit economy and the achievement of wealth values through its processes''); Bufford, *supra* note 36, at 836 (''One of the unrecognized policies of bankruptcy law is to provide a safety net for the national economy. It prevents secured creditors from collectively starting a downward spiral of foreclosures and bank failures that could result in the failure of the entire economy, as it nearly did in 1933''); ''Making a Success of Failure,'' *The Economist*, Jan. 9, 2010, at 68 (''America's generosity to capitalism's losers has served it remarkably well- . . . . Bankruptcy is an occupational hazard for entrepreneurs; even those with plenty of business experience under their belts fail much more often than they succeed. America's leniency towards bankrupts encourages novices to start their own businesses and allows people who have failed to start again'').

[167]Senate report, *supra* note 20, at 9-10.

[168]The partners of a general partnership are personally liable for the recourse debts of the partnership. *See, e.g.*, Revised Uniform Partnership Act sections 306, 404. Thus, if the partnership is unable to pay those debts, it is probably because the partners lack the wherewithal to fund the partnership's obligations and are either insolvent or eligible to declare bankruptcy.

[169]Section 108(a)(1)(C), (c)(2) (1985) (repealed 1986) (permitting a solvent taxpayer to exclude CODI attributable to the discharge of QBI; the exclusion was available only to the extent of the tax basis of any depreciable property held by the taxpayer and available for attribute reduction). All indebtedness of a corporation was QBI, and indebtedness of an individual was QBI if it was incurred in connection with property used in a trade or business. Section 108(d)(4) (repealed); *see generally* Boris I. Bittker and Boris H. Thompson Jr., ''Income From the Discharge of Indebtedness: The Progeny of *United States v. Kirby Lumber Co.*,'' 66 *Cal. L. Rev.* 1159, 1185-1187 (1978) (discussing the application of the QBI exclusion); Asofsky II, *supra* note 71, at 28 (noting that solvent partners may reduce their basis in depreciable property if the debt constitutes QBI under former section 108(d)(4)); section 108(d)(4) (repealed 1986).

If a partnership were to issue an interest to a creditor in repayment of partnership indebtedness, the partners may have been able to rely on the judicially developed stock-for-debt exception to avoid the realization of CODI at the partnership level. *See* Henry L. Ahrens, ''Restructuring Partnership Indebtedness: The Equity-for-Debt Exception in the Partnership Arena,'' 13 *Va. Tax Rev.* 329 (1993) (discussing the stock-for-debt exception and its potential application to partnerships); Karen C. Burke, ''Partnership Debt-Equity Exchanges: *Kirby Lumber* and SubChapter K,'' 47 *Tax Law.* 13 (1993) (same). *But see* Lee A. Sheppard, ''Problems Encountered in Real Estate Partnership Bankruptcies,'' *Tax Notes*, Dec. 9, 1991, p. 1100 (''There is about as much evidence of the existence of the [partnership debt-for-equity exception] as there is of the existence of the Loch Ness monster.''). For a general discussion of the stock-for-debt exception, see Asofsky I, *supra* note 50, at 13-9 to 13-11.

It is important to note that in the partnership context, section 752 treats any reduction in a partner's share of partnership indebtedness as a deemed cash distribution that triggers capital gain to the distributee partner if the amount of the deemed distribution exceeds the distributee partner's outside basis in his partnership interest. Sections 731(a)(1), 741, and 752. Thus, unless a partner had sufficient pre-discharge outside basis in his

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exceeded corporate income tax rates — the highest individual rate was 70 percent, whereas the highest corporate rate was 48 percent — most operating businesses were conducted through C corporations.[170] This largely relegated limited partnerships to the world of syndicated tax shelters.[171]

In that environment, it would have made sense for Congress to adopt a system under which the CODI exclusions apply at the partner level and asset sale gain is passed through to the partners.[172] First, the new regime would require a solvent limited partner of a tax shelter partnership to recapture prior tax deductions and losses in the form of taxable CODI or asset sale gain. When the bankruptcy of an operating partnership rendered its general partner bankrupt, a corporate general partner could escape taxation on CODI by filing for bankruptcy, and an individual general partner could escape taxation on both CODI and asset sale gain by filing for bankruptcy.[173] Even if the bankruptcy of an operating partnership did not force its general partners into bankruptcy, those partners could still escape taxation on partnership-level CODI in most instances by relying on the insolvency exclusion, the QBI exclusion, the partnership debt-for-equity theory, or NOLs from prior partnership operations.

Such a regime, while sometimes imperfect and almost always less partner-friendly than the pre-BTA regime, produced results that were both reasonable and defensible in the environment in which the BTA was enacted. Unfortunately, post-BTA changes in tax law and business practice changed the nature of the tax rules for bankrupt passthrough entities from reasonable to inhospitable.

- Congress repealed the QBI exclusion in 1986, in the process leaving solvent partners of a bankrupt operating partnership exposed to an ordinary tax liability on partnership-level CODI.[174]
- The 1986 enactment of section 469 curtailed the use of limited partnerships as tax shelter vehicles.[175]
- The inversion of corporate and personal income tax rates brought about by the Tax Reform Act of 1986, combined with the repeal of the *General Utilities* doctrine, encouraged taxpayers to conduct operating businesses through partnerships and sole proprietorships.[176]
- By the late 1990s, every state had adopted an LLC statute,[177] and Treasury had adopted the check-the-

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partnership interest, a debt-for-equity exchange could trigger gain to the partner even if the stock-for-debt exception were to apply. *See* Ahrens, at 354.

In any event, section 108(e)(8)(B) now provides that if a partnership issues a partnership interest to a creditor in repayment of indebtedness, the partnership will realize CODI if the amount of the indebtedness exceeds the FMV of the partnership interest. *See* Sowell, *supra* note 95, at 859-861.

[170]*See infra* text accompanying notes 179-184 (analyzing government statistics concerning the extent to which U.S. business income is earned through different business entities).

[171]*See, e.g.*, Louis S. Freeman, ''Some Early Strategies for the Methodical Disincorporation of America After the Tax Reform Act of 1986: Grafting Partnerships Onto C Corporations, Running Amok With the Master Limited Partnership Concept, and Generally Endeavoring to Defeat the Intention of the Draftsmen of the Repeal of *General Utilities*,'' 269 *PLI/Tax* 85, 88 (1988) (''Prior to the Economic Recovery Tax Act of 1981, there was not a great deal of attention given to flow-through treatment for active profitable businesses because the individual maximum marginal rate on ordinary income was so much higher than the corporate maximum marginal rate on ordinary income. Thus, flow-through treatment was not always attractive; rather than having income be taxed directly to the ultimate owners at rates up to 70 percent, it was frequently more beneficial to have income be taxed at the corporate level at the lower 48 percent rate, deferring indefinitely any second level of tax at the shareholder level''); David H. Ehrenwerth, ''Two Years Later: The Impact of the Tax Reform Act of 1986 on Limited Partnership Offerings — Joining Income Products With Shelter Products and Other Responses,'' C381 *ALI-ABA* 417 (Westlaw) (1989) (''Historically, wealthy investors looked primarily to limited partnership investments as a way to reduce taxes and not necessarily to obtain economic gain. . . . Consequently, many investments emphasized tax shelter and offered more reduced cash flow and economic appreciation'').

[172]*See* Richard M. Lipton and Todd D. Golub, ''Taxation Meets Bizarro World: Passthroughs and Debt Workouts,'' 88 *Taxes* 97, 118 (2010) (noting that when the rules were enacted, ''most partnerships . . . were general partnerships with only a handful of partners. Partnerships were viewed as comprised of individuals who had recourse liability on the debts of the partnerships, so it made sense for solvency to be determined at the individual partner level'').

