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DESCRIPTION AND SECTION-BY-SECTION ANALYSIS TO ACCOMPANY BANKRUPTCY-TAX BILL

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Introduction

This bill contains Federal tax provisions to complement H.R. 8200, a bill passed by the Judiciary Committee that would completely revise the bankruptcy laws by codifying and enacting title 11 of the United States Code. In the course of revising the bankruptcy laws, it became apparent that the tax/bankruptcy interface under current law is inadequate in several respects.

Accordingly, this bill proposes several amendments to the Internal Revenue Code designed to modernize the tax treatment of insolvency proceedings and bankruptcy cases. Title I of the bill contains twenty sections making substantive amendments to the Internal Revenue Code of 1954 [hereinafter cited as IRC]. Title II of the bill contains clerical, technical, and conforming amendments to the Internal Revenue Code made necessary by the proposed repeal of the Bankruptcy Act and the enactment of title 11. Title III of the bill contains four special tax provisions in title 11 that were confined to State and local impact in the bankruptcy legislation. Whenever possible, the taxation of insolvency proceedings under State law is accorded identical treatment with the taxation of entities under title 11 in order to eliminate tax considerations as a factor in choosing which financial relief remedy to pursue.

The discussion of title I is divided into six basic areas. First, sections 101, 114, 115, and 116 of the bill are discussed dealing with various recapture provisions in the Internal Revenue Code. Then a discussion of discharge of indebtedness is covered examining sections 102 and 104 of the bill. Third, the subject of reorganizing insolvent corporations is examined by focusing on sections 106 through 111 of the bill. Fourth, miscellaneous corporate tax provisions are discussed covering sections 103 and 105 of the bill. Then other miscellaneous provisions in sections 112 and 113 are discussed. Finally, procedural tax amendments covered in sections 117 through 120 of the bill are examined. After the general discussion, a detailed section-by-section analysis follows.

Discussion

The first area to be discussed concerns various recapture provisions in the Internal Revenue Code that are neutralized with respect to bankruptcy cases commenced under proposed title 11 and in some instances with respect to State insolvency proceedings as well. After an extensive examination of amendments concerning investment credit recapture under IRC section 47, depreciation and farm loss recapture are discussed.

One of the major abuses under current law arises from the recapture of investment credits in connection with bankruptcy. Case law holds that the transfer of property from a debtor to a trustee in bankruptcy constitutes a circumstance such that the property ceases to be section 38 property for purposes of IRC section 47(a)(1). *Henry C.*

Mueller, 60 T.C. 36 (1973), *rev'd on other grounds*, 469 F.2d 899 (5th Cir. 1974). *See* Rev. Rul. 74–26, 1974–1 Cum. Bull. 7. Recapture of an investment credit may also occur to the extent basis is reduced according to Treas. Reg. § 1.47–2 (c) (1); the IRS has applied this principle to effectuate a partial recapture of an investment credit to the extent indebtedness is forgiven in bankruptcy. Rev. Rul. 72–248, 1972–1 Cum. Bull. 16 and Rev. Rul. 74–184, 1974–1 Cum. Bull. In addition, it is uncertain whether the transfer of property from a trustee to an individual debtor or to a corporation controlled by such individual provides an occasion for investment credit recapture. Finally, several forced transfers to ConRail under the Regional Rail Reorganization Act of 1973 might be considered to be dispositions of property sufficient to trigger recapture of investment credits.

Section 101 of the bill amends IRC section 47 to prevent investment credit recapture in each of these circumstances; the general policy of these provisions is to avoid the inequity of recapture when constitutional rights are being exercised. New sections (d) (1) and (d) (3) neutralize investment credit recapture with respect to bankruptcy based on the proposition that the estate and debtor are alter egos insofar as the transfer of property is concerned.

Section 47 (d) (1) insulates transfers to the trustee from investment credit recapture and overrules the *Mueller* case, *supra*. This provision was proposed by the Commission on the Bankruptcy Laws of the United States [hereinafter cited as Commission] in section 1 of its suggested amendments to the Internal Revenue Code of 1954. The provision was also supported by William T. Plumb, Jr., in testimony before the Subcommittee on Civil and Constitutional Rights, *Hearings Before the Subcommittee on Civil & Constitutional Rights of the House Committee on the Judiciary*, 94th Cong., 1st & 2d Sess. 2067 (1975–1976) [hereinafter cited as *Hearings*], and by the Internal Revenue Service in testimony from then Commissioner Alexander, *Hearings* at 1980. No testimony was received in opposition to this change.

It should be emphasized that exempting the transfer of property from the debtor to the trustee in no way affects the recapture of an investment credit on the subsequent disposition of such property by the trustee. It is anticipated that the trustee will succeed to the debtor's tax attributes. This is the result under current law if the debtor is a corporation under IRC section 6012(b) (3). The result is retained for corporations and expanded to cover partnerships under proposed section 346 (c) (1) and individuals under proposed section 346 (i) (1) of title 11. Thus, the trustee steps into the shoes of the debtor for purposes of determining the useful life of investment credit property and whether a disposition is early for purposes of IRC section 47 (a) (1).

Section 47 (d) (3) in section 101 (a) of the bill insulates certain dispositions of property by the trustee from triggering investment credit recapture under IRC section 47 (a) (1). The theory behind this exemption is to allow the debtor to step back into his own shoes without penalty. This results under present IRC section 47 (b) when a trustee succeeds to the tax attributes of a corporation under IRC section

6012 (b)(3) and transfers property to the debtor corporation or to a successor corporation in a reorganization that satisfies IRC section 381. Present law with respect to corporations is continued by proposed section 346(c)(1) of title 11 although the class of qualifying successor corporations is expanded by amendments to IRC section 381 proposed in section 110 of this bill as discussed *infra*.

Proposed section 346(c)(1) of title 11 purports to change present law with respect to partnerships by having the trustee succeed to the tax attributes of the partnership but the treatment with respect to investment credit recapture will be different from that of a corporation because IRC section 381 will not apply under IRC section 47(b). Also, under proposed section 346(d) of title 11, the estate of an individual debtor under chapter 13, though not a separate taxable entity, will be treated differently from a corporation under IRC section 47(b). The differences are even greater with respect to individual debtors whose estates are separate taxable entities under present law and under proposed section 346(b)(1) of title 11 in cases under proposed title 11.

Hence, section 47(d)(3)(A) exempts the transfer of property from the estate to the debtor from triggering investment credit recapture unless the property is sold to the debtor in a public or private sale. Thus, if property is exempted from property of the estate under proposed section 522, abandoned under proposed section 554, distributed to the debtor under proposed section 726(a)(6), or returned to the debtor under a plan confirmed under proposed chapter 11 of title 11, no investment credit recapture will occur. This provision is consistent with the intent of the Commission, though it was probably omitted from the Commission's report as self evident. Also, the result is probably consistent with IRC section 47(b). Codification of the intended result should avoid litigation concerning the issue. Section 47(d)(3)(B) also clarifies the thrust of IRC section 47(b). Clause (i) exempts the transfer from the estate of an individual or partnership debtor to a corporation controlled by such debtor. This is consistent with the proposed amendment to IRC section 351 in section 106 of this bill discussed *infra*. The policy is to facilitate bankruptcy reorganizations by removing tax penalties or disincentives. Clause (ii) extends this principle to protect transfers of property from the estate of an individual or partnership debtor to a corporation controlled by such debtor's creditors, or both such debtor and such creditors, if the corporation would have succeeded to the tax attributes of the business under IRC section 381 had the business been a corporation. Of course, IRC section 269 will apply to prevent abuse of this section as will proposed section 1129(d) of title 11.

Section 47(d)(4) of the bill corrects an oversight in present law relating to transfers to ConRail. Several railroads that were forced to turn over property to ConRail under the Regional Rail Reorganization Act of 1973 were precluded from recognizing losses by IRC section 374(c). That result is continued in proposed IRC section 374(a) as discussed in connection with section 109 of this bill, *infra*.

In light of IRC section 374(c), it is unconscionable to consider such forced transfers to be early dispositions for purposes of investment

credit recapture under IRC section 47(a)(1). The railroads that invested in good faith should not be subjected to a penalty that is designed to prevent conferring tax benefits on sham investments. Accordingly, section 47(d)(4) retroactively protects these transfers from investment credit recapture.

The most controversial change proposed in section 101 of the bill is embodied in section 47(d)(2). That provision proposes to exempt the reduction of basis of property under proposed section 346(j)(5) of title 11 or under IRC section 1017 from triggering the recapture of an investment credit, except to the extent that the basis of such property was reduced under sections 108(e) and 1017 or under section 346(j)(5) of title 11 due to the forgiveness of indebtedness incurred with respect to the acquisition of such property.

The position taken in this bill is that reduction of basis that occurs as a result of discharge of unrelated indebtedness in an insolvency or bankruptcy context is not *per se* a disposition of property for purposes of investment credit recapture. A position exempting any basis reduction was recommended by the Commission in section 1 of its IRC amendments and was supported by William T. Plumb, Jr., at page 2067 of the *Hearings*. The provision was opposed without explanation by the Internal Revenue Service in testimony from then Commissioner Alexander at page 1980 of the *Hearings*. Under present Treasury Regulation section 1.47–2(c)(1), reduction of basis may result in the recapture of investment credits. This has been interpreted in *Rev. Rul.* 74–184, 1973–1 Cum. Bull. 8 to apply to a reduction in basis resulting from an election under IRC sections 108 and 1017; undoubtedly, an identical result would pertain to reduction of basis under sections 270, 396, or 522 of the Bankruptcy Act.

While recapture may be justified when the cost or basis of investment credit property is directly adjusted, it is not justified when the reduction of basis occurs as an indirect result of forgiving unrelated indebtedness. Indeed, under present law, the indebtedness need not be related to the purchase of investment credit property; yet the credit would be recaptured even if the property was acquired with cash before any indebtedness was incurred.

In short, recapture of investment credits because of an unrelated reduction in basis is inconsistent with the tax benefit approach this bill embraces. If the investment property is otherwise retained, the reduction in basis under section 346(j)(5) of proposed title 11 or IRC section 1017 due to the discharge of unrelated indebtedness will not constitute a disposition of section 38 property. The protection under paragraph (2) applies to insolvency proceedings as well as to cases under title 11 for the same reasons.

Similar adjustments with respect to depreciation recapture are made in sections 114 and 115 of the bill. Section 114 amends section 1245 of the Internal Revenue Code by adding a new subsection (b)(8) to exempt certain transfers in cases under title 11 from depreciation recapture. Proposed IRC section 1245(b)(8)(A) insulates transfers of property from the debtor to the estate at the beginning of the bankruptcy case. As with investment credit recapture, this amendment does not protect the trustee when he disposes of section 1245 property. Rather, the trustee stands in the debtor's shoes and the estate or the

debtor, if the estate is not a separate taxable entity, is liable for any tax arising from recapture of depreciation on the disposition of section 1245 property. A similar result applies to section 1250 property under proposed section 1250(d)(11)(A) in section 115(a) of the bill.

Proposed IRC section 1245(b)(8)(B) is analogous to proposed section 47(d)(3) in section 101(a) of the bill. Transfers back to the debtor in whose shoes the trustee is standing will not constitute a disposition for purposes of depreciation recapture unless the transfer is a sale. A similar rule applies with respect to transfers from the estate to a controlled corporation. A comparable amendment to IRC section 1250(d)(11)(B) is provided in section 115(a) of the bill with respect to section 1250 property.

It should be noted in passing that an oversight with respect to transfers to ConRail also occurred with respect to section 1245 and 1250 depreciation recapture. Section 109 of this bill cures that defect by redesignating IRC section 374(c), concerning transfers to ConRail, as IRC section 374(a). In so doing, the present cross reference to section 374(a) in IRC sections 1245(b)(3) and 1250(d)(3) will provide retroactive recapture protection.

Finally, section 116 of the bill extends these principles to prevent recapture of farm losses. Section 116(a) amends IRC section 1251(d) by adding a new paragraph (7). Subparagraph (A) exempts transfers of farm recapture property from the debtor to the estate at the commencement of the case. Subparagraph (B) protects transfers from the bankruptcy estate to the debtor, other than by sale, or to a controlled corporation.

It is the intent of the bill that as a general rule, a transfer to a trustee at the commencement of the case or back to the debtor at the close of the case is not a disposition for tax purposes. This should apply to sections of the IRC that are not specifically amended such as IRC section 453(d).

The next major topic dealt with in the bill concerns the treatment of discharge of indebtedness. Amendments to IRC sections 108 and 312 are made in sections 102 and 104, respectively, of the bill.

Section 102 of the bill incorporates a meaningful substantive reform to the concept of taxation of discharged indebtedness. The section is modeled after proposed section 346(j) of title 11 in H.R. 8200. Subsection (a) amends IRC section 108 and creates six new subsections that rationalize the treatment of recognition of income, reduction of basis, and reduction of loss carryovers. The policy of the section is based on a tax benefit approach.

The general rule in section 108(a) is that gross income will not include discharged indebtedness to the extent that an election is made to reduce basis under section 108(e). In the case of insolvency or in a case under title 11 (Bankruptcy), the amount includable in gross income is governed by a basis solvency test, but adjustments to deductions and loss carryovers will be made in any event. The final paragraph in section 108(e)(1) defines an insolvency to include a case under title 11 whether or not the debtor is actually insolvent.

Discharged indebtedness may itself be of a deductible nature—such as interest. Alternatively, the indebtedness discharged may not be itself deductible, as for example, borrowed funds, which were in turn

expended for operating expenses, thus contributing to deductions, or for capital expenditures, thus contributing to the basis of assets.

In either event, if the taxpayer has had or may enjoy a tax benefit as the result of indebtedness that is discharged, then that benefit should be erased. Thus, current years' deductions with respect to a discharged liability are automatically disallowed under section 108(b). However, if it is established that the indebtedness was of a deductible nature but was not deducted, or that the indebtedness resulted in "wasted" deductions which did not offset income and contributed to an expired net operating loss carryover, then no benefit has been realized and under section 108(d) no adjustment to net operating losses or basis is necessary.

The second sentence of section 108(b) makes clear that a capital loss incurred on the disposition of a capital asset will be treated as a deduction with respect to any liability incurred in connection with the purchase of such capital asset. When the sale of a capital asset purchased with borrowed funds and the resulting capital loss on the sale occur prior to discharge, the tax years prior to the year in which the discharge occurs will not be affected, but any capital loss carryover to the year of discharge or subsequent tax years would be reduced. This treatment benefits both the Internal Revenue Service and the taxpayer. The Internal Revenue Service is benefitted by the reduction of a deduction when there are no net operating losses or excess of basis over liabilities to be adjusted under subsection (c) or (e) respectively. The provisions benefits the taxpayer by causing a reduction of a capital loss rather than a net operating loss. As a general rule, a capital loss cannot offset ordinary income, except with respect to an individual to a very limited extent under IRC section 1211, whereas a net operating loss offsets both ordinary income and capital gain.

If current years' deductions are not involved and the discharged indebtedness did not result in "wasted" deductions, then three possibilities exist to cancel the benefit. First, under section 108(c), any net operating loss of an individual or corporation must be reduced. Once net operating losses are adjusted, then an election may be made to either recognize income under sections 61 and 108(a) or to reduce basis under section 108(e). Flexibility is important because the basis of property may be an important factor to be considered.

Two limitations serve to soften the impact of taxation of these four adjustments resulting from discharge of indebtedness. First, section 108(f) sets forth rules which deem indebtedness exchanged for stock or rights issued by the taxpayer or forgiven as a contribution to capital not to be discharged indebtedness, provided that the indebtedness discharged was not of a deductible nature, such as interest. This paragraph is designed to give the taxpayer the same tax treatment that would have resulted if the taxpayer had issued stock or rights rather than debt in the first place. Second, under section 108(e)(1)(B), the concept of "basis solvency" is a limit on the reduction of basis or the recognition of income by an insolvent individual, partnership, or corporation. This limit is appropriate because a bloated basis is a tax benefit that should be adjusted but will not be under traditional insolvency standards.

Proposed section 108 represents an improvement over current law in IRC section 108 and sections 268, 270, 396, 520, and 522 of the Bank-

ruptcy Act with respect to insolvent taxpayers. Under present bankruptcy law, forgiveness of indebtedness is not taxable, but basis is reduced at most to the extent it exceeds the fair market value of the assets. Current case law applying IRC section 108 to nonbankruptcy insolvencies goes one step further limiting taxation of discharge of indebtedness if the taxpayer is insolvent before and after such discharge. *Dallas Transfer & Terminal Warehouse Co. v. Commissioner*, 70 F.2d 95 (5th Cir. 1934); *Commissioner v. Simmons Gin. Co.*, 43 F.2d 327 (10th Cir. 1930); *Kramon Dev. Co.* 3 T.C. 342, 349 (1944) Cum. Bull. 17; Reg. § 1.61–12(b); Rev. Rul. 56–600, 1958–2 Cum. Bull. 29. If the transaction leaves the taxpayer with an excess of assets over liabilities, he is taxed only to the extent of the resulting free assets. *Lakeland Grocery Co.*, 36 B.T.A. 289 (1937); *Haden Co.*, 1939 B.T.A.M. ¶ 39, 465, *aff'd*, 118 F.2d 285 (5th Cir. 1941). Present bankruptcy law is justified on the ground that the reorganized company should get assets with a fair market value basis. Present tax law is justified on the ground that it would be unfair to tax a taxpayer to the extent the income being taxed exceeds assets available to pay the tax. A codification and extension of this principle was proposed by the Commission in sections 7–315(b) and (d) of its model statute.

