TAX ATTRIBUTES IN BANKRUPTCY -- 2008

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INTRODUCTION[2]

Distressed corporations are almost always losing money when they file for bankruptcy. And yet tax considerations play a surprisingly important role in the entire bankruptcy process, from the decision to file, through the day-to-day operation of the debtor in bankruptcy, to the design and implementation of the plan of reorganization.

This paper focuses on the debtor corporation's tax attributes -- principally its net operating losses ("NOLs")[3] and its tax basis in assets and stock, and discusses a number of important recent developments that affect, both positively and negatively, the value of those attributes to the debtor corporation when it emerges from bankruptcy.

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[2] This paper reflects developments through April 30, 2008. For a more complete discussion of bankruptcy tax issues, see Jenks, Ridgway, and Purnell, 790 T.M., *Corporate Bankruptcy* (2004).

[3] For ease of exposition, I will frequently use the term "NOLs" in this paper to refer to the entire laundry list of items (other than basis) listed in section 108(b)(2): NOLs, general business credits, minimum tax credits, capital loss carryovers, passive activity loss and credit carryovers, and foreign tax credit carryovers. The reader should so assume, unless the text indicates a different intention. (Unless indicated, all section references are to the Internal Revenue Code of 1986, as amended.)

The first portion of the paper sets forth in simplified fashion the way in which the tax attribute system functions in bankruptcy, highlighting the rather complex interrelationship between the rules governing cancellation of debt ("COD") income and the tax consequences of a change of ownership. The second portion of the paper describes and analyzes recent developments and practice pointers involving (a) the deductibility of interest and professional fees incurred during bankruptcy, (b) discharging debt, and (c) the change of ownership rules.

I. How the Tax Attribute System Works in Bankruptcy -- An Overview

A. Filing for Bankruptcy

1. When a corporation files for bankruptcy protection, the vast majority of the rules contained in the Code and regulations continue to apply to it without modification.

a. The corporation is the same taxable entity after the filing that it was before.[4]

b. The corporation's taxable year does not close.[5]

c. If the corporation was a member of an affiliated group filing consolidated returns before filing for bankruptcy, it will remain so afterward.[6] This is true even in

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4 *See* section 1399.

5 15 *Collier on Bankruptcy* ¶ TX 3.02[2][b] n.34 (15th ed. rev. 2007) (construing section 1399).

6 Rev. Rul. 63-104, 1963-1 C.B. 172. *See also* PLR 200643001 (July 26, 2006) (second-tier subsidiary forced into liquidation by court order must continue to be included in parent group's consolidated return as long as section 1504 affiliation tests are met).

cases in which less than all of the members of an affiliated group filing consolidated returns file for bankruptcy.

d. If the corporation had elected to be treated as an S corporation before the filing, the election remains in place afterward.[7]

B. Discharging Debt

1. In most corporate bankruptcies, the debtor corporation will discharge its pre-petition indebtedness for less than its adjusted issue price, thereby generating COD income to the debtor corporation.[8]

2. Special rules set forth in sections 108 and 1017 govern the tax consequences of COD income triggered in a title 11 bankruptcy or when (and to the extent that) the debtor is insolvent. Those rules are as follows:

a. COD income triggered in a title 11 case or when the taxpayer is insolvent is excluded from gross income.[9]

b. The exclusion for insolvent corporations not filing for bankruptcy is limited to the amount of insolvency; there is no such limit for insolvent corporations that do file.[10]

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[7] *See Mourad v. Comm'r,* 121 T.C. 1 (2003), *aff'd,* 387 F.3d 27 (1st Cir. 2004).

[8] Sections 61(a)(12); 108.

[9] Section 108(a)(1)(A), (B).

[10] Section 108(a)(3).

EXAMPLE 1

Acme Corp. owes BigBank $100 million, but is unable to meet its debt service requirements. If Acme can persuade BigBank to allow it to pay off its $100 million debt for, say, $40 million, Acme will recognize COD income of $60 million. If this debt restructuring is implemented in bankruptcy, none of the COD income will be taxed whether or not Acme was insolvent before or after the restructuring.[11] On the other hand, if the debt restructuring is implemented outside of bankruptcy, the COD income will not be taxable to Acme if Acme can prove to the IRS that it is insolvent (*i.e.*, has liabilities that exceed the fair market value of its assets), in which case Acme's COD income is not taxed to the extent of its pre-restructuring insolvency. If Acme can prove that it is, say, $56 million insolvent before the restructuring but $4 million solvent afterward, the amount of COD income that is excluded by the joint operation of sections 108(a)(1)(B) and 108(a)(3) is limited to the pre-restructuring insolvency of $56

[11] Although the vast majority of corporations filing for bankruptcy are insolvent at the time of the filing, there is no requirement in the Bankruptcy Code that a corporation must be insolvent in order to file. *See, e.g.*, *United States v. Huebner*, 48 F.3d 376, 379 (9th Cir. 1994) ("The Bankruptcy Act does not require any particular degree of financial distress as a condition precedent to a petition seeking relief"); *In re James Wilson Assoc.*, 965 F.2d 160, 170 (7th Cir. 1992) ("One might have supposed that the clearest case of bad faith would be filing for bankruptcy knowing that one was not bankrupt, but the Bankruptcy Code permits an individual or firm that has debts to declare bankruptcy even though he (or it) is not insolvent"); *In re Johns-Manville Corp.*, 36 B.R. 727, 732 (Bankr. S.D.N.Y. 1984) ("it should also be noted that neither Section 109 nor any other provision relating to voluntary petitions by companies contains an insolvency requirement"). *Cf. In re Integrated Telecom Express, Inc.*, 384 F.3d 108 (3d Cir. 2004) (while desire "to avail oneself of a particular protection in the Bankruptcy Code" not bad faith, that desire alone cannot satisfy general requirement that petition be filed in good faith).

million, with the other $4 million being included in income.

c. COD income that is excluded from gross income because of insolvency or a bankruptcy filing nevertheless reduces the corporation's tax attributes in the rather complicated fashion outlined in sections 108(b) and 1017.[12]

EXAMPLE 2

Same as Example 1, with the added fact that Acme has at least $60 million in NOLs. If Acme files for bankruptcy, its entire $60 million in COD income will be excluded from gross income, but its NOLs will be reduced by a like amount. By contrast, if Acme restructures its debt outside bankruptcy, $56 million of its COD income will be excluded from gross income and will therefore reduce Acme's NOL by a like amount as a result of the operation of section 108(b), but the amount not so excluded -- $4 million -- will in effect reduce Acme's NOLs by an additional $4 million, thereby putting Acme in roughly the same spot that it would have been in had it filed.[13]

12 Veteran tax practitioners will remember with fondness the old stock-for-debt exception to the COD rules, which would have resulted in no reduction in Acme's NOLs if it had been able to discharge its $100 million debt to BigBank in bankruptcy by issuing Acme common stock to BigBank, even common stock concededly worth less than $100 million. *See generally* Henderson and Goldring, *Tax Planning for Troubled Corporations* § 504 (2008 ed.). Unfortunately, however, this wonderful rule was repealed for all bankruptcy cases filed after 1993, and stock used to discharge debt is now treated like cash having an equal value. *See* section 108(e)(8).

13 Only "roughly" the same spot because for most years only 90% of the COD income that is treated as taxable income (*i.e.*, the amount by which the restructuring renders the debtor solvent) can be sheltered from the alternative minimum tax by NOL carryforwards. *See* section 56(d)(1). Therefore, on these facts, an AMT liability of $80,000

> Therefore, for regular tax purposes at least, the practical benefit of the blanket COD exclusion in bankruptcy ceases to exist if the debtor has NOLs at least as large as the COD in question.

d. In most situations (the "Normal Case"), the corporation's tax attributes will be reduced in the order that they are set forth in section 108(b)(2): NOLs, general business credits, minimum tax credits, capital loss carryovers, basis in property, passive activity loss and credit carryovers, and foreign tax credits.

e. In the Normal Case, if the debtor corporation's COD income is sufficient to make it through

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(10% of $4 million times 20%, the current AMT rate) would generally be owed in the out-of-court case, but none in the bankruptcy case. This detriment is partially offset by an AMT credit carryforward created by payment of AMT tax that can be used whenever the company returns to profitability for regular tax purposes. (*See* section 53.) In addition, the 90% limitation on NOL utilization for AMT purposes was suspended for 2001 and 2002, thereby rendering the entire AMT point moot for those particular years. P.L. 107-147, § 102(c), 116 Stat. 21, 26 (Mar. 9, 2002). Finally, the American Jobs Creation Act of 2004, P.L. 108-357, 118 Stat. 1418 (Oct. 22, 2004) (the "AJCA") made two important changes to the availability of foreign tax credits to offset the AMT: first, it repealed the 90% AMT limitation on the use of foreign tax credits previously set forth in section 59(a)(2)(A)(ii) (AJCA section 421(a)(1)); and second, it extended the carryforward period for foreign tax credits under section 904(c) from five years to ten (AJCA section 417(a)). It is conceivable that these statutory changes will occasionally make it more desirable to treat foreign tax credits generated in one or more open or future years as creditable rather than deductible in order to take advantage of the fact that the 90% AMT limitation will not apply to foreign tax credits but will apply to NOLs. It should also be noted that the Senate has made several, so far unsuccessful, attempts to extend the 2-year NOL carryback period under section 172. *E.g.*, S. 2650, 110th Cong. (2008) (providing for a 5-year carryback with respect to NOLs arising in taxable years beginning or ending in 2006, 2007 or 2008). One such attempt passed the Senate and is currently pending before the House of Representatives. H.R. 3221, 110th Cong. §601 (as passed by the Senate, April 10, 2008) (providing for a 4-year carryback with respect to NOLs arising in taxable years ending in 2008 or 2009).

the first four layers (NOLs, business credits, minimum tax credits, and capital loss carryovers) and into the fifth layer (basis in property), the rules of section 1017(b)(2) prevent the corporation's basis in its assets from being reduced below the corporation's liabilities immediately after the discharge has taken place (hereinafter the "Liability Stop"). The Liability Stop is intended to allow the debtor to emerge from bankruptcy (or a debt restructuring) in a position where it could sell its assets in return for the assumption of its liabilities without triggering any taxable income.

EXAMPLE 3

> Same as Example 2, except that Acme has only $20 million in NOLs but has $55 million in asset basis. If Acme files for bankruptcy (or is at least $60 million insolvent before the debt restructuring), the tax consequences of discharging its $100 million debt to BigBank for common stock worth $10 million and a new debt obligation having an issue price and value of $30 million would be as follows: the $60 million in COD income ($100 million of debt being discharged for stock and debt worth $40 million) would be excluded entirely from income; Acme's $20 million in NOLs would be wiped out; and Acme's basis in its assets would be reduced by $25 million (not $40 million) to $30 million, because any further reduction in asset basis would violate the Liability Stop rule. The amount of COD income left over -- $15 million in Acme's case -- is permanently excluded from Acme's gross income without ever generating a corresponding attribute reduction. Call it the "Black Hole."[14]

[14] A similar result would occur if Acme's COD income had been greater than the sum of its tax attributes (*i.e.*, NOLs and basis in

f. With the repeal of the stock-for-debt exception in 1993, the Black Hole is the only permanent (as opposed to timing) tax benefit conferred on distressed companies by the Code. Maximizing the size of the Black Hole is therefore a worthy goal of all those who provide tax advice to distressed corporations.

g. Because the size of the Black Hole depends on the amount of debt that the debtor corporation has on its balance sheet after the COD event, it may in certain circumstances make sense from a pure tax point of view to maximize the amount of the debtor's post-COD liabilities.

EXAMPLE 4

> Same as Example 3, except that Acme's $100 million debt is discharged for $8 million in common stock and $32 million in debt (compared to $10 million in stock and $30 million in debt in Example 3). While the amount of COD income remains the same, the Liability Stop rule requires that the reduction of Acme's asset basis stop at $32 million, rather than $30 million, thereby increasing the Black Hole from $15 million to $17 million and preserving $2 million in asset basis at no direct tax cost.[15]

h. Section 108(b)(5) allows a debtor to elect to reduce asset basis under section 1017 first, rather than following the statutory ordering set forth in 108(b)(2)

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assets). Any excess COD income would go unreflected in Acme's tax balance sheet, thereby falling into the Black Hole as well.

[15] There may be an indirect cost, however: as we will see shortly (*see* I.C.2 Example 9, *infra*), Acme's ability to take deductions attributable to its net unrealized built-in loss at the time of the change of ownership may be reduced to a small extent by this increase in debt and reduction in common stock.

(which puts NOLs first). If this election is made, however, the Liability Stop does not come into play.[16]

EXAMPLE 5

Same as Example 4 (that is, Acme has $20 million in NOLs and $55 million in asset basis when it triggers COD income of $60 million). If Acme elects to reduce asset basis first under section 108(b)(5), then it would lose its entire $55 million in asset basis plus $5 million in NOLs. Making the 108(b)(5) election therefore produces two consequences: (a) it results in a full $60 million reduction in attributes ($55 million in asset basis and $5 million in NOLs) as opposed to the $43 million ($20 million in NOLs and $23 million in asset basis) that took place without the 108(b)(5) election (because the Liability Stop does not apply and therefore no COD goes into the Black Hole); and (b) the election allows Acme to retain $15 million in NOLs, rather than having them entirely wiped out, as would occur in the absence of an election.

i. While section 108(b)(5) elections are rather rare (in substantial part because of the fact that making the election eliminates the Liability Stop -- and therefore most of the benefit of having the Black Hole), there will be occasions when making the election will produce a better result.

EXAMPLE 6

Same as Example 4, except that Acme's asset basis is $105 million, rather than $55 million. If no 108(b)(5) election is made, the results would be as follows: Acme's $60 million of COD income would first wipe

16 *See* section 1017(b)(2)(B).

> out its $20 million in NOLs, and would then reduce Acme's basis in assets by $40 million (from $105 million to $65 million), since doing so would not trigger the Liability Stop. If a 108(b)(5) election were made, all $60 million of COD income would be used to reduce Acme's basis in assets (which would drop from $105 million to $45 million); Acme's NOLs would remain untouched at $20 million. This may result in the 108(b)(5) election being advantageous on a present value basis, because a larger portion of Acme's attributes will be in the form of NOLs (immediately available for use, subject to whatever 382 limitation is imposed by the emergence from bankruptcy), rather than basis in assets (only available through depreciation or amortization over time).

j. Importantly, the reduction in asset basis that occurs under sections 108 and 1017 does not take place on the date that the debtor's COD income is triggered. Instead, it takes place at the start of the next taxable year.

EXAMPLE 7

> Same as Example 5 (that is, Acme has $60 million in COD income and $55 million in asset basis, and makes a l08(b)(5) election to reduce basis in assets first). Acme's debt discharge occurs on July 1. On August 30, Acme sells for $10 million one of its assets in which (before giving effect to the basis reduction regime of 108/1017) it had a basis of $10 million. Since Acme's basis in assets has not yet been reduced at the time of the sale, it will have no gain on the sale ($10 million amount realized less $10 million in basis) rather than $10 million in gain, which would have been the result if it had sold the same asset on January 2 of the following year. As a result, Acme's $60 million in COD income would first reduce Acme's basis in its remaining assets still on hand at

> the end of the year ($45 million, consisting of the original $55 million in basis less the $10 million in basis in the sold asset), with the remaining $15 million reducing Acme's NOLs from $20 million to $5 million.[17]

C. Undergoing a Change of Ownership

1. The vast majority of all corporate reorganizations under title 11 of the Bankruptcy Code result in a change of ownership under section 382 of the Code.

EXAMPLE 8

> Acme's plan of reorganization provides that all of its outstanding stock will be canceled, and all of its new stock will be issued to BigBank in discharge of its $100 million debt claim. Acme will undergo a section 382 change of ownership on the effective date of the plan.[18]

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[17] In this case Acme has traded $10 million in NOLs for $10 million of current gain unrecognized; if it had sold the asset after the new year and recognized the gain, it **may** have been able to use its $10 million in retained NOLs to shelter its gain, but it might also have been prevented from doing so by limitations on post-emergence use of NOLs under section 382, as discussed below.

[18] At one time, practitioners had been concerned that a literal reading of the option attribution provisions in the 382 regs could lead to the conclusion that the change date in many consensual bankruptcies would occur before the effective date of the plan if, for example, creditors at some point in the case (or even before the bankruptcy filing, in the case of so-called pre-packaged bankruptcies) bound themselves contractually to a plan that would predictably result in a change of ownership. *See, e.g.*, PLR 9019036 (Feb. 9, 1990) (bankruptcy plan creates option or interest similar to option on **confirmation** date). The 382 regs now helpfully provide that this will not be the case. *See* Treas. Reg. § 1.382-9(o) (section 382 option rules do not apply to options created by plan solicitation, acceptance or confirmation but rather apply to options only after the time the plan becomes effective). Puzzlingly, the IRS issued a letter ruling in early

2. When a section 382 change of ownership takes place pursuant to a plan of reorganization, the tax attributes that remain after giving effect to the 108/1017 attribute reduction rules are generally -- although not in every case -- subject to an annual limitation on future use. That limitation is equal to the annual long-term tax-exempt bond rate (4.55%)[19] times the value of Acme's equity immediately after the change of ownership (and after giving effect to the reduction in liabilities occurring pursuant to the plan of reorganization).[20]

EXAMPLE 9

> Same as Example 5 (that is, after making a section 108(b)(5) election and giving effect to the attribute reduction rules of sections 108 and 1017, Acme has $15 million in NOLs and no basis in its assets). If the stock that Acme issues to its creditors is worth $40 million after giving effect to the plan of

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2007 holding that a debtor's change of ownership took place on the date of confirmation, rather than on the effective date of the plan. PLR 200720012 (Jan. 25, 2007). This result seemed squarely at odds with Treas. Reg. § 1.382-(9)(o), which the ruling did not even bother to cite. *See* Willens, "Ruling Favors Firm in Fixing 'Ownership Change' Date at Bankruptcy Confirmation," Daily Tax Report (June 11, 2007) (endorsing result reached by ruling). Happily, it later turned out that this ruling had been issued in error, and was subsequently corrected by the IRS in a ruling issued in late 2007. PLR 200748015 (Nov. 30, 2007).

[19] The long-term tax-exempt rate used is the highest of the adjusted federal long-term rates for the month in which the change date occurs and the prior two months. The adjusted federal long-term rate for the month of April 2008 is 4.55%, and the long-term tax-exempt rate for ownership changes occurring during April 2008 is also 4.55%. As such, 4.55% will be used as the long-term tax-exempt rate for purposes of the numerical examples. *See* Rev. Rul. 2008-20, 2008-14 I.R.B. 716 (Mar. 18, 2008).

[20] For a discussion of how section 382 applies to AMT NOLs, see Simon, "Compound Complexity: Accounting for Built-in Gains and Losses Under the AMT After an Ownership Change," 107 Tax Notes 477 (Apr. 25, 2005).

> reorganization, Acme will be able to use $1.820 million (4.55% times $40 million) of its NOLs per year post-emergence to offset income. If, on the other hand, Acme discharges its obligation by issuing $30 million in debt and $10 million in stock to BigBank, Acme's 382 limitation will be only $455,000 (4.55% times $10 million).

3. If Acme restructured its debt with BigBank in precisely the same way outside of bankruptcy, it would not be able to give effect to the elimination of the BigBank debt before calculating the 382 limitation.

EXAMPLE 10

> Same as Example 9, except Acme and BigBank reach a negotiated agreement outside of bankruptcy. Since 382(l)(6) is only available for changes of ownership occurring in a "title 11 or similar case", Acme's 382 limitation on future use of its NOLs will likely be zero, because, prior to the discharge of Acme's debt to BigBank, its stock was presumably worthless.

4. If Acme has a net unrealized built-in loss (a "NUBIL") in its assets on the change date that exceeds the lesser of (a) 15 percent of the fair market value of those assets or (b) $10 million, then deductions attributable to that NUBIL will in most cases be subject to a similar limitation for the next five years.[21]

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[21] *See* section 382(h). Any built-in losses that are recognized during the five-year recognition period and that are subject to treatment as pre-change NOLs under section 382(h)(1)(B)(i) become subject to the 382 limitation indefinitely, not just during the recognition period. *See* section 382(h)(4). It is not clear whether recognized built-in losses can be carried back. The statutory language of section 382(h)(4) can be read as permitting rather than requiring a carryforward, and a prohibition on carrybacks would appear to run contrary to Section 382's

EXAMPLE 11

Same as Example 6 where no 108(b)(5) election is made (that is, Acme's $60 million in COD income first wipes out its $20 million in NOLs and then reduces its asset basis from $105 million to $65 million). If the Acme plan of reorganization cancels Acme's old stock and issues 100% of its new stock (worth $40 million) to BigBank in discharge of its $100 million debt claim, Acme will be in a NUBIL situation (*i.e.*, its assets will have a basis -- $105 million[22] -- that exceeds their value -- apparently $40 million -- by $65 million, which in turn exceeds the statutory requirements of section 382(h)(3)(B)). Therefore, for the next five years, any deductions claimed by Acme with respect to its built-in asset loss will -- in most cases -- be subject to Acme's annual limitation of $1.820 million, just as if they were NOLs.

overall objective, which is to limit the ability of a corporation's new shareholders to benefit from losses borne by former shareholders, not to penalize the former shareholders (to the extent they would be entitled to the refund of pre-change taxes generated by a carryback). But there is authority for the position that recognized built-in losses can only be carried forward, not back. *See, e.g.*, H.R. Conf. Rep. No. 99-841 at II-173 (1986), *reprinted in* 1986 U.S.C.C.A.N. 4075, 4261; Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 14.44[4][a] n.299 (7th ed. 2007); FSA 002252, 2002 ARD (CCH) 100-18 (Jan. 13, 1998).

[22] See IV.A.2, *infra*, for discussions of (a) the Service's position that attribute reduction resulting from COD income does not enter into the calculation of Acme's NUBIG or NUBIL but can have an impact on whether a post-change gain or loss on sale is treated as a recognized built-in gain or loss for section 382 purposes, and (b) the ABA Tax Section's recommendation that COD income that is "built-in" or "inchoate" on the change date should be taken into account in measuring the loss corporation's NUBIG or NUBIL.

5. In a limited set of circumstances, debtors can undergo a change of ownership in bankruptcy and emerge without any 382 limitation on their attributes, be they NOLs or built-in loss. In order to qualify for this election[23] (the "382(l)(5) Election" or simply "L5"), the following criteria must be met:

-- shareholders and qualified creditors of the loss corporation must end up owning at least 50% of the reorganized debtor's stock (by vote and value);[24]

-- those shareholders and creditors must receive their 50% stock ownership in discharge of their interest in and claims against the debtor; and

-- stock is received by qualified creditors only if and to the extent that it is received in satisfaction of indebtedness that (a) had been held by the creditor for at least 18 months on the date of the bankruptcy filing (*i.e.*, was "old and cold"), or (b) arose in the ordinary course of the debtor's business

[23] For ease of exposition, I will treat section 382(l)(5) as elective, even though the statute rather curiously works the other way: the 382(l)(6) rule, which clearly predominates in the real world, is technically elective, whereas the 382(l)(5) rule, which is used only occasionally but is potentially very valuable, is the default setting.

[24] Although the statute does not itself create any holding period requirement, the IRS has suggested informally that transitory ownership of stock by qualified creditors may not be respected. *See* CCA 200444002 (July 22, 2004) (in outlining steps that should be taken in auditing loss corporation in a 382(l)(5) case, Service should "verify that a sufficient proportion of qualified creditors (preferably 50 percent) retained their stock in Reorganized Debtor for a reasonable (not transitory) period of time after the bankruptcy plan is consummated.") *See generally* Berg and Mahmoudov, "Selected Federal Income Tax Issues Arising in Corporate Debt Restructurings," 789 PLI/Tax 151, 220 (2007).

and is held by the person who at all times held the beneficial interest in that indebtedness.