[173]*See* section 1398. Section 1398 was included in the bankruptcy commission proposed legislation and enacted as part of the BTA. The provision allows individuals to declare bankruptcy under chapters 7 or 11 of the Bankruptcy Code and shift to a separate bankruptcy estate the tax liability attributable to asset sales that occur in connection with the bankruptcy process. Senate report, *supra* note 20, at 24-32; section 1398(c)(1). Because those tax liabilities become liabilities of the estate and not the individual, tax liabilities will generally be satisfied from the same pool of assets from which creditors' claims must be satisfied. If the assets of the bankruptcy estate are insufficient to satisfy that liability, the liability will not be paid. Bankruptcy Code sections 727, 1141, 1228, and 1328(b). The individual and the estate also benefit from the bankruptcy exclusion to CODI. *See* section 1398(c)(1). For a general discussion of the operation of section 1398, see Leonard L. Silverstein et al., ''Discharge of Indebtedness, Bankruptcy and Insolvency,'' 540-3d *Tax Mgmt. Portfolio* A-41 to 60 (2009); Swartz, *supra* note 95, at 1098-1101; Blake D. Rubin, ''Tax Planning for the Debtor in Bankruptcy,'' 19 *J. Real Est. Tax'n* 322, 326-328 (1992).

[174]Tax Reform Act of 1986, P.L. 99-514, section 822, 100 Stat. 2085, 2373. Congress found the exception in former section 108(a)(1)(C) ''too generous'' to solvent individuals who recognized CODI as a result of their day-to-day business operations. *See* S. Rep. No. 99-313, at 161 (1986). There is no evidence that Congress ever considered the effect that the repeal of the QBI rule would have on solvent partners of a bankrupt operating partnership. *See* Asofsky I, *supra* note 50, at 13-25.

[175]*See infra* text accompanying note 171.

[176]The highest individual rate was set at 28 percent, whereas the highest corporate rate was set at 40 percent. P.L. 99-514 sections 101(a), 501(a), 601(a), 631-633; *see also* Freeman, *supra* note 171, at 88.

[177]Although Wyoming enacted the first LLC statute in 1977, it was the IRS's issuance of Rev. Rul. 88-76, 1988-2 C.B. 260 —

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box regulations,[178] thereby laying the groundwork for the widespread use of passthrough LLCs throughout the business landscape.

The net result of these developments is remarkable; they simultaneously curtailed the use of limited partnerships as syndicated tax shelters[179] and spawned the trend of using passthrough entities to conduct operating businesses.[180] In each year between 1980 and 1987, the amount of income generated by partnerships and S corporations (collectively, fiscally transparent entities) was inconsequential, limited partnerships generated an overall net loss, and most U.S. business income was generated through C corporations.[181] In 1987 the amount of income generated by limited partnerships swung from negative to positive.[182] Beginning in the 1990s, the percentage of U.S. business income earned by fiscally transparent entities increased dramatically.[183] Today more than half of all U.S. business income is earned through fiscally transparent entities, and a large proportion of those entities are partnerships and sole proprietorships.[184]

Although the business landscape has changed dramatically since the enactment of the BTA, with business activity shifting from C corporations to partnerships and DEs, the bankruptcy tax rules applicable to those entities have not kept pace with the times. As a result, many everyday bankruptcy restructuring transactions involving passthrough entities can trigger devastating owner-level tax liabilities. That situation is worsened by the existence of rules that impose different tax results on transfers of encumbered assets, depending on whether the debt encumbering the assets is recourse or nonrecourse.

In the end, in many cases the tax rules applicable to bankrupt passthrough entities simultaneously discourage parties from completing a successful restructuring and encourage parties to adopt techniques that generate little or no tax liability. In today's environment, those rules produce results that contradict not only the goals of bankruptcy policy and economic policy, but the goals of revenue collection as well.

We have not located any evidence that the 96th Congress was aware of or anticipated the problems described in Section III of this report when it enacted the BTA partnership rules.[185] This raises the legitimate question whether the 96th Congress would have adopted the same partnership rules if current conditions had existed in 1980. In our view, that analysis, when combined with an analysis of the rules' adverse social and economic consequences, favors changing them to reestablish Congress's long-standing policy of designing the tax law to facilitate the bankruptcy restructuring process.

a. Pure tax policy. When it comes to pure tax policy — that is, the timing and amount of income inclusions, etc.

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which provided that LLCs could qualify for partnership taxation under the old *Kintner* regulations — that prompted states that did not already have LLC statutes on the books to adopt them. *See* Blaise S. Sonnier and Sharon S. Lassar, "Tax Court Allows Valuation Discount for Membership Interest in Disregarded Entity," 112 *J. Tax'n* 45, 46 n.3 (2010).

The growth in LLC business receipts between 1993 and 1997 also demonstrates the boom in LLC usage that followed Rev. Rul. 88-76. During that period, LLC business receipts grew by 90.7 percent, and LLC net income grew by 104.3 percent. Between 1997 and 2002, LLC gross receipts grew by 26.7 percent, and their annual net income grew by 20.9 percent. *See* Tom Petska et al., "An Analysis of Business Organizational Structure and Activity From Tax Data," in *Special Studies in Federal Tax Statistics* at 15 (IRS 2005), *available at* http://www.irs.gov/pub/irs-soi/05petska.pdf. Although it is unclear from the statistics reported by the IRS, the numbers likely take into account only LLCs that are taxed as partnerships, and not those that are DEs. *See id.*

[178]Reg. section 301.7701-3; T.D. 8697 (Dec. 17, 1996), *Doc 96-32369*, *96 TNT 245-1*.

[179]Ehrenwerth, *supra* note 171, at 417 (noting that although limited partnerships were primarily used as tax shelter vehicles, the TRA eliminated many of the structural elements necessary for tax shelter vehicles).

[180]*See, e.g.*, Stanley L. Blend, "Impact of the Tax Reform Act of 1986 on Choice of Entity," C458 *ALI-ABA* 1 (1989) (discussing the post-1986 tax incentives to conduct operating businesses through partnerships).

[181]IRS, SOI Tax Statistics — Integrated Business Data, Table 1 (2007), http://www.irs.gov/taxstats/bustaxstats/article/0,,id=152029,00.html (hereinafter Tax Statistics). For example, C corporations accounted for 80 percent of the net revenue (less deficit) earned in 1980, while sole proprietorships accounted for 18.2 percent. *See* Petska, *supra* note 177. Partnerships and S corporations, however, combined for less than 2 percent of the total income (less deficit) earned in 1980, and partnerships generated losses in that year. The Tax Statistics reflect a similar breakdown of business income among those classes of business entities in each year between 1980 and 1987.

[182]*Id.*

[183]*Id.* The growth rates for partnership gross receipts and C corporation gross receipts further illustrate the rise in the use of partnerships as vehicles for operating businesses. Between 1987 and 1993, C corporation gross receipts grew at a rate of 4.3 percent, and partnership gross receipts grew at a rate of 5.3 percent. Between 1993 and 1997, C corporation gross receipts

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grew by 7.1 percent, and partnership gross receipts grew by 17.8 percent. Finally, between 1997 and 2002, C corporation gross receipts grew at a rate of 3.6 percent, and partnership gross receipts grew at a rate of 15 percent. *See* Petska, *supra* note 177, at 15.

The annual growth rate of C corporation and partnership net income tells a similar story. Between 1993 and 1997, C corporation net income grew by 12.5 percent, and partnership net income grew by 23.1 percent. Between 1997 and 2002, C corporation net income *fell* by 17.1 percent, while partnership net income grew by 9.5 percent. By 2002, C corporations accounted for just 39.1 percent of net income, while fiscally transparent entities had increased their share of net income from 4 percent in 1987 to 40 percent in 2002 — a tenfold increase in a mere 15 years. *See* Petska, *supra* note 177, at 15.

[184]Merrill, *supra* note 3.