Under section 7–315(b) of the Commission's proposal, if assets are purchased with borrowed funds and the assets decline in value and are sold at a loss, and then the indebtedness is discharged, that loss is disallowed. However, under section 7–315(d) of the Commission's proposal, if the time sequence is changed so that the indebtedness is first discharged, and then the assets are sold for their fair market value, then that loss (the excess of basis over the fair market value of the assets) will be allowed except to the extent that the taxpayer is rendered solvent. Assuming a basis of $100,000, fair market value of $20,000 and debts of $80,000, all but $10,000 of which are discharged, under both section 108, as amended by this bill, and the Commission's proposal if the property is sold prior to the discharge the loss carryover would be reduced by $70,000. However, if the property were sold after discharge, under the Commission's proposal, the basis of the assets would be reduced only to the extent that the debtor was made solvent (or from $100,000 to $90,000), and a $70,000 postbankruptcy loss could be realized on disposition. If the situation were identical except that the basis of the assets was deflated, and let us say the assets worth $20,000 had a basis of $10,000, and the taxpayer was solvent to the extent of $10,000 after the discharge, then under the Commission's proposal the basis of the assets would be reduced to zero and gain realized on disposition. This variation in result under the Commission's proposal is unjustifiable. Similar criticism applies to the solvency value limitation imposed under present case law interpreting IRC section 108.

By contrast, because section 108(e) (as amended by this bill) focuses on tax benefits, it achieves a consistent result whether assets are sold before or after indebtedness is discharged. In the example given, if the assets with the $100,000 basis are sold for $20,000 and then indebtedness is discharged to the extent of $70,000, the loss carryover would be reduced by $70,000. If the discharge occurs first, income would be recognized to the extent of $70,500, or, if an election is made, basis

would be reduced by $70,000, thus reducing to this extent the subsequent loss on disposition.

Similarly, section 108(e) achieves a more equitable approach when the discharged indebtedness exceeds the tax benefits enjoyed as a result of losses or increased basis deriving from such indebtedness. Thus, section 108(e)(1)(B) recognizes that the excess of the total adjusted basis of the assets (excluding new capital) over uncanceled liabilities is the appropriate limitation for an insolvent individual, partnership, or corporation. Whether the basis is bloated above or depressed below the value of the assets, the basis will never be reduced below the point where the basis of the assets will equal liabilities. Only to the extent that there is an excess of basis over liabilities is there a tax benefit, or "basis solvency." Though the concept of basis solvency will not apply to a solvent individual, partnership, or corporation, the other adjustments made under section 108 will result in a more rational result than under current law. Accordingly, section 108 reaches a result that is sound as a matter of tax policy; the result is also equitable as a matter of bankruptcy or insolvency theory.

As a corollary to the detailed changes made in section 102 of the bill with respect to the treatment of discharged indebtedness under IRC section 108, section 104 of the bill amends IRC section 312 with respect to earnings and profits.

The first change to section 312 involves the termination of shareholders' interest rather than indebtedness. A new IRC section 312(l) reduces a deficit in earnings and profits to the extent the capital account reflects interests of shareholders that are terminated under proposed section 1141(d)(1)(B) of title 11 or extinguished in an insolvency proceeding. However, positive earnings and profits are not increased or created. There is no reason to permit carryover of a deficit in earnings and profits to the extent the deficit reflects the investment of shareholders whose interests have been extinguished. On the other hand, the new shareholders should not be penalized by positive earnings and profits that reflect an investment they never made.

The second change to section 312 involves adjustments to earnings and profits as a result of discharge of indebtedness. The adjustments are to be made after any adjustments under subsection (*l*). A new IRC section 312(m) increases earnings and profits, or reduces a deficit therein, to the extent indebtedness of a corporation is discharged, with six basic exceptions. The first exception, in IRC section 312(m)(1), excludes discharged indebtedness that was used to reduce basis. Because the gain from the reduced basis will be recognized in earnings and profits when the property is sold (or a loss reduced), the exception in paragraph (1) is needed to eliminate double counting. The second exception, in IRC section 312(m)(2), excludes discharged indebtedness that was applied to reduce a deduction other than a loss carryover. Again, the exception is made to prevent double counting; to the extent a deduction is reduced, earnings and profits will be reduced, or a deficit increased, to a lesser extent than if the deduction had not been reduced. This does not apply with respect to loss carryovers because the losses will have been reflected in lower earnings and profits (or an increased deficit) even though the loss was not utilized in reducing taxes and had to be carried over; when the loss carryover is reduced,

no corresponding increase in earnings and profits would otherwise take place to rectify the prior decrease in earnings and profits, or an increased deficit therein, due to the loss. Thus, the exclusion of loss carryovers from the second exception will result in an increase in earnings and profits to the extent the indebtedness reflected in the loss carryover is discharged.

The third exception, in IRC section 312(m)(3), excludes discharged indebtedness that was included in the corporation's gross income. Obviously, if the indebtedness results in gain or ordinary income to the corporation and is otherwise reflected in earnings and profits, to do so again would be double counting. The fourth exception, in IRC section 312(m)(4), excludes discharged indebtedness of a deductible nature that had not been previously deducted from earnings and profits under the corporation's method of accounting. Thus, a deferred expense that never reduced earnings and profits, or increased a deficit therein, should not result in an adjustment when discharged because no compensating and offsetting entry to earnings and profits will ever have been made. The fifth exception, in IRC section 312(m)(5), excludes indebtedness that was not of a deductible nature that is discharged as a capital contribution by shareholders or by creditors in exchange for stock. In addition, the indebtedness must not have been deducted from earnings and profits under the corporation's method of accounting. If indebtedness of this kind has not reduced earnings and profits, or increased a deficit, then there is no reason to increase earnings and profits, or reduce the deficit, when that indebtedness is contributed to the capital of the corporation through discharge. On the other hand, if the indebtedness exchanged was deducted, then there is, and should be, an increase in earnings and profits, or a reduction in the deficit therein except to the extent that the issuance of stock has the same income tax consequences to the creditor as a cash payment. That exception is covered in new section 312(m)(6) and is justified to accord the taxpayer the same treatment that would have resulted if stock had been issued to satisfy the indebtedness *ab initio*, as long as the creditor must regard the transfer of stock for tax purposes the same as any other property. If stock is used to currently pay a salary expense, instead of the corporation having to borrow money to pay the salary, the fair market value of the stock may be deducted. If a previously accrued salary expense is satisfied by the issuance of stock equal in value to the accrual, then cancellation of the deduction by an adjustment to earnings and profits would be unfair, and the exception in paragraph (6) prevents that result.

The changes made by sections 102 and 104 of the bill are fairly noncontroversial. The Commission proposed a change in tax provisions relating to cancellation of indebtedness in section 2 of its proposed amendments to the Internal Revenue Code. The tax benefit approach on which section 102 of this bill is based was first advocated at pages 2005–27 of the *Hearings* by then Assistant Attorney General of the Tax Division, Scott Crampton. Parts I and VII of his testimony indicate the difficulties with the Commission's proposals, many of which have been recounted *supra*. Instead of focusing only on future tax benefits as the Commission's approach did, the Justice Department's approach takes account of past and future tax benefits. Nothing

in the testimony of former Commissioner Alexander for the Internal Revenue Service seems at odds with the tax benefit approach. *See Hearings* at 1976–79. A similar conclusion applies to the testimony of William T. Plumb, Jr., at 2068–70 of the *Hearings*.

The companion amendment to IRC section 312 was suggested in section 4 of the Commission's proposed IRC amendments and supported in substance in the testimony of each of the above-mentioned witnesses. *Hearings* at 2022–23, 1980–82, and 2070–71, respectively. Changes made in section 104 of this bill are in response to proposed changes suggested in that testimony.

The next major group of proposed amendments to be discussed concerns insolvency reorganizations and is found in sections 106–111 of the bill.

Sections 109, 110, and 111 of the bill totally revamp parts IV and V of subchapter C concerning insolvency reorganizations. The thrust of those sections is to bring insolvency reorganizations into conformity with other corporate reorganizations at the corporate level. Amendments made by sections 107 and 108 of the bill accomplish the same result at the creditor, security holder, and shareholder level. Finally, section 106 of the bill extends the reform by analogy to individual and partnership debtors involved in corporate organizations,

The present law concerning insolvency reorganizations is a hodgepodge. Arrangements under chapter XI of the Bankruptcy Act are never tax free unless they fall within IRC section 368(a). Corporate reorganizations under chapter X or in a State insolvency proceeding can gain tax free status under IRC section 371. Railroad reorganizations under section 77 are treated separately in IRC section 374. Security holders under a section 368 reorganization are subjected to the principal amount test under sections 354 and 356; security holders in a section 371 reorganization are treated under a different rule granting tax free status set forth in section 371(b); and security holders in a section 374 reorganization are treated under section 354(c) with respect to the recognition of gain or loss on the exchange of securities and stock. The basis to the acquiring corporation also depends under which section the reorganization occurs.

This bill sets forth a uniform rule for all corporate bankruptcy and insolvency reorganizations in a revised IRC section 371. Special treatment of railroad reorganizations is eliminated by the deletion of present IRC sections 374 (a) and (b). Also, section 371(d) eliminates confusion under present law whether a reorganization may qualify under both sections 368(a) and 371; the bill makes clear that section 371 is the predominant, though not the exclusive, method to reorganize insolvent corporations. Finally, section 372 is patterned after the general basis rule in IRC section 362(b), and section 374 preserves existing law regarding transfers to ConRail with the addition of one sentence to preclude a double tax benefit from a single net operating loss.

The general rule prescribed by proposed IRC section 371(a) permits assets for stock reorganizations in a manner similar to section 371 of current law, but the procedure is expanded to allow the tax free transfer of assets to a subsidiary in return for stock of the parent corporation. This change is similar to the amendments to section 368 that resulted in IRC 368(a)(2)(C). The effect is to overrule cases such as *Avco Manufacturing Co.*, 25 T.C. 975, 983–85 (1956). The change

was never made to section 371 and as such never applied to insolvency reorganizations under present law.

Another significant change from current law involves the expansion of section 371 to cover reorganizations in which the absolute priority rule does not apply. The consolidation of chapters X, XI, and XII into one chapter 11 means that the continuity of interest rule will not always be complied with. A complete explanation of the modified continuity of interest test is discussed in connection with section 111 of the bill, *infra*. Essentially, it is sufficient that any combination of creditors, security holders, or shareholders in the debtor have an interest preserved in the form of equity in the reorganized corporation; fictions with respect to proprietary ownership are thus unnecessary. To this extent, it is intended that cases such as *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942) and *Helvering v. Minnesota Tea Co.*, 296 U.S. 378 (1935) be limited to their facts and that cases such as *Mascot Stove Co. v. Helvering*, 120 F.2d 153 (6th Cir. 1941), *cert. denied*, 315 U.S. 802 (1942) be overruled. The fact that old shareholders make a new capital contribution is irrelevant. The line should be drawn to prohibit acquisition by strangers to the debtor when the interest continued by creditors, security holders, and shareholders of the debtor is not definite and material. The interest continued need not be controlling; as long as the stock interest acquired represents a substantial part of the value of the claims or interests surrendered. Thus, cases such as *John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935) and *Detroit-Michigan Stove Co. v. United States*, 121 F. Supp. 892 (Ct. Cl. 1954) should be followed with respect to section 371 reorganizations involving cases under chapter 11 of title 11. The modified continuity of interest test also would apply to non-bankruptcy reorganizations, without the necessity of invoking fictions used in cases such as *Palm Springs Holding Corp. v. Commissioner*, 315 U.S. 185 (1942).

In addition, in order to prevent flagrant trafficking in assets having a bloated basis, IRC section 269 and proposed section 1129(d) of title 11 should be applied liberally in cases under chapter 11 of title 11 when a proprietary interest in the business is neither retained nor acquired by entities that were shareholders, security holders, or creditors of the debtor in a case under title 11. This is a more practical approach than having to fictionalize whether the old shareholders, junior creditors, or senior creditors were in control of the equity of the debtor corporation at the time of reorganization.

The last significant change made in section 371 at the corporate level derives from the absorption of railroad reorganizations, currently treated under IRC section 374, into the general rules of IRC section 371. Under present IRC section 374(a) a railroad reorganization may be tax free only if the transfer is to another railroad corporation; under present IRC section 371(a), a reorganization from a nonrailroad corporation is only tax free if the transfer is to another nonrailroad corporation. Proposed IRC 371 would allow mixed tax free reorganization without regard to the character of the corporation.

The amendment made in section 109 of the bill is based on sections 7, 8, and 9 of the proposed amendments to the Internal Revenue Code of 1954 made by the Commission. It was supported during the *Hear-*

ings in testimony on behalf of the Internal Revenue Service and the Department of Justice, *Hearings* at 1983–84 and 2138, and by William T. Plumb, Jr., at pages 2071–74 of the *Hearings*. Mr. Plumb's testimony included a statement that the continuity of interest rule should be continued, but that the absence of absolute priority should not *per se* constitute a violation of the rule.

Before discussing the changes in insolvency reorganizations at the shareholder level, important changes to IRC sections 381 and 382 with respect to the carryover of net operating losses and other tax attributes must be examined. Sections 110 and 111 of the bill propose to amend IRC sections 381 and 382 to make them appply to insolvency reorganizations, including those in which the business of the debtor is divided among two or more corporations. Unlike the amendment in section 109 of the bill, these amendments are very controversial.

Under present law, the carryover provisions in IRC sections 381 and 382 do not apply to insolvency reorganizations under either IRC section 371 or 374. It is uncertain whether section 381 will apply if the reorganization also meets the requirements of IRC section 368, and also unclear if carryovers may be permitted on independent grounds if section 381 does not apply. Be that as it may, section 110 of the bill, modeled after section 10 of the Commission's tax proposals, amends IRC section 381(a) to incorporate section 371 reorganizations and to provide for an apportionment of tax attributes among the transferor and transferee corporations, to the extent permitted under regulations prescribed by the Secretary, when no one corporation owns substantially all the assets of the debtor corporation. Guidelines are provided to indicate that tax attributes should follow the assets transferred or retained as the case may be. Section 111 of the bill incorporates the limitations on net operating loss carryovers found in IRC section 382 with respect to section 371 reorganizations with the mitigating factor that claim holders, including creditors and security holders, as well as shareholders, are to be considered shareholders for purposes of applying the 40 percent and 20 percent tests. As a result, *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194 (1942), is overruled to the extent it excluded creditors with a proprietary interest from the 20 percent test.

It is important to recognize that the continuity of interest test, as modified, will apply with respect to section 371 reorganizations whether or not the reorganization is in a case under proposed title 11. Codification of the modified rule is found in proposed IRC section 382(b)(4)(D), and it is intended that this expansive treatment apply in IRC sections 371 and 381 as well. The new test specifies that claim holders and shareholders of the loss corporation, as well as their successors (other than by purchase) that acquire shares in the acquiring corporation in exchange for the extinguishment or relinquishment of their claim or interest are deemed to be shareholders of the loss corporation immediately before the reorganization unless their claim or interest was acquired for the purpose of acquiring stock in the acquiring corporation.

It also bears reiterating that several tax attributes specified in IRC section 381(c) will have been reduced as an effect of forgiveness of indebtedness under IRC sections 108 and 312 as amended by sections

102 and 104 of this bill. Thus, the continuity of interest test and the paring down of tax benefits should serve to minimize the possibility of abuse under IRC sections 381 and 382.

Yet, this does not exhaust the safeguards against abusing IRC section 381. The ubiquitous section 269 serves as an additional limitation on the trafficking of carryovers as does proposed section 1129(d) in a case under chapter 11 of title 11. In addition, the practical desirability of obtaining beneficial tax attributes is to utilize them under a consolidated return which requires at least 80-percent ownership under IRC section 1504(a). If an outsider owns 80 percent of the reorganized company's stock, then creditors, security holders, and shareholders in the debtor can hold at most 20 percent. Under the rigid rules of IRC section 382(b), this means a maximum net operating loss carryover of only 30 percent, and the same result pertains under IRC section 383 with respect to unused investment credits under IRC section 46(b), unused WIN credits under IRC section 50A(b), excess foreign taxes under IRC section 904(c), and any net capital loss under IRC section 1212. The net result is that it is very difficult to foresee flagrant abuses if sections 381 and 382 are extended to encompass insolvency reorganizations, divisive or otherwise.

On the other hand, the tax consequences that derive from whether sections 381 and 382 apply, can have a great impact on shaping a legitimate insolvency reorganization in which tax attributes should carry over. The present confines of IRC section 368(a) are wholly inappropriate in the insolvency context. As a result, the Commission proposed, and this bill adopts, amendments to bring section 371 reorganizations within the scope of IRC sections 381 and 382 as outlined, *supra*. The effect will be to increase the flexibility of insolvency reorganizations by neutralizing the tax effects in a broader range of plans than under present law.

Aside from the incorporation of section 371 reorganizations into the framework of section 381, two other changes increase the flexibility of passing through carryovers in the insolvency context. As previously mentioned, section 381 is amended by adding a new subsection (d) to permit the Secretary to apportion tax attributes in a divisive reorganization. It is well established that the circumstances of insolvency reorganizations frequently require the transfer of less than substantially all of the debtor's assets to an acquiring corporation. *See Western Massachusetts Theaters, Inc. v. Commissioner*, 236 F.2d 186 (1st Cir. 1956). That case involved the acquisition by a newly organized corporation of part of the theaters owned by a debtor in a State court insolvency receivership. Counsel for the Government on oral argument admitted that under section 112(b)(10) of the 1939 IRC (the predecessor to the 1954 IRC section 371), the amount of property transferred was not a decisive factor in determining whether a tax-free reorganization occurred; the requisite continuity of interest was the overriding factor. The court reaffirmed the wisdom of the Government's concession and cited *Lewis v. Commissioner*, 176 F.2d 646 (1st Cir. 1949) in support. There are many other legitimate circumstances when part of the business of a debtor is given to creditors and part is retained by shareholders. In those circumstances, there is no justifiable tax policy to deny apportionment of carryovers; in fact,

the requisite continuity of interest argues in favor of facilitating such reorganizations by avoiding the "tax penalty" that would apply if tax attributes were not permitted to be carried over. The Secretary, who is authorized to apportion earnings and profits in a divisive context under IRC section 312(h), should be able to draw sufficient guidelines in terms of continuity of interest and continuity of the business to achieve the desired result. At a minimum, there should be no difference between the bankruptcy of a parent and two subsidiary corporations and the bankruptcy of one corporation with two clearly identifiable departments or divisions; a discrete division should be permitted with carryovers in either case if the continuity of interest test is complied with.