EXAMPLE 12

Since BigBank had held the Acme debt for more than 18 months when Acme filed for bankruptcy, Acme can make use of 382(l)(5) if it chooses to do so.

6. If a debtor chooses to fall within 382(l)(5), it has to take the bitter with the sweet.

a. The Bitter

i. If a debtor undergoes a second change of ownership within two years of the first one, it will be treated as having a zero limitation on its NOLs from and after the date of the second change.[25] This result is normally so cataclysmic that debtors rarely use L5 without imposing sufficient limitations on the transferability of large amounts of the stock issued in the reorganization so as to absolutely guarantee that no second change can occur within two years. Some classes of claimants are radically opposed to limitations of this sort.

EXAMPLE 13

Same as Example 12, except that Acme has two classes of creditors: BigBank and unsecured creditors (most of whom are bottom-fishing arbitrageurs interested in a quick turnaround on their investment). If BigBank ends up with 51% of the Acme stock (with the holders of the unsecured claims getting the remainder), L5 is still available to Acme (since more

[25] *See* PLR 200751011 (Dec. 21, 2007). *See also* Willens, "The Impact of a Second Ownership Change," 118 Tax Notes 747 (Feb. 11, 2008).

than half of the stock of the reorganized debtor is going to an old and cold creditor),[26] but Acme may find it difficult to structure such a result unless BigBank is willing to take stock that cannot be sold for at least two years. If BigBank insists that all creditors -- including the holders of unsecured claims -- agree to tie up 51% of their new stock for two years (rather than having BigBank tie up all of its shares), the arbs may refuse, and Acme may have to settle for 382(l)(6) unless some or all of the arbs are less than 5% shareholders and therefore generally not taken into account in determining whether a second change of ownership has occurred post-emergence.

ii. If creditors receiving stock of the reorganized debtor (in addition to Big Bank) are willing to accept restrictions on stock trading, the reorganized debtor may be able to use some combination of partial restrictions on sales by various holders and accumulations by would-be acquirors to make sure that a second change of ownership cannot take place.

EXAMPLE 14

BigBank owns 51% of Reorganized Acme; the rest of the shares are widely held. Acme can prevent a second change of ownership from occurring in several ways:

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[26] If none of the arbs (acting individually or in concert) ends up owning as much as 5% of the reorganized debtor's stock, rather generous rules set forth in the 382 regulations may allow the debtor to ignore the fact that the arbs are neither old and cold nor ordinary course. *See* Treas. Reg. § 1.382-9(d)(3). See IV.A.7, *infra*, for a discussion of the Service’s application of these rules to investment funds under common management.

-- Restrict BigBank's[27] 51% stock interest from being transferred for at least two years.[28]

[27] As a theoretical matter, limiting BigBank's ability to sell its 51% stock interest is not an absolute guarantee that a change of ownership will not take place: BigBank itself could be acquired by a third party, which would have the effect of causing an indirect change of ownership of Reorganized Acme. Concerns of this sort keep tax professionals awake at night, but in the real world it may not be possible to make the problem go away, because BigBank's shareholders are not party to these arrangements and it is doubtful that a bankruptcy court injunction against change-of-ownership sales at the BigBank shareholder level would be enforceable.

[28] In fact, many L5 transfer restrictions extend for substantially longer than the two years within which a second change of ownership will result in a zero 382 limitation. This reflects the fact that, not only is it important to avoid losing the benefits of section 382(l)(5) through a prompt second change of ownership, but even after the two-year period has passed a subsequent change of ownership would impose a 382(a) annual limitation on the use of any remaining NOL carryforwards, which could materially reduce the value of using 382(l)(5) in the first place. Consideration should therefore be given to limiting stock trading for as long as the debtor thinks is reasonably necessary to use all of its NOL carryforwards. And imposing limitations on stock trading for, say, ten years is not as Draconian as it might seem: in the typical case, the board is free to lift the restriction if it concludes that the restriction is no longer necessary or useful (because, for example, the NOLs have all been used or a potential acquiror has appeared).

The use of sponsored rights offerings to raise cash from creditors (as well as from the sponsor itself) in connection with the debtor's emergence from bankruptcy raises some intriguing 382(l)(5) issues. *See, e.g., In re Northwest Airlines Corp. et al.,* No. 05-17930, *disclosure statement* (Bankr. S.D.N.Y. Mar. 15, 2007).

Interestingly, the IRS recently ruled that it will ignore a transaction by a 5% shareholder that apparently caused a change of ownership during a bankruptcy case where the transaction was in violation of a stock trading injunction, and where the bankruptcy court judge ruled that the portion of the trade in excess of 5% would be treated as void *ab initio*. PLR 200713015 (Dec. 20, 2006). *See generally* Willens, "Recent Ruling Illustrates Scenario Where 'Ownership Change' Can Be Reversed," Daily Tax Report (April 19, 2007). The ruling seemed to place considerable emphasis on the fact that the portion of the trade that had to be voided was itself less than 5% of the loss

-- Restrict transfers of all stock issued to creditors other than BigBank to prohibit any one individual or entity (acting individually or in concert) from accumulating as much as 5% of the Acme stock, and require BigBank to hold on to at least 2% of the Acme common for two years (which, when added to the 49% shares going to those other than BigBank, assures that 51% of Acme's common will not trade or be treated as trading).

-- Some combination of the two, such as letting BigBank transfer up to 25% of the Acme stock, while prohibiting more than 25% of the stock not held initially by BigBank from ending up in the hands of 5% shareholders.

iii. A debtor's NOLs will suffer a statutory "haircut" if L5 is used. That haircut consists of the interest deductions that (a) increased the debtor's tax loss during the last 3+ years before the change date and (b) were generated with respect to debt being discharged for stock in the plan of reorganization.[29]

EXAMPLE 15

Same as Example 9 (that is, after making a 108(b)(5) election and giving effect to the attribute reduction rules of sections 108 and 1017, Acme has $15 million in NOLs). If Acme qualifies for and elects to use 382(l)(5), its NOLs will not be subject to any future 382 limitation on usage, but must first be reduced to the extent that they reflect prior interest deductions

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corporation's outstanding shares, thereby perhaps suggesting that the IRS will be more receptive to requests for absolution from small foot-faults than from large ones.

[29] *See* section 382(l)(5)(B).

> subject to the haircut set forth in section 382(l)(5)(B). If, for example, Acme accrued interest deductions on its BigBank debt of $5 million per year for each of the past three years and Acme had taxable losses of exactly that amount in each of those years, then Acme's NOLs would be entirely eliminated if L5 were chosen.

iv. It is important to note that the interest haircut is limited to interest deductions attributable to debt discharged with stock of the debtor. Deductions attributable to interest on debt whose recovery comes in the form of some other consideration, such as cash or new debt, are not subject to the haircut.

EXAMPLE 16

> Same as the first half of Example 15 (that is, Acme has $15 million of NOLs, but if its debt to BigBank is discharged for stock, Acme's NOLs will be entirely eliminated as a result of the L5 haircut rule). If Acme were instead to discharge its obligation to BigBank for a $40 million package of consideration made up of one-third cash, one-third new debt, and one-third stock, Acme's haircut would be limited to those interest deductions that were claimed during the last 3+ years with respect to that portion of BigBank's debt that is being discharged with stock.[30]

b. The Sweet

i. 382(l)(5) is the Nirvana of bankruptcy tax. In that golden land, once the haircut has been clipped (and sturdy handcuffs slapped on the wrists of

[30] See IV.B.2 n.167, *infra*, for a discussion of the issues surrounding the question of how one determines what portion of Acme's debt is being discharged for stock.

the reorganized debtor's shareholders to prevent a second change of ownership), section 382 has lost its sting. The effect on attribute value can be dramatic.

EXAMPLE 17

> Same as Example 15 with no L5 haircut (that is, Acme qualifies for L5 and emerges with $15 million in NOLs[31]). Since Acme is not subject to any 382 limitation on its NOL carryforward, Acme can shelter its first $15 million in taxable income[32] with its NOL carryforwards, even if that income is earned faster than the $1.820 million annual limitation that would have applied under 382(l)(6).

ii. A great deal of technical underbrush is carried away as well if L5 can be utilized. For example, the substantial complexities involved in determining whether a debtor has a NUBIL (*see* IV.A, *infra*) are irrelevant under L5, since there simply is no 382 limitation on any of the debtor's attributes, including built-in losses.

EXAMPLE 18

> Same as Example 11 (that is, Acme has a NUBIL of $15 million). As long as Acme can qualify for (and

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[31] Note that 382(l)(5) does not eliminate all the negative consequences of a typical bankruptcy reorganization: the attribute reduction system of sections 108 and 1017 works in exactly the same fashion whether the debtor's change of ownership is covered by 382(l)(5) or 382(l)(6). The only real difference between the two provisions (as far as determining the amount of the debtor's tax attributes upon emergence is concerned) is the 382(l)(5) haircut, which can impact only NOLs, not asset basis.

[32] For regular tax purposes, at least. See I.B.2 n.13, *supra*, for a discussion of the AMT rules on the use of NOL carryforwards.

elects to use) L5, the fact that Acme has a NUBIL is irrelevant -- all deductions otherwise attributable to Acme's built-in loss may be used to shelter future income without limitation under section 382.

D. Comparing Alternatives

1. Much of what follows in this outline involves alternative structures or elections that are available to the debtor in structuring its plan of reorganization. Although the basic rules outlined above concerning debt discharge and changes of ownership are relatively simple when viewed in isolation, those same rules -- when applied two or three or four at a time -- rapidly attain very substantial complexity that often renders the tax professional unable to be sure which combination produces the best tax result.

EXAMPLE 19

Same as Example 6 (that is, Acme has $20 million in NOLs and $105 million in asset basis). Acme has come to you to ask two questions: (a) should it plan to make a 108(b)(5) election? And (b) should it try to qualify for L5? Although there are only four cells in the resulting matrix, there is no intuitive way to answer this type of question without distilling each of the four outcomes to a single metric, and then comparing the answers. What is the proper metric?

2. The best approach is to compare the respective present values of the tax savings generated by the debtor's attributes for each possible structure on the date that the debtor emerges from bankruptcy. In order to carry out this analysis, a fairly large amount of information (much of it in the form of educated guesstimates) has to be assembled: (a) the debtor's enterprise (*i.e.*, debt-free) value, (b) the debtor's likely capital structure (*i.e.*, the amount of its debt and equity) on emergence, (c) the reorganized debtor's projected taxable income for the relevant projection period (three to five years, generally), (d) the appropriate discount rate to be applied to future tax savings, (e) etc.

3. Once this information has been assembled, the arithmetic exercise is usually straightforward.

EXAMPLE 20

Acme is trying to decide whether L5 would be better for it than L6 (assuming that it could qualify for L5 and would be able to achieve the needed post-emergence control of stock sales). Acme expects to have $20 million in NOLs and $45 million in asset basis, all of which relates to fifteen-year property depreciated on a straight-line basis. Acme expects to have gross income (taxable income before use of NOLs or recovery of asset basis) of $5.5 million per year for each of the first five years after emergence. Acme expects that, if it uses L5, its NOL haircut will be $12 million. If it uses L6, its annual limitation is assumed to be $1.5 million. (Acme is not in a NUBIL position.)

L6

Year	Gross Income	Unlimited Depreciation	Limited NOLs	Taxable Income	Tax Savings @ 40%	**PV Tax Saving @ 15%**
Yr 1	5.50	(3.00)	(1.50)	1.00	1.80	**1.57**
Yr 2	5.50	(3.00)	(1.50)	1.00	1.80	**1.36**
Yr 3	5.50	(3.00)	(1.50)	1.00	1.80	**1.18**
Yr 4	5.50	(3.00)	(1.50)	1.00	1.80	**1.03**
Yr 5	5.50	(3.00)	(1.50)	1.00	1.80	**0.89**
	27.50	(15.00)	(7.50)	5.00	9.00	**6.03**

L5

Year	Gross Income	Unlimited Depreciation	Unlimited NOLs	Taxable Income	Tax Savings @ 40%	**PV Tax Saving @ 15%**
Yr 1	5.50	(3.00)	(2.50)	0.00	2.20	**1.91**
Yr 2	5.50	(3.00)	(2.50)	0.00	2.20	**1.66**
Yr 3	5.50	(3.00)	(2.50)	0.00	2.20	**1.45**
Yr 4	5.50	(3.00)	(0.50)	2.00	1.40	**0.80**
Yr 5	5.50	(3.00)	0.00	2.50	1.20	**0.60**
	27.50	(15.00)	(8.00)	4.50	9.20	**6.42**

Therefore, on these assumptions, an L5 election would be worth a bit more than L6 -- $390,000 -- on a present value basis, but that's not very much. The pain and agony associated with an L5 election may not be worth it under these circumstances.

4. Interestingly, the relative attractiveness of 382(l)(5) and 382(l)(6) will vary with interest rates. The lower the applicable interest rate, the more attractive 382(l)(5) will become, all other things being equal: (a) lower prior interest rates will generally translate into a smaller L5 haircut, and (b) lower current interest rates will generate a smaller 382(l)(6) limitation post-emergence, thereby rendering a no-limitation result under 382(l)(5) more attractive.

II. Filing for Bankruptcy

A. Accrual of Post-Petition Interest -- The *Dow Corning* Decision

1. Corporations that file for bankruptcy generally stop making interest payments on their pre-petition debt. Indeed, heavily-leveraged corporations often find their cash-flow in bankruptcy dramatically improved by this simple fact. The tax question is whether an accrual basis debtor can continue to accrue interest deductions while in bankruptcy, despite the fact that interest payments are not being made currently (and in fact may never be made, depending on the terms of the eventual plan of reorganization).

2. The existing authorities have been divided.[33]

3. A decision involving Dow Corning analyzes in depth the issues posed by interest accrual during bankruptcy and comes down solidly in favor of continued accrual.[34]

EXAMPLE 21

> Dow Corning filed for bankruptcy in mid-1995. On its first two post-petition returns, it accrued deductions for interest at the contract rate on its pre-petition bank debt and capital borrowings even though it stopped cash payment of those amounts upon the filing. Dow Corning later submitted an informal claim for post-petition interest at the federal judgment rate on its trade debt. The IRS denied all post-petition interest deductions and filed a claim for

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[33] *Compare Zimmerman Steel Co. v. Comm'r*, 130 F.2d 1011, 42-2 U.S.T.C. ¶ 9697 (8th Cir. 1942) (accrual of interest deduction permitted even though no reasonable expectation that accrued interest would actually be paid); Rev. Rul. 70-367, 1970-2 C.B. 37 (taxpayer undergoing railroad reorganization permitted to accrue interest deduction despite no reasonable expectation of payment); *In re Cajun Elec. Power Coop., Inc.*, 185 F.3d 446, 455 (5th Cir. 1999) (debtor's obligation with respect to post-petition interest terminates only if and when debtor obtains discharge from bankruptcy court), *with In re Continental Vending Mach. Corp.*, 77-1 U.S.T.C. ¶ 9121 (E.D.N.Y. 1976) (accrual of interest deduction on unsecured debt denied until determination at end of case that sufficient assets exist to pay all claims plus post-petition interest); *Kellogg v. United States (In re West Texas Marketing Corp.*, 155 B.R. 399, 93-2 U.S.T.C. ¶ 50,637 (Bankr. N.D. Tex. 1993), *aff'd*, 94-1 U.S.T.C. ¶ 50,063 (N.D. Tex. 1993), *aff'd*, 54 F.3d 1194, 95-1 U.S.T.C. ¶ 50,296 (5th Cir. 1995) (similar). *See generally* Henderson and Goldring, *Tax Planning for Troubled Corporations* § 302 (2008 ed.).

[34] *In re Dow Corning Corp.*, 270 B.R. 393, 2002-1 U.S.T.C. ¶ 50,155 (Bankr. E.D. Mich. 2001) (Spector, J.).

administrative period expenses with respect to the alleged deficiency thus created.

4. At trial, the IRS took the position that the accrual of interest during bankruptcy was barred by section 502(b)(2) of the Bankruptcy Code, which generally precludes claims "for unmatured interest." While acknowledging that sections 726(a)(5) and 1129(b)(1) of the Bankruptcy Code can in tandem result in the payment of post-petition interest in those rare cases in which the debtor's assets are more than sufficient to pay all pre-petition claims in full, the IRS argued that this provision only operated to create a fixed liability once the case was at an end (and the necessary court determination made), thereby precluding accrual under the "all events" test during the case.

5. The Bankruptcy Court for the Eastern District of Michigan rejected the government's arguments with respect to the debtor's bank debt and capital borrowings. First, the court found unpersuasive the decisions in *Continental Vending* and its progeny, because they ignored the fact that the right of a creditor to receive interest was (in the case of bank debt and capital borrowings) contractual, not statutory, and nothing in the Bankruptcy Code seemed to deprive the creditor of its right to that interest. Relying on *Collier on Bankruptcy* among other authorities, the court reasoned that the "rule" against pre-petition interest set forth in section 502(b)(2) of the Bankruptcy Code is a "rule of liquidation practice rather than . . . a rule of substantive law." "A claim for such interest therefore retains its validity even if it has been disallowed. So while it is true that, as against the estate, 'interest stops accruing at the date of the filing of the petition,' . . . post-petition interest can accrue against the debtor notwithstanding 502(b)(2)."[35]

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[35] *Id*. at 400-01 (citing 4 *Collier on Bankruptcy* ¶ 502.01 (15th ed. rev. 2001).

6. Second, the court rejected the government's suggestion that the debtor's interest deduction should be denied because the debtor may have been insolvent at the time. In the court's words, "we summarily reject the proposition that an unconditional payment obligation becomes contingent -- *i.e.*, conditional -- in the event the obligor goes broke." After reviewing those cases that suggested that solvency was an appropriate consideration in determining the debtor's right to accrue interest, the court rejected them, concluding that "the imposition of some kind of solvency requirement in connection with section § 163 cannot be justified as reflecting the manifest will of Congress."[36]

7. Third, the court concluded that, since the debtor had taken the position that its obligation to pay post-petition interest to **trade** creditors arose under sections 726(a)(5) and 1129(b)(1) of the Bankruptcy Code (provisions that come into play at the close of the case), any interest accrual with respect to trade debt was not contractual in nature and therefore should not be accrued until the right to payment was determined.

8. Against this contentious background, the IRS surprisingly conceded the issue in late 2007. Adopting many of the arguments previously made by the taxpayer in *Dow Corning*, the IRS Chief Counsel reversed the government's prior litigation posture on the issue and concluded that current accrual is permitted.[37] Chief Counsel then went on to invoke the tax benefit rule in holding that, if the accrued interest is in fact not paid at the end of the case, the prior deduction must be recaptured. Query whether the accrued but unpaid interest is a debt whose discharge generates excluded COD income, rather than recapture income. In

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[36] *Id.* at 407.

[37] CCA 200801039 (Sept. 24, 2007).

many cases, this will be a distinction without a difference, but that may not always be the case. For example, if discharge is treated as generating excluded COD income and if a section 108(b)(5) election is made, the net result may well be to increase the debtor's post-emergence NOLs (admittedly subject to a section 382 limitation) while decreasing asset basis by a like amount. On the other hand, if discharge is treated as recapture income, existing NOLs will always be reduced first.[38]

9. Finally, what about pre-petition tax claims? Does interest ever run post-petition on them? The answer is yes, but only in those circumstances (certain property taxes, for example) in which the claims are secured by property worth more than the claim.[39] The Bankruptcy Code provision in question -- section 506(b) -- allows the holder of an oversecured claim to recover "interest on such claim, and any reasonable fees, costs, or charges **provided for under the agreement under which such claim arose**" (emphasis supplied). The key question in *Ron Pair* was whether 506(b) should apply to a tax claim, which by definition does not arise under any agreement. The lower courts had split on the question, but the Supreme Court decided that a literal reading of 506(b) -- that it only applied to consensual situations -- was not supportable from the legislative history or the purpose of the provision, and therefore held that the governmental claimant should recover interest post-petition if its claim were oversecured.[40]

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[38] Query also whether, in light of the CCA, accrual-basis debtors will effectively be required to accrue interest post-petition, because failure to do so might be treated as an unauthorized change in accounting method. Hopefully the answer is no, and the IRS will so hold.

[39] *See United States v. Ron Pair Enters, Inc.*, 489 U.S. 235, 89-1 U.S.T.C. ¶ 9179 (1989).

[40] For a discussion of the rate of interest that applies to oversecured tax claims in bankruptcy, see Jenks, "Filing for Bankruptcy:

B. Deductibility of Professional Fees

1. As all debtors soon discover, bankruptcy is a very expensive proposition. Not only do most debtors require the professional services of lawyers, accountants, and financial advisors, but under the terms of the Bankruptcy Code the debtor will also be responsible for paying the

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A Starter Kit for Corporate Tax Advisors," 789 PLI/Tax 1157, 1208-10 (2007). Note also that, prior to the enactment of section 511 of the Bankruptcy Code in 2005, the U.S. Supreme Court had ruled that the proper method for determining the interest rate that is to be applied to deferred property disbursements made in chapter 13 cases is the so-called prime-plus method, pursuant to which the national prime rate is treated as the starting spot and is augmented as necessary to account for the nonpayment risk posed by the debtor's particular financial position. *Till v. SCS Credit Corp.*, 541 U.S. 465 (2004). The Court plurality suggested in *dictum* that the decision in *Till* should resolve the same issue wherever it appears in the Bankruptcy Code, including section 1129(a)(9)(C), the provision that authorizes reorganized debtors to pay pre-petition priority tax obligations over a six-year period. Especially in light of the low interest rate environment that currently prevails, this decision suggested that debtors can and should take the position that the interest rate that should apply to deferred tax payments is the national prime rate (currently 5.25%) plus whatever additional amount is necessary to reflect nonpayment risk posed by the debtor's financial position. The resulting rate would in many cases be lower than the section 6621 rate currently 8.0% for corporate underpayments of more than $100,000 that the IRS frequently argues is the proper rate, and will almost always be lower than the generally higher interest rates that the states argue are applicable. Much of this analysis will change, however, for corporations that file for bankruptcy after October 17, 2005, the effective date of the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, P.L. 109-8, 119 Stat. 23 (Apr. 20, 2005) (the "BAPCPA"). That Act adds a new Section 511 to the Bankruptcy Code, which provides that the interest rate applicable to pre-petition and administrative period tax claims (as well as the interest rate applicable to deferred tax payments made under Section 1129(a)(9)(C) of the Bankruptcy Code) shall be the applicable rate under non-bankruptcy law. *See generally* Jenks, "The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: Summary of Tax Provisions," 77 Am. Bankr. L.J. 893, 902-03 (2005); *reprinted in* 790 PLI/Tax 345 (2007). This provision will generally increase the rate of interest that debtors pay on oversecured pre-petition tax claims or deferred tax payments made after emergence. It will also circumscribe dramatically the impact of the Supreme Court's decision in *Till*.

professional fees incurred by the creditor and other committees appointed by the U.S. Trustee.[41] In larger cases, total fees will be in the tens of millions of dollars -- or even more[42] -- before the debtor limps out of bankruptcy.[43]

2. From the debtor's point of view, more is at stake than just the amount of cash that must be paid out: there is also the crucial question of whether the fees can be deducted for tax purposes, or must instead be capitalized in some fashion. Unfortunately, the law in the area remains undeveloped, even after the issuance of the *INDOPCO* capitalization regulations, discussed below. For this reason, the issue is a lurking audit problem for every company that goes through bankruptcy.

3. The basic issue is whether professional fees incurred in a bankruptcy are ordinary and necessary expenses that may be deducted under section 162, or capital expenditures that cannot be.[44] Under *INDOPCO*,

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[41] *See* Bankruptcy Code section 503(b).