[185]*See* Asofsky I, *supra* note 50, at 13-25 (discussing various problems presented by the repeal of the QBI rule; "in partnerships containing both solvent investors and insolvent or bankrupt investors, a restructuring tension rises. Because the bankruptcy and insolvency exclusions are determined at the partner level, a restructuring involving discharge of indebtedness income will have differing impacts on different partners. *Once again, there is no evidence that Congress took these problems into account* [in repealing the QBI rule]." (emphasis added)).

— the tax rules applicable to bankrupt passthrough entities present a classic conundrum. On one hand, the rules ensure that, except in limited circumstances, income does not escape the system as a result of a cancellation of indebtedness or a transfer of property. On the other hand, experience suggests that the current rules do not generate significant additional tax revenue, because they encourage the affected taxpayers to adopt behaviors that reduce, defer, or even eliminate the tax that would otherwise arise in connection with a bankruptcy restructuring.

In the end, we should broaden the debate beyond the mechanical rules used to calculate income and ask ourselves whether the current rules produce good results. In that regard, even the strongest supporters of our current system should acknowledge some basic facts:

- The tax system encourages most business owners to operate their businesses or hold their business assets through passthrough entities.[186]
- The system provides several incentives that encourage business owners to finance their activities with debt, rather than equity.[187]
- When a leveraged business entity experiences financial distress, the parties will often find that a bankruptcy reorganization will yield a better result than a liquidation from an economic and social perspective.[188]
- By creating potentially crushing owner-level tax burdens, the tax rules applicable to bankrupt passthrough entities simultaneously discourage owners from pursuing formal bankruptcy processes and encourage the use of the alternate techniques described in Section III.C above and Section V below.

Those four facts lead to one simple conclusion: Although our system is good at ensuring that items of tax deduction or tax basis are ultimately offset by items of taxable income or gain, the system produces real-world results that offend basic notions of fairness and equity. Simply put, our system should not operate in a manner that encourages owners to conduct businesses and own assets through passthrough entities, encourages financing those businesses and assets using debt, and ruins owners when the entities begin to struggle with their debts. In our view, notions of pure tax policy argue in favor of substantial changes to our current system.[189]

B. Potential Approaches

There are several statutory approaches to the problems described in Section III. They range from ''nibbling at the fringes'' to the radical. History suggests that those two extremes can be evaluated either in terms of attainability (with the likelihood of congressional enactment decreasing as one moves across the spectrum from the nibbling to the radical),[190] or in terms of effectiveness (with the likelihood of improved economic and social results decreasing as one moves across the spectrum from the radical to the nibbling). The trick is to find the sweet spot — the approach that produces the best balance between likelihood of congressional enactment and likelihood of improved results. This reflects that the entire field of bankruptcy taxation is an exercise in compromise among tax advocates, bankruptcy advocates, creditors, debtors, failed businesses, and the healthy businesses that will have to compete with failed businesses following bankruptcy.[191]

In our view, the current method of taxing bankrupt passthrough entities presents two key problems: owner-level application of the CODI exclusions, and the classification of gain from the disposition of property subject to nonrecourse debt. In the case of CODI, unless the owner of the bankrupt passthrough entity is bankrupt, insolvent, or able to rely on another CODI exclusion, the realization of CODI at the passthrough entity level may trigger a ruinous tax liability for the owners. If the bankrupt passthrough entity disposes of property subject to nonrecourse indebtedness or it restructures the debt of a DE, the transaction may trigger gain that cannot be excluded from income.

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[186]*See supra* text accompanying notes 174-184 (discussing the post-1986 trend toward using passthrough entities to conduct operating businesses).

[187]For example, in the corporate context, interest payments on indebtedness are deductible, whereas dividend payments on stock are not deductible, a condition that encourages corporations to finance their activities with debt. *See* sections 163(a), 311(a); Canellos, *supra* note 98, at 279 (''Since interest is deductible but dividends are not, the Code encourages companies to use more debt and less equity in their capital structures.''). Similarly, a foreign portfolio investor would prefer to hold a corporate bond rather than preferred stock because interest payments can be received tax free whereas dividend payments are subject to a 30 percent withholding tax, unless reduced by a treaty. Sections 871(h), 881(c), 1441(a), and 1442(a). The list goes on, but the message is clear: The code is set up to encourage taxpayers to finance their activities with debt. *See* Cannellos, *supra* note 98, at 279-280 (discussing the code-based rules that encourage corporate taxpayers to adopt debt-heavy capital structures that contribute to bankruptcy filings).

[188]*See supra* notes 132-159.

[189]*Cf.* Bittker and Thompson, *supra* note 169, at 1160 (discussing the early development of case law that permitted taxpayers to exclude CODI from income; ''frequently when creditors agree to accept less than the amount due, it is because the debtor is in financial distress; taxing such debtors may have seemed anomalous, even heartless, especially since the closer the debtor approaches the abyss of bankruptcy, the greater the discount creditors are willing to grant and therefore the heavier the potential tax burden if the discount were taxed'').

[190]On this topic, consider the fate of the bankruptcy commission recommendations on the tax treatment of bankrupt partnerships. As discussed above, those recommendations would have shielded the partners of a bankrupt partnership from all tax liability associated with the forgiveness of indebtedness or the sale of assets outside the ordinary course of the partnership's business. *See supra* text accompanying notes 67-68. Those recommendations were dropped from the BTA without any discussion in the legislative history.

[191]*See* Asofsky I, *supra* note 50, at 13-8 to 13-11 (discussing the roster of witnesses who testified at hearings considering the BTA, such as accounting professionals and representatives from Treasury, the tax and bankruptcy bars, and affected industries). Asofsky refers to the BTA as ''the product of extended study and debate'' and says it ''represented a rational compromise of competing views and interests.'' *Id.* at 13-14.

Those problems, which are responsible for all of the poor results described in Section III, could be addressed by adopting two relatively simple recommendations.

- The section 108 exclusions should be applied at the entity level for partnerships and DEs that are engaged in a trade or business.[192]
- If a taxpayer disposes of, or is treated as having disposed of, property subject to nonrecourse debt incurred in connection with a trade or business, the excess of the principal amount of the debt over the FMV of the property should be treated as CODI.

The first recommendation would remedy most of the problems described in Section III by bringing section 108 up to date with current business and tax practice. In addition to correcting the economic anomaly Justice O'Connor discussed in her concurring *Tufts* opinion and harmonizing the tax treatment of transactions involving the satisfaction of recourse and nonrecourse debt, the second recommendation would help reduce the costs of foreclosure in situations in which foreclosure is unavoidable. This recommendation has also been analyzed and suggested by many commentators.[193] Each recommendation is limited to passthrough entities engaged in a trade or business, because the policy rationale for the recommendations is that the tax system should not prevent the bankruptcy system from restoring the economic productivity of a distressed *business* entity.

For each recommendation, the real action lies not in the recommendation itself, but in the process of attribute reduction. Simply put, whose attributes should be reduced, and by how much? This is a difficult question because current law does not provide a clear analytical model. For example, in the S corporation context, the attribute reduction rules apply at the entity level, except that some losses that were passed through from the entity to its shareholders are treated as NOLs of the entity.[194] Thus, owner-level tax attributes that are unrelated to the S corporation are not subject to reduction even if the S corporation experiences black hole CODI. Although some might view that model as appropriate in the partnership/DE context, there is one critical difference between a partnership/DE and an S corporation: Generally speaking, the indebtedness of an S corporation does not provide its shareholders with outside tax basis that can support tax-free distributions or the passthrough of deductions, whereas the owners of a partnership or DE are allowed to use entity-level indebtedness to support both of those items. Accordingly, the owners of a bankrupt partnership or DE, in all likelihood, will have enjoyed owner-level tax benefits as a result of entity-level indebtedness, which supports the argument that entity-level CODI should result in a reduction of owner-level tax attributes.