In this context, the necessity for the second change becomes apparent. As noted, section 382(b)(4) is amended essentially to deem creditors, security holders, and shareholders to be shareholders of the debtor for purposes of applying the continuity of interest test in an insolvency context. Creditors, in many cases, are the equitable owners of the debtor corporation in insolvency proceedings or bankruptcy cases. They should not be deemed to be purchasers of stock and thereby denied the tax attributes of assets that they own as a matter of equity if they acquire legal ownership in the reorganization. It is immaterial whether the claims of the creditors are exchanged tax free under IRC section 354, because it is equitable ownership that should be important for purposes of IRC section 381.

The essence of these proposals is contained in sections 10, 11, and 12 of the Commission's tax amendments. They were debated at length during the *Hearings* with opposition being voiced to the expansion to divisive reorganizations by the IRS and Justice at pages 1950, 1985–86, and 2138–39 of the *Hearings*. However, inclusion of divisive reorganizations was supported by the National Bankruptcy Conference and by William T. Plumb, Jr., at pages 1932, 2074, and 2084–85 of the *Hearinas*. By contrast, there was unanimous agreement that section 381 should be amended to incorporate nondivisive section 371 reorganizations, *Hearinas* at pages 1932, 1985, 2074, and 2139, and that section 382(b) should be amended to deem creditors of the insolvent debtor to be shareholders, *Hearings* at pages 1986, 2074, and 2139. Subsequent correspondence from the Department of Justice indicated reservations concerning these changes unless unpaid government claims are made nondischargeable.

Having examined the impact of insolvency reorganizations at the corporate level, it is appropriate to discuss the impact on creditors, security holders, and shareholders. Sections 107 and 108 of the bill amend IRC sections 354 and 356 to create a uniform rule with respect to exchanges in insolvency reorganizations. Section 107 amends IRC section 354(c) to permit a tax-free exchange of securities of a corporation that is a party to the reorganization in an insolvency reorganization; rather than applying the principal amount test, the amendment utilizes a fair market value test. The definition of "a corporation a party to the reorganization" is defined to include securities of a parent corporation as was done in section 109 of the bill with respect to IRC section 371. Finally, IRC section 356 is amended by section 108 of the bill to incorporate the taxation of excess securities as boot and to tax

the boot as dividends if it is distributed as such to shareholders. As in section 354(c), a fair market value test is used rather than the principal amount test used in noninsolvency reorganizations.

Recommendations during the *Hearings* regarding sections 5 and 6 of the Commission's tax proposals concerning sections 354 and 356 suggested several alternative approaches. There was unanimous agreement that the failure of present law to tax excess securities as boot under IRC section 371(b) must be corrected. There was also unanimous agreement that present law under IRC sections 302(b)(4) and 371(b) is defective in failing to characterize boot as dividends in proper circumstances concerning insolvency reorganizations. *Hearings* at 1950, 1982–83, 2073–74, and 2138.

The difference of opinion expressed during the hearings centered around two issues. First, there was concern whether the principal amount test should apply to measure excess securities in an insolvency context, and if not, how the test should be modified and what scope the modification should encompass. Second, witnesses debated whether the "Carman" doctrine, failing to tax an exchange of accrued interest, should be abolished, and if so, what form the modification should take. Section 107 and 108 of the bill abandon the principal amount test only in insolvency cases and adopt a fair market value test in lieu thereof. The result in *Carman v. Commissioner*, 13 T.C. 1029, (1949) nonacq., 1950–1 (Cum. Bull. 7, withdrawn and acq. substituted, 1954–2 (Cum. Bull. 3, *aff'd in part and rev'd in part*, 189 F.2d 363, 51–1 U.S.T.C., ¶ 9312 (2d Cir. 1951), is modified only in insolvency cases to the extent that securities received in exchange for accrued interest is taxable as capital gain. The fact that this bill is limited to an insolvency context militated against a general revision to IRC sections 354 and 356 as an original proposition.

The principal amount test in IRC sections 354(a) and 356(d) has been the subject of criticism for many years. *See Hearings on Advisory Group Recommendations on Subchapters C, J, and K of the Internal Revenue Code before the House Committee on Ways and Means*, 86th Cong., 1st Sess. 652 (1952). *See also* ALI, *Income Tax Problems of Corporations and Shareholders*, 452–53 (1958). The present test treats as boot the fair market value of the excess principal amount of securities received in exchange for securities surrendered. (The securities, which do not include stock, are in a corporation a party to the reorganization.) The purpose of the test is twofold. First, the test is designed to avoid a bailout by a shareholder to escape the redemption rules of IRC section 302. If a shareholder could exchange stock for debt and then sell the debt, any ordinary income that would have resulted from straightforward redemption of the stock is turned into capital gain. Second, the test is designed to tax securities received in exchange for securities and accrued interest. While the bailout is unlikely to arise in a bankruptcy context because of the probable absence of positive earnings and profits, the exchange of securities for accrued interest is very likely to occur.

The problem lies in the irrationality of the principal amount test. Aside from a principal amount, the value of debt securities is determined by the interest rate and maturity date. One rationale of the principal amount test is to limit the tax-free exchange to securities less

accrued interest. While the principal amount is an adequate measure of this component near maturity under normal circumstances, it is a gross overstatement in an insolvency context when the value of the security is invariably below the principal amount. Moreover, legitimate business reasons, such as feasibility, often preclude adjustment of the interest rate and maturity date in insolvency cases to engineer an equivalent principal amount. As a result, application of the principal amount test would unfairly tax a security holder when no accrued interest is involved. For example, consider a bond with a $75 basis, with no accrued interest, in a principal amount of $1,000 that bears interest at a rate of 10 percent and that is due to mature in 1980. That bond may be worth $200 in terms of fair market value. In the typical case, the corporation will want to reduce the interest rate or extend the maturity date, or both, for cash flow reasons. Thus, a new bond with $2,000 principal amount bearing interest at 5 percent and maturing in 1990 may be worth a present fair market value of $200 and exchanged for the old bond under a plan. Gain would be realized to the extent of $125. The principal amount test would unfairly consider $100, the fair market value of the $1,000 excess securities received, to be boot. Gain would be recognized to the extent of the boot ($100). Accordingly, commentators have advocated comparing values in lieu of principal amounts. In the above example, no gain would be recognized under this test. But in order to prevent abuse when there is an accrued interest component as part of the exchange, the fair market value of that component must be deducted from the securities surrendered.

That is precisely what the bill does. Thus, in the above example, if there had been accrued interest of $250 owing and all other facts were the same, gain would be recognized to the extent of $40. Since the $1,000 principal amount of the securities and $250 accrued interest are securities are received and only $160 worth are surrendered, gain of $40 is recognized.

The issue then becomes whether the $40 should be taxed as ordinary income or as capital gain. Under present law, the result of *Carman* is to tax stock or debt received in exchange for accrued interest as capital gain when the stock or securities are sold. The bill treats securities exchanged for accrued interest the same as cash or other boot by causing an immediate recognition of capital gain, but retains the present rule with respect to stock if stock and securities are received in exchange for securities and accrued interest. When the *Carman* rule is abandoned for noninsolvency reorganizations, it should be abandoned in this context as well. In the meantime, the bill takes a step in the right direction.

As previously noted, witnesses testifying during the *Hearings* reached different conclusions about the best course to follow. The Justice Department recommended immediate action to overrule *Carman* in all reorganizations; the proposed amendments to IRC sections 356 and 358 are set forth at page 2025 and discussed at pages 2014 and 2015 of the *Hearings*. It should be noted that while the Justice Department proposal solves the *Carman* problem, it intentionally fails to correct the irrational principal amount test, as discussed *supra*. William T. Plumb, Jr., supported abandonment of the principal amount rule,

but concurs with the Justice Department testimony that *Carman* be overruled. *Hearings* at 2073. The IRS supported the Commission's proposals which would retain the principal amount test but did not address the *Carman* Issue.

The last amendment to be analyzed in this group is contained in section 106 of the bill which modifies IRC section 351 treating with certain insolvency organizations. Under present law, creditors in a corporation who exchange stock for debt, other than securities, may gain tax free status under IRC section 351 if they acquire 80 percent control. *Helvering v. Cement Investors, Inc.*, 316 U.S. 527 (1942) and *Alexander E. Duncan*, 9 T.C. 468 (1947) acq. 1948–2 Cum. Bull. 2. For creditors of an individual or partnership undergoing reorganization, section 351 is the only avenue for tax-free treatment. While the Commission broadened the class of persons qualifying as shareholders for purposes of continuity of interest in the context of insolvency reorganizations, the corporate organization provision in IRC section 351 was overlooked.

Section 106(a) of the bill creates a new IRC section 351(e) to enlarge the group of persons transferring property in an insolvency proceeding or bankruptcy case to an acquiring corporation under IRC section 351. For purposes of satisfying the control requirements of IRC section 368(c), it will suffice if any combination of the debtor and/or its creditors own the requisite 80 percent of stock in the acquiring corporation. The basis of property in the hands of the acquiring corporation will be the debtor-transferor's basis under IRC section 362(a) as it is under IRC section 362(b) with respect to a corporate reorganization. In both cases, the basis is adjusted under IRC sections 108 and 1017.

Because the Commission did not propose to amend IRC section 351, no testimony was received on this point during the *Hearings*. There is precedent in the law for considering the debtor and debtor's creditors as cotransferors of the assets of the debtor. *Bessemer Limestone & Cement Co.*, 22 T.C. 303 (1954). To the extent the creditors have an equitable interest in the debtor, this is appropriate. However, in order to simplify matters and achieve the same result as would pertain in a corporate reorganization, the debtor-transferor's basis is used in all circumstances. To this extent, *Bessemer Limestone & Cement Co.*, T. C. Mem. 1956–250, 15 T.C.M. 1277 (1956) is not followed. Consistent with that result, there is no taxable transaction whereby the creditors are deemed to have gained control of or acquired property from the debtor. Thus, *Helvering v. Cement Investors*, 316 U.S. 257 (1942), is followed and *United States v. Santa Inez Co.*, 145 F.2d 667 (9th Cir. 1945) is overruled on that issue. The creditor's basis will, however, be applied under IRC section 358 to the stock received in the acquired corporation. The amendment made in section 106 of the bill completes the reform of the basic insolvency reorganization provisions in the Internal Revenue Code.

The bill contains two amendments that are collateral to the insolvency reorganization amendments. As a corollary to the amendments to IRC sections 354 and 356 made in sections 107 and 108 of the bill, section 103 of the bill rationalizes the result concerning boot in railroad reorganizations. Section 105 of the bill extends the reform

of the Internal Revenue Code to eliminate discrimination with respect to insolvency liquidations.

Section 103 of the bill contains a noncontroversial amendment to IRC section 302 concerning the redemption of stock issued in railroad reorganizations under section 77 of the Bankruptcy Act. The amendment deletes IRC section 302(b)(4) so that it will have no prospective application to cases under proposed subchapter IV of chapter 11 of title 11, or to redemption, of stock issued in cases under the Bankruptcy Act, on or after October 1, 1978. Because IRC section 302(b)(4) would only have retrospective application before October 1, 1978, to redemption of stock issued in section 77 cases, it is deleted from the code essentially as deadwood.

Testimony during the *Hearings* was unanimous in support of this amendment. *Hearings* at 1980, 2073. As noted, this is in accord with amendments to IRC sections 354 and 356 and also has the effect of treating the redemption of railroad stock identically with redemption of other corporate stock for tax purposes.

Section 105 of the bill contains a proposed amendment to IRC section 337 for certain insolvency liquidations. As presently written, IRC section 337 provides a liquidation procedure under which no gain or loss is recognized if all assets of the corporation are distributed in complete liquidation. The Internal Revenue Service has taken the position that the non-recognition provisions of IRC section 337 do not apply if the corporate is insolvent. *See* Rev. Rul. 56–387, 1956–2 Cum. Bull. 189, as modified by Rev. Rul. 73–264, 1973–1 Cum. Bull. 178. The provision also does not apply in a liquidating reorganization where no gain or loss is recognized by the shareholders or security holders. *Davant v. Commissioner*, 366 F.2d 874, 881–83 (5th Cir. 1966).

IRC section 337 was drafted so that gain or loss from liquidating a business would not be recognized at both the corporate and shareholder levels. H.R. 1337, 83d Cong., 2d Sess. A107 (1954). When the original shareholders' interests are terminated, the shareholders are taxed under IRC section 331(a)(1) as though the stock were sold for the amount received. Thus, under section 331 and 337, it is possible for the corporation to have a gain that is not recognized and for the shareholder to recognize a loss. See Rev. Rul. 73–264, 1973–1 Cum. Bull. 178.

The fact that shareholders will always suffer a loss when they receive nothing is not a valid basis to support the IRS' position. There is little to distinguish between liquidations in which the shareholders receive $1 and those in which they receive $0. Indeed, when the assets are being distributed to creditors, equity demands that tax not be imposed at the corporate level for such a tax would not impact the shareholders, but would result in taxing the creditors. It should also be noted that to the extent creditors are not paid, they will likely have business bad debts that are deductible resulting in a probable net revenue loss to the Government. Moreover, the possibility of abuse from a tax benefit standpoint is slight due to superseding recapture provisions, *e.g.*, IRC sections 47, 617, 1245, and 1250.

In order to create a uniform result, the amendment to IRC section 337 applies to insolvency liquidations or liquidating reorganizations

whether or not involved in a case under proposed title 11. As a result, a tax benefit accorded all solvent corporations will no longer be withheld from those insolvent corporations in the greatest financial need.

The provision in section 105 of the bill is far less broad than the proposal in section 7–315(c) of the Commission's bill which would have prevented gain or loss on all sales not in the ordinary course of business by a reorganizing corporation. While the Commission's suggestion was properly criticized with respect to reorganizations where there is a continuity of ownership and the business continues, *Hearings* at 1974–76, 2004, 2061–62, it is appropriate in a complete liquidation or liquidating reorganization when the other requirements of IRC section 337 are complied with.

The bill contains two other amendments to substantive tax provisions in the Internal Revenue Code. Section 112 of the bill corrects a deficiency in current law by exempting a corporation in a case under title 11 from being considered as a personal holding company for purposes of part II of subchapter G of chapter 1 of the Internal Revenue Code. The amendment accomplishes this result by adding such corporations to the list of exceptions to the definition of personal holding company contained in IRC section 542(c).

In addition, the amendment contains language indicating that the exception is to apply notwithstanding proposed section 346(c)(1) of title 11. That section, as amended by section 301 of this bill, indicates that the commencement of a case under title 11 does not affect the status of a corporation for purposes of any income tax law, and proposed section 346(a) indicates that section 346(c)(1) is to apply notwithstanding any tax law. Since it is possible to argue that the status of a corporation in a case under title 11 is changed—unless it is previously exempt—in the context of personal holding companies, the inapplicability of section 346(c)(1) of title 11 is indicated in order to resolve the conflict. It should be noted in passing that the purpose of section 346(c)(1) is to prevent characterization of the estate of a corporation as a separate taxable entity and to avoid termination of the corporation's tax year; the section is not intended to overrule specific provisions in the Internal Revenue Code or in State or local tax laws treating with the manner or degree of tax, *e.g.*, sections 47, 108, 337, 371, and 1245 of the IRC.

The amendment made by section 112 of the bill is fairly noncontroversial. No testimony was received during the hearings on this issue because the Commission's tax proposals did not include an amendment to IRC section 542(c). The issue has arisen in litigation where the Internal Revenue Service has taken the position that a corporation's estate is a personal holding company with respect to income earned during a bankruptcy case, though the issue was not decided by the court. *In re I. J. Knight Realty Corp.*, 366 F. Supp. 450, 460 n. 25 (E.D. Pa. 1973). The effort in section 112 of the bill to foreclose the position argued by the Service could give rise to abuse if solvent corporations filed chapter 11 petitions merely to avoid the personal holding company tax under IRC section 541. It is intended that section 707 or 1112 of proposed title 11 be used to dismiss such cases with a retroactive imposition of the personal holding company tax on the corporations resulting under section 349(b)(3) of title 11.

The other substantive tax amendment remaining to be discussed is found in section 113 of the bill. That section amends IRC section 731 to treat with the very complicated matter of taxing a partner when indebtedness of a partnership is forgiven or discharged in an insolvency proceeding or in a case under title 11. Because the indebtedness discharged is not indebtedness of the partner, IRC section 108 does not apply under present law and will not apply under the amendment made by section 102 of this bill. Rather, under present law, IRC sections 752(b) and 731 apply to characterize the discharged indebtedness as a distribution of money to the partner that results in a recognition of gain to the extent such indebtedness exceeds the adjusted basis of the partner's interest in the partnership immediately before such discharge. Even if gain is not recognized, the amount of indebtedness discharged serves to reduce the basis of the partner's interest in the partnership under IRC section 733(1). No special exceptions are made if the partner, as well as the partnership, is insolvent.

Whatever may be said with respect to the merits of the insolvency exception in IRC section 108, there is no reason to prevent uniform application of that principle in this context. While it would be convenient to merely extend IRC section 108 to apply to this situation, it was simpler to draft a special rule in IRC section 731 because the gain recognized in this context is ordinarily capital gain rather than ordinary income.

Thus section 113(a) of the bill proposes a new IRC section 731(d) to limit the recognition of gain by an insolvent partner attributable to a decrease in the partner's share of liabilities discharged by reason of the partnership's insolvency. The limit prescribed is generally the total of (1) any net losses of the taxable year from the sale or exchange of capital assets and any capital loss carryovers to such year, plus (2) any excess of deductions over income for the taxable year, and plus (3) any excess of the total adjusted basis of the partners assets over his liabilities. The total is to be computed before any IRC section 731 gain arising from the discharge of such indebtedness is taken into account and before considering any IRC section 1202 deduction that might be attributable to such gain. The statute also makes clear that excess deductions under paragraph (2) include any net operating loss carryover but exclude net operating loss carrybacks. In addition, the statute prescribes a special rule with respect to paragraph (3) for a partner in a case under title 11. As under IRC section 108(e)(1)(B) (ii), as added by section 102 of this bill, the assets in question are those assets existing before the discharge and the liabilities must be preexisting liabilities that exist both before and after the discharge. This eliminates any assets acquired or liabilities incurred by the partner after the discharge, for example, new capital contributions if the partner is a corporation.