[42] To take a couple of extreme examples, the professional fees in Enron amounted to $780 million. If fees and services denied by the court are added back in, the total surpasses $1.8 billion. *See* Iwata, "Enron's Legacy: Scandal Marked Turning Point for Business World," USA Today (Jan. 30, 2006). The professional fees in WorldCom/MCI were $657 million. *See* Johnson, "UAL a Ch. 11 Fee Machine: Lawyers, Consultants, Bankers Have Already Raked in $240 million," Crain's Chicago Business (June 27, 2005).

[43] One recent study concluded that public companies generally incur professional fees equal to between 1% and 3% of the value of their assets, but that professional fees have decreased as a percentage of debtor assets over the past two decades as debtors and their professionals have become more familiar with the big-case bankruptcy process. *See* LoPucki and Doherty, "The Determinants of Professional Fees in Large Bankruptcy Reorganization Cases," 1 J. Empirical Legal Stud. 111, 141 (Mar. 2004).

[44] A third possible result -- that professional fees incurred by a debtor in bankruptcy might qualify as "specified liability losses" under section 172(f)(1)(B) that can be carried back ten years -- has been

capitalization is required to the extent that the expenditure produces significant benefits that will be enjoyed beyond the close of the current tax year.[45]

4. Cases dealing with the professional fees issue outside of bankruptcy have historically looked to the "origin of the claim" in resolving the question.[46] Pursuant to this analysis, legal expenses incurred in the negotiation of a new loan facility would be capitalized into the loan and amortized over its term, whereas expenses incurred in defending against a product liability action would be deductible currently as ordinary and necessary costs of doing business.

5. The Service's principal pronouncement on the topic before the *INDOPCO* regulations were issued -- Rev. Rul. 77-204[47] -- generally follows the origin of the claim approach by holding that expenses incurred in bankruptcy are deductible in the same manner that they would have been in the absence of a bankruptcy filing, but also takes the position that costs and expenses incurred with respect to the institution and administration of a bankruptcy reorganization (as opposed to a liquidation) are not deductible because those expenses will benefit the corporation in future years.

6. Considerable confusion was created by TAM 9204001 (May 13, 1991), which seemed initially to take the position that, under Rev. Rul. 77-204, costs incurred in defending against tort claims in bankruptcy were deductible as ordinary and necessary expenses because that would have

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rejected by the U.S. Court of Appeals for the Federal Circuit. *See Major Paint Co. v. United States*, 334 F.3d 1042 (Fed. Cir. 2003).

[45] *See INDOPCO, Inc. v. Comm'r*, 503 U.S. 79, 92-1 U.S.T.C. ¶ 50,113 (1992).

[46] *See, e.g.*, *United States v. Gilmore*, 372 U.S. 39, 63-1 U.S.T.C. ¶ 9285 (1963).

[47] 1977-1 C.B. 40.

been their treatment outside the bankruptcy setting. However, the ruling then seemed to change course and took the position that this rule only applied to costs incurred dealing with tort claims **outside** of bankruptcy, even though it was clear that the taxpayer in TAM 9204001 had filed for bankruptcy precisely because it wanted to resolve its tort claim problems **inside** bankruptcy.

7. The principal decided cases have not been very illuminating.

a. In *In re Placid Oil,*[48] the bankruptcy court agreed as a theoretical matter that some expenses (such as those incurred in objecting to creditor claims) would be deductible, but found that the taxpayer had not met its burden of proving which expenses qualified and therefore treated all expenses as capital on the theory that they were incurred in connection with a "reorganization." On appeal, the Fifth Circuit rejected the lower court's theory that all expenses could be swept into the capitalization category merely because the case involved a reorganization, and remanded for the lower court to classify the expenses as (a) currently deductible, (b) amortizable over the useful life of the underlying asset or transaction, or (c) allocable to nonamortizable intangible assets (and therefore permanently capitalized).[49]

[48] 140 B.R. 122, 92-1 U.S.T.C. ¶ 50,049 (Bankr. N.D. Tex. 1990), *aff'd*, 148 B.R. 464, 92-1 U.S.T.C. ¶ 50,051 (N.D. Tex. 1991), *nonacq*., 1995-16 I.R.B. 4, I.R.S. AOD 1995 WL 508737 (Apr. 17, 1995).

[49] *In re Placid Oil Co.*, 988 F.2d 554, 93-1 U.S.T.C. ¶ 50,234 (5th Cir. 1993).

b. More recently, in *In re Hillsborough Holdings Corp.*,[50] a bankruptcy judge in Florida held that all professional expenses incurred by the various creditor committees had to be capitalized as a matter of law since "'but for' the original bankruptcy filings, there would not have been these expenses incurred." On the other hand, the *Hillsborough* court did allow the debtor to deduct expenses that it incurred in connection with veil-piercing litigation, claims disputes, and credit facilities that were pursued but never created. Debtor expenses incurred in connection with case administration and plans of reorganization were capitalized.

8. Before the *INDOPCO* regulations (discussed immediately below) were promulgated, disputes over the portion, if any, of the professional fees the debtor could deduct were often difficult to resolve because of the "all or nothing" approach taken by taxpayers and the IRS in light of the uncertain state of the law.

EXAMPLE 22

> Acme files for bankruptcy to resolve thousands of product liability claims against it. During the first two years of the bankruptcy proceeding, Acme incurs $70 million in professional fees. On audit, the agent takes the position that all of Acme's fees must be capitalized because they were paid in connection with a "reorganization." Acme counters that the fees are all deductible because they were incurred to resolve tort claims. Neither side concedes any amount. Each of IRS Appeals and the bankruptcy court understandably refuses to wade through the thousands

[50] 2003-1 U.S.T.C. ¶ 50,394 (Bankr. M.D. Fla. 2003), *adopting and incorporating by reference* 99-1 U.S.T.C. ¶ 50,514 (Bankr. M.D. Fla. 1999).

of pages of documents that memorialize the individual activities to which the fees relate.

9. Against this background, the IRS in late December 2003 issued its long-anticipated final regulations governing the capitalization of intangible asset expenses.[51] These lengthy regulations address a large number of capitalization questions (including the treatment of bankruptcy fees), and represent a "peace treaty" of sorts in which the IRS concedes some ground (and some revenue) to promote administrative convenience and greater certainty for both sides.

10. With respect to bankruptcy fees, the new regulations generally follow the guidance previously set forth in Rev. Rul. 77-204: amounts paid to institute or administer a chapter 11 reorganization must be capitalized on the theory that they are paid to facilitate a reorganization. In this connection, the regulations provide that costs associated with the following types of activities are subject to mandatory capitalization in a reorganizing chapter 11 case: (a) preparing and filing the initial bankruptcy petition, (b) seeking an extension of exclusivity, (c) formulating a plan of reorganization, (d) analyzing plans of reorganization formulated by other parties in interest, and (e) obtaining approval of a plan.

11. The *INDOPCO* regulations break substantial new ground in several areas.

a. First, they take the position that amounts paid to formulate, analyze, contest or obtain approval of the portion of a plan of reorganization that

[51] T.D. 9107, 69 Fed. Reg. 436 (Jan. 5, 2004) (effective Dec. 31, 2003). *See generally* Blais, Jenks, and Wallace, "IRS Issues Final Regulations on Capitalizing Intangibles," *available at* www.jonesday.com, publications file (Mar. 2004).

resolves tort liabilities will be deductible so long as the amounts in question would have been deductible had the bankruptcy proceeding not been instituted. While this result is not as sweeping as several commentators had suggested,[52] it does represent a considerable retreat from the litigation position that the government had been advancing in cases like *Hillsborough Holdings*.

b. Second, the regulations announce the general proposition that amounts paid by the debtor to operate its business during a bankruptcy are not subject to automatic capitalization but should instead be treated on a "look-through" basis as if the bankruptcy filing had never taken place. While this statement is in some sense just a reiteration of the general approach announced in Rev. Rul. 77-204, its inclusion in the *INDOPCO* regulations should help restrain agents who are otherwise tempted to suggest a sweeping capitalization approach in non-tort cases.

c. Third, the new regulations contain several simplifying conventions that will be helpful to debtors, particularly the convention that employee compensation -- including compensation paid for secretarial and clerical services provided by outside contractors -- is not subject to automatic capitalization. This should allow the debtor to deduct its costs of claims reconciliation (and other similar activities) even if they are not related to tort claims.

12. A number of issues remain even after promulgation of the *INDOPCO* regulations.

a. The precise scope of the "institute or administer" rule remains uncertain. Particularly in the early stages of the case, the bankruptcy court will be involved in a

[52] *See, e.g.*, "E&Y Comments on Proposed Regs' Treatment of Professional Fees," 2003 TNT 213-22 (Oct. 14, 2003).

variety of ordinary course matters, such as employee compensation, utility contracts, and vendor disputes. If court involvement is the touchstone for capitalization, few if any professional fees will be deductible. On the other hand, the ordinary course exception should not be so broad as to swallow the general capitalization rule.

b. In multi-year proceedings, the debtor will make many determinations as to the proper tax treatment of an item while the plan is still being formulated. Under the general "origin of the claim" principle, tax characterization usually depends on a completed transaction. For this reason, the debtor may have to capitalize certain expenses provisionally and then deduct them or capitalize them on effectiveness of the plan.

13. Despite the uncertainties in this area, well-counseled debtors make every effort to classify their professional fee expenses on a contemporaneous basis into the three categories outlined in *Placid Oil*, in order to have the best chance of convincing an agent on audit that all the debtor's expenses should not be permanently capitalized.

III. Discharging Debt

A. Cancellation of Debt Income in the Consolidated Return Setting.

1. As noted earlier in this paper, COD income triggered in a title 11 case or when the taxpayer is insolvent is excluded from gross income by statute.[53] However, COD income thus excluded from gross income nevertheless reduces the corporate taxpayer's tax attributes (principally its NOLs and basis in assets) in the rather complicated fashion

53 *See* I.B.2, *supra*; section 108(a)(1).

outlined in the Internal Revenue Code.[54] Until recently, it was unclear whether COD income earned by one member of an affiliated group filing consolidated returns reduced the entire group's NOLs, or only the NOLs attributable to the member incurring the COD income.

EXAMPLE 23

> Acme and its wholly owned subsidiary file consolidated returns. Acme borrows $20 million from a bank, and contributes the proceeds to its subsidiary. The subsidiary spends the $20 million in a deductible fashion, generating a $20 million NOL at the subsidiary level, while Acme itself breaks even. Acme then files itself and its subsidiary for bankruptcy, and upon emergence discharges its $20 million bank debt for new Acme common stock worth $5 million. Does Acme's $15 million in COD income reduce the $20 million loss generated by the subsidiary from $20 million to $5 million? Or does Acme's COD income only reduce Acme's own attributes (here, its basis in assets, including its stock in its subsidiary)?

2. The IRS initially thought that affiliate COD income would only reduce NOLs allocable to that affiliate.[55] The statute, after all, specifically states that the tax attributes which must be reduced pursuant to section 108 are the attributes of "the taxpayer". Moreover, the provisions of section 1017(b)(3)(D) (requiring that affiliated debtors electing 108(b)(5) effectively look through to their subsidiaries when reducing asset basis) strongly suggest that Congress understood that section 108 operated on an entity-by-entity basis, unless otherwise specified.

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[54] *See I.B.2*, *supra*; sections 108(b) and 1017.

[55] *See* PLR 9121017 (Feb. 21, 1991).

3. A few years later, however, the IRS issued a Field Service Advice taking the position that a consolidated group that excludes COD income under section 108 must reduce its consolidated NOL by the amount of the COD income, even if the CNOL was not attributable to the member with the excluded income.[56]

4. Some read the Supreme Court's decision in *United Dominion Industries, Inc. v. United States*[57] as effectively resolving the issue in the Service's favor.[58] Not surprisingly, the IRS seemed to agree.[59]

5. In August 2003, Treasury issued temporary regulations (subsequently finalized in 2005) that resolve these issues in the government's favor and do so in a way that

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[56] FSA 199912007 (Dec. 14, 1998).

[57] 532 U.S. 822, 2001-1 U.S.T.C. ¶ 50,430 (2001).

[58] *See* Paul, "*United Dominion*: Implications for Attribute Reduction," 95 Tax Notes 262, 264-66 (Apr. 8, 2002).

[59] *See* CCA 200149008 (Aug. 10, 2001) (citing *United Dominion* in support of reducing CNOLs no matter where debt discharged). See the excellent discussion of these difficult issues in Dubroff et al., 1 *Federal Income Taxation of Corporations Filing Consolidated Returns* § 33.06[1] (2d ed. 2007). More recently (and long after the issuance of the consolidated attribute reduction regulations discussed *infra*), IRS Chief Counsel concluded that, for taxable periods prior to the adoption of those regulations, members of a consolidated group with excluded COD income must reduce NOLs and AMT credits on a single-entity (i.e., consolidated) basis, but need only reduce asset basis on a separate entity basis. CCA 200714017 (Dec. 1, 2006). In that internal legal memorandum, Chief Counsel also addressed several of the arguments to the contrary raised by the taxpayer in *United Dominion*, and concluded rather cavalierly that those arguments were "meaningless", "not reasonable", or both. For a critique of the CCA and more background to the new regulations, *see* Axelrod, "What's 'Reasonable' Before the Consolidated COD Regulations?," 54 Tax Practice 153 (June 1, 2007). *See also* Willens, "Reducing the Tax Attributes of a Consolidated Group Member," 115 Tax Notes 1069 (June 11, 2007).

may have a major impact on how corporate debtors will be taxed after emergence.[60]

a. Treasury started from the proposition that, since CNOLs would be available to a debtor member to offset COD income if that income were taxable, those same CNOLs should be subject to reduction on account of the debtor member's excluded COD income.

b. The regulations impose such a regime in a tiered fashion, however, subjecting all of the attributes of (or allocable to) the debtor member to reduction first.

EXAMPLE 24

> Acme borrows $20 million from Big Bank and uses the proceeds to buy business assets and liabilities that it uses in conducting its business. Acme discovers that the assets it purchased contain asbestos and that it has assumed the potential liabilities related to those assets, and so files itself and its consolidated subsidiaries for bankruptcy. Pursuant to a Plan of Reorganization, Big Bank's $20 million claim against Acme is discharged for 100% of Reorganized Acme's stock, which is worth $4 million (resulting in $16 million of COD income to Acme). At the time of emergence the Acme group has $20 million of NOLs, $5 million of which were produced by Acme, and $15 million of which were produced by other subsidiaries. The portion of the CNOL allocable to Acme is reduced first on account of Acme's $16 million of

[60] *See* Treas. Reg. § 1.1502-28T; T.D. 9089, 68 Fed. Reg. 52,487 (Sept. 4, 2003) (effective Aug. 29, 2003). The regulations are generally effective for discharges of debt that occur after August 29, 2003. Final regulations were issued on March 22, 2005. *See* Treas. Reg. § 1.1502-28. *See generally* T.D. 9192, 70 Fed. Reg. 14395 (Mar. 22, 2005) (effective Mar. 21, 2005).

COD income, but the CNOL attributable to its subsidiaries is not subject to reduction until Acme's basis in its assets (its basis in the purchased assets, plus its basis in its other assets, including the stock of its subsidiaries) has been reduced by the remaining $11 million of COD income.

c. Somewhat surprisingly, however, the regulations impose a look-through rule that provides that, in circumstances in which the attribute reduction rules result in the debtor's basis in stock of an affiliate being reduced, a parallel reduction in that affiliate's tax attributes, including not only its NOLs but also its own asset basis, must occur as well.

EXAMPLE 25

Acme borrows $20 million from BigBank, and uses the proceeds to buy the stock of Opco, a subsidiary of BigCorp. In connection with that purchase, Acme and BigCorp make an election to treat the transaction as an asset sale, so that Opco's basis in its own assets is $20 million, Acme's purchase price.[61] Acme and Opco file returns on a consolidated basis. Acme discovers that products Opco sold decades earlier contained asbestos, and decides to file both itself and Opco in bankruptcy. Pursuant to a plan of reorganization, BigBank's $20 million claim against Acme is discharged for 100% of Reorganized Acme's stock, which is worth $4 million. Prior to the promulgation of the regulations, Acme's $16 million in excluded COD income would have reduced Acme's basis in its Opco stock from $20 million to $4 million (assuming Acme had no NOLs), but Opco's basis in its assets would have remained at $20 million. Under

[61] *See* section 338(h)(10).

> the new regulations, however, there is a double reduction in basis: Acme's basis in its Opco stock is written down by $16 million (from $20 million to $4 million), and Opco's basis in its own assets is written down by the same amount.

d. The mechanic for producing this result is to "deem" Opco to have COD income in the amount of the reduction in its stock basis, **solely** for purposes of the attribute-reduction regime. Thus, for instance, if Opco has insufficient NOLs and asset basis to absorb its "deemed" COD, there are no further ricocheting reductions in CNOL or asset basis elsewhere in the group for that COD. This segregation of attribute reduction is designed to prevent COD income in one part of the consolidated group from inappropriately reducing attributes elsewhere in the group.

EXAMPLE 26

> Acme has two wholly-owned subsidiaries, SubA and SubB, and includes both of them in its consolidated return. Acme contributes $20 million to SubA, which spends it in a deductible fashion, generating a $20 million NOL at the SubA level. Meanwhile, SubB borrows $10 million from BigBank and uses those funds to buy the stock of Sub B-1, which generates an operating loss of $1 million. If SubB were to file for bankruptcy and realize $9 million in COD income in the process of restructuring its debt to BigBank, the ordering rules would provide that SubB's COD income would reduce its basis in its Sub B-1 stock by $9 million, to $1 million, which would in turn cause the reduction of the CNOL attributable to Sub B-1 from $1 million to $0, and the basis of Sub B-1's assets by the remaining $8 million of Sub B-1's "deemed" COD income. If, however, Sub B-1's basis in its assets is less than the remaining $8 million of

"deemed" COD, the CNOL attributable to Sub A is not affected.

e. In some circumstances, however, the COD income of one member of the group can ricochet to reduce NOLs -- but not basis -- of members of the group not in its own chain.

EXAMPLE 27

Same as Example 26, except that when Sub B files for bankruptcy its basis in its Sub B-1 stock has already been reduced to $7 million. Its $9 million COD reduces its $7 million basis in its Sub B-1 stock to $0, which would in turn result in Sub B-1 being treated as having $7 million in COD income, thereby eliminating Sub B-1's $2 million portion of the CNOL and up to $5 million in asset basis. The $2 million of COD income left unaccounted for would then bounce back out to reduce the $20 million CNOL allocable to Sub A by $2 million.

f. Because a lower-tier entity is treated as if it had COD of its own, the Section 1017 Liability Stop should apply to cut off basis reduction at each level under the look-through rule.

EXAMPLE 27A

Acme has a basis of $10 million in its Sub A stock, its sole asset, and will have debt of $5 million on effectiveness of a chapter 11 plan that includes Sub A. Sub A, in turn, has operating assets with a basis of $7 million and will have liabilities of $4 million on effectiveness of the plan. If Acme has COD income of $10 million and no other tax attributes, it will reduce its basis in its Sub A stock by only $5 million because of the Liability Stop. Sub A, in turn, will be deemed to have COD income of $5 million under the look-through rule, but will only reduce its basis in its assets by $3 million (to $4 million) because a separate Liability Stop applies to Sub A.[62]

g. The look-through rule does not require a reduction in inside asset basis in situations in which the debtor's basis in membership interests in pass-through entities (such as LLCs or partnerships) is being reduced,[63] and nothing in the partnership tax rules seems to produce that result independently. The draftsmen of the COD regulations apparently concluded that reducing the debtor's basis in its pass-through entity investment (but not the entity's own basis in its assets) was sufficient to eventually produce the desired effect, either by increasing the debtor's gain when it sells its interest, or by reducing or eliminating its ability to claim losses recorded at the pass-through entity level.[64]

h. Final regulations were issued on March 22, 2005.[65] Those final regulations address a number of technical issues, including (a) the apportionment of NOLs to a subsidiary when the subsidiary leaves the group, (b) the timing of asset basis reduction, (c) the application of the look-through rule to situations in which there is a reduction of the stock basis of a subsidiary that ceases to be a member of the consolidated group on the last day of the group's taxable year, (d) the identification of the attributes that are

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[62] Although intercompany indebtedness is cancelled in most plans, a bona fide loan from parent to sub that played through a bankruptcy would presumably be respected as a liability when determining the amount of the Liability Stop.

[63] Unless, of course, a section 108(b)(5) election has been made. *See* Treas. Reg. § 1.1017-1(g)(2).

[64] *See* section 704(d).

[65] *See* Treas. Reg. § 1.1502-28. *See generally* T.D. 9192, 70 Fed. Reg. 14,395 (Mar. 22, 2005) (effective Mar. 21, 2005).

subject to reduction where the member realizing the excluded COD income leaves the group (or its assets leave the group in a section 381 transaction), and (e) the application of the attribute reduction rules to situations in which, as a result of intragroup reorganizations or group structure changes, the taxable year of the member realizing the excluded COD income closes and the assets of that member are transferred to a successor member.

i. It is conceivable that taxpayers will take the position that the look-through portion of the new regulations is invalid, at least to the extent that it requires reduction in the basis of assets of members other than the debtor member.[66]

6. It is, of course, not just NOLs that are at stake. There are other items subject to potential reduction under section 108(b) that are consolidated tax attributes: (a)

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[66] An argument could be as follows: (a) the Internal Revenue Code allows corporate debtors to elect to reduce asset basis (rather than NOLs) first, but if that election is made in the context of a consolidated group, any reduction in stock basis must be replicated by a reduction in the asset basis of the subsidiary (*see* sections 108(b)(5)(b) and 1017(b)(3)(D)); (b) prior to issuance of the regulations, for those debtors who chose not to make this election, basis in subsidiary stock was treated just like any other asset, and a reduction in stock basis produced no parallel reduction in the subsidiary's asset basis; and (c) by purporting to in effect impose a mandatory look-through election on those taxpayers who file consolidated returns (but not on those who do not), the regulations violate the prevailing law on consolidated returns. *See Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001). However, Congress may well have taken this argument away legislatively by including in the AJCA a provision amending section 1502 for taxable years beginning before, on or after the date of enactment of the AJCA, to provide that in exercising its authority to issue consolidated return regulations under section 1502, the Treasury may prescribe rules treating corporations filing consolidated returns differently from corporations filing separate returns, thus overturning *Rite Aid* in this respect. *See* P.L. 108-57, § 844, 117 Stat. 858 (July 14, 2003).

foreign tax credits,[67] (b) minimum tax credits,[68] and (c) general business credits.[69]

7. Finally, should this question be impacted by whether the bankruptcy cases of the affiliates have been substantively consolidated under the Bankruptcy Code? I think not. Although there is one private ruling in which the Service took the position that substantive consolidation could have an impact on how the proportionality rules of the old stock-for-debt test should be applied,[70] the Service's theory of the CNOL issue does not seem to require (or be strengthened by) a procedural bankruptcy point like substantive consolidation.[71]

B. Planning Opportunities to Protect Subsidiary Asset Basis

1. As noted earlier, the reduction in asset basis that occurs under sections 108 and 1017 does not take place on the date that the debtor's COD income is triggered. Instead, it takes place "at the beginning of the taxable year following the taxable year in which the discharge occurs," and only impacts property held by the taxpayer at that time.[72] This little provision creates important planning opportunities.

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67 Treas. Reg. §§ 1.1502-4, -79(d).

68 Prop. Treas. Reg. § 1.1502-55.

69 Treas. Reg. § 1.1502-3.

70 S*ee* PLR 9105042 (Feb. 27, 1990).

71 *Cf.* FSA 199952016 (Sept. 24, 1999) (substantive consolidation of group of related partnerships did not merge the partnerships); FSA 200108004 (Oct. 24, 2000) (same).