On balance, it would seem satisfying, from both a policy perspective and an analytical perspective, to apply the attribute reduction rules first at the entity level and then, if necessary, at the owner level, with one caveat: Any owner-level tax credit carryforwards or loss carryforwards, including NOLs, suspended losses, and passive activity losses, should be treated as tax attributes of the entity to the extent the past operations of the entity produced credits or carryforwards. Although those attributes exist at the owner level, they would be reduced before the reduction of asset basis at either the entity level or the owner level. The entity and the owner would, however, continue to enjoy the protection of the liability floor and the other rules governing the attribute reduction mechanism. In our view, this approach remains true to both the substance of the bankruptcy commission report[195] and the congressional intent underlying the revised attribute reduction rules adopted in the BTA.

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[192]To apply these recommendations to DEs, DEs would be treated in essence as single-owner partnerships. This means that excluded CODI earned at the DE level would flow up to its owners as excluded CODI. In a situation in which a partnership directly or indirectly owns a DE, excluded CODI that flows up to the partnership from the DE would be treated as excluded CODI at the partnership level. In either case, attribute reduction would occur first at the DE level and then at successive levels up the chain of ownership. A similar solution has been proposed in the past. *See* Stephanie R. Hoffer, "Give Them My Regards: A Proposal for Applying the COD Rules to Disregarded Entities," *Tax Notes*, Apr. 18, 2005, p. 327, *Doc 2005-5259*, or *2005 TNT 74-50* (arguing to "regard" DEs for purposes of section 108).

[193]*See, e.g.*, Asofsky I, *supra* note 50, at 13-40 ("Common sense and economics should dictate the result here. If property is transferred to a creditor in complete or partial satisfaction of debt, the bifurcation rules [applicable to transfers of property in satisfaction of recourse indebtedness] should apply, if the debt is a nonrecourse debt. Thus, all indebtedness would be treated the same for purposes of sections 108 and 1001"); Coverdale, *supra* note 112, at 1555-1556 ("In an arm's-length transaction like that in *Tufts*, the taxpayer cannot be said to have received for the property cash or other property in excess of the fair market value of the property sold"); Deborah A. Geier, "*Tufts* and the Evolution of Debt-Discharge Theory," 1 *Fla. Tax Rev.* 115 (1992) (arguing that Treasury should treat nonrecourse debt like recourse debt); Alice Cunningham, "Payment of Debt With Property; The Two-Step Analysis After *Commissioner v. Tufts*," 38 *Tax Law.* 575, 598 (1985) ("only the [bifurcated approach] yields tax consequences for in-kind debt relief consistent with those applicable to in-cash transactions"). For criticism of this position, see, *e.g.*, Alvin D. Lurie, "New Ghosts for Old: *Crane* Footnote 37 Is Dead (or Is It?)," *Tax Notes*, July 4, 1983, p. 3 (arguing against treating nonrecourse and recourse debt alike because "the position of the nonrecourse mortgagor is considerably different from the recourse debtor once the property value becomes clearly less than the encumbrance. It is that very difference which the property owner bargains for when he does not accept personal liability for the mortgage in the first place").

[194]Section 108(d)(7) (attribute reduction generally occurs at the S corporation level); reg. section 1.108-7(e), Example 5 (some suspended losses of an S corporation shareholder are treated as deemed NOLs that are eligible for attribute reduction). For a discussion of those rules, see Lee G. Zimet, "Debt Workouts of S-Corporations," 2010 *ABA/Tax-CLE* 0122045 (Jan. 22, 2010).

[195]Bankruptcy commission report, *supra* note 8, at 81 ("Rehabilitation of business debtors requires separate relief of businessmen, whether proprietors, partners, or principals of corporate entities, as distinguished from relief for the businesses they conduct"); *cf.* Sydney Krause and Arnold Y. Kapiloff, "The Bankrupt Estate, Taxable Income, and the Trustee in Bankruptcy," 34 *Fordham L. Rev.* 401, 417 (1965) ("No useful purpose is served by shifting to the bankrupt the tax upon the unrealized

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We recognize that this approach is far from perfect and therefore subject to criticism. For example, assume that (1) an owner of a distressed DE owns unleveraged high-basis assets outside the DE and expects that those assets will appreciate in value; (2) if the DE were to complete a bankruptcy restructuring, the owner would recognize a substantial amount of excluded CODI that would significantly reduce the basis of the owner's high-basis assets; and (3) if the owner were to sell the distressed DE to a third party for nominal consideration, he would recognize a manageable capital gain. In this case, the owner may decide that, compared with a bankruptcy restructuring, a sale of the DE will place the owner in a better after-tax economic position because it will not require the owner to reduce the basis of his high-basis assets. Thus, assuming that a bankruptcy restructuring of the DE would have produced a better result from an economic and social perspective, the tax law, even with our recommendations, would have undercut the bankruptcy process in much the same way as described in Section III above.

The recommendations could also be criticized as being too generous to the owners of bankrupt passthrough entities. We believe that this criticism is unwarranted for two reasons. First, the government already uses a similar approach in the consolidated return regime and the S corporation regime. In our view, when it comes to the exclusion of CODI, there is no reason the tax treatment of a corporation that owns an interest in a bankrupt DE should be less beneficial than the treatment of a corporation that owns an interest in a bankrupt consolidated subsidiary. Similarly, we believe a partner in a bankrupt partnership should not be treated more harshly than a shareholder in a bankrupt S corporation.

Second, although the recommendations would shield the owners of a bankrupt passthrough entity from an immediate tax on CODI, the owners would be subject to the attribute reduction rules at both the entity level and the owner level. In this sense, the government's claim for taxes would be converted from a current claim against the owner of the bankrupt passthrough entity into a deferred claim contingent on the owner's future income. This treatment is similar to the treatment typically received by unsecured creditors in bankruptcy, and it reflects the widely held view that prior tax benefits enjoyed by an owner in respect of borrowed funds — for example, the tax-free receipt of borrowed funds and accelerated depreciation deductions — are akin to interest-free loans made by the government to the owner.[196] Under this view, by using the combination of the CODI exclusion and attribute reduction to convert the government's claim for an immediate recapture of prior tax benefits into a future claim for increased taxes, the recommendations would essentially treat the government as an unsecured creditor in bankruptcy.

Perhaps the most stinging criticism of the recommendations is that they are simply a rehash of old ideas that have come and gone throughout the decades. Admittedly, this is true. The recommendations combine elements of the old QBI exclusion, the current QRPBI exclusion, and others' views on the treatment of transfers of property subject to nonrecourse debt. The recommendations also draw bits and pieces from the bankruptcy commission proposals on CODI and asset sale gain recognized by a bankrupt partnership, as well as the pre-BTA statutory and regulatory authorities that permitted the exclusion of CODI at the partnership level.

That said, when it comes to statutory solutions that fall inside the sweet spot between the nibbling and the radical, the attainable and the unattainable, the only tools in the toolbox seem to be the CODI exclusion and attribute reduction. This was made clear when Congress discarded without discussion the bankruptcy commission proposals on bankrupt partnerships, a set of rules that were properly placed on the radical end of the spectrum. Although our recommendations are admittedly imperfect, they are both attainable and helpful. Bankruptcy taxation has always been imperfect, since the system requires a compromise between the competing and sometimes irreconcilable goals of bankruptcy policy, which favors the forgiveness of claims, and tax policy, which favors the collection of tax.[197] In our view, the

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appreciation in his assets, which appreciation is realized upon liquidation in bankruptcy. Such tax treatment simply would frustrate the theory of rehabilitation of giving a debtor a fresh start and should not be a part of any statutory amendments'').

[196]Sang I. Ji, ''Nonrecourse Financing of Real Property: Depreciation Allocation and Full Recapture to Minimize Deferral and Eliminate Conversion,'' 29 *Colum. J.L. & Soc. Probs.* 217, 220 (1996) (''The Code's allowance of depreciation deductions that are not in proportion to economic risk effectively permits the taxpayer, utilizing the device of nonrecourse financing, to receive two loans — one from the mortgagee and one from the

(Footnote continued in next column.)