Proposed IRC section 731(d) is analogous to proposed IRC section 108 in other respects. The definition of an insolvent partner in section 731(d) is pegged to the definition in section 108(e)(1) to include a partner in a case under title 11 whether or not insolvent in the bankruptcy sense. Also section 731(d) contains language permitting an election to reduce basis rather than recognize gain as though section 108(e) and 1017 applied.

Yet, there are several instances in which proposed IRC section 731 (d) differs from proposed IRC section 108. As previously noted, gain under section 731 is ordinarily capital gain rather than ordinary income. Accordingly, section 731(d)(1) takes account of capital losses and capital loss carryovers because those tax attributes may be used to offset capital gains under IRC section 731. On the other hand, capital losses and loss carryovers were omitted in section 108 because they may be offset against ordinary income only to a limited extent under IRC section 1211(b) and incorporating a special rule would be more trouble than it is worth. Instead, section 108(b) treats with the issue in a limited fashion by denying capital loss deductions incurred on the disposition of a capital asset with respect to the discharge of a liability that was incurred in connection with the acquisition of that capital asset.

Another area of difference between proposed IRC sections 731 and 108 concerns application of section 108(b) dealing with disallowance of deductions. This section is inapplicable in the case of a partner because a partnership liability would never be deducted by a partner. The same is true concerning section 108(d) with respect to deductible liabilities not actually deducted.

One last difference concerns the wasted loss or tax benefit tracing limitation in section 108(d). This was deleted as inappropriate with respect to a partner. Discharge of indebtedness would be treated as a distribution producing capital gain even though by reason of such indebtedness a partner had deducted from ordinary income partnership losses in excess of his equity interest in the partnership. Were a tax benefit tracing principle strictly applied, the recoupment of such losses, through sale of the partner's interest or through a reduction of liabilities resulting in a distribution under IRC section 731, would be taxed as ordinary income rather than capital gain. Thus, since tax benefit tracing is not applied as to recoupment of losses, the tax benefit tracing limitation of section 108(d) is inappropriate with respect to recognition of gain. This is consistent with the approach taken in the Internal Revenue Code with respect to other provisions. For example, the section 1202 deduction is not allowed in computing either a net operating loss or the income for a year to which a loss is carried (subsections (b)(2), (c), and (d)(2) of IRC section 172) and if the alternative method is used in calculating tax liability the tax benefit of the net operating loss deduction is lost in part for the carryover year to the extent that it exceeds the ordinary income for that year. *United States v. Foster Lumber Co.*, 429 U.S. 32 (1976).

The statutory reference to IRC section 1202 deserves explanation. The section 1202 deduction that is available to noncorporate taxpayers is excluded from the initial recognition of gain and from the election to reduce basis under proposed IRC section 731(d).

Obviously, such deduction cannot enter into that component of the limitation set out in paragraph (1), since if capital losses exceed capital gains there is no deduction allowable. It cannot enter into that component of the limitation set out in paragraph (2) for any excess of deductions over income because to the extent that gain is recognized the section 1202 deduction is allowable, but until the gain is recognized the amount of section 1202 deduction is not determinable. Lastly, such

deduction has no relevance under paragraph (3) in calculating the excess of basis over liabilities.

When gain is recognized it is the total gain (before calculating the section 1202 deduction which is a function of the amount of gain recognized). Thus, an election to reduce basis rather than recognize gain would require reduction of basis by the total amount of gain not recognized. A taxpayer may have the benefit of either capital gain treatment to the extent gain is recognized (the alternative tax limitation, or the section 1202 deduction) or of an election to reduce basis instead of recognizing gains, but not both. Of course, except to the extent that there were losses or excess of basis over liabilities, gain deriving from discharge of partnership indebtedness would not be recognized by an insolvent partner in any event.

One last point remains to be discussed. Proposed IRC section 731(d) contains language indicating that the new subsection is to apply notwithstanding section 346 of title 11. As mentioned *supra* with respect to section 112 of the bill, this language is included to negate any inference that section 346 is intended to supersede this provision.

Title I of the bill contains four sections amending procedural provisions of the Internal Revenue Code. Sections 117–120 of the bill are intended to modernize tax procedure with changes made in the bankruptcy legislation codifying title 11.

Sections 118–120 are designed to alter the procedural effect of a bankruptcy case in regard to assessment and proceeding in the tax court. Under IRC section 6512(a) of present law, a taxpayer may proceed in the tax court after the Secretary has mailed a notice of deficiency under IRC section 6212(a) if the taxpayer files a petition with the tax court in compliance with IRC 6213(a). Section 6213 indicates that assessments are stayed pending tax court proceedings. But if the taxpayer is involved in a bankruptcy case, IRC section 6871 requires an immediate assessment and also forecloses the taxpayer prepayment relief in the tax court.

The ostensible purpose of IRC section 6871 is to enable the Service to claim the tax in bankruptcy court. But with the abolition of the requirement of provability in the new bankruptcy legislation, the Service will always be able to file proof of a contingent claim that will be allowed and estimated under proposed section 502(c) of title 11. Moreover, the assessment under present law has a detrimental effect that is unwise as a matter of tax policy. Even if the Service does not file a claim in the bankruptcy case, unless the tax assessed is discharged, the immediate assessment stands as a bar to prepayment review after bankruptcy.

This discrimination against bankrupt taxpayers is eliminated by an amendment to IRC section 6871 made in section 119 of the bill. No longer will bankruptcy serve as a basis for immediate assessment. The normal prerequisites under IRC sections 6212 and 6213 will therefore apply and the debtor's option of tax court relief will not be foreclosed. If the debtor receives a notice of deficiency and commences a case in the tax court, or if such a case is pending when the bankruptcy case is commenced, then the trustee may intervene in the case to adjudicate the estate's *in rem liability* if the estate is a separate taxable entity.

In additon to tax court relief, proposed section 1471(b) of title 28 in section 243(a) of the bankruptcy legislation contemplates concurrent jurisdiction in the bankruptcy court to determine the debtor's *in personam* liability and the estate's *in rem* liability with respect to refunds that are property of the estate. Accordingly, section 118 of the bill amends IRC section 6512(a) by adding an exception in a new paragraph (4) to the exclusive jurisdiction of the tax court concerning such matters. The filing of the bankruptcy case will not divest the tax court of jurisdiction with respect to the *in personam* liability of the debtor-taxpayer. Thus, the debtor-taxpayer in a case under title 11 has a choice whether to pursue the refund in the bankruptcy court or in the tax court. It is important to note that if the estate is a separate taxable entity, any action by the trustee will not concern the debtor's personal liability for taxes. Therefore, if the trustee proceeds in the bankruptcy court, the debtor may proceed in the tax court with separate courts passing on the *in rem* and *in personam* aspects of the case. On the other hand, if the trustee chooses to intervene in the tax court proceeding, the estate will be bound by the result. Because the bankruptcy and tax courts serve separate functions, it is appropriate to afford the debtor the choice of choosing in which forum he will proceed to adjudicate his *in personam* liability. Of course, the debtor may not proceed in the tax court with respect to employment taxes or other taxes beyond the scope of IRC section 6512; the bill merely preserves the taxpayer's rights to proceed in the tax court to the same extent as if bankruptcy had not occurred. If the bankruptcy court finds a tax liability of the estate that exceeds the personal liability of the debtor as determined by the tax court, then no refund will be due to either the estate or the debtor, because the decision of identical factual issues by one court is not *res judicata* with respect to a different party in the other court.

Another aspect of discrimination against bankrupt taxpayers under present law is eliminated in section 120 of the bill. That section amends IRC section 6873(a) to remove the Secretary's right to demand collection of an allowed claim for taxes that is unpaid during a bankruptcy case from the debtor after the case is closed. Since the claim for taxes in a case under title 11 will not be dispositive of the taxpayer's personal liability unless that matter litigated in the bankruptcy court, there is no longer any justification for an automatic power to demand collection of unpaid bankruptcy claims. The usual prerequisite of a notice of deficiency under IRC sections 6212 and 6213 with the opportunity for tax court relief, if available, will apply. The alternative of a jeopardy assessment under IRC section 6861 is also available.

None of the amendments in section 118–120 of the bill were contained in the Commission's tax proposals. Nevertheless, the amendment to IRC sections 6512 and 6871 were supported by William T. Plumb, Jr., at pages 2036 and 2075–77 of the *Hearings*, and no testimony in opposition was raised on the record, though the Internal Revenue Service did request that IRC section 6871 be expanded to cover chapter 42 or 43 taxes as a technical matter. *Hearings* at 1970.

The final amendment in title I of the bill to be discussed concerns a proposal of the Internal Revenue Service with respect to tentative

carryback adjustments under IRC section 6411(b). Under present law, the Secretary must refund a tentative carryback adjustment even if recoupment of such refund, if erroneous, would be placed in jeopardy. In the context of a bankruptcy case under present law, the Service is forced to file a claim for the erroneous refund with the bankruptcy court where the prospect for repayment is dim.

To remedy this defect in current tax procedure, section 117 of the bill proposes to amend IRC section 6411(b) to make clear that the Secretary need not refund a tentative carryback adjustment if a case under title 11 concerning the taxpayer is pending. The amendment was not included in the Commission's tax proposals, but was endorsed by the Service at page 1987 of the *Hearings*. No opposition to this suggestion was encountered.

While title I contains the bulk of the substantive amendments affecting the IRC, title II is confined to clerical, technical, and conforming amendments to 16 sections of the IRC. These sections contain amendments to sections, titles, cross references, and items in tables of sections that are outmoded as a result of the proposed repeal of the Bankruptcy Act and enactment of title 11 of the United States Code. The amendments made in those sections are largely self-explanatory and are not susceptible to meaningful discussion.

Title III of the bill contains four sections expanding proposed sections 346, 728, 1146, and 1331 of title 11 to cover Federal taxes in addition to the coverage of State and local taxes in the bankruptcy bill as reported by the House Judiciary Committee. In the interest of uniformity, the sections achieve an identical result of respect to Federal, State, and local tax policy.

Although jurisdiction over State taxes is vested in the Judiciary Committee, there is valid claim of concurrent jurisdiction in the Ways and Means Committee to the extent these provisions affect the Internal Revenue Code. Rather than approach this issue solely from a bankruptcy perspective, the bill strives to balance bankruptcy and tax policy in deference to the impact these special tax provisions will have on the entire Internal Revenue Code. This accounts in part for the divergence in policy between this bill and the proposals of the Bankruptcy Commission and the National Conference of Bankruptcy Judges in their bills (H.R. 31 and H.R. 32, 94th Cong. [hereinafter cited as Commission's bill and Judges' bill respectively]), with respect to taxes. The insensitivity to tax issues in those bills was evidenced during the *Hearings* at pages 1948–51, 1970–86, 2004–27, 2055–64, 2067–77, and 2123–26. On the other hand, the tax provisions in this bill do not satisfy fully objections raised in the testimony of the Internal Revenue Service, the Department of Justice, and William T. Plumb, Jr., Esquire, reflected in those pages of testimony.

In an attempt to produce a balanced approach in these sections, a task force of staff from the Department of the Treasury, Department of Justice, and Internal Revenue Service was consulted. The unofficial advice of this task force in combination with the advice of William T. Plumb, Jr., Esquire, was invaluable, and led to the refinement of the special tax provisions.

From a historical perspective, Congress has taken great care to insure that tax policy will not frustrate the operation of bankruptcy.

Thus, the Bankruptcy Act and the Internal Revenue Code contain numerous provisions recognizing special treatment for bankruptcy liquidations, reorganizations, and arrangements. The IRC often contains similar provisions with respect to nonbankruptcy insolvencies.

Congressional policy also applies to prevent State tax laws from frustrating the purposes of bankruptcy. A similar rationale has been upheld by the Supreme Court as acceptable under the Supremacy Clause when the effect, but not the purpose, of State nontax law was to frustrate bankruptcy policy. *Perez v. Campbell*, 402 U.S. 637 (1971).

The four tax provisions in this title differ in the scope of cases under title 11 they will affect. From a procedural standpoint, certain tax provisions will apply in liquidation, reorganization, or wage earner cases. These general provisions are found in 11 U.S.C. 346. Sections 728, 1146, and 1331 of title 11 contain tax provisions that only apply in a case under chapter 7, 11, or 13 of that title, respectively.

Sections 301 to 304 of the bill amend sections 346, 728, 1146, and 1331 of title 11 which set forth rules designed to prevent State and local tax laws from hindering the bankruptcy process. The amendments contained in title III of this bill expand these sections of title 11 to cover Federal taxes as well. The issue of expansion is not nearly as important as the issues of policy in the substantive tax provisions in sections 346, 728, 1146, and 1331 of title 11.

A threshold issue to be considered when a debtor files a petition under title 11 is whether the estate created under section 541 should be treated as a separate taxable entity. The inquiry must be addressed with respect to individuals, partnerships, and corporations in each chapter under which those entities may proceed.

Under present law, the basis for taxing a bankruptcy estate under the IRC is tenuous. Tradition has lumped bankruptcy estates together with decedents' estates under IRC section 641. Any fair-minded individual will readily admit that subchapter J of chapter 1 of the IRC was not designed with bankruptcy estates in mind. Section 6012(a)(3) of the IRC indicates that a return shall be made for every estate that has a gross income of $600 or more. Section 6012(b)(4) requires the fiduciary of an estate to file the return and IRC section 6012(b)(3) requires the trustee in bankruptcy of the business of a corporation to make a return for such corporation in the same manner as for corporations. These three sections have led the Service to contend, with varying degrees of success in the courts, that the estate of an individual or partnership is a separate taxable entity, but the estate of the corporation is not.

The approach taken in the Commission's bill and the Judges' bill is somewhat different. Section 5–104(b) provides that the estate is a separate taxable entity in a liquidation case concerning an individual, partnership or corporation. The wage earner and reorganization chapters are silent on the subject with the implication that present law would apply. The Commission reasoned that the trustee in a liquidation case should only pay taxes if the estate contained a surplus after distribution to creditors was completed. Therefore, the corporation's taxable year was terminated at the date of the petition because of the small likelihood that postpetition taxes would ever have to be paid.

Sections 346 and 728 of title 11 set forth rules that differ from both present law and Commission's bill. The guiding principle is that the tax treatment of a bankruptcy estate should not deter the debtor from filing bankruptcy. With respect to an individual, sections 346 (b)(1), 728(a), and 1146(a) of title 11 adopt the Service's position by establishing a separate taxable entity in a case under chapter 7 or 11 of that title. This is consistent with the fresh start that bankruptcy gives most debtors.

In a wage earner case, section 346(d) of title 11 indicates that the estate is not a separate taxable entity. As a practical matter, the function of chapter 13 of title 11 is to give the debtor a breathing spell in which to reach an arrangement with creditors. The plan is filed very rapidly. Although a trustee serves in the case, section 1303 of title 11 gives the debtor exclusive rights to use collateral and section 1306(b) of title 11 mandates the debtor to remain in possession of all property of the estate before confirmation of a plan. Most significant is the fact that discharge normally occurs only after completion of all payments under the plan which can be expected to be 2 or 3 years after the commencement of the case, if at all. Therefore, because the debtor does not get an immediate fresh start and because the debtor remains in possession and control of his property, the estate is not made a separate taxable entity. This is bolstered by the administrative reality that most chapter 13 estates will only remain open for 1 or 2 months until confirmation of the plan at which time section 1327(b) of title 11 will almost always revest title to property of the estate in the debtor.

With respect to a corporate debtor, section 346(c)(1) of proposed title 11 follows current law. The estate is not a separate taxable entity, and the corporation remains taxable as if the case had not been commenced.

Section 346(c)(1) of title 11 treats a partnership debtor in the same fashion. The estate of a partnership is not a separate taxable entity, and the partnership remains taxable to the same extent as if the case had not been commenced. This represents a departure from the current Service position which taxes the estate of a partnership even though the partnership itself is not taxable before the commencement of the case. The taxation of a partnership estate under present law is supported by the argument that partners no longer have an interest in the partnership, especially in a liquidation case. Often advocates of that approach are very careful to preserve an exception to the separate entity approach to insure that the "disinterested partners" will be affected by forgiveness of indebtedness of the partnership estate. The bill alters present law by returning to the position taken by the Internal Revenue Service in 1931 that the estate of a partnership is not a separate taxable entity. G.C.M. 8488, X–1 C.B. 270 (1931). The Service withdrew from this position in 1945. The position taken in section 346(c)(1) of title 11 is supported by the fact that the tax relationship between the partners and the partnership remains the same until the partnership is dissolved. The approach taken in this section also has the support of William T. Plumb, Jr., Esq.

Having discussed which entity is taxable, it is appropriate to examine the administrative responsibility for the taxes imposed.

If the estate is a separate taxable entity, then the representative of the estate is responsible for filing any income tax returns and paying

any taxes due by the estate. Section 728(b) of title 11 requires the trustee of the estate of an individual in a liquidation case to file returns only if the estate has net taxable income during the entire pendency of the case after the order for relief. If the estate has net taxable income, then the trustee is required to file a return for each tax year during which the case was pending after the order for relief. If the estate has no net taxable income, then the cost of preparing tax returns is saved.

In lieu of returns, section 704(7) of title 11 requires the IRS to be given copies of any reports of the operation of the business that are filed with the court. This appears to be a reasonable compromise between section 6012 of the IRC which requires the trustee to file returns in any year in which gross income of the estate exceeds $600 and the position taken in section 5–104(a) of the Commission's bill that the trustee file returns only if the estate contains a surplus of assets after distribution to creditors.

The other situation in which the estate is a separate taxable entity concerns an individual in a case under chapter 11 of title 11. Section 1146(b) of title 11 requires the trustee to make a tax return for each taxable year during which the case is pending. If the debtor in possession is the representative of the estate then he will file the return for the estate. This differs from current court cases holding that the estate of an individual debtor under chapter XI of the Bankruptcy Act is not a separate taxable entity, but is consistent with the position taken by the IRS.