72 *See* section 1017(a)(2). Interestingly, the general provision in section 108 governing the timing of attribute reduction is not precisely the same as the language in section 1017 (which is limited to one aspect of that process, namely, basis reduction under section 108(b)(2)(E)). According to section 108(b)(4)(A), the reduction of tax

EXAMPLE 28

> On June 30, Acme emerges from bankruptcy, triggering $60 million in COD income. At the time of emergence, Acme has no NOLs and owns two assets: Building A, which is fully depreciated, and Building B, in which Acme has a basis of $20 million. On September 30, Acme sells Building B for cash equal to its basis, *i.e.*, $20 million. On January 1 of the following taxable year, Acme will have no NOLs and a zero basis in its remaining asset, Building A. Therefore, Acme will not suffer any attribute reduction at all as a result of its COD income, and its $60 million in COD income will fall into the Black Hole without having any impact on Acme's tax attributes.[73]

2. In the consolidated return context, this year-end attribute reduction rule may create additional planning opportunities.

EXAMPLE 29

> Parent owns all of the stock of two first-tier subsidiaries, Sub 1 and Sub 2. On June 30, Sub 1 incurs COD income of $50 million at a time when Sub 1 is either in bankruptcy or more than $50 million insolvent. Sub 1 has $30 million in NOLs

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attributes called for by section 108(b)(2) "shall be made after the determination of the tax imposed by this chapter for the taxable year of the discharge." By contrast (and as noted in the text), section 1017(a)(2) calls for the basis reduction to take place at the beginning of the next taxable year.

[73] *See* 15 *Collier on Bankruptcy* ¶ TX6.03[4][b][ii] (15th ed. rev. 2007). I do not read the applicable provisions of section 1017 or Treas. Reg. § 1.1017-1 as resulting in a basis reduction in Acme's cash. Therefore, Acme should not be required to reduce its basis in its $20 million sale proceeds to reflect its COD income.

> and a zero basis in its depreciable property. On December 31, Parent contributes the stock of Sub 2 (with stock basis and basis in its assets of at least $50 million) to Sub 1; sometime after the beginning of the following year, Sub 1 distributes the stock of Sub 2 back to Parent. Sub 1 makes a section 108(b)(5) election with respect to its attribute reduction responsibilities under section 108. Pursuant to the provisions of section 1017(b)(3)(D), Sub 1 can treat its stock in Sub 2 as depreciable property for 1017 purposes if Sub 2 consents to a corresponding reduction in the basis of its own depreciable property. The consequences are as follows: (a) Sub 2's basis in its depreciable property is reduced by $50 million; (b) Sub 1's $30 million in NOLs are preserved, and (c) Parent's basis in its Sub 2 stock is reduced by $50 million.[74]

3. The net result of this scenario is that Sub 1 was able to preserve its entire NOL carryforward in exchange for eliminating depreciable basis in assets of Sub 2. Especially if Sub 2's depreciable assets were long-lived, this maneuver could create a very substantial present value benefit to the Parent consolidated group.[75]

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[74] *See* PLR 9650019 (Sept. 11, 1996) (simplified).

[75] One should note, however, that the preamble to the temporary consolidated COD regulations announced that IRS and Treasury are considering adopting rules "to address the effect of transitory transactions and other transactions designed to avoid the application of the rules concerning attribute reduction." T.D. 9089, Fed. Reg. 52,487, 52,490 (Sept. 4, 2003) (effective Aug. 29, 2003). Query whether these rules, if eventually adopted, will change the results of transactions such as those described in PLR 9650019. In any event, the preamble to the final regulations announced that no additional rules with respect to transitory transactions were needed at this time in light of the availability of general tax principles like the step transaction doctrine. *See* T.D. 9192, 70 Fed. Reg. 14,395 (Mar. 22, 2005) (effective Mar. 21, 2005).

4. Before the issuance of the consolidated COD regulations, it appeared that the 108/1017 rules -- and the Service's interpretation of them in situations like PLR 9650119 -- would permit a debtor to protect its basis in assets by transferring them to a subsidiary before the end of the year of discharge.[76]

EXAMPLE 30

> Parent has a basis in its Sub stock of $100 million; both are in bankruptcy. In connection with their plan of reorganization, Parent contributes its headquarters building (in which it has a basis of $30 million) to Sub as part of an overall financing strategy designed to concentrate all of the Parent group's real estate assets in Sub. As a consequence of the contribution, Parent's basis in its Sub stock will go from $100 million to $130 million, and Sub will take a carryover basis of $30 million in the headquarters building. On January 1 of the following year, Parent's basis in its Sub stock will be reduced by the amount of Parent's COD income -- $80 million -- from $130 million to $50 million. Prior to the promulgation of the look-through rule, Sub's basis in its assets -- including the headquarters building -- would have been unaffected by Parent's COD income. Under current law, however, Sub would be treated as having $80 million of COD income, and would reduce its basis in its assets -- including the headquarters building -- by a like amount. If the contribution of the headquarters building to Sub produces a materially better result for Parent and Sub than keeping the headquarters

[76] The government has occasionally contested results flowing from a literal reading of the 108 rules in the consolidated return context, but without much success. *See, e.g., CSI Hydrostatic Testers, Inc. v. Comm'r*, 103 T.C. 398 (1994), *aff'd per curiam*, 62 F.3d 136, 95-2 U.S.T.C. ¶ 50,476 (5th Cir. 1995).

> building at the Parent level,[77] it is possible that the IRS could argue on audit that the basis reduction rules should be applied as if Parent still owned the headquarters building.[78]

5. In the summer of 2001, the IRS issued a Field Service Advice[79] in which it concluded that the rules of 108/1017, when combined with the rules applicable to "G" reorganizations, would permit debtors to avoid asset basis reduction altogether when they emerged from bankruptcy.

EXAMPLE 31

> Acme is in bankruptcy. Pursuant to its plan of reorganization, Acme transfers substantially all of its assets to New Acme in exchange for all of the stock of New Acme, and distributes that stock to Acme's creditors in a transaction qualifying as a "G" reorganization. Acme realizes $60 million in COD income in the reorganization, all of which is excluded from income under 108(a)(1). At the beginning of the next taxable year, when Acme sets about to reduce its asset basis for 1017 purposes, it will find that it no longer owns any assets, since they have all been previously transferred to New Acme. Therefore,

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[77] Assume that some of the other assets held by Sub have built-in losses subject to a 382 limitation stemming from a prior change of ownership of Sub at a time when it was in a NUBIL position. If Parent contributes the headquarters building to Sub, some of the $80 million in COD income deemed recognized by Sub will reduce its basis in the built-in loss assets at relatively little present-value tax cost, while allowing some of the headquarters basis to be preserved. The result may be a net positive for the Parent/Sub group.

[78] *See* T.D. 9089, 68 Fed. Reg. 52,487 (Sept. 4, 2003) (effective Aug. 29, 2003) (Preamble). However, assuming that Parent can show a bona fide effort to concentrate its real estate assets in Sub, such an argument would be unlikely to prevail.

[79] FSA 200145009 (July 31, 2001).

> there are no assets whose basis Acme can reduce, nor is New Acme's basis in those assets subject to any reduction.[80]

6. While the question was not free from doubt, there was a persuasive argument -- based on analogous decisions in the S corporation area -- that when the debtor's NOLs migrated to the debtor's transferee in a "G" reorganization, they would also remain untouched by any attribute reduction triggered by the debtor's COD income, just like the asset basis involved in FSA 200145009.[81] The statutory changes made by the Job Creation and Worker Assistance Act of 2002 in an effort to statutorily reverse *Gitlitz* were limited to S corporations[82] and did not purport to affect the jurisprudence and commentary in this area that suggested that in a G reorganization NOLs migrated to the transferee under section 381 without any attribute reduction taking place under 108/1017.[83]

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[80] *Id*. *See also* Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 12.30[3] at 12-166 & n.552 (7th ed. 2007) (reaching same result).

[81] *Cf. Gitlitz v. Comm'r*, 531 U.S. 206, 2001-1 U.S.T.C. ¶ 50,147 (2001); *United States v. Farley*, 202 F.3d 198, 2000-1 U.S.T.C. ¶ 50,179 (3d Cir. 2000).

[82] *See* P.L. 107-147 § 402, 116 Stat. 21, 40 (Mar. 9, 2002).

[83] Note that it should be possible to structure an acquisitive transaction as a G reorganization even if the vast majority of the consideration flowing from the acquiror to the creditors consists of cash or other boot. In determining whether the continuity of interest requirement is met in a G reorganization, the most senior class of creditors receiving stock of the acquiring corporation (along with the creditors in all equal or junior classes) will be considered the proprietors or equity owners. *See* S. Rep. No. 96-1035, at 36-37 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7050-52; *Atlas Oil & Refining Corp. v. Comm'r*, 36 T.C. 675 (1961). *See generally* Henderson and Goldring, *Tax Planning for Troubled Corporations* § 605.1.4 (2008 ed.). *Accord*, Prop. Treas. Reg. § 1.368-1(e)(6) (in measuring continuity of interest in G reorganization context, proposed "no net value" regulations bifurcate

7. New Regulations. On July 17, 2003, Treasury issued temporary regulations that effectively reversed the IRS's prior Field Service Advice and held that any tax attributes to which the acquiring corporation succeeds in a "G" reorganization (including the basis in assets transferred to the acquiring corporation by the debtor) are subject to reduction for COD income just as if they were still owned by the debtor.[84] As a result, until and unless the "G" regulations are held to be invalid,[85] it will not be

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most senior class getting stock into creditor claim and proprietary interest, then treat all more junior classes as entirely proprietary). Therefore, even though a large amount of cash and other boot in the reorganization goes to senior secured and/or bank lenders who are not receiving stock, continuity of interest can still be met -- and the overall transaction can still qualify as a G reorganization -- so long as (a) a substantial portion of the recovery that goes to junior classes receiving stock (50 percent under traditional IRS ruling guidelines) is in the form of stock and (b) at least one of the creditors receiving stock or securities qualifies as a securityholder for tax purposes. Note also that the proposed "no net value" regulations would generally make it easier for continuity to be met in these circumstances. *See* Prop. Treas. Reg. § 1.368-1(e)(6). *See generally* Silverman et al., "Assessing the Value of the Proposed No Net Value Regulations," 108 Tax Notes 1135, 1147-50 (Sept. 5, 2005).

[84] *See* Treas. Reg. §§ 1.108-7T and 1.1017-1T; T.D. 9080, 68 Fed. Reg. 42,590 (July 18, 2003) (effective July 17, 2003). These temporary regulations are effective for discharges of indebtedness occurring after July 17, 2003. Subsequently, on May 10, 2004, the Service issued final and temporary regulations superseding the July 2003 temporary regulations. *See* Treas. Reg. §§ 1.108-7 and 1.1017-1(b)(4)); T.D. 9127, 69 Fed. Reg. 26,038 (May 11, 2004) (effective May 10, 2004). These final and temporary regulations broaden the temporary regulations in certain technical respects. *See also* CCA 200444002 (Oct. 29, 2004) (applying "G" reorganization regulations).

[85] It is not out of the question that a court faced with the issue might find the "G" regulations invalid. The preamble to the regulations placed central reliance on an example in the legislative history to the Bankruptcy Tax Act of 1980 that (according to the preamble) shows that "Congress specifically anticipated that amounts that carry over in a transaction described in section 381, including the basis of transferred property, are to be adjusted under the rules of sections 108 and 1017 to account for excluded COD income." T.D. 9080, 68 Fed. Reg. 42,590 (July 18, 2003) (effective July 17, 2003) (citin*g* H.R. Rep. No. 96-833, at 32-34; 2d Sess.; H.R. 5043 (1980)). The example to

possible to use a "G" reorganization to shelter asset basis or NOLs from 108/1017 COD reduction.

C. Taxable Sale of Assets to Creditors -- The Bruno's Maneuver

1. While tax-free recapitalizations and G reorganizations are often tax-efficient, there are occasions when a better result can be achieved if the debtor's assets can be purchased by the creditors at fair value.

EXAMPLE 32

> Acme is in bankruptcy. It has $15 million in NOLs and its assets have a NUBIG of $15 million (value of $40 million versus basis of $25 million). If Acme is recapitalized or transfers its assets to New Acme in a G reorganization, then Reorganized or New Acme will take a carryover basis in those assets of $25 million. On the other hand, if Acme were to sell its

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which the preamble refers is set forth in the section of the House report dealing with continuity of interest in a "G" reorganization. *See* H.R. Rep. No. 96-833, at 32-34; 2d Sess.; H.R. 5043 (1980). In that example, two sets of creditors received stock in connection with the reorganization, and COD income was triggered in connection with one class of creditors but not the other. When the legislation moved to the Senate and the Senate report was prepared, the same example showed up again, but with one major change: the example now concluded that no COD income would be triggered with respect to either class, and therefore the language from the House report dealing with attribute reduction resulting from COD income in a "G" reorganization context does not appear in the Senate report. *See* S. Rep. No. 96-1035, at 33-39 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7047-53. Therefore, a court might well conclude that, in light of the context in which it arose, the House example is no authority at all, because it was essentially displaced by the Senate report and became nothing more than a footnote to history, rather than a solid expression of Congressional intent, and that the most natural reading of the statute is the one adopted by FSA 200145009, Bittker and Eustice, and (by analogy) the *Gitlitz* court. *See generally* Schanne, "Comment in Opposition to T.D. 9080," 2003 TNT 195-12 (Sept. 10, 2003) (letter from Young Conaway Stargatt & Taylor, LLP to Office of Chief Counsel).

> assets for their fair value, the purchaser would take a $40 million basis in the assets, and Acme would be able to shelter the entire gain by using its $15 million NOL.

2. Until recently, bankruptcy reorganizations in which the debtor's creditors retained control were almost always structured as tax-free transactions, either simple recaps (in those cases in which the creditors exchanged their claims in the debtor for the debtor's new stock) or "G" reorganizations (in which the creditors caused the old debtor to transfer assets to a new entity controlled by the creditors on a tax-free basis). Nevertheless, there is nothing to prevent debtors and creditors from structuring plans of reorganization that are taxable.

EXAMPLE 33

> Same as Example 32. Acme sells most (but not all) of its assets to some of its creditors (or perhaps their legal representative) in satisfaction of $35 million in creditor claims. The creditors (or their legal representative) then convey those assets to New Acme in exchange for its common stock. Acme then cancels its existing common stock and distributes all of its new common stock to its creditors in satisfaction of their remaining $60 million in claims. Acme retains its headquarters building indefinitely and enters into a triple net lease on the building with New Acme.

3. This transaction -- often called the Bruno's maneuver, in recognition of its first publicized use -- should be treated as a taxable transaction, in which Acme recognizes gain (which it uses most of its NOLs to offset), and the creditors, and then New Acme, take a fair market value basis in the transferred assets.[86] Acme will recognize COD income when it issues its new shares to the creditors in exchange for the claims not acquired in the sale transaction, and that COD income will presumably eliminate New Acme's NOLs and its basis in its headquarters building (unless the Liability Stop happens to -- or can be enticed to -- come into play), but the majority of the COD income should end up in the Black Hole.

4. In order for Acme's transaction to work, it must be structured so that it defeats any IRS attempts to classify it as a "G" reorganization. That means that the distribution of stock to the creditors has to fall outside both section 354 and section 355.[87]

a. In order to qualify under section 354, Acme has to transfer substantially all of its assets to New Acme, and then distribute its remaining assets (along with the New Acme stock) to the creditors pursuant to the plan of reorganization.[88] The transaction as structured clearly flunks the second prong (because Acme is retaining its headquarters building and not distributing it), and may flunk the first prong (if the retained assets are enough to prevent the transferred assets from constituting "substantially all," presumably under the relaxed test applicable to "G" reorganizations).

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86 *See generally* Henderson and Goldring, *Tax Planning for Troubled Corporations* § 709 (2008 ed.); Hart, "Restructuring the Bankrupt Corporation," 790 PLI/Tax 127, 179-188 (2007); Einhorn, Canellos, and Schwartz, "Critical Federal Income Tax Issues Relating to Corporate Restructurings," 789 PLI/Tax 491, 499-506 (2007); Woll, "Post Bruno's Bankruptcy Planning: An Analysis of Taxable Emergence Structures," 4 DePaul Bus. & Comm. L.J. 277 (2006).

87 *See* section 368(a)(1)(G).

88 *See* section 354(b)(1).

b. In order to qualify under section 355, Acme would have to (a) distribute New Acme common to some creditors who hold tax securities,[89] and (b) continue to carry on an active five-year business.[90] The transaction as structured should flunk the second prong, because the retained real estate is subject to a triple net lease, and therefore does not meet the active trade or business requirement for 355 purposes.[91] It will also flunk the first prong, unless at least some of the New Acme stock goes to securityholders (*i.e.*, under a commonly-applied rule of thumb, creditors holding debt having an initial maturity of more than at least five -- and maybe as much as ten -- years).[92]

5. The Bruno's structure has now been employed in several public bankruptcies. Soon after the Bruno's transaction was disclosed, Lee Sheppard did her best to

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89 *See* sections 355(a)(1)(D)(ii) (80% requirement), and 355(a)(1)(A)(ii) (distributees must be holders of securities).

90 *See* section 355(b)(1)(A).

91 *See* Treas. Reg. § 1.355-3(b)(2)(iv), -3(c), Example (13); *Rafferty v. Comm'r*, 55 T.C. 490 (1970), *aff'd*, 452 F.2d 767, 72-1 U.S.T.C. ¶ 9101 (1st Cir. 1971). The Service's pronouncement that REITs are potentially capable of doing tax-free spin-offs under section 355 does not call this analysis into question, because the ruling only permits spin-offs where the active trade or business requirement is met, which will not be the case here. Rev. Rul. 2001-29, 2001-1 C.B. 1348.

92 In cases in which it is not clear whether all of the New Acme stock is going to non-securityholders, it may be possible to "bust" the 355 analysis in other ways, such as selling (or transferring as compensation) a class of non-voting (perhaps even preferred) New Acme stock to certifiable non-securityholders. While section 1123(a)(6) of the Bankruptcy Code generally prohibits the issuance of non-voting stock in a bankruptcy, that provision may not apply here, since the stock in question is not technically being issued by the debtor. Alternatively, it has occasionally been argued that stock that is treated as non-voting for tax purposes will not run afoul of section 1123(a)(6) if it votes in the event of a dividend default. *See, e.g.*, Henderson and Goldring, *Tax Planning for Troubled Corporations* § 206 (2008 ed.) (citing 5 *Collier on Bankruptcy* ¶ 1123.01 (15th ed.)).

muster some righteous indignation about it ("It is safe to say that if the Bruno's plan achieves the desired tax result, every reorganizing debtor will use it as a model"), but her heart didn't really seem to be in it.[93]

6. Despite Sheppard's concerns, the IRS National Office seems to have treated the Bruno's structure as nothing more than a variation on a theme that the IRS has (reluctantly perhaps) already embraced.[94] While the recap or "G" reorganization will often be preferable when the debtor is in a NUBIL position (since it will result in the reorganized debtor or New Acme having a higher basis in its assets), the Bruno's taxable approach will often produce better results where the debtor's assets are appreciated in value, or where the debtor's COD would cause a drastic reduction in the debtor's asset basis (or the asset basis of its consolidated subsidiaries, or of its successor in the "G" reorganization context).[95]

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[93] *See* Sheppard, "When Is a Transaction a Tax Shelter?," 85 Tax Notes 984, 985 (Nov. 22, 1999).

[94] *See* CCA 200350016 (Aug. 28, 2003) (Bruno's-type transaction neither G reorganization nor section 351 asset contribution).

[95] Although the area is extremely murky, it is possible that section 346(g)(1)(C) of the Bankruptcy Code will cause New Acme to take a carryover basis in its assets for state tax purposes in a Bruno's transaction. But it is hard to know. Not only are the technical statutory construction issues extremely complex, but the validity and enforceability of section 346 itself (which purports to impose on the states a complicated set of tax rules designed to prevent state taxation from undermining the broad goals of the Bankruptcy Code) has to be considered open to at least some question, in light of the sovereign immunity issues raised by several recent Supreme Court decisions. *See, e.g.*, *Seminole Tribe of Fla. v. Florida*, 517 U.S. 44 (1996); *Fed. Mar. Commission v. S.C. Ports Auth.*, 535 U.S. 743 (2002). *Cf. Cent. Va. Cmty. Coll. v. Katz*, 546 U.S 356 (2006) (restricting scope of *Seminole Tribe*). *See generally* Henderson and Goldring, *Tax Planning for Troubled Corporations* § 1005.1 (2008 ed.). In any event, the impact of section 346(g)(1)(C) of the Bankruptcy Code -- whatever it may otherwise be -- will dissipate over time: effective for bankruptcies filed after October 17, 2005, section 346 has been completely rewritten by the BAPCPA, and no longer includes the language that currently appears in

D. Dealing With Contingent Liabilities

1. The 108/1017 statutory scheme implicitly assumes that the debtor can figure out what its liabilities are. When the debtor is facing situations in which contingent liabilities are involved, difficult questions arise.

EXAMPLE 34

> Same as in Example 3: Acme has $20 million in NOLs and $55 million in asset basis; it will be triggering $60 million in COD income and will have $30 million in liabilities outstanding immediately after emergence; it is therefore subject to the Liability Stop, because, after eliminating its $20 million in NOLs, Acme only reduces its basis from $55 million to $30 million (the amount of its post-emergence debt), thereby causing $15 million in COD income to drop into the Black Hole. The additional fact is this: Acme has rejected a large pre-petition contract with a supplier, and the damage claims arising from that rejection -- which Acme adamantly denies -- have not yet been determined (and indeed are not expected to be resolved until a year or two after Acme emerges from bankruptcy). How should Acme's contingent liability for rejection damages be treated in applying the Liability Stop rule?

2. As a mechanical matter, there would appear to be three possible approaches:

a. Treat the contested claim as not constituting a liability immediately after discharge for

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section 346(g)(1)(C). *See* BAPCPA § 719. *See generally* Jenks, "The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005: Summary of Tax Provisions," 79 Am. Bankr. L.J. 893, 910-12 (2005), *reprinted in* 790 PLI/Tax 345 (2007).

purposes of the Liability Stop calculation, and then deduct as a period cost the entire amount of the allowed claim once it is fixed and determinable.

b. Include the entire amount of the contested claim as a liability immediately after discharge for purposes of the Liability Stop calculation (thereby minimizing the asset basis reduction), and then increase the amount of asset basis reduction if and to the extent that the claim is resolved at a lower level.

c. Exclude the entire amount of the contested claim from the initial Liability Stop calculation (thereby maximizing the asset basis reduction), and then decrease the amount of asset basis reduction if and to the extent that any portion of the claim is eventually allowed.

3. There appears to be no authority directly on point.

a. In a decision involving the question of whether a debtor can take contingent liabilities into account in proving insolvency for purposes of section 108(d)(3), a divided Ninth Circuit panel held that a taxpayer can take a contingent liability into account only if it can prove that it is more probable than not that the liability will in fact have to be paid.[96]

b. For what it's worth, *Merkel* seems wrongly decided, because it creates an all-or-nothing rule that does not appear to reflect the true economic condition of the debtor, which might be viewed as subject to an obligation in an amount equal to the expected value of the contract

[96] *See Merkel v. Comm'r*, 109 T.C. 463 (1997), *aff'd*, 192 F.3d 844, 99-2 U.S.T.C. ¶ 50,848 (9th Cir. 1999).

damages (*i.e.*, the weighted average of various award levels times their respective probabilities).[97]

c. It is conceivable, I suppose, that the government might argue that *Merkel* should apply in the Liability Stop area as well, with the result that Acme would only be able to include its rejection damage liability in its 1017(b)(2) calculation if it could prove that it was more likely than not that it would have to pay the contested amount. Otherwise, it would presumably be excluded from the calculation.

d. Ironically, of course, this approach would in many cases favor the taxpayer: by blithely failing to meet the more probable than not standard, Acme could presumably follow the first of the three suggested alternatives -- *i.e.*, exclude the contingent liability from the Liability Stop calculation but then deduct whatever is eventually paid as a period expense -- and thereby achieve what will often be the best result.

e. Ignoring contingent liabilities altogether seems entirely consistent with the statutory language, which focuses on "liabilities of the taxpayer immediately after the discharge." It also results in a far simpler world for taxpayers and IRS alike.[98]

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[97] *Accord*, Henderson and Goldring, *Tax Planning for Troubled Corporations* § 404 (2008 ed.). *Cf.* Raby and Raby, "Measuring Assets and Liabilities for DOI Purposes," 85 Tax Notes 77, 78 (Oct. 4, 1999) (describing *Merkel* as "a victory for taxpayers generally").