United States Treasury interest-free in the form of deferral of income''); Frances R. Hill, ''Toward a Theory of Bankruptcy Tax: A Statutory Coordination Approach,'' 50 *Tax Law.* 103, 117 (1996) (''The incentive purposes of particular tax provisions exist within the larger framework of the fundamental revenue purpose of taxation. Revenue forgone is a cost. Questions of efficiency and of whether the subsidy is well-tailored to its purpose are questions of economic rationality of cost, but they do not deny the reality of cost. . . . At the same time, the pervasive use of tax provisions as socioeconomic programs which are equivalent to direct government expenditures suggests that bankruptcy tax fits comfortably into tax law as another exception justified by the purposes of bankruptcy law. Indeed, most commentators on bankruptcy tax have cautioned against permitting revenue considerations to interfere with the pursuit of bankruptcy objectives''); *see also* Canellos, *supra* note 98, at 280-281 (''Tax preferences, which accelerate tax deductions and defer economic income, permit a corporation to finance its activities by, in effect, borrowing from the government through the deferral of taxes. These deferred taxes are a second form of tax time bomb in bankruptcy'').

[197]Hill, *supra* note 196, at 104-105 (''Despite the ubiquity and importance of tax claims and tax issues in bankruptcy proceedings, the Bankruptcy Code and the Internal Revenue Code are not systematically coordinated, and neither bankruptcy theory nor tax theory provides an analytical framework for such statutory coordination. There is neither a law of bankruptcy tax nor a theoretical basis for developing one''); Cannelos, *supra* note 98, at 276 (''Bankruptcy and tax policies are often in conflict, and the tension is reflected in the disparate views of the

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recommendations provide a fair balance between the competing goals of bankruptcy policy and revenue collection.[198]

V. Alternative Techniques

Section III of this report analyzed several tax issues facing the owners of distressed passthrough entities and the manner in which those issues affect the owners' approach to the bankruptcy restructuring process. That analysis discussed three techniques that might mitigate the owner-level tax effects of a bankruptcy restructuring of a passthrough entity.

First, the owners could sell their interest in the distressed passthrough entity to the entity's creditors or to a third party. Depending on the circumstances, this strategy could reduce the amount of taxable income recognized by the owners or convert what would otherwise be ordinary CODI into capital gain or loss. In some cases, this strategy could negate the owners' tax liability attributable to the restructuring.

Second, the owners could file for bankruptcy jointly with their distressed passthrough entity. Although this strategy would enable the owners to take advantage of the bankruptcy exclusion of CODI, it also has obvious and material disadvantages.

Third, if the creditors are cooperative, the owners could adopt the extend-and-pretend approach. While this strategy may avoid the recognition of CODI, it too presents obvious material disadvantages, not the least of which is that the owners may end up with a zombie company. This section discusses two other techniques that may be helpful: entity conversion and abandonment.

A. Entity Conversion

One way to manage the owner-level tax exposure presented by the bankruptcy of a passthrough entity is to convert the entity into a tax corporation through a check-the-box election.[199] Once the passthrough entity converts to corporate status, the tax effects of the restructuring process will no longer be borne by the owners.

For the conversion technique to work, owners and their advisers will have to consider two types of issues, which are referred to below as ''threshold issues'' and ''ancillary issues.'' Conceptually, the threshold issues arise from authorities that may prevent the technique from being implemented in the first place, while the ancillary issues arise from authorities that impose a tax cost on the conversion process.

1. Threshold issues. To successfully convert a distressed or potentially bankrupt passthrough entity into a corporation for tax purposes, the two threshold issues that must be addressed are the *Prudential Lines* doctrine, which is a bankruptcy law doctrine, and section 269, which is a code-based anti-abuse rule.

a. *Prudential Lines*. The *Prudential Lines* doctrine originated with the Second Circuit's decision in *In re Prudential Lines, Inc.*[200] Although the scope of the doctrine and the courts' ability to enforce the doctrine are debatable,[201] the basic thrust of the doctrine is simple: The tax status and tax attributes of a bankrupt business entity are assets of the entity's bankruptcy estate, and the court may use its equity powers to protect the value of those assets.

In *Prudential Lines*, the Second Circuit considered whether a bankruptcy court could enjoin the sole shareholder of a bankrupt corporation from reporting a worthlessness deduction for the stock of that corporation. Prudential Lines was a C corporation and a wholly owned subsidiary of PSS Steamship Co. Inc. Prudential Lines filed for bankruptcy protection, but PSS did not.

At the time of its bankruptcy filing, Prudential Lines had a significant NOL that, as a practical matter, was one of the most valuable assets in its bankruptcy estate. PSS was eligible to report a worthlessness deduction for the stock of Prudential Lines. The bankruptcy trustee representing Prudential Lines moved to enjoin PSS from reporting that deduction because, if permitted, the deduction would trigger an ownership change of Prudential Lines, thereby limiting Prudential Lines' use of its NOL.[202] In other words, the bankruptcy trustee contended that Prudential Lines' NOL was an asset of the bankruptcy estate and that the court had the power to enjoin PSS from taking any action, including the reporting of a valid tax deduction, that would reduce the value of the NOL.

The bankruptcy court agreed with the trustee that Prudential Lines' NOL was an asset of the bankruptcy estate and that the court could stop any action that would diminish the value of that asset. The bankruptcy court therefore enjoined PSS from reporting a worthlessness deduction for the stock of Prudential Lines. The Second Circuit upheld that decision, in the process adopting a broad reading of the ''property'' that forms a bankruptcy

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bankruptcy and tax bars regarding issues of bankruptcy taxation. Bankruptcy policy . . . generally favors the rehabilitation of enterprises [and] disfavors the imposition of penalties. . . . Tax policy has a completely different objective: the proper measurement of taxable income for the purpose of imposing fair and equitable taxes on persons similarly situated. The theory may call for the recognition of income upon the occurrence of certain events associated with bankruptcy'').

[198]*Cf.* ABA report, *supra* note 152, at 216 (''With the fresh start policy in the predominant role, tax policy is left in the subservient and limited position of providing the tax operating rules and preventing abuse of the system.'').

[199]*See* reg. section 301.7701-3; Barbara Spudis de Marigny, ''The 'Check-the-Box' Regulations: Elective Entity Classification,'' 869 *PLI/Tax* 239 (2009).

[200]*Official Comm. of Unsecured Creditors v. PSS Steamship Co. Inc.* (*In re Prudential Lines Inc.*), 928 F.2d 565 (2d Cir. 1991).

[201]Thomas W. Avent Jr. and John F. Simon, ''Preserving Tax Benefits in Troubled Companies — Navigating Mostly Uncharted Water,'' 102 *J. Tax'n* 176 (2005); Lee A. Sheppard, ''NOL Carryovers in Bankruptcy: The Progeny of *Prudential Lines*,'' *Tax Notes*, Sept. 2, 1991, p. 1128, *91 TNT 182-9*.