If the estate is not a separate taxable entity, then administrative responsibility varies according to the nature of the debtor and the chapter under which the case is filed. If the debtor is a corporation in a case under chapter 7 of title 11, then section 728(b) of title 11 applies, as in a case concerning an individual, to require the trustee to file returns only if the estate has net taxable income during the entire case. This is the only exception to the general rule in section 346(c)(2) of title 11 that the trustee file a return for a debtor that is a partnership or a corporation as if no case has been commenced. The disparate treatment of a partnership and a corporation in a case under chapter 7 of title 11 is justified by the need of the partners to have the information contained in a partnership return in order to file their own returns and by the need of the Service to monitor the pass through of tax attributes to the partners.

The only remaining possibility concerns a debtor in a case under chapter 13 of title 11. Section 346(d) indicates that any income of the State is to be taxed only to the debtor. The duration of a chapter 13 case is so short that there is no reason to impose a duty to pay taxes on the trustee. Also, a chapter 13 trustee has a limited role in administering the estate, and is precluded from operating any business of the debtor. The result set forth in section 346(d) of title 11 is consistent with present practice.

Regardless of the duty to file a return, section 346(f) of title 11 requires the trustee to withhold taxes consistent with applicable law. This obviates the confusion under present law as to who the employer is for purposes of withholding taxes.

Once the issues are resolved concerning whether the debtor or the estate is to be taxed and who is responsible with respect to such taxes, the policy concerning the method of taxation should be considered. When the estate is not a separate taxable entity, then taxation of the debtor should be conducted on the same basis as if no petition were filed, with very few exceptions. If the estate is a separate taxable entity, there are several possible approaches. Under present law, the estate is taxed as a decedent's estate under IRC section 641 with a $600 deduction under IRC section 542(b) in lieu of the personal exemption under IRC section 151. Under IRC section 142(b)(4), the estate is ineligible for the standard deduction.

The Commission's bill follows current law in reorganization and wage earner cases, but provides that the estate will not be taxed in a liquidation case, under section 5–104(a), unless there is a surplus after all creditors are paid in full.

Section 346(b)(2) of proposed title 11 follows present law to the extent that the estate is taxed at the same rate as other estates. But the bill pursues a different approach to taxation of the estate or debtor concerning the status of expenses of administration. Under current law, Treasury Regulation section 1.212–1(i) regards all expenses of administration not incurred in connection with a trade or business as deductions for the production of income. Liquidation or reorganization of the estate is not itself considered a business. The result under present law is that the expenses are itemized deductions under IRC section 212 rather than subtracted from gross income as deductions under IRC section 162. Also, under IRC section 172(d)(4), these expenses are not included for purposes of computing a net operating loss to the extent that they exceed nonbusiness income.

Section 346(e) of proposed title 11 eliminates the discriminatory effect of present law and gives the estate or the debtor the same treatment that would result from liquidation or reorganization outside of bankruptcy. The impact on net operating losses is apparent. Characterization of administrative expenses as business expenses will remove any restriction on these losses.

It is important to point out that there are two kinds of administrative expenses that are not deductible under section 346(e) of title 11. First, a claim for a tax that is not otherwise deductible, such as State tax on a State tax return or Federal tax on a Federal tax return, is excluded when appropriate. Second, a capital expenditure that is not otherwise deductible, such as the purchase of new heavy equipment, is not deductible. In a bankruptcy context, costs and expenses incurred in the institution and administration of reorganization under Chapter II would also be capital expenditures. *Cf.* Rev. Rul. 77–204. Finally, any expense of administration that was previously deducted may not be deducted again. For example, an accrued expense deducted by the debtor before commencement of the case may not later be deducted by the debtor who changes to a cash basis method of accounting and pays the expense after the commencement of the case.

This example illustrates a larger problem that is solved in section 346(b)(3) of title 11. That section requires the accounting method of the estate to be the same as the accounting method of the debtor. This departs from current law, but is necessitated by a liberalized policy

with respect to carryovers and by problems, such as assignment of income issues, that exist under present law. The abuse with respect to double deductions previously illustrated is eliminated by this section which also prevents the double deduction of nonbusiness expenses under IRC section 212. When the estate is not a separate taxable entity, then IRC section 481 will apply to prevent a debtor that has changed accounting methods from having the benefit of any double deductions.

Several other provisions that impact the method of taxation deserve comment. Section 346(i)(1) of title 11 indicates that tax attributes of an individual carryover to the estate of an individual. Present law contains no clear statement on this subject; section 346(i)(1) of title 11 appears to resolve the issue in a manner consistent with sound tax policy. From a bankruptcy perspective, since the estate inherits every interest of the debtor, it should also receive all tax attributes held by the debtor when the case is commenced.

Section 346(g)(1)(A) of title 11 also clarifies a principle that is unstated under present law. That section indicates that the transfer of property from the debtor to the estate is not an occasion on which gain or loss will be recognized. This applies whether or not the estate is a separate taxable entity and represents sound bankruptcy and tax policy.

Taxation of partners and partnerships is a subject that gives rise to several special issues. Section 346(b)(1) of title 11 indicates that if an individual partner files a chapter 7 or 11 petition, then any tax attributes flowing from the partnership after the filing of the petition go to the partner's estate rather than to the partner. Present law is silent on the issue; this section clarifies that the partner's interest in the partnership is property of the estate and that tax attributes follow the interest into the estate.

Sections 728 (c) and (d) of title 11 provide special marshalling rules that apply if both a partner and a partnership are liquidating under chapter 7 of title 11. The sections are inspired by section 5–104(d) of the Commission's bill and have no counterpart under present law. Section 728(c) of title 11 indicates that a tax claim on income of a partner that was never distributed from the partnership should be allowed only against the partnership. As between the creditors of the partner and the creditors of the partnership, it seems fair to allocate the claim to the estate that has the benefit of the asset on which the tax claim is based. Of course, if the estate of the partnership does not satisfy the claims of partnership creditors in full, then section 723(c) of title 11 will apply to permit the trustee of the partnership to file a claim against the estate of the partner for the deficit. The amount of the deficit is not reduced by the limitation in section 728(c) of title 11. Moreover, the limitation of this subsection to the purposes of allowance and distribution means that the government still has a claim against the partner for purposes of nondischargeability. Section 728(d) of title 11 requires the apportionment of any tax refund or reduction of tax between the partner's estate and the partnership estate. However, a taxing authority distributing a refund in violation of the apportionment order would not be required to make a double payment.

The partnership should receive any refund or reduction that is

fairly apportionable to the deduction, the carryover, or the carryback of losses sustained by the partnership that are not reimbursed by the partner. The partner's estate is entitled to the balance. Expert opinion is split on these provisions. William T. Plumb, Jr., Esquire, has indicated his support of these sections, but the Internal Revenue Service testified in opposition to the administrative burden of "apportionment" at pages 1973–74 of the *Hearings*.

Another issue concerning the taxation of the estate of an individual, involves the use of tax loss carrybacks of the estate to prepetition tax years of the individual. The issue has not arisen under present law. Section 5–104(c) of the Commission's bill dealt with a related question concerning use of the debtor's prepetition carrybacks. This is not contained in the special tax provisions because the right to a refund is clearly property of the estate under section 541. The related problem was raised during discussion with the joint task force. Section 346 (i)(3) of title 11 is clear that the debtor may not use his carrybacks during the pendency of the case. This is sound because it eliminates any administrative need to determine, as between the estate and the debtor, who is first in using a loss carryback.

The more subtle question concerns the capacity of the debtor to carryback a loss that occurred during the pendency of the case after the estate is closed. No administrative burden exists because action taken by the estate is final. From an analytical viewpoint, the carryback will only apply to nondischargeable taxes because the carryback period and the nondischargeability period are both 3 years. Section 346(i)(3) of title 11 allows the debtor to carryback his losses to a tax period preceding the commencement of the case to which the estate may or may not have carried back losses. The policy is salutary because of the impact on the debtor's fresh start and because of the small probability of significant double counting. In a typical chapter 7 case, operating losses of the estate will be minimal whereas losses of the debtor from a new business may be substantial. On the other hand, in a typical chapter 11 case, operating losses of the estate will derive from operation of the reorganized business, but the debtor, often a debtor in possession, will be very unlikely to have losses from a new venture.

Another provision that affects the method of taxation in bankruptcy applies only in chapter 11. Section 1146(c) of title 11 is modeled after section 267 of the Bankruptcy Act which exempts any security or transfer instrument dealt with under a confirmed chapter X plan from any State or Federal stamp tax. Section 1146(c) of title 11 broadens the exemption to any stamp tax or similar tax on a security or a transfer instrument dealt with under the consolidated chapter 11. No opposition has been voiced with respect to this section.

While the foregoing sections have focused on methods of taxation during the case, there are a few provisions that have tax effects after the case is closed. Sections 346(g)(1)(B) and 346(g)(1)(C) of title 11 indicate that no gain or loss is recognized on distribution of property of the estate to the debtor or to a successor to the debtor. Section 346(g)(2) of title 11 provides that the debtor or successor to the debtor takes the property with the same character, holding period, and basis as in the hands of the estate at the time of transfer. A similar rule

applies with respect to property transferred from the debtor to the estate when the case is commenced.

Adjustment of the basis in the hands of the estate before such transfer occurs as an aspect of the taxation of forgiveness of indebtedness. Section 346(j) contains seven detailed paragraphs that rationalize the treatment of recognition of income, reduction of basis, and reduction of loss carryovers. The policy of the section is premised on a tax benefit approach, and is in accord with the amendment to IRC section 108 made by section 102 of this bill. Most of the analysis accompanying the discussion of that section applies here as well, but is repeated for ease of reference, verbatim, when necessary.

Discharged indebtedness may itself be of a deductible nature—such as interest. Alternatively, the indebtedness discharged may not be itself deductible, as for example, borrowed funds, which were in turn expended for operating expenses (thus contributing to deductions), or for capital expenditures (thus contributing to the basis of assets).

In either event, if the debtor or the estate has had or may enjoy a tax benefit as the result of indebtedness that is discharged, then that benefit should be erased. Thus, current years' deductions with respect to a discharged liability are automatically disallowed under section 346(j)(2) of title 11. However, if it is established that the indebtedness was of a deductible nature but was not deducted, or that the indebtedness resulted in "wasted" deductions which did not offset income and contributed to an expired net operating loss carryover, then no benefit has been realized and under section 346(j)(4) of title 11 no adjustment to net operating losses or basis is necessary with respect to individual or corporate debtors.

The second sentence of section 346(j)(2) of title 11 makes clear that a capital loss incurred on the disposition of a capital asset will be treated as a deduction with respect to any liability incurred in connection with the purchase of such capital asset. When the sale of a capital asset purchased with borrowed funds and the resulting capital loss on the sale occur prior to discharge, the tax years prior to the year in which the discharge occurs will not be affected, but any capital loss carryover to the year of discharge or subsequent tax years would be reduced. This treatment benefits both the taxing authority and the debtor. The taxing authority is benefited by the reduction of a deduction when there are no net operating losses or excess of basis over liabilities to be adjusted under paragraphs (3) or (5) respectively. The provision benefits the taxpayer by causing a reduction of a capital loss rather than a net operating loss. As a general rule, a capital loss cannot offset ordinary income, except with respect to an individual under IRC section 1211, whereas a net operating loss offsets both ordinary income and capital gain.

If current years' deductions are not involved and the discharged indebtedness did not result in "wasted" deductions, then three possibilities exist to cancel the benefit. First, under section 346(j)(3) of title 11, any net operating loss of an individual or corporate debtor must be reduced. Once net operating losses are adjusted, then the debtor may either recognize income under section 346(j)(6) of title 11, or reduce basis under section 346(j)(5). Flexibility is left with the debtor because the basis of property transferred may be crucial element in a plan of reorganization.

Two limitations serve to soften the impact of taxation of these four adjustments resulting from discharge of indebtedness. First, section 346(j)(7) of title 11 sets forth rules which deem indebtedness exchanged for an equity security or forgiven as a contribution to capital not to be discharged indebtedness, provided that the indebtedness discharged was not of a deductible nature, such as interest. This paragraph is designed to give the debtor the same tax treatment that would have resulted if the debtor had issued stock rather than debt in the first place. Second, under section 346(j)(5)(B) of title 11, the concept of "basic solvency" is a limit on the reduction of basis or the recognition of income. This limit is appropriate because a bloated basis is a tax benefit that should be adjusted but will not be under traditional insolvency standards.

Section 346(j) represents an improvement over sections 7–315(b) and (d) of the Commission's bill and sections 268, 270, 395, 396, 520, and 522 of the Bankruptcy Act. Under present bankruptcy law, forgiveness of indebtedness is not taxable, but basis is reduced at most to the extent it exceeds the fair market value of the assets. Section 7–315(d) of the Commission's bill goes one step further limiting taxation of discharge of indebtedness or reduction of basis to the extent the taxpayer is solvent after such discharge. Present law is justified on the ground that the reorganized company should get assets with a fair market basis. The Commission's bill is justified on the ground that it would be unfair to tax a debtor to the extent the income being taxed exceeds the assets available to pay the tax.

Under section 7–315(b) of the Commission's bill, if assets are purchased with borrowed funds, and the assets decline in value and are sold at a loss, and then the indebtedness is discharged, that loss is disallowed. However, under section 7–315(d) of the Commission's proposal, if the time sequence is changed so that the indebtedness is first discharged, and then the assets are sold for their fair market value, then that loss—the excess of basis over the fair market value of the asset—will be allowed except to the extent that the debtor is rendered solvent. Assuming a basis of $100,000, fair market value of $20,000 and debts of $80,000 all but $10,000 of which are discharged, under both section 346(j) and the Commission's proposal if the property is sold prior to the discharge the loss carryover would be reduced by $70,000. However, if the property were sold after discharge, under the Commission's proposal, the basis of the assets would be reduced only to the extent that the debtor was made solvent (or from $100,000 to $90,000), and a $70,000 post-bankruptcy loss could be realized on disposition. If the situation were identical except that the basis of the assets was deflated, and let us say the assets worth $20,000 had a basis of $10,000, and the debtor was solvent to the extent of $10,000 after the discharge, then under the Commission's proposal the basis of the assets would be reduced to zero and gain realized on disposition. This variation in result under the Commission's proposal is unjustifiable. Similar disrepute has been heaped on the solvency value limitation of present law.

By contrast, section 346(j)(5) of title 11, because it focuses on tax benefits, achieves a consistent result whether assets are sold before or after indebtedness is discharged. In the example given, if the assets

with the $100,000 basis are sold for $20,000 and then indebtedness is discharged to the extent of $70,000, the loss carryover would be reduced by $70,000. If the discharge occurs first, basis would be reduced by $70,000, thus reducing to this extent the subsequent loss on disposition.

Similarly, section 346(j)(5) of title 11 achieves a more equitable approach where the discharged indebtedness exceeds the tax benefits enjoyed as a result of losses or increased basis deriving from such indebtedness. Thus, section 346(j)(5)(B) of title 11 recognizes that the excess of the total adjusted basis of the debtor's assets—excluding new capital—over uncanceled liabilities is the appropriate limitation. Whether the basis is bloated above or depressed below the value of the assets, the basis will never be reduced below the point where the basis of the assets will equal liabilities. Only to the extent that there is an excess of basis over liabilities is there a tax benefit, or "basis solvency". Accordingly, section 346(j) of title 11 reaches a result that is sound as a matter of tax policy and equitable as a matter of bankruptcy theory.

Another group of tax provisions that are of primary effect after the case is closed concern the debtor's capacity to succeed to tax attributes not utilized by the estate. The provisions apply only when the estate is a separate taxable entity. Section 346(i)(2) of title 11 allows the debtor to succeed to any attribute that the debtor originally passed into the estate but that was unutilized by the estate. The section does not allow the debtor to succeed to attributes first generated by the estate. In order to prevent the debtor from being prejudiced by the pendency of the case, section 346(i)(2) of title 11 stays any time limitation on the utilization of such attributes during the pendency of the case. In addition, section 346(h) of title 11 makes clear that the creation of the estate as a separate taxable entity does not create an extra taxable year for purposes of limitations on loss carryovers or carrybacks. This section applies to the use of carryovers by the estate during the case as well as by the debtor after the case is closed. By contrast, present bankruptcy law contains no counterpart to section 346(h) of title 11, and IRC sections 441(b)(3) and 7701(a)(23) establish a rule contrary to section 346(h) of title 11 creating a short taxable year when the estate is formed. It is submitted that the position taken in section 346(i)(2) is correct. From a tax perspective, the characteristics may be regarded as never having passed to the estate. From a bankruptcy perspective, equity suggests that unutilized tax attributes be preserved as "assets" in order to facilitate the fresh start of the debtor. As a matter of policy, it would be unwise to discourage bankruptcy by denying the debtor tax benefits that would have been his to use but for the creation of the bankruptcy estate.

In addition to the above mentioned substantive tax provisions, there are a few procedural tax provisions that merit discussion.

Section 1146(e) and section 1331 of title 11 continue a provision found in sections 271, 397, and 523 of the Bankruptcy Act and proposed in section 7–315(e) of the Commission's bill. These sections recognize that the Service may be unable to assess first or sixth priority tax claims against the debtor before a plan is confirmed. Therefore, any assessment of such tax that occurs before 1 year after the commencement of the case and after confirmation of a plan may be collected from the debtor or a successor to the debtor under the plan.

To cover the capacity of the trustee representing the estate of an individual to get an advance determination of the estate's liability, section 1146(e) of title 11 is made subject to section 505(c).

Section 1146(d) of title 11 is the procedural vehicle permitting an expedited declaration of the tax effects of a reorganization plan. In order to give taxing authorities a chance to dispose of the issues, the court may permit the plan's proponent to request a taxing authority to declare the tax effects of the plan. After the authority responds, or in any event after 270 days after such request, the court may bind the taxing authority by declaring the tax effects, in the event of an actual controversy. The provision is necessary to facilitate acceptance of plans and does not impose an unreasonable burden on Federal, State, or local taxing authorities.

Section by Section Analysis

Title I contains 20 sections that amend the substance of the Internal Revenue Code of 1954 with respect to insolvency proceedings and cases under proposed title 11. Each section states a general rule and indicates an effective date; occasionally, clerical, technical, or conforming amendments are included.

Section 101 is entitled "Investment Credit Recapture Exception." Subsection (a) amends IRC section 47 by adding a new subsection (d) which prescribes four situations in which IRC section 47(a) will not apply.

The first paragraph overrules the practice under present law by exempting from investment credit recapture the transfer from a debtor to the estate in a case under the Bankruptcy Code.