[98] *Cf.* IV.A.2, *infra* (treatment of contingent built-in items of income and deduction in NUBIG/NUBIL context). *See also* IV.D, *infra* (year of emergence issues on similar facts).

E. Uncertainties Where Debtor Is a Disregarded Entity

1. U.S. corporations are increasingly discovering the benefits that can be derived from using disregarded entities to hold and operate businesses.[99] It is therefore only a matter of time before practitioners -- and bankruptcy judges -- will find themselves pondering how section 108's exclusion of COD income triggered in bankruptcy should apply where the obligor is a disregarded entity.

EXAMPLE 35

> Acme conducts one of its businesses through a single-member LLC, Sub, which is treated for tax purposes as a disregarded entity. Acme and Sub both have significant liabilities, and it is determined that a bankruptcy filing should take place. Acme therefore files itself for bankruptcy, but it is decided that Sub should remain outside bankruptcy for customer relations reasons. As a result of global negotiations with the principal creditors of Acme and Sub, Acme compromises its debts pursuant to a plan of reorganization, whereas Sub's debts are compromised pursuant to a settlement with Sub's creditors. It seems clear that Acme has COD income from the discharge of the Sub debt, since Sub is generally ignored for federal income tax purposes, and a debt of Sub has been discharged for less than its adjusted issue price. The question is whether the section

[99] *See generally* White and Wright, "Disregarded Entities in Corporate Transactions," 772 PLI/Tax 1007 (2007); Silverman and Zarlenga, "Use of Limited Liability Companies in Corporate Transactions," 772 PLI/Tax 1059 (2007); Steinberg and Mendelson, "The Use of Partnerships and Disregarded Entities by U.S. Corporations," 81 Taxes 261 (Mar. 2003); Teitelbaum, "A Disregarded Entity Must Be Taken Into Account," 97 Tax Notes 1205 (Dec. 2, 2002), *reprinted in* 773 PLI/Tax 9 (2007).

108(a)(1)(A) bankruptcy exclusion will apply at the Acme level with respect to this COD income.

2. The law on this question has yet to develop.

a. On the one hand, the government might argue that the discharge of Sub's debt did not "occur in a title 11 case" (because the discharge involved Sub and the discharge was not "granted by the court" nor was it "pursuant to a plan approved by the court"[100]), and that therefore the bankruptcy exception does not apply, with the consequence that Acme can only avoid recognizing the COD income on Sub's discharge if and to the extent that Acme can show that it is insolvent.

b. On the other hand, Acme might argue that, since Sub is generally ignored for federal income tax purposes, the discharge of Sub's debt **did** "occur in a title 11 case" for tax purposes, because the discharge involved an obligation of a mere branch of Acme for tax purposes and Acme **is** in bankruptcy.

3. Note how the tables are turned if Sub files for bankruptcy, but Acme does not.

a. Now it is the government's turn to argue that, since Sub is ignored for all federal income tax purposes, the discharge of the Sub debt **did not** "occur in a title 11 case" for tax purposes because Acme is not in bankruptcy, and that therefore the COD income on Sub's debt discharge can be excluded from income by Acme only if and to the extent that Acme can prove that it is insolvent.

b. By contrast, Acme will argue that, since the debt discharge clearly took place pursuant to a plan

[100] *See* Section 108(d)(2).

of reorganization in a bankruptcy proceeding in which it must be deemed to be involved (since its "branch" is), any COD income resulting therefrom must be covered by the bankruptcy exception.

4. One would hope that the IRS and the courts will eventually resolve these issues by focusing on the status of the disregarded entity's owner, not the disregarded entity itself. In other words, if Acme is in bankruptcy, then COD income triggered by the restructuring of the Sub debt should be automatically excluded by the bankruptcy exception, whether Sub is also in bankruptcy or not. On the other hand, if Acme is not in bankruptcy, then COD income triggered by the restructuring of the Sub debt should only be excluded from Acme's income to the extent that Acme is insolvent, even if Sub has filed for bankruptcy.[101] On a literal reading of the statute, however, this result may be hard to reach.[102]

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[101] *Accord*, Cummings, "The Disregarded Entity Is and Isn't (Disregarded)," 99 Tax Notes 743, 746 (May 5, 2003). *See also* Treas. Reg. § 1.1445-2(b)(2)(iii) (disregarded entity not transferor for withholding tax purposes). *Cf.* PLR 200315001 (Sept. 19, 2002) (no debt modification where obligor converted from corporation to disregarded entity); Treas. Reg. §. 1.752-2(k)(1) (in determining partner's economic risk of loss for a partnership liability, the payment obligations of a disregarded entity are taken into account only to the extent of the net value of the disregarded entity); ILM 200338012 (Sept. 19, 2003) (disregarded entity not an "other person" for federal tax purposes, including collection of employment taxes under section 3505(a), and treated like single member owner for purposes of assessment); Rev. Rul. 2004-88, 2004-32 I.R.B. 165 (providing that a disregarded entity that is the general partner in a limited partnership will be regarded as a "pass-thru partner" (as defined in section 6231(a)(9)) and may be designated the tax matters partner of such partnership under section 6231(a)(7)); Treas. Reg. § 301.7701-2(c)(2)(ii), (iii) (disregarded entity treated as separate entity if it is a bank, for purposes of certain Federal tax liabilities and for purposes of refunds or credits of Federal tax); Treas. Reg. § 301.7701-2(c)(2)(iv), (v) (rule providing for disregarded entity status does not apply for purposes of employment taxes and certain excise taxes).

[102] *See generally* Hoffer, "Give Them My Regards: A Proposal for Applying the COD Rules to Disregarded Entities," 107 Tax

F. COD Income in Corporate Liquidations

1. In a typical chapter 11 bankruptcy reorganization, there is no doubt that the debtor is being discharged from its pre-petition debts, whether they are paid in full or not, because the Bankruptcy Code so states.[103] By contrast, however, the Bankruptcy Code makes it just as clear that, if "the plan provides for the liquidation of all or substantially all of the property of the estate," the corporate debtor's unpaid debts are not discharged.[104] Congress enacted this provision in 1978 to avoid trafficking in corporate NOLs. At that time, it was possible for a bankrupt entity to be restored to life without diminution of its tax attributes. Rather than attack the tax attributes themselves, Congress made the liquidating entity unattractive by not discharging its unpaid debts, thereby subjecting any after-acquired assets to the unsatisfied claims of the corporation's pre-bankruptcy creditors.[105] The tax question raised by these provisions is whether liquidating bankruptcies give rise to COD income.

2. There does not appear to be any controlling authority on point. The argument against the triggering of COD income in a liquidating bankruptcy is a simple one: the

Notes 327 (Apr. 18, 2005) (arguing that section 108 should be amended to subject disregarded entities to COD rules). *See also* Cuff, "Indebtedness of a Disregarded Entity," 81 Taxes 303 (Mar. 2003); Bennett, "To Be or Not to Be, That is the Question: Disregarded Entities and Debt Modification," 81 Taxes 9 (Dec. 2003).

[103] *See* section 1141(d)(1)(A) of the Bankruptcy Code (confirmation of plan "discharges the debtor from any debt that arose before the date of such confirmation").

[104] *See* section 1141(d)(3)(A) of the Bankruptcy Code.

[105] *See* S. Rep. No. 95-989, at 129, 130 (1978), *reprinted in* 1978 U.S.C.C.A.N. 5787, 5915-16; H. Rep. No. 95-595, at 418 (1977), *reprinted in* 1978 U.S.C.C.A.N. 5963, 6374. *See also In re Goodman*, 873 F.2d 598, 602 (2d Cir. 1989); *NLRB v. Better Bldg. Supply Corp.*, 837 F.2d 377, 378 (9th Cir. 1988).

Bankruptcy Code expressly bars discharge in a liquidation, and without a discharge there can be no COD income.[106] The argument in favor of triggering COD income in these circumstances is equally simple: since the distribution of the debtor's assets to its creditors renders the debtor completely unable to pay any other debts, they must be treated as discharged if form is not to prevail over substance.[107]

3. The IRS recently issued a private letter ruling[108] that lends at least some support to the argument that COD income does not arise in a liquidating case, at least so long as the corporate shell remains in place. In that ruling, the IRS concluded that a liquidating cooperative would not have to recognize income with respect to unsatisfied patronage equity (which the cooperative had previously deducted) because, under the Bankruptcy Code, the holders' rights to that equity were unaffected by the proceeding. By analogy, this ruling can be read as suggesting that a liquidating corporation should not have COD income either, because the creditors' rights with respect to unpaid claims are unaffected by the liquidation.[109]

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[106] The case of *Friedman v. Comm'r*, 216 F.3d 537, 545-46 (6th Cir. 2000), might be read as providing some support for this general view.

[107] The case of *Cozzi v. Commissioner*, 88 T.C. 435, 448 (1987), might be read as providing some support for **this** general view. *See also Benson v. Comm'r*, T.C. Memo 2004-272 (debt discharged at moment it becomes clear that debt will never have to be paid).

[108] PLR 200414019 (Apr. 2, 2004).

[109] Another recent ruling concludes that a section 382 change of ownership does not occur in a liquidating bankruptcy in which the holders of common and preferred stock were given pro rata interests in a common equity trust and a preferred equity trust, respectively, on the off-chance that the liquidation might result in some recovery. PLR 200445020 (Nov. 12, 2003). This ruling can be read to be broadly consistent with the cooperative COD ruling discussed in the text: until there has been a legal extinguishment of rights in a liquidating bankruptcy, no taxable event has taken place.

4. And in response to those who continue to argue that rulings like the liquidating cooperative ruling would lead to an overly formalistic result were they applied to corporate liquidations in bankruptcy, one might suggest that the tax and bankruptcy worlds can be reconciled by saying that, so long as the liquidating debtor is still in existence and has not completed the process of distributing all of its assets (and could theoretically, though on its deathbed, yet be revived), section 1141(d)(3) of the Bankruptcy Code governs and no COD income has been triggered. On the other hand, once the liquidation has been completed and the debtor has been dissolved (or otherwise ceased legal existence, such as by being struck from the corporate registry of its state of incorporation), the purpose that section 1141(d)(3) was designed to serve has become irrelevant, and therefore no harm would be done by concluding that debt discharge has now occurred for tax purposes.[110] This interpretation allows a liquidating corporation to avoid COD income (and attendant loss of NOLs and basis) during what may be a multi-year process of distributing, selling off or otherwise disposing of assets, while still eventually closing the tax books on the corporation at the end of the day.

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[110] Two recent cases in the S corporation context support this view. *See Friedman v. Comm'r*, 216 F.3d 537 (6th Cir. 2000); *Alpert v. United States*, 430 F. Supp. 2d 682 (N.D. Ohio 2006). *See generally* Henderson and Goldring, *Tax Planning for Troubled Corporations* § 404.8 (2008 ed.).

IV. Undergoing a Change of Ownership

A. 382(l)(6) Practice Pointers

1. "Stuffing" Permitted Up To Debtor's Gross Asset Value

a. It is often thought that a loss corporation's 382 limitation cannot be increased by "stuffing" it with assets on the eve of the change date. This belief stems naturally enough from the terms of the statute, which specifically provides that "[a]ny capital contribution received by an old loss corporation as part of a plan a principal purpose of which is to avoid or increase any limitation under this section shall not be taken into account for purposes of this section."[111]

b. Nevertheless, this rule is subject to a major exception in the bankruptcy context that has the effect of allowing the debtor's 382 limitation to be increased quite substantially as a result of assets being transferred to the debtor in connection with the plan of reorganization. Treas. Reg. § 1.382-9(j) provides that the value of a loss corporation under 382(l)(6) is the lesser of (a) the value of the loss corporation's stock immediately after the ownership change, or (b) the value of the loss corporation's pre-change assets.

EXAMPLE 36

> Acme's assets are worth $40 million. Acme has a business deal with its creditors that Acme can emerge from bankruptcy if it conveys $30 million in senior debt and all of Acme's stock (presumptively worth $10 million, the difference between gross asset value of $40 million and the $30 million in new debt Acme

111 *See* section 382(l)(1)(A).

will be issuing) to the creditors. If this is done, the 382 value of Acme will be $10 million -- Acme's stock value -- since Acme's stock value is less than its gross asset value of $40 million. Acme's 382 limitation will therefore be only $455,000 (4.55% times $10 million).

EXAMPLE 37

Same as Example 36, except that, as part of the plan of reorganization, another company worth $40 million merges with and into Acme, with Acme's creditors receiving the same consideration they received in Example 36 ($30 million in debt and $10 million in Acme stock) while the shareholders of the other corporation receive $40 million in Acme stock. On these facts, the value of Acme for section 382 purposes will be $40 million -- Acme's gross asset value -- since Acme's gross asset value is less than its stock value immediately after emergence ($50 million). Acme's section 382 limitation will therefore be $1.820 million (4.55% times $40 million).

c. While this result may at first glance seem to violate the basic anti-stuffing rule set forth in section 382(l)(1), it properly reflects the conclusion of the drafters of the regulations that in the bankruptcy context stuffing produces the same economic result as emerging from bankruptcy debt-free, and should therefore not be punished.[112]

[112] *See* CO-88-90, 57 Fed. Reg. 34,736, 34,738 (Aug. 6, 1992), *reprinted in* 1992-2 C.B. 616, 618, *promulgated as final regulations by* T.D. 8530, 1994-1 C.B. 136. Note that Treas. Reg. § 1.382-9(k)(4) expressly disables the operation of section 382(l)(1) in this context.

2. Built-in Gain and Loss in the Change of Ownership Context

a. As noted earlier in this paper,[113] if a debtor undergoes an ownership change on emergence from bankruptcy and falls within the 382(l)(6) regime, the 382 limitation will apply to both the reorganized debtor's NOLs (if any have successfully run the 108/1017 gauntlet) and any deductions claimed with respect to the debtor's NUBIL during the first five years after emergence.[114] In September 2003, the IRS issued a notice (the "NUBIL notice") setting forth the Service's views on a wide range of technical issues that had arisen in the NUBIL area.[115] While a detailed description and analysis of this extensive and complex notice is beyond the scope of this paper, several key aspects of the notice should be mentioned.

i. There is a growing sense in the bankruptcy tax bar that the many technical issues addressed in the NUBIL notice may never be resolved in a fashion that is fully satisfactory from a philosophical and policy point of view. The best evidence of this may be the recently issued

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[113] *See* I.C.4, *supra*.

[114] *See* section 382(h).

[115] *See* Notice 2003-65, 2003-40 I.R.B. 747 (Oct. 6, 2003). *See generally* Henderson and Goldring, *Tax Planning for Troubled Corporations* §§ 508.4.3, 508.4.4 (2008 ed.); Ponikvar, Kestenbaum and Jacobs, "Tax Pitfalls and Opportunities In and Out of Bankruptcy Proceedings," 790 PLI/Tax 205, 238 n. 41 (2007); Silverman, "Section 382," 790 PLI/Tax 599, 913-39 (2007); Anderson, "Comments Concerning Notice 2003-65 Under Section 382 of the Internal Revenue Code Regarding the Treatment of Recognized Built-in Gains and Losses," 790 PLI/Tax 1067 (2007); Einhorn, Canellos and Schwartz, "Critical Federal Income Tax Issues Relating to Corporate Restructurings," 789 PLI/Tax 491, 527 (2007); Raby and Raby, "BIGs, BILs, and Sections 1374, 338, and 382," 101 Tax Notes 621 (Nov. 3, 2003). *See also* Simon, "Compound Complexity: Accounting for Built-in Gains and Losses Under the AMT After an Ownership Change," 107 Tax Notes 477 (Apr. 25, 2005).

ABA Tax Section report on the NUBIL notice, which takes issue with many of the positions adopted by that notice and proposes a regime that differs in many significant respects from the one put forward by the IRS, but which does so while failing to achieve internal consensus on one of the most important issues under debate.[116] It may well turn out that this is one of those issues, like loss disallowance,[117] that is best resolved by adopting a single, reasonable answer, even if it is not necessarily the perfect answer.

ii. Prior to the issuance of the NUBIL notice, many thought that the determination of whether the reorganized debtor had a NUBIL interacted with the attribute reduction regime, that is, that the reorganized debtor should calculate its NUBIG/NUBIL position **after** giving effect to any asset basis reduction that took place pursuant to sections 108 and 1017 as a result of COD income triggered by the ownership change, even though that basis reduction would not actually take place until after the end of the year of the change.

EXAMPLE 38

> Same as Example 11 (that is, Acme does not make a 108(b)(5) election and its $60 million in COD income first wipes out its $20 million in NOLs and then reduces its asset basis from $105 million to $65 million). Prior to the issuance of the NUBIL notice, it appeared that, if Acme's assets were worth $40 million, then Acme would have a $25 million NUBIL (not a $65 million NUBIL), because its asset value

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[116] 2005 TNT 84-16 (Apr. 29, 2005); *reprinted in* 790 PLI/Tax 1067 (2007)..

[117] *See, e.g.*, "LDR Reform: Salem vs. Schler, Round 2," 106 Tax Notes 491 (Jan. 24, 2005) (Messrs. Salem and Schler failing, after extended debate, to reach consensus on "basis disconformity" method enunciated in Notice 2004-58).

should be compared to its adjusted asset basis of $65 million (rather than to its asset basis of $105 million before giving effect to section 1017).[118]

iii. That at least seemed to be the thrust of PLR 9226064,[119] where COD income occurred before the change date, but the basis reduction under 1017 probably took place right after the change date.[120] The IRS seemed to have rather sensibly concluded that it would be the height of formalism to determine whether the debtor had a NUBIG or a NUBIL on the change date without taking into account the imminent basis reduction that the debtor was inevitably going to suffer as a result of the prior COD event, even though technically the write-down would not be implemented until after the change date. The IRS seemed to have quite properly brushed past the statutory requirement of section 382(h)(3)(A) that the NUBIG/NUBIL calculation be made "immediately before an ownership change", but had instead concluded that the statute should be read with eyes wide open, taking into account all relevant circumstances on that date.

iv. In the NUBIL notice, the IRS took the position that COD income not taken into income because of the bankruptcy exclusion is not included in the calculation of the debtor's NUBIG or NUBIL as such. (In other words, on the facts of Example 38, the IRS apparently

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[118] As discussed further at IV.A.2.a.v, *infra*, some also argue in this case that the **entire** $60 million of COD income should be counted as part of "built-in-gains" for purposes of the NUBIG/NUBIL calculation, in which case Acme's NUBIL would be only $5 million.

[119] (Mar. 31, 1992).

[120] *See also* PLR 9409037 (Mar. 4, 1994) (ruling 11) ("The amount of Target's 'net unrealized built in gain' or 'net unrealized built-in loss' for purposes of section 382(h)(3) will be determined after taking into account any basis reductions under section 1017"); Silverman and Keyes, "Restructuring Corporate Debt," 430 PLI/Tax 1009, 1063 (1998) (same).

believes that Acme's NUBIL is $65 million, not $25 million.) However, for purposes of determining the amount of a debtor's post-change recognized built-in gain or loss, any basis reduction occurring as a result of the exclusion of COD income realized within the first 12 months of the recognition period will be treated as having occurred immediately after the ownership change. As a result, gain resulting from excluded-COD-induced basis reduction will qualify as recognized built-in gain, but will not be taken into account in determining the size of the debtor's NUBIG or NUBIL.

v. There are those who read the NUBIL notice as effectively including excluded COD income in the calculation of the debtor's NUBIG or NUBIL, and the authors of the ABA Tax Section's recent report on the NUBIL notice recommend that the notice be modified to explicitly so provide.[121]

(a) The statute calculates NUBIG/NUBIL by comparing "the fair market value of the assets of such corporation immediately before an ownership change" with "the aggregate adjusted basis of such assets at such time."[122] The NUBIL notice attempts to implement this rule by positing a hypothetical sale immediately before the ownership change of all of the corporation's assets for fair market value to a third party who assumes all the liabilities.[123] The question is whether this formulation should be read as saying that the liabilities that are being assumed in the hypothetical sale include those liabilities that are going to be discharged in the plan of reorganization (i.e., those liabilities whose discharge for less than adjusted issue price

[121] 2005 TNT 84-16 (Apr. 29, 2005); *reprinted in* 790 PLI/Tax 1067 (2007).

[122] *See* section 382(h)(3)(A)(i).

[123] Notice 2003-65, 2003-40 I.R.B. 747, Part III ("The 1374 Approach") (Oct. 6, 2003).

results in excluded COD income to the debtor), or only those liabilities that will survive the plan of reorganization. That is, should the loss corporation be accorded a presumption that its assets are worth at least the amount of its pre-discharge debt despite the obvious facts that the assets are not worth that much (hence the bankruptcy and discharge), and the debt will never be paid? Or should the statutory prescription be taken at face value?[124]

EXAMPLE 39

> Same as Example 38 (that is, Acme has assets with a basis of $105 million, and it discharges $100 million in debt with stock worth $40 million, producing $60 million of COD income). If the NUBIL notice is read to suggest that, in Acme's hypothetical sale to a third party, the amount realized by Acme is deemed to include Acme's $100 million in pre-petition debt which the third party is treated as having assumed (the "Liability Assumption Argument"), then the amount recognized by Acme in the hypothetical sale is $100 million. Acme would therefore have a NUBIL of only $5 million, since that is the amount of the loss that Acme would recognize on the deemed sale. By contrast, if the NUBIL notice is read to suggest that the third party would pay $40 million -- the apparent value of Acme's assets -- in cash or debt assumption, but would not assume any debt in excess of the fair market value of Acme's assets, then the amount recognized by Acme would be $40 million, and Acme would have a NUBIL of $65 million.

[124] It may be worth noting that the NUBIL notice first stipulates the basic rule that the assets must be treated as sold for fair market value, and then describes the "mechanics" of such a sale as including liability assumption. Reading this formulation as permitting -- let alone requiring -- a minimum valuation equal to debt subject to imminent discharge seems a bit of a stretch, to say the least.

(b) The purpose of the NUBIG/NUBIL regime is to ensure that built-in gains and built-in losses are properly reflected in the loss corporation's annual 382 limitation calculation. In essence, it treats the loss corporation's built-in losses, to the extent they exceed its built-in gains, as incurred but not recognized ("IBNR") losses, to borrow from the insurance world. Just as if all of the losses and gains were actually recognized before the ownership change, with the gains offsetting the losses and the excess losses (if any) constituting NOLs, the NUBIL regime tags those losses in excess of the amount of offsetting income as IBNR NOLs.[125] The upshot of this regime is to treat built-in losses and gains the same whether they are actually recognized before or after the ownership change.

EXAMPLE 40

> Same as Example 39 (that is, Acme has assets with a basis of $105 million and a value of $40 million). As part of its strategy for emerging from bankruptcy, Acme is planning to sell off its widget division assets, which are worth $1 million but have a basis in Acme's hands of $11 million. If there were no NUBIG/NUBIL regime in the Code, Acme's NOL limitation position would be dramatically different depending on whether Acme sold its widget division the day before emerging from bankruptcy or the day after. If the assets were sold the day before emergence, the $10 million loss thus generated would be added to Acme's pre-change NOLs (assumed to be $70 million) and would therefore be subject to a 382 limitation in subsequent years. By contrast, if the sale

[125] Conversely, of course, the NUBIG regime applies the same rationale to let the loss corporation's excess built-in gains increase the amount of usable pre-change NOLs as they would have been able to if they had actually been recognized pre-change.