[202]*In re Prudential Lines*, 928 F.2d at 574. Section 382 limits a corporation's use of NOLs following an ownership change. Had PSS been allowed to report the worthless stock deduction, it would have created an ownership change for Prudential Lines, and section 382 would have severely limited Prudential Lines' ability to use its NOLs following bankruptcy. Section 382(g)(4)(D).

estate. The Second Circuit's holding in *Prudential Lines* has been interpreted as standing for ''the proposition that the bankruptcy court can enjoin virtually any activity on the part of a shareholder that would adversely affect the corporation's tax situation, even where such adverse effect might be speculative.''[203]

The courts have extended the reasoning of *Prudential Lines* to situations in which the shareholders of an S corporation attempt to revoke the entity's S election to avoid the shareholder-level tax burdens associated with the entity's bankruptcy restructuring. For example, in *In re Trans-Lines West, Inc.*,[204] the sole shareholder of an S corporation attempted to cause the corporation to revoke its S election shortly before the corporation entered bankruptcy. The bankruptcy court held that an entity's status as an S corporation represents property of the entity's bankruptcy estate and that that property cannot be destroyed by the entity's shareholder in order to benefit that shareholder. The court entered an order that vitiated the effect of the shareholder's revocation of S status.[205]

The court reached the same conclusion in *In re Bakersfield Westar Inc.*[206] There the shareholders of a distressed S corporation attempted to revoke the entity's S election shortly before it filed for bankruptcy and embarked on a chapter 7 plan of liquidation that was expected to result in the taxable sale of all the entity's assets. Because the entity would be liquidated through a series of taxable asset sales, the bankruptcy trustee was concerned that the imposition of tax at the entity level would reduce the amount of money distributed to the entity's creditors. The trustee therefore sued to negate the shareholders' purported revocation of the debtor's S election. Citing *Trans-Lines West*, the court again found that the benefits associated with an S election were property of the bankruptcy estate and that such property could not be destroyed by shareholder-level action. The court therefore vitiated the revocation of the entity's S election.

Although the *Prudential Lines* doctrine is not without its limits,[207] the logic underlying that doctrine could apply in situations in which the owners of a distressed passthrough entity attempt to convert the entity into a corporation for tax purposes to shift from the owners to the entity's bankruptcy estate the tax burden resulting from the bankruptcy restructuring process. If that were the case, the *Prudential Lines* doctrine would likely prevent the owners of a bankrupt passthrough entity from converting that entity into a corporation for tax purposes in situations when the entity is likely to sell assets at a net gain, because the imposition of an entity-level tax would reduce the recovery available to some classes of creditors.[208] In situations when the corporation will recognize significant amounts of CODI and little or no asset sale gain, however, the owners may have a stronger argument against application of the *Prudential Lines* doctrine, because the CODI would be excluded from income at the entity level.

As a final note, one of the key factors in the courts' holdings in *Trans-Lines West* and *Bakersfield Westar* was the temporal proximity between the purported revocation of the entity's S election and the entity's bankruptcy filing. Query whether the owners of a distressed passthrough entity can achieve their desired results by combining a change in entity classification with the extend-and-pretend strategy. In that scenario, the owners would convert the passthrough entity into a corporation at the same time they negotiate extensions of the entity's debts. If the entity can continue servicing its debts for an appropriate amount of time, a court may be unwilling or unable to revoke the conversion even if the entity ultimately succumbs to its debts.

b. Section 269. An entity that converts from passthrough status to corporate status will be treated for tax purposes as transferring its assets to a newly formed corporation in exchange for stock in that corporation and then liquidating.[209] Assuming that the entity conversion survives a *Prudential Lines* challenge, the deemed formation of that new corporation must be analyzed under section 269.

Section 269(a) provides that if a taxpayer acquires control of a corporation and the principal purpose of the acquisition is the avoidance of federal income tax by securing the benefit of a deduction, credit, or allowance that would not otherwise be enjoyed, the IRS may disallow the deduction, credit, or allowance.[210]

As a threshold matter, it would seem strange for the IRS to apply section 269 to disallow the benefits of a check-the-box election, because that election, generally speaking, is always made for tax purposes. Although taxpayers have struggled with this issue since the check-the-box regulations were enacted, the application of section 269 to check-the-box elections is still unsettled.[211]

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[203]Avent and Simon, *supra* note 201, at 179.

[204]*In re Trans-Lines West, Inc.*, 203 B.R. 653 (Bankr. E.D. Tenn. 1996).

[205]*Id.* at 662.

[206]*In re Bakersfield Westar Inc.*, 226 B.R. 227 (B.A.P. 9th Cir. 1998).

[207]*Cf. In re Forman Enters., Inc.*, 281 B.R. 600 (Bankr. W.D. Penn. 2002) (suspended losses of an S corporation shareholder are not assets of the corporation's bankruptcy estate; shareholders may carry those losses back to pre-bankruptcy tax years and receive a refund of taxes paid during those years; that refund is not property of the bankruptcy estate).

[208]As discussed at *supra* note 128, the federal income tax liability attributable to a postpetition sale of assets is treated as an administrative claim against the debtor. Bankruptcy Code section 503(b)(1)(B). An administrative claim is a second priority claim that ranks senior to the unsecured prepetition claims against the debtor, including trade claims that are not themselves classified as administrative claims. Bankruptcy Code section 503(a)(2).

[209]Reg. section 301.7701-3(g)(1)(i).

[210]Section 269(a).

[211]Letter from the NYSBA to the Senate Finance and House Ways and Means committees, Aug. 30, 2004, *Doc 2004-17360*, *2004 TNT 168-49*; James M. Peaslee, ''*Dover* Done In by Senate ETI Bill; Don't Be the Last to Know,'' *Tax Notes*, June 14, 2004, p. 1412, *Doc 2004-11773*, *2004 TNT 115-37*. Indeed, the check-the-box regulations have caused consternation among practitioners in a number of areas. *See* Sheryl Stratton, ''Treasury Officials Clarify Reach of Recent Corporate Guidance,'' *Tax Notes*, Nov.

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That said, for purposes of simplicity, this report assumes that if section 269 could apply to an entity conversion (1) the control requirement would be satisfied; (2) the principal purpose of the acquisition would be the avoidance of federal income tax; and (3) the federal income tax would be avoided by securing the benefit of a deduction, credit, or allowance.[212]

The final question to be resolved is whether the deduction, credit, or allowance achieved through the entity conversion is a benefit that would otherwise be enjoyed. If that benefit would otherwise be enjoyed, then section 269 cannot apply. If that benefit would not otherwise be enjoyed, the IRS could apply section 269 to disallow the benefits of the entity conversion.

The owners of a distressed passthrough entity can advance two arguments in support of the position that the benefit produced by the entity conversion strategy would otherwise be enjoyed. First, they could argue (1) that the words ''would not otherwise enjoy'' describe a situation in which the disallowed benefits could not have been received *but for* the acquisition of control of the new corporation; and (2) that that standard is not satisfied in the entity conversion context because the tax benefits associated with the entity conversion could be achieved without acquiring control of the new corporation. For example, in *Commodores Point Terminal Corp. v. Commissioner*,[213] an acquiring corporation acquired 58 percent of the stock of a target corporation in exchange for debt. The acquiring corporation subsequently claimed three benefits from the transaction: a dividends received deduction for dividends paid on the acquired stock, a deduction for interest paid on the debt issued in the acquisition, and deductions for stamp taxes incurred as a result of the transaction. The IRS attempted to disallow the benefits under section 269, but the Tax Court held for the taxpayer, relying in part on the conclusion that none of the disallowed benefits were contingent on the acquisition of control of the target corporation (that is, the same benefits would have been produced whether the acquiring corporation acquired 51 percent of target stock or 49 percent of target stock). According to the court, ''the word 'otherwise' can only be interpreted to mean that the deduction, credit, or allowance, if it is to be disallowed, must stem from the acquisition of control.''[214]

Although some may view the scope of the *Commodores Point* holding as unclear,[215] the holding provides support to the owners of a distressed passthrough entity that converts to corporate status. That is because the desired tax benefit — the taxation of restructuring-related income at the entity level rather than the owner level — can be achieved regardless of whether the owners acquire control of the new corporation. In other words, if the owners of a distressed passthrough entity transfer their interests in that entity to a C corporation in exchange for stock, they will receive the same tax benefits regardless of whether their stock interest represents 1 percent or 100 percent of the equity of that corporation.