The second paragraph is new and indicates that in an insolvency proceeding or bankruptcy case under proposed title 11, the reduction in basis of section 38 property from the discharge of indebtedness that was not incurred with respect to the acquisition of such property will no longer result in the recapture of an investment credit.

The third paragraph clarifies the law by exempting from investment credit recapture the transfer from the bankruptcy estate of an individual or partnership debtor to such debtor, other than by a sale to such debtor, or to a corporation controlled by such debtor within the meaning of section 368(c). The transfer is also exempted to a corporation controlled by creditors, of such a debtor, or both such a debtor and such creditors, if the corporation would have succeeded to the tax attributes of the business of the debtor under section 381 had the business been a corporation.

The fourth paragraph corrects an oversight in the 1976 Tax Reform Act by exempting a transfer to ConRail under section 374(a), as amended by section 109 of this bill, from investment credit recapture.

Subsection (b) indicates that paragraphs (1), (2), and (3) are to apply to cases commenced under the Bankruptcy Code on or after October 1, 1978, and that paragraph (4) is to apply to all transfers to ConRail, *i.e.*, transfers on or after March 31, 1976.

Section 102 is entitled "Discharge of Indebtedness." Subsection (a) amends IRC section 108 by adopting a completely new approach to the tax effects of discharge of indebtedness.

Proposed section 108(a) states the general rule that forgiveness of indebtedness is not taxable to the extent that an election is made to reduce basis under subsection (e). In addition, the amount includable in gross income is limited to the excess of the limitation in subsection (e)(1)(B) over the amount by which basis is reduced, but any adjustments under subsections (b) and (c) will be made in any event.

Subsection (b) disallows deductions for liabilities of a deductible nature in any year during or after the year of cancellation of such liabilities. For the purposes of this subsection, "a deduction with respect to a liability" includes a capital loss incurred on the disposition of a capital asset with respect to a liability that was incurred in connection with the acquisition of such asset.

Subsection (c) causes any net operating loss of an individual or corporation to be reduced by any discharge of indebtedness except as provided in subsections (b) or (d). If a deduction is disallowed under subsection (b) then no double counting occurs. Thus, subsection (c) will reflect the reduction of losses by liabilities that have been forgiven, including deductible liabilities or nondeductible liabilities such as the principal amount of borrowed funds.

Subsection (d) specifically excludes two kinds of indebtedness from reduction of net operating losses under subsection (c) or from reduction of basis under subsection (e). Paragraph (1) excludes items of a deductible nature that were not deducted or that could not be deducted such as gambling losses or liabilities for interest owed to a relative of the taxpayer. Paragraph (2) excludes indebtedness that resulted in deductions which did not offset income and that did not contribute to an unexpired net operating loss or loss carryover in the case of an individual or corporation. In these situations, the taxpayer has derived no tax benefit so there is no need to incur an offsetting reduction.

Subsection (e)(1) provides a two-pronged test for electing to reduce basis. An election to reduce basis property belonging to a solvent individual, partnership, or corporation may be made under subparagraph (A) to the extent indebtedness has been discharged, less any adjustments under subsections (b) and (c). An individual is limited to reducing the basis of property used in a trade or business or with respect to which the indebtedness was incurred. Subparagraph (B) sets out the maximum amount by which basis may be reduced for an insolvent individual, partnership, or corporation. Clause (i) contains the general amount equal to the total indebtedness forgiven less adjustments made under subsections (b) and (c). This avoids double counting. If a deduction is disallowed under subsection (b) or a carryover is reduced under subsection (c) then the tax benefit is neutralized, and there is no need to reduce basis. Clause (ii) further limits the reduction of basis to the extent total basis of assets immediately before discharge exceeds the total preexisting liabilities after discharge of indebtedness. This is a "basis solvency" limitation which differs from the usual test of solvency because it measures against the remaining preexisting liabilities the tax benefit aspect of preexisting assets, their basis, rather than their value. Subsection (e) is not intended to cover preexisting assets that will be eliminated in a tax-free liquidation after the reduction of basis. Thus, the step-transaction doctrine would prevent reduction of basis of the stock of a subsidiary that will be liquidated tax-free under IRC section 332.

The final paragraph of section 108(e) defines an insolvent entity as one whose aggregate property, at a fair market value, is insufficient to pay its total liabilities whether or not due. The concept also includes any entity concerning which a case under title 11 (bankruptcy) is pending when the indebtedness is discharged whether or not such entity is insolvent in the bankruptcy sense.

Subsection (e)(2) specifies that the election to reduce basis under paragraph (1) will follow a procedure pursuant to regulations prescribed by the Secretary under section 1017.

Subsection (f) treats with discharge of certain indebtedness connected with the issuance of stock or with a contribution to capital by a shareholder. There are two circumstances in which indebtedness will not be treated as discharged for purposes of section 108. Paragraph (1) excludes indebtedness with respect to which stock or rights are issued by the taxpayer to a creditor, or which is forgiven as a contribution to capital by a shareholder, to the extent such indebtedness consists of items not of a deductible nature. Paragraph (2) creates the second exclusion for indebtedness consisting of items of a deductible nature, if the exchange of stock or rights issued by the taxpayer for indebtedness has the same effect as a cash payment equal to the value of the stock or rights, in the amount of the fair market value of the stock or rights or, if less, the extent to which such exchange has such effect. These two provisions treat the taxpayer as if it had originally issued stock instead of debt. Paragraph (2) rectifies the inequity under current law between a cash basis and accrual basis taxpayer concerning the issuance of stock or rights in exchange for previous services rendered of a greater value than the stock or rights. Paragraph (2) also changes current law by taxing forgiveness of indebtedness to the extent that stock or rights are exchanged for the accrued interest component of a security, because the recipient of such stock would not be regarded as having received money under the *Carman* doctrine.

Subsection (b) of section 102 of the bill is a clerical amendment to the table of sections.

Subsection (c) of section 102 of the bill indicates that the amendments made by section 102 will apply to indebtedness discharged, other than under the Bankruptcy Act, on or after October 1, 1978. October 1, 1978, is the effective date of proposed title 11. Cases under the Bankruptcy Act continuing after that time will operate under present IRC section 108 while cases commenced under title 11 will have the benefit of section 108 as amended by section 102 of this bill.

Section 103 of the bill is entitled "Stock Issued in Railroad Reorganizations." Subsection (a) amends IRC section 302(b) by deleting paragraph (4) which prescribes a special rule for redemption of stock issued in railroad reorganizations under section 77 of the Bankruptcy Act. Subsection (b) of section 103 contains three conforming amendments to IRC section 302(b) that renumber paragraphs and delete cross references to old paragraph (4). Subsection (c) indicates that the repeal is effective with respect to any redemption occurring on or after October 1, 1978.

Section 104 of the bill is entitled "Earnings and Profits." Subsection (a) amends IRC section 312 by adding two subsections. New subsec-

tion (1) concerns the effect of termination of shareholders' interests on earnings and profits. If a shareholder's interest in a corporation is terminated under proposed section 1141(d)(1)(B) of title 11, or extinguished in an insolvency proceeding, then the deficit in earnings and profits is to be reduced by the amount of the capital account attributable to the terminated or extinguished interest. Under no circumstances will earnings and profits be increased or created; the section is limited to reducing any deficit.

New subsection (m) contains the general rule that earnings and profits will be increased, or a deficit therein reduced, to the extent that indebtedness of a corporation is discharged. The adjustments in this subsection are to be made after any adjustments made under subsection (*l*). There are six exceptions indicating kinds of discharged indebtedness that will not affect earnings and profits. Paragraph (1) excepts indebtedness that was applied to reduce basis under proposed section 346 (j)(5) of title 11 or under IRC sections 108 and 1017 (as amended by sections 102, 203, and 301 of this bill). Paragraph (2) excepts discharged indebtedness that was applied to reduce a deduction, other than a loss carryover, under IRC section 108(b) or proposed section 346(j)(2) of title II. Paragraph (3) excepts discharged indebtedness that was included in the corporation's gross income, such as under proposed section 346(j)(6) of title 11. Paragraph (4) excludes discharged indebtedness of a deductible nature that had not previously been deducted from earnings and profits under the corporation's method of accounting. Paragraph (5) excludes certain discharged indebtedness that is not of a deductible nature and that had not previously been deducted from the corporation's earnings and profits account. The discharged indebtedness must either constitute a capital contribution by shareholders of the corporation or must have been held by creditors whose interest in the corporation was continued through the issuance of stock in such corporation in consideration of the discharge. The value of the stock exchanged for indebtedness in this last instance need not be equivalent to the amount of the indebtedness discharged in order for the exception to apply. Paragraph (6) excludes the fair market value of stock or rights issued by the corporation in discharge of indebtedness of a deductible nature that was previously deducted from earnings and profits to the extent the issuance of stock has the same income tax consequences to the creditor as a cash payment equal to the fair market value of the stock or rights.

Subsection (b) indicates that the amendment made by section 104(a) of the bill will apply to indebtedness discharged or interests terminated or extinguished on or after October 1, 1978. Though the amendment applies to all cases commenced under proposed title 11, as well as to nonbankruptcy instances of discharge of indebtedness, the amendment will not apply to indebtedness discharged under the Bankruptcy Act, even if the indebtedness is discharged after October 1, 1978.

Section 105 of the bill is entitled "Certain Corporate Insolvency Liquidations." Subsection (a) amends IRC section 337 by adding a new subsection (e). The new provision indicates that subsection (a) of section 337 will apply even if shareholders do not receive any dis-

tribution by reason of the insolvency of the corporation. This overrules the current position of the IRS in Rev. Rul. 56–387, 1956–2 Cum. Bull. 189, as modified by *Rev. Rul.* 73–264, 1973–1 Cum. Bull. 178. The new subsection also limits *Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966); *Ralph C. Wilson, Sr.*, 46 T.C. 334 (1966); and *Rev. Rul.* 61–156, 1961–2 Cum. Bull. 62, 63, insofar as liquidating reorganizations under chapter 11 of proposed title 11 will be eligible for section 337 treatment when there is a complete liquidation and the interest of the old shareholders in the corporation is obliterated.

Subsection (b) indicates that the amendment made by section 105 (a) will apply with respect to all liquidations, commenced on or after October 1, 1978, other than under the Bankruptcy Act. Thus present law will apply with respect to cases commenced under the Bankruptcy Act before October 1, 1978, in which the first liquidation of corporate assets is on or after October 1, 1978, for purposes of IRC section 337.

Section 106 is entitled "Transfer to Controlled Corporation." Subsection (a) amends IRC section 351 by creating a new subsection (e). That subsection contains a special rule for insolvency organizations giving debtors, under title 11 or otherwise, the same chance at tax-free organization that an insolvent corporation has at a tax-free reorganization under IRC section 371, as amended by section 109 of this bill. Thus, if property of a debtor (or of the debtor's estate) is transferred to a corporation organized or made use of to effectuate a plan of reorganization, that is approved or confirmed by the court, solely in exchange for stock or securities, then no gain or loss is recognized except as provided in sections 108 and 1017; also, the transferee corporation must be controlled by the debtor and/or creditors and the transfer must be either pursuant to an order of the court having jurisdiction over the property in an insolvency proceeding or under chapter 11 of title 11, or pursuant to a plant of reorganization confirmed or approved by such court.

If the transfer is not solely in exchange for stock or securities, then IRC section 351(b) applies, to recognize gain not in excess of any boot received, by virtue of section 106(b) of the bill which makes a conforming amendment to that extent. It should be noted in passing that the corporation's basis under IRC section 362 will be the debtor-transferor's basis even though the creditors may be in partial or total control for purposes of section 368(c). No antecedent component transaction between the debtor (or the debtor's estate) and creditors in connection with the relinquishment or extinguishment of creditors claims and their subsequent acquisition of stock in the transferee corporation is recognized as a taxable event under this amendment. The only indirect impact is through section 108(f) (as amended by section 102 of this bill) which affects the debtor's basis (and hence the transferee corporation's basis) in certain circumstances when stock issued by the debtor (or by the estate or a successor corporation) is exchanged for indebtedness. Of course, the basis of the creditors' extinguished debt will be transferred to the stock they receive under IRS section 358.

Subsection (c) indicates that the amendments made by subsection (a) and (b) will be effective with respect to property transferred, other than in a case under the Bankruptcy Act, on or after October 1, 1978.

Section 107 is entitled "Exchange of Stock and Securities in Certain Insolvencey Reorganizations." Subsection (a) amends IRC section 354(c) by incorporating an entirely new rule for insolvency reorganizations. As amended by this bill, section 354(c)(1) provides for IRC section 354(a)(1) to apply to plans of reorganization confirmed under chapter 11 of proposed title 11, approved by the ICC under section 20b of the Interstate Commerce Act, or approved in a receivership, foreclosure, or similar proceeding. The reorganization need not qualify under section 368(a). Proposed IRC section 354(c)(2) limits the application of section 354(c)(1) to cases in which the fair market value of any securities (in a corporation that is a party to the reorganization) that are received by the creditor does not exceed the fair market value, less the fair market value of any accrued interest, of any such securities surrendered by the creditor. Section 354(c)(1) will also not apply if securities in a corporation that is a party to the reorganization are received but no such securities are surrendered. Thus, section 354(c), in combination with the amendment to IRC section 371(b) made by section 109 of this bill, will apply to permit recognition of gain or loss at the security-holder level in certain insolvency reorganizations that is not recognized under current law. For example, suppose a creditor holds a bond with a basis of $400, a $1,000 principal amount, and no accrued interest, and that the creditor will receive in exchange two bonds with a total principal amount of $2,000 but with a maturity date far in the future. If the fair market value of what is received is equal to what is given up, say $900, then the creditor would realize a gain of $500 but would recognize no gain. If there was, in addition, accrued interest of $500, then section 354(a)(1) would not apply, because the fair market value of the securities received ($900) would exceed the fair market value of the securities surrendered ($900) less the fair market value of the accrued interest component ($300). As will be shown, gain will be recognized under section 356(d)(2)(D) to the extent of $300.

Paragraph (3) in new section 354(c) indicates that a party to a reorganization includes an acquiring corporation and any corporation in control of such a corporation for purposes of applying section 354(a)(1) in section 354(c) and for purposes of section 356(d)(2)(D), notwithstanding section 368(b). Paragraph (4) contains a cross reference to section 356.

Subsection (b) of section 107 indicates that the amendment made by section 107(a) is effective with respect to plans of reorganization, other than under the Bankruptcy Act, approved or confirmed on or after October 1, 1978.

Section 108, entitled "Receipt of Additional Consideration in Certain Insolvency Reorganizations", makes corresponding changes to IRC section 356(d)(2) by adding a new subparagraph (D). That new subparagraph applies to section 354(c) exchanges (as amended by section 107 of this bill) in which the fair market of the securities received exceed the fair market value of any accrued interest. In that event, subparagraph (D) defines "other property" to mean such excess for purposes of applying section 356(a). If no securities in any corporation a party to the reorganization are surrendered, then the excess is the entire fair market value of the securities received. Thus, in the

example used in discussing section 107(a), section 356(d)(2)(D) would apply to recognize receipt of "other property", and hence gain, to the extent of $300, the fair market value of the $500 of accrued interest surrendered. It should be noted by virtue of IRC section 356 (a) the $300 gain would be capital gain. The result is to preserve the holding in *Carman v. Commissioner*, 13 T.C. 1029 (1949), nonacq., 1950–1 Cum. Bull. 7, withdrawn and acq. substituted, 1954–2 Cum. Bull. 3, *aff'd in part* and *rev'd in part*, 189 F.2d 363, 51–1 U.S.T.C., ¶ 9312 (2d Cir. 1951), to the extent that accrued interest is part of the securities exchanged, but to modify the impact that the principal amount rule presently has on non-section 371 insolvency reorganizations. The effect of the fair market value test in section 356(d)(2)(D) is to treat payment of accrued interest in securities the same as payment in cash or other property, not in instances when the principal amount of the securities exchanged happen to differ, but when the values of the principal amounts differ.

Subsection (b) indicates that the amendment made by section 108 (a) will apply with respect to exchanges under plans of reorganization confirmed or approved, other than under the Bankruptcy Act, on or after October 1, 1978.

Section 109, entitled "Insolvency Reorganizations", is the heart of title I of the bill. Subsection (a) amends part IV of subchapter C by thoroughly redrafting each of the three sections contained therein. Proposed IRC section 371 is entitled "Reorganization in Certain Receivership Proceedings and in Cases under Title 11." It contains four subsections threating with transfers in corporate reorganizations under chapter 11 of proposed title 11 or in a receivership, foreclosure, or similar proceeding. Subsection (a) of section 371 provides that, subject to sections 108 and 1017, no gain or loss shall be recognized in such a case if property of a corporation is transferred to another corporation organized or made use of to effectuate an approved or confirmed plan of reorganization in exchange solely for stock or securities in such other corporation or in a corporation that is in control of such other corporation. Subsection (b) of section 371 provides that if subsection (a) would apply, but for the fact that property received consists of other property or money (boot) in addition to stock or securities, then no gain or loss is recognized if the corporation receiving the boot distributes it under the plan. If the corporation does not distribute the boot under the plan, then section 371(b)(1)(B) indicates that any gain to the corporation shall be recognized in an amount not to exceed the fair market value of the undistributed boot received. The value of the boot is the sum of any money received plus the fair market value of other property received. Section 371(b)(2) indicates that if undistributed boot is received, a loss may not be recognized. Section 371 (c) contains a cross reference indicating that section 357 applies to transactions in a section 371 reorganization involving an assumption of a liability or the acquistion of property that is subject to a liability.

Subsection (d) clarifies that a transaction described in both section 368(a) and 371 is to be treated as described only in section 371 for purposes of subchapter C of chapter 1 of the Internal Revenue Code of 1954.

Proposed IRC section 372 concerns basis rules for property transferred in a section 371 reorganization. If section 371 applies to a transfer, then the basis of the property transferred in the hands of the acquiring corporation is the same as it was in the hands of the corporation whose property was acquired just before the transfer (subject to sections 108 and 1017), increased by any gain recognized to the acquiring corporation under tax laws applicable in the year of transfer.