> were to take place the day after emergence, in the absence of a NUBIG/NUBIL regime Acme's $10 million loss would be post-change and would therefore be available for use without limitation. The NUBIG/NUBIL regime largely eliminates this discrepancy by treating Acme in much the same way whether the sale of the widget division takes place before or after the change of ownership. It does so by treating built-in losses that are recognized during the five-year recognition period after emergence as if they had been recognized before the change of ownership to the extent of Acme's NUBIL, thus treating all of Acme's losses -- NOLs and net built-in losses recognized during the recognition period -- in the same way.

(c) By including all liabilities -- including those that will be discharged for less than their adjusted issue price when the bankruptcy plan of reorganization goes effective -- in the deemed sale price, the Liability Assumption Argument treats the debtor's assets as being worth at least as much as the debtor's liabilities, which is of course not true in the vast majority of bankruptcies. This would defeat the basic purpose of the NUBIG/NUBIL regime by producing dramatically different results depending on whether built-in loss assets are sold just before or just after the change date.

EXAMPLE 41

> Same as Example 40 (that is, Acme has assets with a basis of $105 million and a value of $40 million, it has pre-change NOLs of $70 million, and it intends to discharge its $100 million in debt by canceling its old stock and issuing all of its new stock to the holders of its debt). If the Liability Assumption Argument were the law, Acme's NUBIL would be $5 million (total asset basis of $105 million less amount recognized of

$100 million on the assumption by the buyer of Acme's liabilities). If Acme were to sell its widget division for a $10 million loss immediately before emergence, that loss would be added to Acme's pre-change NOLs and would therefore be subject to a section 382 limitation after emergence. By contrast, if the sale were to take place the day after emergence, $5 million of Acme's $10 million loss -- the amount in excess of Acme's NUBIL amount -- would be post-change (and not NUBIL) and therefore not subject to any section 382 limitation.

(d) A closer look at the ABA Tax Section's position may help to clarify what is at stake. The NUBIL notice basically focuses on those circumstances in which items that are recognized post-change should be treated as recognized built-in gain or recognized built-in loss. The ABA Tax Section's central contribution to the debate was its proposal that COD income that is "built-in" or "inchoate" on the change date should be treated as recognized built-in gain when it is recognized post-change. In the Tax Section's view, built-in COD income is indistinguishable in this respect from built-in gain in any other asset.[126]

(e) As a general rule, loss corporations that undergo an ownership change on emergence from bankruptcy do not emerge with "built-in" or "inchoate" COD. A reorganizing corporation by necessity discharges all debt that it cannot repay prior to emergence. Therefore, there can be no debt on a reorganized debtor's balance sheet that has built-in COD imbedded in it, for the simple reason that any debt still in existence on that date is expected to be repaid in full. Indeed, a corporate debtor cannot emerge from bankruptcy until the bankruptcy court

[126] *See* 790 PLI/Tax 1067, 1086-93 (2007).

concludes, based on factual evidence presented to it, that the plan is "feasible", i.e., that the reorganized debtor is capable of paying all of its remaining debts.[127] Another way of making this same point is to say that the Tax Section's principal focus seems to have been on loss corporations that undergo changes of ownership in the ordinary course of business, rather than as a result of a bankruptcy reorganization, and thereafter recognize COD income that was "built-in" or "inchoate" on the change date.

(f) Once the Tax Section decided to argue that built-in COD income should be treated as RBIG if it is recognized during the recognition period, it became necessary to argue that the hypothetical sale model of the Notice needed to somehow be adjusted to make room in the NUBIG/NUBIL number for built-in COD income recognized post-change. The Tax Section made several proposals as to how that adjustment could be made, but principally suggested that the fair market value of the loss corporation's assets be assumed to be no less than the adjusted issue price of the corporation's liabilities outstanding as of the beginning of the change date. That assumption was necessary because no benefit would be derived from treating built-in COD income as RBIG when recognized if the loss corporation's NUBIG/NUBIL amount were not previously increased to reflect the amount of built-in COD income. To illustrate:

EXAMPLE 42

> Immediately prior to an ownership change, LossCo has built-in COD income of $150, and a built-in loss with respect to its assets of $50. If LossCo's built-in COD income is not included in the NUBIG/NUBIL calculation, LossCo will be in a NUBIL position, and

[127] *See* Bankruptcy Code section 1129(a)(11).

therefore treating the eventual recognition of the built-in COD income as recognized built-in gain will not increase the 382 limitation. On the other hand, if the built-in COD income is taken into account, LossCo will be in a NUBIG position of $100. If its built-in COD income is recognized during the recognition period, LossCo's 382 limitation will be increased by $100, and $100 of the built-in COD income will be sheltered by LossCo's NOLs (assuming that LossCo is solvent and not in bankruptcy).

(g) But what application would this approach have in bankruptcy, where (a) the reorganized debtor will not have any built-in COD income after emergence, and (b) all COD income from pre-petition debt will be triggered on the change date, will be excluded from income by the debtor, and will result in a corresponding reduction of pre-change losses? The answer, according to the Tax Section, stems from the fact that the change date must necessarily serve double duty here: (a) it must be included in the pre-change period for purposes of determining the amount of income that can be offset without limitation by section 382; but (b) it must also be included in the recognition period for purposes of the treatment of built-in gains and losses. As a result, income (including COD income) that is built-in as of the beginning of the change date but that is realized on the change date will be taken into account in computing the loss corporation's NUBIG/NUBIL position, and will be treated as a recognized built-in gain or recognized built-in loss when triggered. To illustrate:

EXAMPLE 43

At dawn on the morning that its plan of reorganization is to go effective, LossCo has pre-petition debt of $200, and assets having an aggregate value and basis of $75. The plan provides for holders of LossCo debt to receive an aggregate recovery worth $75. If LossCo's NUBIG/NUBIL position were calculated at that moment (as the Tax Section recommends that it should be), LossCo would have a NUBIG of $125, because it has built-in COD income of that amount ($200 face amount minus $75 recovery) and no other built-in gain or loss in its assets. When the plan goes effective later that same day, LossCo recognizes a recognized-built-in gain of $125 when its built-in COD income is triggered. That income uses up the entire NUBIG of $125, even though as a technical matter LossCo's change date income is not subject to any 382 limitation at all. (Under existing law, COD income triggered as part of a bankruptcy reorganization is excluded from the computation of taxable income, and therefore would not use up any of the debtor's section 382 limitation. The Tax Section recognized that, if its proposal were adopted to include COD income in calculating the debtor's 382 limitation, then the COD recognized built-in gain triggered by the plan would have to be treated as using up the debtor's section 382 limitation to the extent that tax attributes subject to the section 382 limitation (e.g., pre-change NOLs, credits or capital loss carryovers) were reduced by that COD income. This would represent a change in current law.) When the dust settles at sunset on the effective date, LossCo has neither a NUBIG nor a NUBIL. (The authors of the Tax Section report were quite aware of the fact that there is something a bit puzzling about having built-in gain that is triggered on the change date both use up the increased 382 limitation created by the recognition of the recognized built-in gain and be outside the 382 regime altogether, but they argued that this was a discontinuity in the statute that has nothing to do with COD income. The heading to this section is entitled "Perceived Statutory Anomalies Surrounding Change Date Income".[128])

(h) Since the inclusion of built-in COD income in the NUBIG/NUBIL calculation will reduce (and frequently eliminate) an asset-based NUBIL, the Tax Section approach will reduce (and frequently eliminate) the extent to which built-in losses in a reorganized debtor's regular assets will be subject to a 382 limitation upon emergence. To illustrate:

EXAMPLE 44

Same as Example 43, except that LossCo's basis in its assets is $85, resulting in a built-in asset loss of $10. On these facts, LossCo would have a NUBIG of $115 ($125 in built-in COD income minus $10 in built-in asset losses). When the plan goes effective, LossCo recognizes $125 of recognized built-in gain when its built-in COD income is triggered, LossCo's 382 limitation is increased by $115 (the lesser of the COD income and the net NUBIG), and LossCo's NOLs are reduced from $200 to $75. LossCo's NUBIG of $115 would also be eliminated, but the fact that LossCo's built-in COD income exceeded its NUBIG position would not result in LossCo being treated as having a NUBIL. Therefore, the $10 in built-in asset losses would not be subject to the NUBIL regime when those losses are recognized.

[128] *See* 790 PLI/Tax 1067, 1073-1077 (2007).

(i) To summarize: The basic focus of the Tax Section's report is the situation in which a loss corporation undergoes an ownership change outside of bankruptcy at a time when it has built-in COD income. The Tax Section's recommendation that the hypothetical sale treat the buyer as assuming all of the loss corporation's debts even if some of them are subject to immediate discharge was mandated by its recommendation that built-in COD income be treated as recognized built-in gain when triggered during the recognition period. In a typical bankruptcy situation, the Tax Section recommends that the initial NUBIG/NUBIL calculation be done immediately before the plan goes effective, and that all debt be taken into account in the hypothetical sale. This will always result in debtors that would otherwise be in an asset-based NUBIL position having their asset-based NUBIL reduced (and frequently eliminated). When the plan goes effective later the same day, the built-in COD recognized built-in gain will be triggered, and the amount of the debtor's NUBIG will be reduced dollar-for-dollar, as long as the COD income reduces NOLs that would otherwise be subject to a 382 limitation going forward, or would end up in the "black hole". (The results are similar but somewhat more complicated if asset basis is reduced.) If and to the extent that the the debtor would otherwise have been in an asset-based NUBIL position, the result will be to free up built-in asset losses for future use without any 382 limitation.

(j) I think that many firms have assumed in the past that the NUBIG/NUBIL calculation was to be made after giving effect to the plan of reorganization. As a result, COD income triggered by the plan was implicitly treated as not recognized built-in gain and therefore the NUBIG/NUBIL calculation didn't need to be adjusted to take that income into account. The Tax Section's technical construct is somewhat different, and will reach a different (and more pro-taxpayer) result whenever the debtor would otherwise be in an asset-based NUBIL position.

This is true because it is only in the case in which the debtor is in an asset-based NUBIG (or break-even) position that the Tax Section's methodology leaves the debtor in the same position (i.e., NUBIG or break-even) after the inclusion of built-in COD in the NUBIG/NUBIL computation that it would have been in had built-in COD been ignored. Where the debtor would otherwise have been in an asset-based NUBIL position, the result of the Tax Section's approach will be to free up asset-based built-in losses for future use without any 382 limitation. (The amount of the NOL carryforward available on emergence from bankruptcy will of course remain the same in all instances.)

EXAMPLE 45

> Bigco decides to sell the stock of its subsidiary Acme to a management buy-out group. The total purchase price is $100 million, which is funded with $5 million in equity from management and $95 million in senior and subordinated debt. Bigco and Acme agree to make a section 338(h)(10) election in connection with the acquisition; as a result, Acme's initial basis in its assets is $100 million. Shortly after the closing, previously unknown (and un-indemnified) liabilities are discovered at Acme, and the holders of Acme's debt begin private discussions with potential investors. HedgeFund eventually emerges as the winning bidder for the Acme debt, agreeing to pay $10 million cash for it. A pre-packaged bankruptcy plan is negotiated and filed with the bankruptcy court. Pursuant to that plan, the Acme stock held by management will be canceled, and HedgeFund's $95 million in Acme debt will be exchanged for all of the new Acme common. By the time the plan goes effective, Acme's depreciation deductions have reduced the basis in its assets from their initial basis of $100 million to $85 million, but Acme still has a built-in loss in those assets of $75 million ($85

million basis less apparent value of $10 million). If the Liability Assumption Argument were the law, Acme would not be in a NUBIL position at all despite its economic built-in loss, because the hypothetical sale to a third party would produce a gain of $10 million -- amount recognized of $95 million (the deemed assumption of Acme's old debt) less basis of $85 million. As a result, HedgeFund could cause Acme to sell a built-in loss asset the day after emergence and the loss thus generated could be utilized by Acme without limitation. This result is comparable to the one that would have occurred if section 382(l)(5) had been available to Acme, but on these facts section 382(l)(5) would clearly not be available because HedgeFund is not a qualified creditor.

(k) As far as I am aware, no unified theory of bankruptcy tax attributes has yet emerged. It may be that, when and if such a theory is ever developed, the Liability Assumption Argument will somehow turn out to play a vital role. In the absence of such a theory, however, the Liability Assumption Argument seems in isolation to do some real damage to the existing statutory regime, by making the timing of built-in loss recognition extremely important, while raising the specter of trafficking in built-in losses by short-term investors. If the Liability Assumption Argument were accepted, we would end up with the vast majority of all bankrupt corporations being treated counter-factually as if they were in a NUBIG position, and we would arrive at that result by positing a hypothetical sale to a third party in which the deemed sale price will almost always exceed fair market value, often by extremely large amounts. This strikes me as a curious basis for resolving these important issues.

(l) At least until a unified theory emerges, a better approach to these issues can be found in the private rulings issued by the IRS in the Nineties (and discussed above at IV.A.2.a.iii.): do not include excluded COD in the NUBIG/NUBIL computation, but perform the NUBIG/NUBIL computation after giving effect to any asset basis reduction that actually takes place pursuant to section 108 and 1017 as a result of the COD income, even though that basis reduction does not actually take place until after the end of the year of the change.

EXAMPLE 46

> Same as Example 41 (that is, Acme has assets with a basis of $105 million and a value of $40 million, it has pre-change NOLs of $70 million, and it intends to discharge its $100 million in debt by canceling its old stock and issuing all of its new stock to the holders of its debt). As long as Acme does not make an election under section 108(b)(5) to cause its excluded COD income to reduce asset basis first, Acme will have a NUBIL of $65 million (asset basis of $105 million and value of $40 million). On the other hand, if Acme **does** make a section 108(b)(5) election, its $60 million in excluded COD income will be entirely absorbed through a reduction of Acme's asset basis from $105 million to $45 million, thereby yielding a NUBIL of only $5 million ($45 million of adjusted asset basis and value of $40 million).

This approach would appear to reach the right economic and policy results of (a) assuring neutrality between losses triggered before or after an ownership change and (b) preventing tax-motivated trafficking in losses, and would do so while avoiding the unrealistic economic assumptions implicit in the Liability Assumption Argument. While technically this approach does some damage to the statutory requirement that the NUBIG/NUBIL calculation be made "immediately before an ownership change,"[129] this result is one that the IRS has already reached in the private ruling context, and it is one that in my view interprets the statutory language appropriately, given all the circumstances.

b. In determining whether a debtor emerging from bankruptcy has a NUBIL whose deductions are subject to a 382 limitation, the statutory focus is not limited to asset value and basis. The provisions of section 382(h)(6) expand the strictly asset-based analysis of 382(h)(3)(A) to reflect items that surely are built in on the change date but are not reflected in the built-in gain or loss of the assets themselves.

i. Section 382(h)(6) provides that items of income or deduction that are taken into account within five years of the change of ownership and that are "attributable to" periods before the change date are to be treated as recognized built-in gains or losses in the year in which they are properly taken into account, and the NUBIL or NUBIG amount "shall be properly adjusted" to reflect these amounts.

ii. Prior to the issuance of the NUBIL notice, it seemed to me that the better reading of section 382(h)(6)(C) was that it required that the loss corporation determine at the time of the change of ownership what items of income and deduction attributable to the pre-change period existed as of the date of change, and then immediately reflect them in the NUBIG/NUBIL calculation.[130] This conclusion was based on the language of section 382(h)(6)(C), which -- while far from a model of clarity -- seemed to anticipate a hypothetical calculation

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[129] *See* section 382(h)(3)(A).

[130] *See* Jenks, "Tax Attributes in Bankruptcy," 592 PLI/Tax 981, 1037-38 (2003).

made at the time of the change of ownership,[131] rather than a retrospective adjustment of the original NUBIG/NUBIL calculation each time an item of income or deduction is actually reflected in income under sections 382(h)(6)(A) or 382(h)(6)(B).[132] The NUBIL notice confirms by implication that the IRS shares this view of the statute.

EXAMPLE 47

> Acme has an asset-based NUBIL of $65 million without regard to any built-in items under section 382(h)(6). Acme will emerge from bankruptcy on December 31, 2004, at a time when a pre-petition tort claim against Acme remains unresolved. Acme expects to resolve this claim in 2005, and has booked a liability of $2 million for this item in its fresh-start accounting balance sheet. Since Acme's payment to its tort claimant in 2005 will constitute a built-in item of deduction for purposes of section 382(h)(6)(B), Acme should increase its NUBIL as of the date of emergence from $65 million to $67 million to reflect the operation of 382(h)(6)(C).[133]

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[131] The NUBIG/NUBIL amount is to be adjusted "for amounts which **would be** treated as recognized built-in gains or losses under this paragraph **if such amounts were** properly taken into account . . . during the recognition period." Section 382(h)(6)(C) (emphasis supplied).

[132] *Accord*, Brock, "The Forthcoming Built-In Item Regulations: Issues for the Government to Address," 95 Tax Notes 97 (Apr. 1, 2002) ("Presumably items of [built-in income] and [built-in deduction] are considered in computing the NUBIG for purposes of the threshold determination regardless of whether they are actually taken into account during the Recognition Period").

[133] This would be the result under the NUBIL notice's "338 approach." Under the NUBIL notice's alternative "1374 approach," the unresolved tort claim would not be a built-in deduction item and would not increase the NUBIL because it is not yet "fixed" under the Section

iii. It would appear that this interpretation of the statute could, in certain circumstances, result in an asset-based NUBIG becoming an overall NUBIL, or vice-versa.

EXAMPLE 48

> Acme has an asset-based NUBIG of $5 million. If Acme's tort liability is $8 million rather than $2 million, then Acme is in fact in a $3 million NUBIL position (*i.e.*, the $5 million NUBIG is more than offset by the $8 million tort liability), even though its assets have built-in gain.

iv. Prior to the issuance of the NUBIL notice, it was not clear what was supposed to happen if a debtor's actual items of income and deduction were not equal to the amounts included in the initial NUBIG/NUBIL calculation pursuant to section 382(h)(6)(C).

EXAMPLE 49

> Same as Example 48 (that is, Acme has an asset-based NUBIG of $5 million, but is in a net NUBIL position of $3 million once its expected tort liability of $8 million is reflected in the calculation). If Acme ends up settling the tort liability for only $2 million, what is the analysis? Is Acme (with the benefit of twenty-twenty hindsight) now revealed to be a NUBIG company all along, thereby allowing Acme to amend its prior returns to eliminate any 382 limitation that it may have had to impose on its supposed built-in loss deductions? What happens if the tort liability isn't paid until the fifth year after

461 accrual rules. The 338 and 1374 approaches are discussed in the text that follows.

emergence, at a time when some of the post-change years are closed?

v. The NUBIL notice appears to take the position that subsequent events do not result in any revisions to the original NUBIG/NUBIL calculation. This strikes me as an appropriate result that is consistent with the need for administrative feasibility and taxpayer certainty in this area.

EXAMPLE 50

As of the change date, Acme believes that it is in a net $15 million NUBIG position, based on a $20 million asset-based NUBIG position, and a tort liability properly estimated at $5 million that it expects to resolve and pay in the year after it emerges from bankruptcy. If the facts surrounding Acme's tort exposure change post-emergence and Acme ends up paying $40 million to settle the claim, Acme should remain in a NUBIG position, and no portion of the $40 million tort payment should be subject to a 382 limitation.

vi. The NUBIL notice prescribes a general rule under which the existence and amount of NUBIG or NUBIL is determined by hypothesizing a sale of all of the loss company's assets at fair market value. The deemed proceeds of such a sale, minus the basis of the assets and minus all of the loss company's deductible liabilities (which are deemed to have been assumed in the hypothetical asset sale), is the amount of the NUBIG (if positive) or NUBIL (if negative). The NUBIL notice also gives the loss company an election with respect to the determination of which income and loss items are "attributable to" the pre-change period (and therefore constitutes recognized built-in gains ("RBIG") or recognized built-in loss ("RBIL"). First, the loss company can elect to treat as built-in items only those that have met the all-events test for accrual taxpayers on the change date and have not been accrued to date only because of accounting method limitations imposed by the Code (principally the economic performance rules[134]). Second, the loss company can elect to apply the rules that would apply if its stock were sold in a transaction treated as an asset sale. Under this approach,[135] the focus is not limited to items that have met the all-events test, but also extends to all built-in items (including contingent liabilities) at the time of the change of ownership.

vii. Finally, is it ever appropriate to treat COD income that is triggered when the debtor's plan of

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[134] *See* section 461(h) and Treas. Reg. § 1.461-4(g). *Cf*. Notice 2003-65, 2003-40 I.R.B. 747 (Oct. 6, 2003). Because this election follows (but does not completely duplicate) the rules set forth in analogous circumstances in the S corporation area, the notice refers to this election as the "1374 approach."

[135] *Id.* Called the "338 approach" in the NUBIL notice, by reference to the election under section 338 to treat a stock purchase as an asset purchase. Note also that, if the 338 approach is elected, and if the loss corporation is in a NUBIG position, the loss corporation's NOL limitation will be increased by the amount of depreciation and amortization that is associated with the notional basis step-up that would have been generated had a section 338 election actually been made for the loss corporation. *See* Notice 2003-65, 2003-40 I.R.B. 747, § IV (Oct. 6, 2003). Under the right set of circumstances, this can make the loss corporation's NOLs substantially more valuable than they might otherwise have been, and without any actual gain from the deemed 338 election having to be recognized. *See generally* Willens, "Eddie Bauer's Net Operating Losses – A Textbook Bankruptcy Case," Daily Tax Report (June 16, 2006). In the extreme case where the amount of the NUBIG is no greater than the loss corporation's NOLs, it may make sense in an acquisition context for the buyer to make an actual 338(a) election (as opposed to the notional 338 election under the NUBIL notice), in order to step up the basis of all the target's assets (including amortizable goodwill) to fair market value. Any NOL deductions in excess of the target's NUBIG would be lost (and a 2% AMT tax would have to be paid), but those lost NOL deductions would have been subject to an annual limitation had they survived, and the increased depreciation and amortization deductions generated in the future by making the 338(a) election will be free of any section 382 limitation.

reorganization goes effective as an item of built-in gain for purposes of section 382(h)(6)(A)? I would argue that the answer should be no. The basic idea behind the built-in gain construct is to take a snapshot of the debtor at the time of the ownership change to see whether its gross assets, if sold, would produce gain or loss. Since a debtor's own liability is not an asset to the debtor, it is hard to see why income attributable to discharge of that liability would come into play in calculating the debtor's NUBIG/NUBIL position. It is true that COD income actually recognized in connection with a change of ownership may well be an "item of income" "attributable to" the pre-change period under section 382(h)(6)(A), thereby increasing the debtor's NUBIG (or decreasing its NUBIL) calculated without regard to the COD and thereby potentially increasing the 382 limitation when the COD is recognized.[136] The Notice appropriately so treats such COD income that a debtor actually does recognize. But that is not the normal case: in a typical bankruptcy, the COD income is expressly excluded from income by section 108 and should therefore not be treated as "taken into account" during the recognition period for purposes of section 382(h)(6)(A). As suggested earlier, the proper method for integrating excluded COD income and the NUBIG/NUBIL system is by calculating NUBIG/NUBIL after giving effect to any asset basis reductions under section 1017 that result from excluded COD income.