The second argument that the owners of a distressed passthrough entity can advance is that section 269 cannot be used to disallow an ''intended benefit'' and that an entity election is an intended benefit. For example, in Rev. Rul. 76-363,[216] an individual formed a corporation, intending it to qualify as an S corporation. The IRS held that applying section 269 to disallow the S election, even when the principal purpose ''was to allow a shareholder to offset the shareholder's losses against the corporation's undistributed taxable income,'' would be inconsistent with the intent of Congress. Likewise, in Rev. Rul. 70-238,[217] the IRS found that section 269 does not apply to the creation of a subsidiary whose only purpose was to

18, 2002, p. 862, *Doc 2002-25338*, or *2002 TNT 219-2* (considering whether the business purpose requirement of section 351 is met when an entity checks the box to be treated as a corporation); James B. Sowell, ''Check-the-Box Entity Conversions: Analyzing the Economic Substance of Deemed Transactions,'' 45 *Tax Mgmt. Memo.* 425 (2004) (analyzing whether ''the tax effect of a conversion transaction [should] be treated as equivalent in all situations to the tax effect that would have occurred in connection with an actual transaction'').

[212]Section 269's definition of ''deduction, credit or allowance'' is likely broad enough to encompass any benefit that a taxpayer would gain from an entity conversion. The regulations state that the term ''allowance'' includes ''anything in the internal revenue laws which has the effect of diminishing tax liability.'' Reg. section 1.269-1(a). Thus, section 269 can bar any benefit when the effect would be ''to distort the liability of the particular taxpayer when the essential nature of the transaction or situation is examined in the light of the basic purpose or plan which the deduction, credit, or other allowance was designed by the Congress to effectuate.'' Reg. section 1.269-2(b).

[213]*Commodores Point Terminal Corp. v. Commissioner*, 11 T.C. 411 (1948), *acq.*, 1949-1 C.B. 1.

[214]*Id.* at 417.

[215]The confusion centers on *Coastal Oil Storage Co. v. Commissioner*, 242 F.2d 396 (4th Cir. 1957), which could be read as questioning the holding in *Commodores Point*. In *Coastal Oil*, a corporation formed a subsidiary and contributed to it income-producing property. Both the parent and the subsidiary claimed surtax exemptions and minimum excess profits credits, which the IRS challenged under section 269. The Tax Court followed the reasoning of *Commodores Point* and held that since the exemptions and credits would be available even if the parent did not acquire control of the subsidiary, section 269 could not be used to disallow their use. The Fourth Circuit disagreed and distinguished *Commodores Point*, saying that the court could find no reason why section 269(a)(1) could not apply to the acquisition of the subsidiary. In so doing, the court stated that *Commodores Point* was ''entirely different'' and that it was therefore ''no precedent here.''

While disagreeing with the lower court's analysis of the facts in *Coastal Oil*, the Fourth Circuit did not appear to disagree with the holding of *Commodores Point*. Further, the court held that the exemptions and credits would have been useless ''but for the acquisition'' of the income-producing property, which the exemptions and credits were used to shelter. The court's focus on the acquisition of the income-producing property may suggest that it was actually deciding the case under section 269(a)(2), which is not dependent on an acquisition of control in a corporation. The court's reasoning in *Coastal Oil* is therefore not entirely inconsistent with the holding of *Commodores Point*. We have not found a primary authority that cites *Coastal Oil* for the proposition that the benefits to be disallowed need not stem from the acquisition of control of the corporation.

[216]Rev. Rul. 76-363, 1976-2 C.B. 90.

[217]Rev. Rul. 70-238, 1970-1 C.B. 61.

qualify as a Western Hemisphere trade corporation. The IRS found that in creating the special deduction for Western Hemisphere trade corporations, Congress intended the benefits to be available to all taxpayers as long as they meet the specific requirements set forth in the code. As such, the creation of a subsidiary to carry on an existing business through such a corporation was not tax avoidance under section 269. The courts have similarly allowed taxpayers to qualify for other benefits that were specifically intended by Congress.[218]

Given the similarities between the entity election provided by the check-the-box regulations and the entity elections analyzed in Rev. Rul. 76-363 and Rev. Rul. 70-238, the owners of a distressed passthrough entity can present a strong argument that an entity election represents the same type of intended benefit described in those rulings.

2. Ancillary issues. The conversion of an entity from passthrough to corporate status may give rise to a number of different tax concerns, including concerns relating to the jurisdiction of the entity, the relationship between the basis of the entity's assets and the amount of its liabilities, the classification of the entity's liabilities as recourse or nonrecourse, the existence of intercompany indebtedness and shareholder indebtedness, and the effect of the conversion on employee owners. A thorough discussion of those issues is beyond the scope of this report. That said, the existence of those concerns requires a qualitative and quantitative analysis of the benefits and tax costs associated with passthrough status, the benefits achieved by converting to corporate status, and the tax costs associated with that conversion.

B. Abandonment

The doctrine of abandonment is a long-standing tax planning tool that owes its popularity to the code's unequal treatment of transactions that give rise to capital gain or loss (capital transactions) and transactions that give rise to ordinary income or deduction (ordinary transactions). Because capital gains are taxed at a lower rate than ordinary income, and capital losses are subject to significant limitations that do not apply to ordinary deductions, taxpayers generally favor capital gains over ordinary income and ordinary deductions over capital losses. Historically, the technique of abandonment provided taxpayers a mechanism for generating an ordinary deduction on the divestiture of a capital asset.[219]

Because it enables taxpayers to report an ordinary deduction on the divestiture of an asset that, if sold, would generate a capital loss, the abandonment doctrine has been viewed with suspicion by the IRS. Over the years, the IRS has issued regulations and rulings that have the effect of converting what would otherwise be an ordinary abandonment deduction into a transaction that generated either a capital loss or a net capital gain.[220] In issuing those authorities, however, the IRS has not restricted the use of abandonment as a means of divesting property. Instead it has attempted to ensure that abandonment transactions produce tax results that are consistent with actual sales.[221]

In the context of a distressed passthrough entity, the abandonment technique typically arises in a situation when the owners of the entity want to sell their equity interests before recognizing CODI but they either cannot locate a willing third-party purchaser or cannot convince creditors to accept ownership of those equity interests. In that context, the abandonment doctrine may prove beneficial to the owners even if the abandonment generates a capital loss, or a net capital gain, rather than an ordinary deduction.

To abandon an asset, the owner must (1) intend to abandon it and (2) undertake an affirmative act of

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[218]*See Barber-Green Americas, Inc. v. Commissioner*, 35 T.C. 365 (1960) (section 269 not applicable to the creation of a Western Hemisphere trade corporation); *Cherry v. United States*, 264 F. Supp. 969 (C.D. Cal. 1967) (same); *Alinco Life Ins. Co. v. United States*, 373 F.2d 336 (Cl. Ct. 1967) (section 269 not applicable to the creation of a subsidiary intended to qualify as an insurance company); *Modern Home Fire & Cas. Ins. Co. v. Commissioner*, 54 T.C. 839 (1970) (section 269 not applicable to the filing of an S election); *Supreme Inv. Corp. v. United States*, 468 F.2d 370 (5th Cir. 1972) (section 269 not applicable to the step-up in basis that occurs in an installment note after a section 334(b)(2) liquidation).

[219]For a transaction to generate a capital gain or loss, it must represent a sale or exchange of a capital asset. Section 1222.

(Footnote continued in next column.)

Thus, if a taxpayer wants to dispose of an asset and recognize an ordinary loss, he has to make sure either that the divestiture does not constitute a sale or exchange or that the asset does not constitute a capital asset. Because the term ''capital asset'' is so broad, taxpayers have often failed in trying to classify an asset as non-capital. *See, e.g., Ark. Best Corp. v. Commissioner*, 485 U.S. 212 (1988) (finding that the exceptions in section 1221(a) are the sole exclusions from the broad definition of capital asset). Because the term ''sale or exchange'' is relatively narrow, however, taxpayers have often been successful in arguing that a state law abandonment of property does not constitute a sale or exchange of the abandoned property under section 1222. *See Citron v. Commissioner*, 97 T.C. 200 (1991); *Matz v. Commissioner*, T.C. Memo. 1998-334, *Doc 98-28660, 98 TNT 184-7*; Rev. Rul. 93-80, 1993-2 C.B. 239.