Section 374, entitled "Gains or Loss Not Recognized in Certain Railroad Reorganizations", contains three subsections treating with transfers to ConRail. The subsections retain the law in present IRC sections 374(c), (d), and (e), but some changes are made because of the deletion of sections 374(a) and (b) which present section 374(c) cross-references. Changes in the law are also made where present law cross-references section 374(a); as a result of this bill, those cross-references will now govern transfers to ConRail, formerly in section 374(c). See IRC 48(h)(9), 49(b)(7), 341(f)(3), 1245(b)(3), 1250(d)(3), and 1251(d)(3). Proposed section 374(a) mirrors present section 374(c) with stylistic incorporations of provisions referred to in present sections 374(a) and (b). Proposed IRC section 374(b) tracks present section 374(d), and proposed IRC section 374(c) is identical with present IRC section 374(e), save for changing "includible" to "includable" in present section 374(e)(1)(B) and for the addition of a final sentence. The new sentence indicates that a net operating loss treated as "expired" under section 108(d) and section 346(j)(4)(B) of title 11 may not be resuscitated to offset gain for purposes of transfers to ConRail. This is necessary to avoid a double tax benefit to the corporation from a single net operating loss.

Subsection (b)(1) of section 109 makes a conforming amendment to IRC sections 48(h)(9), 49(b)(7), 341(f)(3), 1245(b)(3), 1250(d)(3), and 1251(d)(3) changing the cross-reference to section 371(a) to a general reference to section 371. The change is made because the basis in the hands of the transferee will be determined under section 371(a), (b), or (c) as a result of the amendment made by section 109 of the bill. Subsection (b)(2) conforms the cross-reference to section 371 in section 358. Subsection (b)(3) deletes cross-references to IRC section 372(a) and 374(b)(1) in IRC section 617(h)(3) and replaces them with a reference to section 371. Subsection (b)(4) changes cross-references to section 374(c) in sections 354(d) and 358(b) to 374(a) in accordance with the change made to section 374 in subsection (a) of section 109 of this bill.

Subsection (c) of section 109 contains two rules governing the effective dates of amendments made by sections 109 (a) and (b). The general rule is that amendments to IRC sections 371 and 372 and those made in subsection (b) will apply to transfers made, and to plans of reorganization approved or confirmed, other than under the Bankrupty Act, on or after October 1, 1978. The special rule is that IRC section 374, as amended, and the amendment made in subsection (b)(4) will apply to transfers, other than in a proceeding under section 77 of the Bankruptcy Act, made in taxable years ending after March 31, 1976. This has retroactive effect for all transfers to ConRail.

The same effective date applies to all sections of the IRC in which section 374 is cross-referenced, except with respect to transfers made under section 77 of the Bankruptcy Act.

Section 110 of the bill is entitled "Carryovers in Certain Corporate Acquisitions." Subsection (a) contains two paragraphs amending IRC section 381. Paragraph (1) adds a new section 381(a)(3) to allow carryover of the items specified in IRS section 381(c) to an acquiring corporation in a transfer to which section 371—as amended by section 109 of this bill—applies. This allows carryovers in certain insolvency reorganizations, in receiverships, or under proposed title 11 of tax attributes of the debtor to another corporation organized or made use of to expedite a plan of reorganization or to a corporation controlling such other corporation. Paragraph (2) redesignates IRC section 381(d) as 381(e) and creates a new section 381(d) governing certain divisive insolvency reorganizations. New IRC section 381(d)(1) authorizes the Secretary to prescribe regulations to determine whether and to what extent the items specified in section 381(c) shall be retained by the transferor corporation or transferred to one or more acquiring corporations. The Secretary is also authorized to prescribe regulations to determine the extent to which the operating rules of section 381(b) will apply in such a case. Proposed section 381(d)(2) sets forth guidelines to govern the formulation of regulations by the Secretary. If a corporation to which section 371 applies owns a substantial portion of the assets transferred, it is to be deemed an acquiring corporation with respect to items described in IRC section 381(c) (1) and (2)—net operating losses and earnings and profits—to the extent appropriate to such assets. Also, the transferor corporation is to retain that portion of net operating losses and earnings and profits as are appropriate to the assets retained by it. Finally, the other items in section 381(c) are to be treated according to their character and their relationship to the assets and liabilities of the respective corporations.

Subsection (b) indicates that the amendments made in section 110(a) will apply with respect to transfers made and to plans of reorganizations approved or confirmed, other than under the Bankruptcy Act, on or after October 1, 1978.

Section 111 is entitled "Special Limitations on Net Operating Loss Carryover." Subsection (a) contains two amendments to IRC section 382 designed to conform that section with the changes made by section 110 of this bill to IRC section 381. Paragraph (1) amends IRC section 382(b)(1) to include a reorganization under section 371 as amended by section 109 of this bill. This makes the limitations in section 382(b) with respect to net operating loss carryovers applicable to insolvency reorganizations. If the shareholders of the loss corporation own less than 40 percent of the stock of the acquiring corporation, the net operating loss carryover is reduced by a percentage specified in section 382(b)(2). Thus, if shareholders of the loss corporation own 30 percent of such stock, 65 percent of the net operating loss carryovers may be used. If 20 percent of the stock is owned, 30 percent of the net operating loss carryovers may be used; and if 10 percent of the stock is owned, 15 percent of the net operating loss carryover may be used.

Paragraph (2) amends section 382(b)(4) by adding a new subparagraph (D) for purposes of applying section 382(b)(1)(B) to insolvency reorganizations in order to define persons who are shareholders owning stock in the loss corporation. Proposed section 382(b)(4)(D) defines shareholders in the loss corporation, immediately before the reorganization, to include claim holders and shareholders of the loss corporation and successors to such claim holders and shareholders that acquire stock in exchange for, or the extinguishment of, their claim against or interest in the loss corporation. The original claim or interest in the loss corporation must not have been acquired for the purpose of acquiring stock in the acquiring corporation. Also, a successor to such claim holder or shareholder must not have purchased the claim or interest; "purchase," used in this sense, is intended to mean an acquisition of a claim or interest the basis in which is determined by reference to its cost to the holder thereof. Finally, it should be noted that a "claim holder" includes a creditor or a security holder.

Subsection (b) makes clear that the amendments made by section 111(a) apply to transfers and plans or reorganization confirmed or approved (other than under the Bankruptcy Act) on or after October 1, 1978.

Section 112 of the bill is entitled "Personal Holding Companies." Subsection (a) amends IRC 542(c) by adding a new paragraph (8) and by redesignating present paragraph (8) as paragraph (9). The amendment contained in new paragraph (8) makes clear that the term "personal holding company" as defined in IRC section 542(a) does not include a corporation in a case under title 11, United States Code, notwithstanding section 346(c)(1) of that title, as amended by section 301 of this bill. In the unlikely event that title 11 is used for the principal purpose of avoiding the tax imposed under IRC section 541, it is intended that confirmation of a plan be denied under section 1129(d) of title 11, or that the case be dismissed under section 707 or 1112(b) of title 11. The effect of dismissal under section 349(b)(3) of title 11 will be to retroactively impose any tax liability that would have otherwise been due under IRC section 541 on the corporation.

Subsection (b) indicates that the amendment made by subsection (a) of section 112 of the bill is to take effect with respect to cases beginning on or after October 1, 1978. Because the new paragraph added by subsection (a) applies on its face only to cases under title 11, it is not necessary to exempt cases under the Bankruptcy Act from the effective date language in subsection (b).

Section 113 of the bill is entitled "Effect of Discharge of Certain Partnership Indebtedness." Subsection (a) of section 113 amends IRC section 731 by adding a new subsection (d). The new subsection regulates the effect of the discharge of partnership liabilities or indebtedness on the insolvent partners in the partnership, notwithstanding section 346 of title 11, as amended in section 301 of this bill. Likewise, IRC section 108 will not apply because the indebtedness discharged belongs to the partnership and not to the partner.

If a partner is insolvent within the meaning of IRC section 108(e)(1), as amended in section 102 of this bill, then the recognition of gain attributable to a decrease in the partner's share of partnership

liabilities—due to the discharge of those liabilities in an insolvency proceeding or case under title 11 concerning such partnership—is limited. Section 731(d) defines the limit to be the total of (1) any net losses of the taxable year from the sale or exchange of capital assets and any capital loss carryovers to that taxable year; plus (2) any excess of deductions over income for the taxable year, excluding net operating loss carrybacks; and plus (3) any excess of the total adjusted basis of the partner's assets over his total liabilities. The totals are to be computed before any gain relating to the discharge of partnership liabilities is recognized by the partner and before any section 1202 deduction—pertaining to capital gains—relating to such discharge is taken into consideration. In addition, it is intended that deductions in paragraph (2) include net operating loss carryovers and that the calculations in paragraph (3) be done, if a case concerning the partner is pending under title 11, with respect to only those preexisting liabilities that exist after the discharge of indebtedness of the partner and those assets that existed immediately before such discharge. This is similar to the "basis solvency" test imposed under section 346(j)(5) of title 11, as amended in section 301 of this bill, if the partner is a corporation, new capital will thus be excluded. Finally, if the gain—before considering any IRC section 1202 deduction—to the partner from the discharge of partnership liabilities exceeds the total of any amounts in paragraphs (1) and (2), then an election may be made to reduce basis, as though IRC sections 108(e) and 1017 were applicable to the discharge of such partnership indebtedness, rather than to recognize gain. It should be noted that the standards in section 731 differ from the standards under section 108 because the gain under section 731 is ordinarily capital gain where the gain under section 108 is ordinary income.

Subsection (b) of section 113 indicates that the amendment made in subsection (a) will be effective with respect to indebtedness discharged on or after October 1, 1978, other than under the Bankruptcy Act. Thus, if a partnership's indebtedness is discharged under the Bankruptcy Act on or after October 1, 1978, the partner will not be affected by the amendment made to section 731 even if the partner is discharged in a case under title 11 on or after that date. But, if a partnership's indebtedness is discharged under title 11 and the partner's indebtedness is discharged in a case under the Bankruptcy Act, then the amendment is intended to apply because the relevant "indebtedness discharged" is not forgiven under the Bankruptcy Act.

Section 114 of the bill is entitled "Section 1245 Depreciation Recapture Exception." Subsection (a) amends IRC section 1245(b) by adding a new paragraph (8) which prescribes two situations in which the general recapture rules of IRC section 1245(a) will not apply.

Proposed IRC section 1245(b)(8)(A) indicates that a transfer of section 1245 property by the debtor to the bankruptcy estate at the commencement of a case under title 11 will not trigger recapture under IRC section 1245(a). Subparagraph (B) indicates that certain transfers of section 1245 property from the bankruptcy estate will not trigger depreciation recapture. Clause (i) exempts transfers of section 1245 property from the estate to an individual or partnership debtor, unless the transfer is by a sale. Transfers of section 1245 prop-

erty from the estate of corporate debtors to such debtors will not constitute dispositions triggering recapture because those estates are not separate taxable entities under section 346(c)(1) of proposed title 11. Clause (ii) exempts transfers of section 1245 property from the bankruptcy estate of an individual or partnership debtor to a corporation controlled by such debtor, as control is defined in IRC section 368(c). That clause also exempts transfers of section 1245 property from the bankruptcy estate of an individual or partnership debtor to a corporation controlled by creditors of such debtor, or both such debtor and such editors, if the corporation would have succeeded to the tax attributes of the debtor's business under IRC section 381, had that business been a corporation.

Subsection (b) is a clerical amendment to IRC section 617(d) to prevent the recapture of certain mining exploration expenditures relating to certain transfers in cases under title 11. The amendment incorporates the exception added to IRC section 1245(b) by section 114(a) of this bill into the list of cross references already referred to in IRC section 617(d)(3).

Subsection (c) indicates that the amendments made by section 114 of the bill will apply to bankruptcy cases commenced under title 11 on or after October 1, 1978.

Section 115 of the bill is entitled "Section 1250 Depreciation Recapture Exception." Subsection (a) amends IRC section 1250(d) by adding a new paragraph (11) which prescribes two situations in which the general recapture rules of IRC section 1250(a) will not apply.

Proposed IRC section 1250(d)(11)(A) indicates that a transfer of section 1250 property by the debtor to the bankruptcy estate at the commencement of a case under title 11 will not trigger recapture under IRC section 1250(a). Subparagraph (B) indicates that certain transfers of section 1250 property from the bankruptcy estate will not trigger depreciation recapture. Clause (i) exempts transfers of section 1250 property from the estate to an individual or partnership debtor, unless the transfer is by a sale. Transfers of section 1250 property from the estate of corporate debtors to such debtors will not constitute dispositions triggering recapture because those estates are not separate taxable entities under section 346(c)(1) of proposed title 11. Clause (ii) exempts transfers of section 1250 property from the bankruptcy estate of an individual or partnership debtor to a corporation controlled by such debtor, as control is defined in IRC section 368(c). That clause also exempts transfers of section 1250 property from the bankruptcy estate of an individual or partnership debtor to a corporation controlled by creditors of such debtor, or both such debtor and such editors, if the corporation would have succeeded to the tax attributes of the debtor's business under IRC section 381, had that business been a corporation.

Subsection (b) indicates that the amendment made by section 115 of the bill will apply to bankruptcy cases commenced under title 11 on or after October 1, 1978.

Section 116 of the bill is entitled "Farm Loss Recapture Exception." Subsection (a) amends IRC section 1251(d) by adding a new paragraph which prescribes two situations in which the general recapture rules of IRC section 1251(c) will not apply.

Proposed IRC section 1251(d)(7)(A) indicates that a transfer of section 1251 property by the debtor to the bankruptcy estate at the commencement of a case under title 11 will not trigger recapture under IRC section 1251(c). Subparagraph (B) indicates that certain transfers of section 1251 property from the bankruptcy estate will not trigger farm loss recapture. Clause (i) exempts transfers of section 1251 property from the estate to an individual or partnership debtor, unless the transfer is by a sale. Transfers of section 1251 property from the estate of corporate debtors to such debtors will not constitute dispositions triggering recapture because those estates are not separate taxable entities under section 346(c)(1) of proposed title 11. Clause (ii) exempts transfers of section 1251 property from the bankruptcy estate of an individual or partnership debtor to a corporation controlled by such debtor, as control is defined in IRC section 368(c). That clause also exempts transfers of section 1251 property from the bankruptcy estate of an individual or partnership debtor to a corporation controlled by creditors of such debtor, or both such debtor and such creditors, if the corporation would have succeeded to the tax attributes of the debtor's business under IRC section 381, had that business been a corporation.

Subsection (b) indicates that the amendments made by section 116 of the bill will apply to bankruptcy cases commenced under title 11 on or after October 1, 1978.

Section 117 of the bill is entitled "Tentative Carryback Adjustments." Subsection (a) amends IRC section 6411(b) to make clear that the Secretary need not refund a tentative carryback adjustment if a case under title 11 concerning the taxpayer is pending. It is intended that the Secretary will exercise this discretion only if he determines that collection from the debtor would be in jeopardy should it subsequently be determined that the tentative adjustment was erroneous. Thus, if a refund were made and recoupment would derive from a claim under title 11 that is not likely to be paid in full, the Secretary need not make the refund. The amendment does not apply to the mandatory credits that must be made under IRC section 6411(b).

Subsection (b) indicates that subsection (a) of section 117 applies with respect to cases commenced on or after October 1, 1978. The reference is to cases under title 11 and not to cases concerning the tentative adjustment or the refund.

Section 118 of the bill is entitled "Exception to Limitations in Case of Petition to Tax Court." Subsection (a) amends IRC section 6512(a) by adding a new paragraph (4). That new paragraph provides an exception to the stay of suits by the taxpayer for recovery of a tax concerning which the taxpayer has filed a petition in the tax court. The exception permits a trustee in a case under title 11 concerning a taxpayer to seek recovery of any refund that is property of the estate in the bankruptcy court in which such case is pending. For example, the bankruptcy court may order the refund of an overpayment of tax. This is in accord with the concurrent jurisdiction of the bankruptcy court and tax court concerning this controversy as provided in section 1471(b) of title 28, as proposed in section 243(a) of the bankruptcy legislation. It should be noted in passing that the trustee may wish to continue the taxpayer's cause of action for the refund,

to which he succeeds under proposed section 541 of title 11, in the tax court; if the trustee makes that choice, neither the trustee nor the Government may remove the tax court proceeding to the bankruptcy court by virtue of section 1478(a) of title 28, as proposed in section 243(a) of the bankruptcy legislation. If the trustee does continue the taxpayer's action in the tax court, the bankruptcy court should abstain from entertaining a parallel suit in the bankruptcy court under section 1471(c) of title 28, as proposed in section 243(a) of the bankruptcy legislation. Also, it should be mentioned that the powers accorded the trustee in the amendment made by this section also apply to a debtor in possession under proposed chapter 11 of title 11 by virtue of section 1107 of that title which gives the debtor in possession all of the powers of a trustee.

Subsection (b) indicates that the amendment made by section 118(a) of the bill applies with respect to cases commenced on or after October 1, 1978.

Section 119 of the bill is entitled "Claims in Bankruptcy and Receivership Proceedings." Subsection (a) amends IRC section 6871(a) to delete language that causes an immediate assessment upon the adjudication of bankruptcy of any taxpayer in a straight bankruptcy liquidation or the filing or the approval of a petition by or against the taxpayer in any other bankruptcy proceeding. IRC section 6871(b) is also amended to delete the language prohibiting relief in the tax court after an adjudication of bankruptcy or the approval of a petition. The only vitality of IRC section 6871(b) will be with respect to the appointment of a receiver which cannot happen in proposed title 11. The effect of the amendment is to preserve the option of the tax court relief for the debtor in a case under title 11, because the usual requirement of sending a notice of deficiency to the taxpayer under IRC sections 6212 and 6213 prior to assessment will not be waived. The trustee, if the estate is a separate taxable entity, may intervene in the debtor's *in personam* tax court case for the purpose of adjudicating the estate's *in rem* liability. The lack of immediate assessment is not intended to deter the IRS from filing a claim for unpaid taxes in the bankruptcy court; rather, the Government has a claim, contingent on assessment, that may be filed under section 501(a) of proposed title 11 and allowed under section 502 of that title.