3. Valuing the Loss Corporation's Stock

a. The value placed on the reorganized debtor's stock upon its emergence from bankruptcy has a number of tax consequences: (a) it is the basis on which the reorganized debtor calculates its 382(l)(6) limitation; (b) it

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[136] *See* Henderson and Goldring, *Tax Planning for Troubled Corporations* § 508.4.3 (2008 ed.) (citing PLR 9312006 (Mar. 26, 1993)).

has an impact on the amount of COD income that the debtor recognizes (and therefore on the amount of attribute reduction that it faces); and (c) it determines the amount of the deduction that the reorganized debtor can take with respect to stock used to make deductible payments, like executive bonuses.

EXAMPLE 51

> Acme's plan of reorganization calls for it to discharge its $100 million in bank debt with 39 million shares of stock, and to issue 1 million additional shares of stock to its key executives as retention bonuses. If each share of stock is worth $1, then Acme has $61 million in COD income ($100 million in debt discharged for stock worth $39 million) and a compensation deduction of $1 million. If, on the other hand, each share of stock is worth $0.90, then Acme's COD income increases to $64.9 million, while its compensation deduction shrinks to $900,000.

b. Virtually every disclosure statement contains an analysis of the debtor's so-called "reorganization value," which is the amount that the debtor's financial advisor believes the reorganized debtor is worth. While this amount may have some probative force with respect to the value of the debtor's stock upon emergence (especially in a closely-held situation), the disclosure statement's reorganization value will normally take a back seat where the reorganized debtor is publicly traded: the common law of stock valuation generally uses the average exchange price quoted on the valuation date as the benchmark.[137]

[137] *See, e.g., Amerada Hess Corp. v. Comm'r*, 517 F.2d 75, 75-1 U.S.T.C. ¶ 9480 (3d Cir. 1975).

c. Some exceptions to this general rule may occur as a result of the peculiar circumstances of bankruptcy, however: because so many new shareholders of the reorganized debtor are involuntary "investors" who will sell as soon as they can, the law permitting market values to be ignored in cases of overhang may apply.[138]

d. It should be obvious from the foregoing that the debtor may find itself in the middle on valuation. While the debtor is generally benefited from a high stock valuation on emergence (since it reduces COD income while increasing both the 382 limitation and the amount of any deductions generated by the transfer of stock), the debtor's executives (for example) may prefer a much lower valuation of the stock they receive as part of their agreement to remain with the debtor.

e. If the debtor issues new stock for cash as part of its reorganization the cash will increase the value of the computation for section 382 limitation purposes.[139]

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[138] *See generally Bankers Trust Co. v. United States*, 518 F.2d 1210, 75-2 U.S.T.C. ¶ 9593 (Ct. Cl. 1975). *Cf. Questrom v. Federated Dept. Stores, Inc*., 41 F. Supp. 2d 294 (S.D.N.Y. 1999) (in non-tax context, market overhang resulting from issuance of massive amounts of stock to creditors in bankruptcy rendered market price inadequate as measure of fair value). *But see* TAM 200513027 (Dec. 22, 2004) (while agreeing that exceptional market circumstances are to be taken into account in determining equity value for section 382 purposes where market capitalization is aberrational, National Office finds no evidence in this case that market price was aberrational on change date and therefore rejects taxpayer efforts to use appraisal to determine section 382 limitation).

[139] *See* Treas. Reg. § 1.382-9(k)(7).

4. Service's View on "Wasting Asset" Income in the NUBIG Context

a. The Service has taken the position that income earned by a "wasting asset" should not be treated as recognized built-in gain for section 382 purposes.

EXAMPLE 52

> Acme is in the home health care business and has an existing patient base in which it has a basis of zero. Acme undergoes a 382 ownership change at a time when it has NOL carryforwards and is in a NUBIG position. After the change date, Acme earns taxable income by providing equipment and services to the existing patient base. Acme (or at least its well-advised successor) takes the position that income attributable to the built-in gain in its existing patient base is recognized built-in gain for 382 purposes, which would have the effect of increasing Acme's 382 limitation by a like amount. The agent takes the position that none of Acme's income from its patient base is recognized built-in gain.

b. In a surprising and rather puzzling tech advice, the IRS has agreed with the agent and disallowed Acme's attempt to use its NOLs to shelter its income from its existing patient base.[140] The Service concluded that, although there was support in the legislative history for the belief that income from wasting assets was to receive the same built-in treatment as deductions from wasting assets, Congress had tried to signal a different result by wording 382(h)(2)(A) and 382(h)(2)(B) slightly differently. The Service also cited "administrability concerns" and the need to develop an "alternative methodology" that might involve

[140] *See* TAM 200217009 (Apr. 29, 2002).

"sophisticated economic and statistical calculations" as reasons for rejecting the "wasting asset" argument.

c. With all due respect, TAM 200217009 is unpersuasive. The statutory differences cited by the IRS do not lead easily to the result adopted by the Service. Moreover, the result sought by the taxpayer seems the right theoretical result, is fully consistent with the purpose of section 382, and is eminently fair. What is sauce for the built-in loss goose should be sauce for the built-in gain gander.[141]

d. The NUBIL notice offers taxpayers a softening of this position with respect to the treatment of "wasting" built-in gain assets as producing RBIG. Although under the 1374 approach it maintains its position that income from a built-in gain asset does not constitute RBIG because it did not accrue before the change date,[142] the 338 approach treats as RBIG an amount equal to the excess of the depreciation or amortization deduction that would have been allowable with respect to the asset after its deemed purchase at fair market value over the amount of any such deductions actually allowable to the loss corporation.[143]

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141 *See also* Parker, "The Innocent Civilians in the War Against NOL Trafficking: Section 382 and High-Tech Start-Up Companies," 9 Va. Tax. Rev. 625, 695-708 (1990) (statutory definitions of built-in income and built-in deduction are different but treatment should be symmetrical); Brock, "The Forthcoming Built-In Item Regulations: Issues for the Government to Address," 95 Tax Notes 97 (Apr. 1, 2002) (same). Two earlier Field Service Advices also seem to contradict the result reached in TAM 200217009. *See* 1998 FSA Lexis 508 (July 2, 1998); 1993 FSA Lexis 200 (July 8, 1993).

142 Notice 2003-65, 2003-40 I.R.B. 747, § III.B.2.a.(i) (Oct. 6, 2003).

143 *Id*. § IV.B.2. The 338 approach would apply equally to goodwill. Of further note, recently issued temporary and proposed regulations provide that prepaid income (defined as "any amount received prior to the change date that is attributable to performance occurring on or

5. COD Impact on NOL Carryback in Year of Emergence.

a. Background. Debtors not infrequently incur operating losses during the year in which they emerge from bankruptcy, and then generate COD income in connection with emergence. Can that current year NOL be carried back to prior years to obtain a refund without prior reduction to reflect the COD income?

EXAMPLE 53

> Acme filed for bankruptcy in order to deal with extensive product liability claims. The centerpiece of Acme's plan of reorganization will be the creation of a trust that Acme will fund with a combination of cash and Acme stock. Acme's contribution to the trust will create a deduction of $100, which will in turn result in an operating loss for the year of emergence of $80. Other distributions to Acme creditors will generate COD income of $50. Is Acme able to carry back its entire operating loss from the current year -- $80, or only the amount remaining after giving effect to the Internal Revenue Code's rules on reduction of tax attributes -- $30?
>
> Until recently, there was no authority on point, and the commentary was divided.[144]

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after the change date") included in income during the recognition period is not RBIG. Treas. Reg. § 1.382-7T; T.D. 9330, 72 Fed. Reg. 32792-01 (June 14, 2007); Prop. Treas. Reg. § 1.382-7; 72 Fed. Reg. 32828-01 (June 14, 2007). *See* Willens, "Temporary Regulations Deny 'Built-in-Gain' Treatment for Prepaid Income," Daily Tax Report (June 28, 2007).

[144] *Compare* Henderson and Goldring, *Tax Planning for Troubled Corporations* § 404.2 (2007 ed.) (carryback should take place before COD attribute reduction takes place), 15 *Collier on Bankruptcy* ¶ TX6.03[4][b][i] (15th ed. rev. 2005) (same), and Jenks, "Tax Attributes

b. **New Regulations.** Hidden in the new temporary regulations dealing with "G" reorganizations, Treasury announced its position in favor of allowing NOL carrybacks to take place before attribute reduction is given effect, thereby allowing Acme in Example 53 to carry back its entire emergence year loss of $80, rather than only the $30 that would be left if Acme's year of emergence NOLs were reduced for excluded COD income first.[145]

6. Election to Include Value of Non-Consolidated Subsidiaries in Parent's 382(l)(6) Computation

a. In the consolidated return context, the 382(l)(6) limitation is determined by reference to the value of the parent corporation's stock, and generally ignores the value of subsidiary stock owned directly or indirectly by the parent.[146] Section 382(m)(5) authorizes the issuance of regulations governing the same questions as they may arise in the controlled (but not consolidated) context, and regulations carrying out this mandate were issued in 1996.[147]

b. The basic objective of these regulations is to adjust the value of a loss corporation that is

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in Bankruptcy," 592 PLI/Tax 981, 1046-47 (2006) (same), *with* Germain, "Avoiding Phantom Income in Bankruptcy: A Proposal for Reform," 5 Fla. Tax Rev. 249, 259-63 (2001) ("only a skilled linguistic contortionist could interpret section 108(b)(4)(A) to allow the carryback before the attribute reduction takes place").

[145] *See* Treas. Reg. § 1.108-7T(b); T.D. 9080, 68 Fed. Reg. 42,590 (July 18, 2003) (effective July 17, 2003), *redesignated as* Treas. Reg. § 1.108-7, 69 Fed. Reg. 26,038 (May 11, 2004) (effective May 10, 2004).

[146] Treas. Reg. § 1.1502-93(a). *See generally* Henderson and Goldring, *Tax Planning for Troubled Corporations* § 508.7.4 (2008 ed.).

[147] Treas. Reg. § 1.382-8.

a member of a controlled group of corporations so that the same value is not included more than once in computing the 382(l)(6) limitations applicable to the parent and each member of the controlled group, since each has presumably undergone an ownership change when the parent has. This is accomplished by excluding the value of the stock of each controlled subsidiary from the valuation of the parent's stock.[148] The regulations do, however, provide an election that essentially allows the controlled subsidiary to "restore" as much of the value of its stock to the parent as it chooses, at the cost of having the value of its own stock reduced for purposes of 382(l)(6).

EXAMPLE 54

> Parent owns 100% of the stock of Foreignco, which is a controlled corporation for these purposes but is not included in Parent's consolidated return. At the time that Parent undergoes a change of ownership, its stock is worth $100 million and its stock in Foreignco is worth $20 million. In determining Parent's 382(l)(6) limitation, the 1.382-8 regulations in the first instance require that the value of the Foreignco stock – $20 million – be backed out of the equation, thereby leaving the value of the Parent stock at $80 million, thus producing an L6 limitation for Parent of $3.640 million. Foreignco would have its own 382(l)(6) limitation of $910,000 (4.55% times $20 million), although the availability of that limitation may be of little relevance to Foreignco, if it is not a U.S. taxpayer. On the other hand, if Foreignco can be persuaded to "restore" some or all of its $20 million in stock value to Parent, Parent's L6 limitation would be increased (and Foreignco's concomitantly decreased) to reflect that shift in value. Since in most

[148] Treas. Reg. § 1.382-8(a).

cases reducing Foreignco's L6 limitation will have no negative tax consequences, it will be wise for Parent to cause Foreignco to make the restoration election.

c. More recently, the IRS concluded that, since the election to restore is almost always the taxpayer's best choice, the regulations will henceforth deem the election to have been made unless a foreign component member expressly elects **not** to restore.[149]

7. Application of 382 to Private Investment Funds and Non-Public Loss Corporations

a. The IRS has ruled on several occasions that private investment funds under common management will not be treated collectively as an entity for section 382 purposes as long as they make their investment decisions on a fund-by-fund basis (*i.e.*, the investment

[149] *See* Treas. Reg. § 1.382-8T(h)(2) (effective May 30, 2006). Herewith the discussion from the preamble: "The IRS and Treasury Department are aware that taxpayers generally elect to restore value from component members that are foreign corporations. The IRS and Treasury Department are also aware that taxpayers occasionally fail to make the election timely and must file a request for relief under Section 301.9100-1. Therefore, to reduce unnecessary elections and section 9100 requests, Section 1.382-8T(h)(2) will deem foreign component members to elect to restore full value to other component members under Section 1.382-8. Nevertheless, should such members not wish to restore the full amount of such value, they may elect not to restore all or part of such value. Further, a foreign component member that has items treated as connected with the conduct of a trade or business in the United States that it takes into account in determining its value under section 382(e)(3) is not subject to this deemed election." T.D. 9264, 71 Fed. Reg. 30591 (May 30, 2006). Subsequently, the Service issued final regulations effective, in general, for taxable years beginning on or after May 30, 2006. *See* Treas. Reg. § 1.382-8; T.D. 9329, 72 Fed. Reg. 32794-01 (June 14, 2007).

decisions of one fund are not based on the investment decisions made by one or more of the other funds).[150]

b. Moreover, in one recent ruling the IRS discussed the situation in which (a) an investment manager files a Schedule 13D or 13G that reports that two or more investors in the aggregate have economic ownership of more than 5% of the company's common stock, but (b) the investors having economic ownership of the 5% position do not themselves file a Schedule 13D or 13G affirming the existence of a 5% group.[151] On these facts, the IRS ruled that, in the absence of actual knowledge to the contrary, the company can rely on the absence of filings by the investors having economic ownership in concluding that those investors are not members of a group that constitutes an entity for section 382 purposes.

c. Finally, the IRS has ruled that a non-public loss corporation that took reasonable steps to obtain information with respect to its 5% shareholders could rely on its actual knowledge of stock ownership in determining whether it had undergone an ownership change for section 382 purposes.[152]

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[150] *See, e.g.*, PLR 200806008 (Feb. 8, 2008); PLR 200747016 (Nov. 23, 2007); PLR 200713015 (Mar. 30, 2007); PLR 200622013 (Jan. 27, 2006); PLR 200605003 (Oct. 28, 2005); PLR 9725093 (June 20, 1997); PLR 9610012 (Mar. 8, 1996); PLR 9533024 (May 19, 1995). *See generally* Rosen, Rievman, and Endreny, "A Practical Guide to the Tax Considerations and Consequences of Acquiring Stock and Debt Securities of Financially Troubled Corporations," 789 PLI/Tax 431, 470 (2007). *See also* Willens, "Who Owns a Loss Corporation's Stock?", 118 Tax Notes 1147 (Mar. 10, 2008).

[151] PLR 200806008 (Feb. 8, 2008).

[152] PLR 200622013 (Jan. 27, 2006).

B. 382(l)(5) Practice Pointers

1. Qualifying for 382(l)(5)

a. One of the many reasons why 382(l)(5) elections are rarely made is that the debtor's ability to qualify for such an election can be thwarted early in the case by debt trading.

EXAMPLE 55

> When Acme files for bankruptcy, BigBank decides that it doesn't want to hold on to a non-performing asset. It therefore sells its claim to Vulture Fund, which is in the business of speculating in distressed debt. If Vulture Fund ends up with more than 50% of Reorganized Acme's stock, Reorganized Acme cannot elect L5, because Vulture Fund's claim does not qualify as old and cold or ordinary course under section 382(l)(5)(E).

b. The same problem can arise if Acme has non-bank debt.

EXAMPLE 56

> Acme has two types of debt: (a) a $30 million revolving line of credit (fully drawn) from BigBank, and (b) $70 million in debt held by the public. Although the debt held by the public is not listed on any exchange or publicly traded,[153] there is a primitive market of sorts in Acme debt, with bid and asked prices (most recently in the range of 25 cents on the dollar) occasionally showing up in "pink sheet" listings maintained by brokers active in the distressed

[153] Very little corporate debt is listed on an exchange; trading in unlisted corporate debt is notoriously secretive.

debt market. Acme has heard that Vulture Fund has been accumulating blocks of Acme's public debt, but there is no way for Acme to directly confirm that fact, and efforts to find out by calling Vulture Fund have been met with stony silence. It is possible that Vulture Fund has already acquired such a large portion of the $70 million in public debt that L5 will be impossible to achieve, because Vulture Fund might be getting half or more of the stock in the reorganized company.

c. If a debtor believes that 382(l)(5) is a realistic alternative that would generate significant value for the estate, consideration should be given to seeking an injunction against any post-petition trading in debt that would prevent the debtor from making an L5 election.

i. Until recently, first-day orders restricting claims trading generally required court approval for any transaction that resulted in a claimholder owning a dollar amount of claims that the debtor believed could result in the claimholder becoming a 5% shareholder in the reorganized debtor.[154] More recently, however, there has been a trend toward first-day orders that permit free trading in claims, but that potentially require substantial claimholders to reduce their claimholdings below a specified level if the debtor proposes a plan of reorganization that relies on the L5

[154] *See, e.g.*, *In re WHX Corp.*, Case No. 05-11444 (ALG) (Bankr. S.D.N.Y.), Final Order dated Mar. 31, 2005, Interim Order dated Mar. 11, 2005; *In re Williams Communications Group, Inc.*, Case No. 02-11957 (BRL) (Bankr. S.D.N.Y.), Order dated July 24, 2002; *In re Phar-Mor, Inc.*, 152 B.R. 924 (Bankr. N.D. Ohio 1993); *In re Southeast Banking Corp.*, Case No. 91-14561-BKC-PGH (Bankr. S.D. Fla., Order dated July 21, 1994). *See* Henderson and Goldring, *Tax Planning for Troubled Corporations* §§ 508.2.4, 1002.4.1 (2008 ed.) (discussing recent developments in this area).

exception.[155] This trend is at least partly in response to a model order drafted in 2004 by the Bond Market Association and the Loan Syndications and Trading Association, which had as its objective the preservation of debtor tax attributes while minimizing disruption to the full functioning of the debt and equity markets.[156] Moreover, at least one bankruptcy commentator has suggested that the practice of issuing first-day orders enjoining trading is based on questionable legal analysis and could have a wide-ranging impact on the chapter 11 process.[157]

ii. The area has become increasingly contentious. In one recent case involving Dana Corporation, several creditor groups filed objections to the debtor's proposed form of order, and after an extended factual hearing the debtor was ordered to produce a report demonstrating that the use of L5 was a "reasonable possibility" before the court would enter the order.[158]

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[155] *See, e.g., In re Dana Corp., et al.*, Case No. 06-10354 (BRL) (Bankr. S.D.N.Y.), Final Order dated Aug. 9, 2006, Interim Order dated Mar. 3, 2006; *In re Delphi Corp., et al.*, Case No. 05-44481 (RRD) (Bankr. S.D.N.Y.), Final Order dated Jan. 6, 2006, Interim Order dated Oct. 12, 2005; *In re Delta Air Lines, Inc.*, Case No. 05-17923 (PCB) (Bankr. S.D.N.Y.), Final Order dated Dec. 19, 2005, Interim Order dated Sept. 16, 2005; *In re Northwest Airlines Corp.*, Case No. 05-17930 (ALG) (Bankr. S.D.N.Y.), Final Order dated Oct. 28, 2005.

[156] The Bond Market Association/Loan Syndications and Trading Association Model NOL Order (Nov. 2004) and The Bond Market Association/Loan Syndications and Trading Association Model Final NOL Order (June 2006) are available at http://www.lsta.org.

[157] *See* Morris, "Imposition of Transfer Limitations on Claims and Equity Interests During Corporate Debtor's Chapter 11 Case To Preserve the Debtor's Net Operating Loss Carryforward: Examining the Emerging Trend," 77 Am. Bankr. L.J. 285 (Summer 2003). *See also* Mayer, "Liquidity, Disclosure and their Enemies: Securities Issues and Trading Freezes in Chapter 11," (June 2004, prepared for ABI Winter Meeting Dec. 2004) ((restrictions on claims trading to preserve NOLs almost never economically justified), *available at* kramerlevin.com/news.

[158] *In re Dana Corp., et al.*, Case No. 06-10354 (BRL) (Bankr. S.D.N.Y.), Order Continuing Hearing dated Apr. 4, 2006.

Despite the fact that there are undoubtedly circumstances in which the L5 exception will increase the value of the reorganized debtor by millions of dollars, the argument is increasingly being made by creditors and debt traders that the automatic stay cannot be applied to restrict claims trading by unrelated third parties.[159] Those opposing claims trading orders have also been emboldened by the Seventh Circuit's recent statement in *dictum* that injunctions against stock trading to preserve the value of a debtor's NOLs should not be imposed unless the debtor provides a funded mechanism (such as a cash bond or an adequate protection order) for compensating those who might be hurt by the injunction.[160]

iii. Despite the increasing frequency with which debtors are seeking -- and obtaining -- first-day injunctions against trading in debt or stock, any debtor contemplating this course of action should realize that it is stirring up a hornet's nest, in light of the trader mentality -- and extremely short time horizons -- of many of those who are likely to be accumulating the debtor's public debt.[161]

d. In certain circumstances, assistance will come from an unexpected quarter: tort claimants against the debtor.

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159 *See, e.g.*, Motion of American Real Estate Holdings Limited Partnership for Determination that the Automatic Stay Does Not Apply to Restrict Claims Trading or, in the Alternative, Relief from the Automatic Stay, *In re Dana Corp., et al.,* Case No. 06-10354 (BRL) (Bankr. S.D.N.Y.), dated Apr. 17, 2006.

160 *In re UAL Corp*., 412 F.3d 775, 777-78 (7th Cir. 2005). *See generally* Henderson and Goldring, *Tax Planning for Troubled Corporations*, §§ 508.2.4, 1002.4.1 (2008 ed.).

161 For a more detailed discussion of these issues, see Jenks, "Filing for Bankruptcy: A Starter Kit for Corporate Tax Advisors," 789 PLI/Tax 1157, 1211-1225 (2007).

EXAMPLE 57

Acme has some asbestos exposure. After lengthy negotiations between Acme, the lawyers for the asbestos claimants, and the creditors' committee (representing the current holders of Acme's bank facility and its public debt), it is agreed that a trust will be created under section 524(g) of the Bankruptcy Code (which provides statutory protection that Acme is free from any future asbestos liability) to satisfy the asbestos claims, and that 51% of the stock of the reorganized debtor will be contributed irrevocably to that trust.[162] So long as none of the asbestos claims has previously changed hands (or no claimant's transferee ends up with 5% of the Acme stock), Acme should be able to elect L5, because more than 50% of its stock post-emergence will go to asbestos claimants who are both old and cold and (presumably) ordinary course.[163]

e. Life is not always so simple, however. In light of the fact that it is extremely difficult to value

[162] Whether or not the trust meets the requirements of section 524(g) of the Bankruptcy Code, it should qualify as a qualified settlement fund ("QSF") under Treas. Reg. § 1.468B-1.

[163] Note also in this connection that Treasury has issued temporary regulations making it clear that, if a qualified trust distributes an ownership interest in an entity, then for testing dates on or after the date of the distribution, the distributed ownership interest will be treated as having been acquired by the distributee on the date and in the manner acquired by the trust, thereby generally eliminating the risk that distributions of this sort could ever cause a change of ownership. *See* Treas. Reg. § 1.382-10T. These regulations became final, without substantive change, effective after June 23, 2006. *See* Treas. Reg. § 1.382-10; T.D. 9269, 71 Fed. Reg. 36676 (June 28, 2006). *See also* PLR 200618022 (Jan. 18, 2006) (consolidated group’s transfer of stock to PBGC, which assumed obligations of group’s pension plans, not an owner shift; pension plan trusts and PBGC unrelated to any other owner for 382 purposes).

asbestos claims (since many of the manifestations of injury will not appear for years to come), it may not be possible for the parties to arrive at a fixed and final determination of how much stock the asbestos claimants should receive.