[220]*See* Rev. Rul. 93-80, 1993-2 C.B. 239 (treating an abandonment of a partnership interest as a capital transaction if the partnership has any recourse indebtedness or the partner is allocated any share of the partnership's nonrecourse indebtedness); reg. section 165-5(i) (treating abandoned securities as worthless securities, therefore requiring the taxpayer to treat them as if they were sold or exchanged).

[221]For example, although not originally enacted for this purpose, section 1234A may provide the IRS with another argument in favor of characterizing the abandonment of partnership interests as a capital transaction. Section 1234A provides that loss arising from the ''cancellation, lapse, expiration, or other termination'' of a right or obligation with respect to a capital asset will be characterized as capital in nature, even though there was no ''sale or exchange'' of the asset or the right or obligation. Although the issue has never been addressed by the IRS, some commentators have wondered whether this section could be applied to the abandonment of partnership interest, so that the abandonments would yield only capital losses. *See* Sowell, *supra* note 95, at 881-883; Swartz, *supra* note 95, at 1101; Gerald Thomas, ''The Art of Abandoning Securities and Taking an Ordinary Loss,'' 104 *J. Tax'n* 22, 25-27 (2006).

abandonment.[222] Given the uncertainty that pervades most aspects of the tax treatment of bankrupt passthrough entities, it should come as no surprise that the tax law provides no clear guidance on what an owner must do to establish his intent to abandon an interest in a passthrough entity, nor does the tax law provide any bright-line rules on what constitutes an affirmative act of abandonment.

As a practical matter, an intent to abandon an asset is often demonstrated by the affirmative act of abandonment itself. Whether an act constitutes abandonment and demonstrates an intent to abandon will depend on the facts and circumstances surrounding the act.[223] In any event, the clearest way for a taxpayer to abandon property is to relinquish both title to and possession of the property, and not retain any interest therein.[224] In the case of the owner of an interest in a passthrough entity, it would also be appropriate to notify the entity, any other persons who own interests in the entity, the creditors of the entity, and, if applicable, the bankruptcy court, that the owner has abandoned his interest in the entity.[225]

VI. Conclusion

In the final analysis, the current tax rules applicable to bankrupt passthrough entities work at cross-purposes to bankruptcy policy, insofar as bankruptcy policy encourages distressed entities and their stakeholders to restructure claims against the entity, while the tax rules threaten to impose an income tax that discourages the parties from completing that restructuring. Experience suggests that those rules produce little or no additional tax revenue because they result in owner-level bankruptcy filings, the adoption of aggressive positions concerning the application of the section 108 exclusions,[226] or the adoption of alternate techniques that reduce, defer, or eliminate the tax that would otherwise be imposed on the owners. The end result is that bankruptcy restructurings of distressed passthrough entities, which would restore economic productivity to the benefit of both society and the government,[227] are replaced with alternate techniques that may produce little or no additional revenue for the government and that move individuals from the workforce to the unemployment rolls. This situation runs contrary to Congress's long-standing practice of molding the tax law to accommodate bankruptcy policy, and it is inconsistent with congressional intent underlying the BTA.

Unfortunately, when it comes to developing tax rules for bankrupt passthrough entities, no matter how hard we try, we cannot construct a system in which (1) the government collects a significant amount of tax from the owners of those entities and (2) those entities complete the same bankruptcy restructuring they would have completed in the absence of that tax.[228] Taxes affect behavior, especially when times are tough. This means that we have to make a choice — stick with the current system of taxing bankrupt passthrough entities and live with poor economic and social results, or modify the current system in an attempt to achieve superior economic and social results. When faced with a similar choice in 1938, Congress sacrificed tax collection in order to pursue superior economic and social results. We agree with that choice and therefore believe that modifying the

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[222]*See* reg. section 1.165-2(a) (nondepreciable property); reg. section 1.167(a)-8(a)(4) (depreciable property); *see also A.J. Indus., Inc. v. United States*, 503 F.2d 660 (9th Cir. 1974).

[223]Acts the courts have considered effective abandonments include (1) the taxpayer's retirement from the construction business and liquidation of a corporation designed to complete a construction project; (2) delivery of a quitclaim deed along with notification to the tax collector that taxes will not be paid; and (3) the failure to pay real estate taxes on property when the taxpayer can afford to do so. *See* John C. McCoy, ''Loss Deductions,'' 527-3d *Tax Mgmt. Portfolio* A-38 to 42 (2007). A court also found that notification by a majority partner to a minority partner that the majority partner would no longer contribute funds to the limited partnership was sufficient to constitute an abandonment, since the act was a clear and unequivocal indication to the minority partner that the taxpayers were walking away from their ownership in the partnership. *Echols v. Commissioner*, 935 F.2d 703 (5th Cir. 1991).

[224]*See Echols*, 935 F.2d at 707. In that case, the taxpayer, at a partnership meeting, informed the minority partner that the taxpayer would not ''contribute . . . further funds to the Partnership, a clear and unequivocal indication to [the minority partner] and the world that taxpayers were 'walking' from their ownership interest in the partnership.'' The court found these actions sufficient for the taxpayer to abandon its partnership interest.

[225]Sowell, *supra* note 95, at 880. One commentator suggests the following criteria to effect an abandonment of securities: (1) relinquish all interest in the securities for no consideration; (2) make the abandonment clear to the issuer (for example, returning stock or debt certificates and other evidences of ownership of the securities accompanied by a letter); and (3) when possible, obtain an acknowledgment of this action from the issuer of the securities. *See* Thomas, *supra* note 221, at 27 (''the taxpayer must conduct itself as though it no longer owns the securities. Accordingly, it should not attempt to recover any funds or other distributions with respect to its prior ownership of the securities. Further, the taxpayer should not accept any distribution or consideration, directly or indirectly, advertently or inadvertently, in any manner whatsoever, from the issuer or any other person or entity with respect to such abandonment, relinquishment, and surrender of, or its prior ownership interest in, the securities'').

[226]*See supra* text accompanying notes 96-98 (discussing the fact that some owners of bankrupt DEs are maintaining that the bankruptcy exclusion applies to any income recognized in connection with the bankruptcy restructuring of the DE).

[227]Phelan and Sharp, *supra* note 144, at 877 (''The rehabilitated debtor causes a favorable ripple effect and generates a significant positive contribution to the community and to the economy in general. A successful rehabilitation often will result in the generation of substantially greater tax revenues than the small sums that will be collected in connection with a liquidation of the debtor.'').

[228]*Cf.* Krause and Kapiloff, *supra* note 195, at 416 (''Experience has shown that bankruptcies tend to escalate, *i.e.*, when a debtor fails to pay his creditors, the financial positions of the creditors themselves becomes impaired. Imposing income taxes on the trustee in bankruptcy for the sale or use of the bankrupt's property during the bankruptcy proceeding adds insult to injury and thwarts economic rehabilitation. It is reasonable for the Government to absorb a share of the rehabilitation process of the bankrupt and to forgive any tax that would be due on income earned during the administration of the bankruptcy estate.'').

tax system to facilitate the bankruptcy restructuring process is the most responsible course of action in the current environment.[229]

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[229]*Cf.* Asofsky I, *supra* note 50, at 13-34 (''Unless there is a more user friendly tax law, in terms of simplicity, certainty and, in some cases, subsidy, the bankruptcy process is bound to be more expensive and less successful''); ABA report, *supra* note 152, at 214 (''the tax laws should not operate to discourage a debtor and creditor acting at arm's length from reaching a compromise of a debt the terms of which are, by definition, dictated by the existing market place'').