EXAMPLE 58

> Same as Example 57, except the parties agree that (a) upon emergence Acme will transfer 30 million shares of its stock to the asbestos trust and 70 million shares to the bank and public debtholders, and (b) each year for the next thirty years Acme will issue additional shares to the trust (that could ultimately bring its total up to a maximum of 75 million) if and to the extent that additional asbestos claims against Acme come to light.[164] Since the 382(l)(5) analysis must take place as of the change date, an L5 election may well be impossible, unless some of the bank and public debtholders can qualify as old and cold or ordinary course.

2. IRS Interpretation of the 382(l)(5) "Haircut" Rule

a. As noted earlier,[165] a debtor's NOLs will suffer a statutory "haircut" if L5 is used: the debtor's pre-change losses and excess credits that may be carried to a post-change year are to be computed as if no deduction had been allowed for certain interest paid or accrued during the prior 3+ years.[166] That rule may be rather simple to apply

[164] This arrangement would probably continue to qualify under section 524(g) of the Bankruptcy Code, which allows its own majority of voting shares test to be met either immediately or over time "if specified contingencies occur." *See* section 524(g)(2)(B)(i)(III) of the Bankruptcy Code.

[165] *See* I.C.6.a.iii, *supra*.

[166] *See* section 382(l)(5)(B).

where the debtor has a loss for each of the 3+ years that is at least equal to the amount of the interest being disallowed.[167]

b. But what result if the debtor had no loss (or a loss smaller than the interest "haircut") in one or more of the years in question? In FSA 200006004,[168] the taxpayer took the position that "the plain language of Section 382(l)(5)(B) does not require a tax attribute reduction for

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[167] *See id.*; I.C.6.a.iii, Example 15, *supra*. This apparent simplicity may be misleading, however. Consider a case in which a debtor discharges $15 million in pre-petition debt with a package of consideration consisting of $5 million in cash and common stock worth $5 million. For purposes of the haircut rule, what portion of the debtor's debt is being discharged for stock? There appears to be no guidance directly on point. A similar question had come up under the old stock-for-debt exception, and it was believed in that context that any non-stock consideration received by debtholders should be treated as discharging debt dollar for dollar, with the entire remaining amount of debt being treated as discharged for stock. *See generally* Henderson and Goldring, *Tax Planning for Troubled Corporations* § 504A.5 (2008 ed.) (citing legislative history to Bankruptcy Tax Act of 1980 as support for this so-called "residual" approach). In other words, under the old stock-for-debt rule on our facts, $5 million of the pre-petition debt would be treated as discharged for cash, and $10 million for stock, thereby resulting in two-thirds of the interest accrued during the prior 3+ years being subject to the haircut rule. Now that the stock-for-debt exception has been repealed, however, it may be time to readdress this issue as it applies in the 382(l)(5) haircut area. It is certainly possible to argue that the better answer from a tax policy point of view would be to compare the value of the stock and non-stock consideration being received, and to subject to the haircut rule that portion of the debt that corresponds to the portion of the consideration that is stock. In other words, one might argue that, since on our facts half of the consideration is in the form of stock, half of the debt should be treated as discharged for stock. (This was in fact the position taken in the House report accompanying the Bankruptcy Tax Act of 1980. *See id.*) This result has the virtue of eliminating the most glaring anomaly that results when the residual approach is applied to the haircut context: on our facts, once $5 million of the pre-petition debt is treated as discharged for cash, all of the remaining debt is subject to the haircut rule, whether the stock being issued is worth $5 million or $500,000. Finally, it may even be possible to argue that the old rule should be inverted: only that portion of the debt corresponding to the value of the stock being received should be subject to the haircut rule.

[168] (June 28, 1999).

Year 6 because a net operating loss does not exist for Year 6 and therefore cannot be 'computed' as if certain interest expenses were not allowable."

c. The IRS disagreed, however, holding that the statutory language (and its legislative history) is best read as requiring NOL reduction not only for NOLs generated in the 3+ years specified in the statute, but in any pre-change years. On the facts of the FSA, that meant that all of the interest deductions taken during the 3+ year period that were attributable to debt discharged for stock had to be reversed, even though in one of the 3+ years the debtor had no loss.

d. Although FSA 200006004 does not discuss what the possible collateral consequences of its approach to the statutory language might be, there would appear to be many. Consider the following examples.

EXAMPLE 59

On its return as filed for 2000, Acme had an NOL that it carried forward because its carryback capacity had been exhausted by prior year losses. On its return as filed for 2001, Acme broke even and had unused foreign tax credits. If Acme is required to reduce its interest accruals for 2000 in accordance with 382(l)(5), will Acme also need to recalculate its foreign tax credit position based on the fact that it is now in a net taxable income position?

EXAMPLE 60

On its return as filed for 2000, Acme broke even after accruing interest deductions. On its return as filed for 2001, Acme had a loss, which it elected to carry forward under section 172(b)(3). If Acme is required to haircut its 2000 interest deductions (thereby putting

Acme into a taxable income position for that year), will Acme be free to reexamine its decision to make a carryforward election for 2001?

EXAMPLE 61

Acme accrued substantial interest deductions for 2000, but some of those deductions were disallowed pursuant to the earnings stripping rules of section 163(j). If some of the interest deductions that Acme was permitted to take during 2000 are eliminated by 382(l)(5), does Acme recompute its 163(j) disallowance?[169]

C. 382(g)(4)(D) Concerns

1. In the famous *Prudential Lines* case, Parent and Subsidiary filed consolidated returns, and Parent caused Subsidiary to file for bankruptcy. Parent proposed a plan of reorganization for Subsidiary, but the Subsidiary creditors refused to support the plan. In an alleged attempt to coerce the Subsidiary creditors into supporting its plan, Parent threatened to take a worthless stock deduction under section 165(g)(3) with respect to its Subsidiary stock, which would have resulted in Subsidiary's NOLs becoming subject to a zero limitation pursuant to section 382(g)(4)(D)).[170]

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[169] For more background on this difficult and puzzling area, see generally Einhorn, et al., "Critical Federal Income Tax Issues Relating to Corporate Restructurings," 552 PLI/Tax 675, 704 & n.112 (2003); Berg, "Selected Federal Income Tax Issues Arising in Corporate Debt Restructurings," 732 PLI/Tax 9, 79 & n.54 (2006); Silverman, "Section 382 of the Internal Revenue Code of 1986," 683 PLI/Tax 537, 912 (2005); Blanchard, "Acquisitions and Dispositions of Subsidiaries: General Considerations," 486 PLI/Tax 7, 258-59 & n.602 (2000).

[170] Under section 382(g)(4)(D), if a 50-percent shareholder (as defined) of a loss corporation treats its stock as worthless, then the 50-percent shareholder will be treated (a) as having acquired its stock on the first day of the succeeding year, and (b) as not having owned that stock previously. The net result will normally be a change of ownership at a

Subsidiary's creditors sought an injunction against Parent in bankruptcy court, arguing that Parent's threatened worthless stock deduction would reduce the value of one of Subsidiary's assets -- its NOLs -- in violation of the Bankruptcy Code's automatic stay. The injunction was granted.[171]

2. The consolidated return regulations were amended in 1994 to make it impossible in normal circumstance for a consolidated Parent to claim a worthless stock deduction with respect to Subsidiary stock in the middle of a bankruptcy.[172] It does so by deferring any worthless stock deduction under section 165 until that stock is treated as "disposed of" under the principles of Treas. Reg. § 1.1502-19(c)(1)(iii), which will normally not happen until the debtor's plan of reorganization goes effective and the debtor emerges from bankruptcy.[173] Moreover, the -20

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time when the stock of the loss corporation is worthless, thereby imposing a zero 382 limitation.

171 *In re Prudential Lines, Inc.*, 107 B.R. 832 (Bankr. S.D.N.Y. 1989) (preliminary injunction); 119 B.R. 430 (S.D.N.Y 1990), *aff'd*, 928 F.2d 565, 92-2 U.S.T.C. ¶ 50,491 (2d Cir. 1991), *cert. denied*, 502 U.S. 821 (1991) (permanent injunction).)

172 *See* Treas. Reg. § 1.1502-80(c).

173 Prior to the issuance of clarifying regulations in March 2004, there was some reason for concern that even cancellation of the parent's stock in its subsidiary at the end of the case would not permit a worthless stock deduction to be taken. The technical concern was that, in many bankruptcies, none of the three prongs of the Treas. Reg. § 1.1502-19(c)(1)(iii) worthlessness test would be met. The first prong in the test -- disposition, abandonment or destruction of substantially all the subsidiary's assets -- would not normally occur in a case in which the subsidiary successfully reorganizes. The second prong -- any part of the subsidiary's income from debt discharge both (i) not included in gross income and (ii) not treated as tax-exempt income for purposes of Treas. Reg. § 1.1502-32(b)(3)(ii)(C) -- would not appear to be met if no portion of the debtor's COD income falls into the Black Hole (*i.e.*, does not for one reason or another result in a reduction of tax attributes). The third prong -- one member's bad debt deduction with respect to an obligation of a debtor subsidiary not being offset by an equal amount of income or gain

regulations (until they were revoked in 2002) in many circumstances eliminated Parent's temptation to claim a worthless stock deduction with respect to its Subsidiary stock by disallowing a loss on that stock.[174]

3. The bulwark that -80(c) erects against a worthless stock deduction disaster in the consolidated return setting is not present, however, where Parent and Subsidiary are not filing consolidated returns, either because they have not elected to do so, or because Parent's ownership does not meet the requirements of section 1504.

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of the debtor subsidiary -- would fail to come into play in many cases, including those in which the debtor subsidiary is simply not indebted to any of its affiliates. A technical response to this technical concern was that, when the parent's stock in the subsidiary was cancelled, the subsidiary was no longer a member of the consolidated group and the consolidated return worthlessness rules no longer applied. But which technicality controlled was unclear. This was all mercifully put to rest in March 2004 by the issuance of additional temporary regulations modifying the loss limitation rules applicable to corporations filing consolidated returns. *See* T.D. 9118, 69 Fed. Reg. 12,799 ((Mar. 18, 2004).) The preamble accompanying the regulations explains that, since the policy goal of Treas. Reg. § 1.1502-80(c) is to defer -- but not to disallow -- worthless stock deductions with respect to subsidiary stock, the new rules set forth in Treas. Reg. §§ 1.1502-80(c) and -80T(c) provide that the deferral of an otherwise allowable loss under section 165 terminates immediately prior to the time that the subsidiary ceases to be a member of the group. *See id.* at 12,800. While these new rules on their face only apply to taxable years beginning after March 18, 2004, taxpayers may also choose to apply them to taxable years beginning on or after January 1, 1995. Subsequently, the Service issued final regulations effective for taxable years with tax returns do (without extensions) after July 18, 2007 (however, the taxpayer may apply them to taxable years beginning on or after January 1, 1995). *See* T.D. 9341, 72 Fed. Reg. 39313-01 (July 18, 2007).

[174] *See* Treas. Reg. § 1.1502-20, *repealed by* T.D. 8984, 67 Fed. Reg. 11,034 (Mar. 12, 2002) (which added Treas. Reg. § 1.1502-20T, effective Mar. 7, 2002), *amended by* T.D. 8998, 67 Fed. Reg. 37,998 (May 31, 2002) and T.D. 9057, 68 Fed. Reg. 24,351 (May 7, 2003).

EXAMPLE 62

Parent owns 80% of Subsidiary's common stock, but does not file on a consolidated basis with Subsidiary. Subsidiary is in bankruptcy, and its common stock may well be worthless. If Parent successfully claims a worthless stock deduction with respect to its Subsidiary stock and continues to hold that stock at the end of the year, Parent will be treated as having purchased its Subsidiary stock for the first time on the first day of the following year for nothing, thereby imposing a zero 382 limitation on Subsidiary's NOLs and NUBIL. The -80(c) consolidated return regulations would obviously have no application to the situation.

Subsidiary would therefore be well-advised to consider injunctive relief or other arrangements that would prevent Parent from taking such a step.

4. Note, however, that 382(g)(4)(D) only applies if Parent continues to own Subsidiary stock on the last day of the taxable year.[175] Therefore, it should be possible in the right factual circumstances for Parent to claim a worthless stock deduction under 165(g)(3) without subjecting Subsidiary's losses to a zero limitation.

EXAMPLE 63

Same as Example 62, except Parent claims that its Subsidiary stock became worthless on March 31, and Subsidiary emerges from bankruptcy on December 20 pursuant to a plan of reorganization that results in the cancellation of Parent's stock in Subsidiary. Parent should receive an ordinary loss on its Subsidiary

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[175] *See* section 382(g)(4)(D).

> stock under 165(g)(3) on the cancellation of its shares pursuant to the plan of reorganization. While Subsidiary will be treated as undergoing a change of ownership as a result of the plan of reorganization, it should be eligible for the favorable rules set forth in 382(l)(6) (or even perhaps 382(l)(5)), thereby obtaining a non-zero 382 limitation on its NOLs and NUBIL. 382(g)(4)(D) will not come into play because Parent owned no Subsidiary stock on the last day of the year.

5. Note also that a 382 change of ownership does not automatically occur under 382(g)(4)(D) just because a shareholder that meets the definition of a "50-percent shareholder" in section 382(g)(4)(D) (flush language) treats its Subsidiary stock as worthless. This is because the statute, although not worded particularly artfully, only treats those shares still actually owned by the 50-percent shareholder at the end of the year as being subjected to the deemed "new purchase" regime.

EXAMPLE 64

> Parent owns 100% of the stock of Subsidiary. On July 1, 2001, Parent spins off 90% of its Subsidiary stock in a tax-free spin-off under section 355. On August 31, 2002, Subsidiary files for bankruptcy. Parent claims a worthless stock deduction with respect to its remaining 10% of Subsidiary stock. Subsidiary does not emerge from bankruptcy until 2003. Parent is a 50-percent shareholder of Subsidiary at the time it takes its worthless stock deduction, because within the statutory look back period of three years it did indeed own more than 50% of Subsidiary. Nevertheless, the fact that Parent treated its remaining 10% of Subsidiary stock as worthless will not by itself trigger an ownership change, since only those shares still held by Parent at

the time of the worthless stock deduction will be treated by 382(g)(4)(D) as having been purchased by Parent for the first time on the first day of 2003. And the distribution of the 90% of Subsidiary stock to Parent's shareholders does not, itself, constitute an owner shift.

6. In the right set of circumstances, it should be possible to structure a transaction in which Parent can take a 165(g)(3) deduction even while it and Subsidiary are filing consolidated returns, despite the 1994 amendments to -80(c).

EXAMPLE 65

Parent and Subsidiary are in bankruptcy. Subsidiary is deeply indebted to Parent, and its stock is worthless. Subsidiary sells substantially all of its assets to a third party (or to another subsidiary of Parent) for cash, and then uses the cash to repay a portion of its debt to Parent (or, if creditors of Subsidiary object to such a cash payment in the middle of the case, escrows the cash for the benefit of Subsidiary's creditors, including Parent, until a final plan is arrived at). Subsidiary retains enough assets to avoid a constructive liquidation. Parent should be able to claim a worthless stock deduction with respect to its Subsidiary stock (which remains worthless despite the partial repayment of Subsidiary's debt to Parent), because Subsidiary's use of its sale proceeds to repay its debt to Parent qualifies as a "disposition" for purposes of -19(c)(1)(iii) and -80(c).[176]

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[176] *See* FSA 199932011 (May 4, 1999). *See generally* Dubroff et al., 3 *Federal Income Taxation of Corporations Filing Consolidated Returns* § 72.03[1][a] (2d ed. 2007) (discussing definition of "disposition"). Note also that section 165(g)(3)(B) contains a gross receipts test that must be met if a worthless stock deduction is to be taken. For a discussion of some of the issues that can arise in this area, see

Prior to the extinguishment of the -20 regs, it was unclear how 382(g)(4)(D) would apply in this context.[177] With the extinguishment of -20 and the Supreme Court's decision in *United Dominion*, the area seems even less clear. Hopefully these difficult issues will have no practical significance in most cases, however, either as a result of Subsidiary being able to carry back its NOLs to obtain a refund (which will not be affected by a zero 382 limitation), and/or as a result of COD income eliminating any remaining NOLs upon emergence.

D. Year of Emergence Issues

1. Careful attention needs to be paid to the tax consequences of deductions taken in connection with the emergence from bankruptcy.

EXAMPLE 66

> Acme has decided to reject a lease in connection with its plan of reorganization. Under the Bankruptcy Code, Acme's rejection of the lease will make its landlord a general unsecured creditor of the estate, entitled to damages against it.[178] Acme's obligation to make payment (and the approximate amount of that

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Willens, "Securing an Ordinary Loss Deduction for Worthless Holding Company Stock," Daily Tax Report (March 22, 2007). See also the Service's recent ruling that, in determining whether a subsidiary met the gross receipts test, the subsidiary should take into account the historic gross receipts of its former subsidiaries that liquidated into it in transactions that qualified under section 381, making appropriate eliminations where needed to prevent duplication. (PLR 200710004 (Mar. 9, 2007).)

[177] *See* Dubroff et al., 3 *Federal Income Taxation of Corporations Filing Consolidated Returns* § 42.05[3][c][iii] (2d ed. 2007).

[178] *See* sections 365(g) and 502(b)(6) of the Bankruptcy Code.

payment) will be fixed before Acme emerges from bankruptcy, but payment will not take place until the exact amount of damages is proven up by the landlord several months after emergence. How is the deduction attributable to Acme's leasehold rejection damages to be treated for 382 purposes?

2. The starting point is the 1.382-6 regs, which set forth the rules for allocating income and loss between the pre- and post-change portions of the year of emergence.[179] The first question under the -6 regs is whether the deduction attributable to the leasehold rejection damages is deductible on or before the change date, or after it. That in turn depends on the operation of the economic accrual rules of section 461 (and the economic performance regs set forth in Treas. Reg. § 1.461-4). The controlling portion of the economic performance regs is -4(d) ("Liabilities arising out of . . . the use of property"), which provides that the item is accruable at the later of the "use of the property" or the completion of the all events test. Since on these facts whatever "use of the property" there was took place in the past and since the all events test was met once the lease had been rejected and the damages had been roughly established, accrual was proper before the change date.[180]

[179] The discussion that follows applies to free-standing debtors whose change of ownership occurs in the middle of their taxable period as a result of a change in their equity ownership. Where the debtor is an affiliate filing consolidated returns and the change of ownership occurs as a result of a departure from the affiliated group, the similar -- but by no means identical -- rules set forth in Treas. Reg. § 1.1502-76 govern. Where both sets of rules apply in the same year, Treas. Reg. § 1.382-6(d) provides that the -76 rules should be applied first.

[180] *See* PLR 9852013 (Sept. 24, 1998). It is true that Treas. Reg. § 1.461-4(g)(2) requires cash-basis treatment for "Liabilities arising . . . out of any . . . breach of contract," but a close reading indicates that the only case in which damages arising out of the breach of a lease become cash-basis liabilities for -4(g)(2) purposes is when the damages are "incidental, consequential or liquidated." *See* Treas. Reg.

3. Once it has been established that a deduction for leasehold rejection damages is properly taken before the change date, the basic rule set forth in Treas. Reg. § 1.382-6 is that the taxpayer can either close its books or pro rate across the year of emergence on a daily basis.

EXAMPLE 67

> Acme has neither income nor loss for the entire year of emergence (other than the deduction resulting from its $100,000 leasehold rejection damages). It emerges from bankruptcy on March 31, and is a calendar year taxpayer. A closing of the books would result in the entire $100,000 in damages being treated as pre-change, and thus subject to Acme's 382 limitation. By contrast, if the pro rata method were chosen, $25,000 of the deduction would be pre- and $75,000 would be post-change. As long as Acme is not in a NUBIL situation, only the pre-change loss would be subject to section 382.[181]

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§ 1.461-4(g)(2)(i). Professor Bittker reads the regulation in the same way: "If the taxpayer breaches an agreement to pay for . . . the use of property, the price payable under the contract is not considered a liability for breach of contract, but instead it accrues under the [-4(d)] rules described earlier when the services, property, or use of property is received by the taxpayer. However, liabilities for incidental, consequential, or liquidated damages are a breach of contract liability and thus accrue only on payment." *See* Bittker and Lokken, 4 *Federal Income Taxation of Income, Estates and Gifts* ¶ 105.6.4 (3rd ed. 1999**)**. *Accord*, PLR 9852013 (Sept. 24, 1998).

[181] Although Treas. Reg. § 1.382-6 is silent on the point, the IRS has consistently ruled that there is a "ceiling rule" implicit in the -6 regs that will be applied when the closing of the books method is used. *See, e.g.*, PLR 9644004 (Aug. 6, 1996). The ceiling rule provides that neither the pre-change nor the post-change period may have a loss or income amount that exceeds the loss or income amount for the year of change as a whole. For example, if in Example 64 Acme had had $40,000 of operating income for the year as a whole (before taking the $100,000 leasehold rejection damages into account), then the ceiling rule

EXAMPLE 68

> Acme has some asbestos exposure, and a group of asbestos claims has been filed in the case. A settlement has been reached, and Acme has agreed to pay the asbestos claimants $3 million in exchange for the release of their claims. Because of some practical difficulties in creating the QSF into which the funds will initially be transferred, Acme does not expect to make payment on the asbestos claims until two or three months after emerging from bankruptcy.

4. Once again, the starting point is the 461 regs. If one assumes (as seems appropriate) that the asbestos claims against Acme sound in tort, then Acme will not be permitted a deduction until payment is actually made to the QSF, *i.e.*, after the change date.[182] This means that Acme's deduction for its asbestos settlement payment will be subject to the special rule set forth in Treas. Reg. § 1.382-6(c)(1)(ii)(A), which provides that any loss to which section 382(h)(5)(A) applies -- *i.e.*, any loss that is built-in on the change date and that is treated as a pre-change loss for NUBIL purposes pursuant to section 382(h)(6)(B) -- is allocated entirely to the post-change period.

5. Once the asbestos deduction has been allocated entirely to the post-change period, the focus turns to Acme's NUBIG/NUBIL position.

a. If, after giving effect to the asbestos deduction pursuant to section 382(h)(g)(C), Acme is still in a

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would limit the pre-change or post-change loss to $60,000, the net loss for the year as a whole (after taking the leasehold rejection damages into account). The ceiling rule should not come into play on the facts of the examples discussed in this portion of the paper.

[182] *See* Treas. Reg. § 1.461-4(g)(2).

NUBIG position, then no 382 limitation will apply to the asbestos deduction.

b. If, on the other hand, Acme is in a NUBIL position after giving effect to its asbestos deduction, the entire deduction will be subject to 382 under the NUBIL rules.

6. To summarize:

a. If the deduction in question is taken on or before the change date, then the pro rata method should normally be used, in order to allocate the resulting deduction between the pre- and post-change periods; the earlier in the taxable year the debtor can emerge from bankruptcy, the better.

b. If the deduction in question is taken after the change date, and if the debtor is in a NUBIL situation, then the entire deduction will be treated as a recognized built-in loss subject to 382; but if the debtor is not in a NUBIL situation, then the entire deduction will fall in the post-change period and not be subject to any limitation (*i.e.*, the best of all possible worlds).

7. There is a special (and rather surprising) rule in the 382 regs that allows losses that would otherwise be subject to limitation in the year of change to be used to offset capital gain income without regard to the section 382 limitation.[183]

EXAMPLE 69

Acme's $3 million asbestos deduction is allocated entirely to the post-change period as a result of Treas.

183 *See* Treas. Reg. § 1.382-6(c)(2)(ii), (f) example 2(v).

Reg. § 1.382-6(c)(1)(ii)(A), and is generally subject to Acme's $2 million 382 limitation because Acme is in a NUBIL situation. Nevertheless, if Acme has capital gain income (from, for example, the sale of its headquarters building to a third party), it can use any remaining portion of the asbestos deduction to offset the capital gain income without reference to the basic 382 limitation, whether the gain was triggered before or after the change date.