Subsection (b) contains eight technical or clerical amendments resulting from the deletion of the language requiring immediate assessment in IRC section 6871(a). Paragraph (1)(A) contains an amendment to IRC section 6871(b) to change the reference from "bankruptcy" to a "case under title 11". Subparagraph (B) contains a technical amendment deleting language prohibiting a petition for redetermination of a deficiency in the tax court while the bankruptcy case is pending. In the absence of immediate assessment, there is nothing to justify the limitation contained in present law.

Paragraph (2) of section 119(b) amends the section title of IRC section 6871 by replacing "bankruptcy" with "cases under title 11". Paragraph (3) makes a conforming change in the section title in the table of sections of subchapter B of chapter 70. Paragraph (4) similarly conforms the heading of subchapter B of chapter 70 to refer to "cases under title 11" in lieu of "bankruptcy", and paragraph (5)

contains an amendment that does likewise with respect to the item relating to subchapter B in the table of subchapters of chapter 70.

Paragraph (6) changes the heading of chapter 70 by striking out "bankruptcy" and inserting "cases under title 11" in lieu thereof. Paragraph (7) makes a corresponding change with respect to the item relating to chapter 70 in the table of chapters of subtitle F.

Finally, paragraph (8) amends 37 U.S.C. 558 (relating to income tax deferment of a member of a uniformed service), which incorporates IRC section 6871 by reference, to delete the reference to bankruptcy.

Subsection (c) of section 119 of the bill indicates that the amendments made by subsections (a) and (b) will apply with respect to cases commenced on or after October 1, 1978.

Section 120 of the bill is entitled "Deletion of unpaid bankruptcy claims." Subsection (a) amends IRC section 6873(a) to delete references to proceedings under the Bankruptcy Act. As a result, the Secretary will not be able to demand collection of an allowed claim for taxes that is unpaid during a bankruptcy case from a debtor after the case. The claim against the estate is an *in rem* proceeding and is not dispositive of the taxpayer's personal liability. As such, the procedure is deleted and the Secretary is left with the normal options under sections 6213 and 6861 of the IRC.

Subsection (b) indicates that the amendment made by subsection (a) is effective with respect to cases commenced on or after October 1, 1978.

Title II contains 16 sections that make technical or conforming amendments to the Internal Revenue Code of 1954 based on the proposed repeal of the Bankruptcy Act and enactment of title 11.

Section 201 of the bill is entitled "Amendment to Section 124(a)(1)." Subsection (a) makes a conforming amendment to IRC section 124(a)(1) to change terminology currently in the IRC that refers to the Bankruptcy Act to new terminology under title 11.

Subsection (b) of section 201 indicates that the amendment made by subsection (a) is effective beginning on October 1, 1978, other than with respect to cases under the Bankruptcy Act.

Section 202 of the bill is entitled "Amendment to Section 422." Subsection (a) makes a conforming amendment to IRC section 422 to change terminology currently in the IRC that refers to the Bankruptcy Act to new terminology under title 11.

Subsection (b) of section 202 indicates that the amendment made by subsection (a) is effective beginning on October 1, 1978, other than with respect to cases under the Bankruptcy Act.

Section 203 of the bill is entitled "Amendment to Section 1017." Subsection (a) makes a technical amendment to IRC section 1017 to change terminology currently in the IRC that refers to the Bankruptcy Act to new terminology under title 11.

Subsection (b) of section 203 indicates that the amendment made by subsection (a) is effective beginning on October 1, 1978, other than with respect to cases under the Bankruptcy Act.

Section 204 of the bill is entitled "Amendment to Section 1018." Subsection (a) repeals IRC section 1018 as deadwood in light of the re-

peal of section 270 of the Bankruptcy Act. Subsection (b) of section 204 deletes the item relating to section 1018 from the table of sections of part II of subchapter O of chapter 1 of the IRC.

Subsection (c) of section 204 indicates that the amendments made by subsections (a) and (b) take effect beginning on October 1, 1978, other than with respect to cases under the Bankruptcy Act.

Section 205 of the bill is entitled "Amendment to Section 1024(2)." Subsection (a) makes a conforming amendment to IRC section 1024 (2) to change terminology currently in the IRC that refers to the Bankruptcy Act to new terminology under title 11.

Subsection (b) of section 205 indicates that the amendment made by subsection (a) is effective beginning on October 1, 1978, other than with respect to cases under the Bankruptcy Act.

Section 206 of the bill is entitled "Amendment to Section 1052." Subsection (a) adds a new subsection (d) to IRC 1052 to preserve the old basis of property acquired under IRC section 372(a) or 374(b) before they were amended by section 109 of this bill.

Subsection (b) of section 206 indicates that the amendment made by subsection (a) is effective beginning on October 1, 1978, other than with respect to cases under the Bankruptcy Act.

Section 207 of the bill is entitled "Amendment to Section 6012(b) (3)." Subsection (a) makes a conforming amendment to IRC section 6012(b)(3) to change terminology currently in the IRC that refers to the Bankruptcy Act to new terminology under title 11.

Subsection (b) of section 207 indicates that the amendment made by subsection (a) is effective beginning on October 1, 1978, other than with respect to cases under the Bankruptcy Act.

Section 208 of the bill is entitled "Amendment to Section 6036." Subsection (a) makes a conforming amendment to IRC section 6036 to change terminology currently in the IRC that refers to the Bankruptcy Act to new terminology under title 11.

Subsection (b) of section 208 indicates that the amendment made by subsection (a) is effective beginning on October 1, 1978, other than with respect to cases under the Bankruptcy Act.

Section 209 of the bill is entitled "Amendment to Section 6155(b) (2)." Subsection (a) strikes the cross reference to bankruptcy from IRC section 6155(b)(2) because of the amendments made to IRC section 6873 in section 120 of this bill.

Subsection (b) of section 209 indicates that the amendment made by subsection (a) is effective beginning on October 1, 1978, other than with respect to cases under the Bankruptcy Act.

Section 210 of the bill is entitled "Amendment to Section 6161(c)." Subsection (a) makes conforming amendments to IRC section 6161(c) to change terminology currently in the IRC that refers to the Bankrupcy Act to new terminology under title 11.

Subsection (b) of section 210 indicates that the amendments made by subsection (a) are effective beginning on October 1, 1978, other than with respect to cases under the Bankruptcy Act.

Section 211 of the bill is entitled "Amendment to Section 6216(1)." Subsection (a) makes a conforming amendment to IRC section 6216 (1) to change terminology currently in the IRC that refers to the Bankruptcy Act to new terminology under title 11.

Subsection (b) of section 211 indicates that the amendment made by subsection (a) is effective beginning on October 1, 1978, other than with respect to cases under the Bankruptcy Act.

Section 212 of the bill is entitled "Amendment to Section 6326." Subsection (a) makes technical amendments to IRC section 6326 to change terminology currently in the IRC that refers to the Bankruptcy Act to new terminology under title 11.

Subsection (b) of section 212 indicates that the amendments made by subsection (a) are effective beginning on October 1, 1978, other than with respect to cases under the Bankruptcy Act.

Section 213 of the bill is entitled "Amendment to Section 6503(i)(2)." Subsection (a) makes a conforming amendment to IRC section 6503(i)(2) to change terminology currently in the IRC that refers to the Bankruptcy Act to new terminology under title 11.

Subsection (b) of section 213 indicates that the amendment made by subsection (a) is effective beginning on October 1, 1978, other than with respect to cases under the Bankruptcy Act.

Section 214 of the bill is entitled "Amendment to Section 6872." Subsection (a) makes a technical amendment to IRC section 6872 change terminology currently in the IRC that refers to the Bankruptcy Act to new terminology under title 11.

Subsection (b) of section 214 indicates that the amendment made by subsection (a) is effective beginning on October 1, 1978, other than with respect to cases under the Bankruptcy Act.

Section 215 of the bill is entitled "Amendment to Section 7430." Subsection (a) makes technical amendments to IRC section 7430 to change terminology currently in the IRC that refers to the Bankruptcy Act to new terminology under title 11.

Subsection (b) of section 215 indicates that the amendment made by subsection (a) is effective beginning on October 1, 1978, other than with respect to cases under the Bankruptcy Act.

Section 216 of the bill is entitled "Amendment to Section 7508(d)(1)." Subsection (a) makes a conforming amendment to IRC section 7508(d)(1) to change terminology currently in the IRC that refers to the Bankruptcy Act to new terminology under title 11.

Subsection (b) of section 216 indicates that the amendment made by subssection (a) is effective beginning on October 1, 1978, other than with respect to cases under the Bankruptcy Act.

Title III of the bill contains four sections amending special tax provisions in title 11 of the United States Code. The bankruptcy legislation containing those four sections confines them to State and local taxes. The amendments proposed in these sections are identical to the sections contained in the bankruptcy legislation except that the scope of the sections is expanded to cover Federal taxes.

Section 301 of the bill is entitled "Amendment to Section 346 of title 11, United States Code." Subsection (a) expands section 346 of title 11 to encompass Federal taxes in addition to State and local taxes. Section 346 of title 11 contains ten subsections which embody special provisions that apply in cases under chapter 7, 11, or 13.

Subsection (a) indicates that subsections (b), (c), (d), (e), (g), (h), (i), and (j) apply notwithstanding any Federal, State, or local tax law.

Subsection (b)(1) provides that in a case concerning an individual under chapter 7 or 11 of title 11, income of the estate is taxable only to the estate and not to the debtor. The second sentence of the paragraph provides that if such individual is a partner, the tax attributes of the partnership are distributable to the partner's estate rather than to the partner, except to the extent that section 728 of title 11 provides otherwise.

Subsection (b)(2) states a general rule that the estate of an individual is to be taxed as an estate. The paragraph is made subject to the remainder of section 346 and section 728 of title 11.

Subsection (b)(3) requires the accounting method, but not necessarily the accounting period, of the estate to be the same as the method used by the individual debtor.

Subsection (c)(1) states a general rule that the estate of a partnership or a corporate debtor is not a separate entity for tax purposes. The income of the debtor is to be taxed as if the case were not commenced, except as provided in the remainder of section 346 and section 728.

Subsection (c)(2) requires the trustee, except as provided in section 728 of title 11, to file all tax returns on behalf of the partnership or corporation during the case.

Subsection (d) indicates that the estate in a chapter 13 case is not a separate taxable entity and that all income of the estate is to be taxed to the debtor.

Subsection (e) establishes a business deduction consisting of allowed expenses of administration except for tax or capital expenses that are not otherwise deductible. The deduction may be used by the estate when it is a separate taxable entity or by the entity to which the income of the estate is taxed when it is not.

Subsection (f) imposes a duty on the trustee to comply with any Federal, State, or local tax law requiring withholding or collection of taxes from any payment of wages, salaries, commissions, dividends, interest, or other payments. Any amount withheld is to be paid to the taxing authority at the same time and with the same priority as the claim from which such amount was withheld was paid.

Subsection (g)(1)(A) indicates that neither gain nor loss is recognized on the transfer by law of property from the debtor or a creditor to the estate. Subparagraph (B) provides a similar policy if the property of the estate is returned from the estate to the debtor other than by a sale of property to the debtor. Subparagraph (C) also provides for nonrecognition of gain or loss in a case under chapter 11 if a corporate debtor transfers property to a successor corporation or to an affiliate under a joint plan. An exception is made to enable a taxing authority to cause recognition of gain or loss to the extent provided in IRC section 371 (as amended by section 109 of this bill).

Subsection (g)(2) provides that any of the three kinds of transferees specified in paragraph (1) take the property with the same character, holding period, and basis in the hands of the transferor at the time of such transfer. The transferor's basis may be adjusted under section 346(j)(5) even if the discharge of indebtedness occurs after the transfer of property. Of course, no adjustment will occur if the

transfer is from the debtor to the estate or if the transfer is from an entity that is not discharged.

Subsection (h) provides that the creation of the estate of an individual under chapters 7 or 11 of title 11 as a separate taxable entity does not affect the number of taxable years for purposes of computing loss carryovers or carrybacks. The section applies with respect to carryovers or carrybacks of the debtor transferred into the estate under section 346(i)(1) of title 11 or back to the debtor under section 346(i)(2) of title 11.

Subsection (i)(1) states a general rule that an estate that is a separate taxable entity nevertheless succeeds to all tax attributes of the debtor. The six enumerated attributes are illustrative and not exhaustive.

Subsection (i)(2) indicates that attributes passing from the debtor into an estate that is a separate taxable entity will return to the debtor if unused by the estate. The debtor is permitted to use any such attribute as though the case had not been commenced.

Subsection (i)(3) permits an estate that is a separate taxable entity to carryback losses of the estate to a taxable period of the debtor that ended before the case was filed. The estate is treated as if it were the debtor with respect to time limitations and other restrictions. The section makes clear that the debtor may not carryback any loss of his own from a tax year during the pendency of the case to such a period until the case is closed. No tolling of any period of limitation is provided with respect to carrybacks by the debtor of post-petition losses.

Subsection (j) sets forth seven special rules treating with the tax effects of forgiveness or discharge of indebtedness. The terms "forgiveness" and "discharge" are redundant, but are used to clarify that "discharge" in the context of a special tax provision in title 11 includes forgiveness of indebtedness whether or not such indebtedness is "discharged" in the bankruptcy sense.

Paragraph (1) states the general rule that forgiveness of indebtedness is not taxable except as otherwise provided in paragraphs (2)–(7). The paragraph is patterned after sections 268, 395, and 520 of the Bankruptcy Act.

Paragraph (2) disallows deductions for liabilities of a deductible nature in any year during or after the year of cancellation of such liabilities. For the purposes of this paragraph, "a deduction with respect to a liability" includes a capital loss incurred on the disposition of a capital asset with respect to a liability that was incurred in connection with the acquisition of such asset.

Paragraph (3) causes any net operating loss of a debtor that is an individual or corporation to be reduced by any discharge of indebtedness except as provided in paragraphs (2) or (4). If a deduction is disallowed under paragraph (2), then no double counting occurs. Thus, paragraph (3) will reflect the reduction of losses by liabilities that have been forgiven, including deductible liabilities or nondeductible liabilities such as repayment of principal on borrowed funds.

Paragraph (4) specifically excludes two kinds of indebtedness from reduction of net operating losses under paragraph (3) or from reduction of basis under paragraph (5). Subparagraph (A) excludes items of a deductible nature that were not deducted or that could not be

deducted such as gambling losses or liabilities for interest owed to a relative of the debtor. Subparagraph (B) excludes indebtedness of a debtor that is an individual or corporation that resulted in deductions which did not offset income and that did not contribute to an unexpired net operating loss or loss carryover. In these situations, the debtor has derived no tax benefit so there is no need to incur an offsetting reduction.

Paragraph (5) provides a two-point test for reduction of basis. The paragraph replaces sections 270, 396, and 522 of the Bankrupty Act. Subparagraph (A) sets out the maximum amount by which basis may be reduced—the total indebtedness forgiven less adjustments made under paragraphs (2) and (3). This avoids double counting. If a deduction is disallowed under paragraph (2) or a carryover is reduced under paragraph (3) then the tax benefit is neutralized, and there is no need to reduce basis. Subparagraph (B) reduces basis to the extent the debtor's total basis of assets before the discharge exceeds total preexisting liabilities still remaining after discharge of indebtedness. This is a "basis solvency" limitation which differs from the usual test of solvency because it measures against the remaining liabilities the benefit aspect of assets, their basis, rather than their value. Paragraph (5) applies so that any transferee of the debtor's property who is required to use the debtor's basis takes the debtor's basis reduced by the lesser of (A) and (B). Thus, basis will be reduced, but never below a level equal to undischarged liabilities.

Paragraph (6) specifies that basis need not be reduced under paragraph (5) to the extent the debtor treats discharged indebtedness as taxable income. This permits the debtor to elect whether to recognize income, which may be advantageous if the debtor anticipates subsequent net operating losses, rather than to reduce basis.

Paragraph (7) establishes two rules excluding from the category of discharged indebtedness certain indebtedness that is exchanged for an equity security issued under a plan or that is forgiven as a contribution to capital by an equity security holder. Subparagraph (A) creates the first exclusion to the extent indebtedness consisting of items not of a deductible nature is exchanged for an equity security, other than the interests of a limited partner in a limited partnership, issued by the debtor or is forgiven as a contribution to capital by an equity security holder. Subparagraph (B) excludes indebtedness consisting of items of a deductible nature, if the exchange of stock for debt has the same effect as a cash payment equal to the value of the equity security, in the amount of the fair market value of the equity security or, if less, the extent to which such exchange has such effect. The two provisions treat the debtor as if it had originally issued stock instead of debt. Subparagraph (B) rectifies the inequity under current law between a cash basis and accrual basis debtor concerning the issuance of stock in exchange for previous services rendered that were of a greater value than the stock. Subparagraph (B) also changes current law by taxing forgiveness of indebtedness to the extent that stock is exchanged for the accrued interest component of a security, because the recipient of such stock would not be regarded as having received money under the *Carman* doctrine.

Subsection (b) of section 301 of the bill indicates that the amendment made by subsection (a) of section 301 will take effect beginning on October 1, 1978.

Section 302 of the bill is entitled "Amendment to Section 728 of title 11, United States Code. Subsection (a) expands section 728 of title 11 to encompass Federal taxes as well as State and local taxes.

Section 728 of title 11 contains four subsections which embody special tax provisions that apply in a case under chapter 7. Subsection (a) terminates the taxable year of an individual debtor on the date of the order for relief under chapter 7 of title 11. The date of termination of the individual's taxable year is the date on which the estate first becomes a separate taxable entity. If the case was originally filed under chapter 11 of title 11, then the estate would have been made a separate taxable entity on the date of the order for relief under that chapter. In the rare case of a multiple conversion, then the date of the order for relief under the first chapter under which the estate was a separate taxable entity is controlling.

Subsection (b) permits the trustee of the estate of an individual debtor or a corporation in a case under chapter 7 of title 11 to make a tax return only if the estate or corporation has net taxable income for the entire case. If the estate or corporation has net taxable income at the close of the case, then the trustee files an income tax return for each tax year during which the case was pending. The trustee of a partnership debtor must always file returns for each such taxable period.

Subsection (c) sets forth a marshalling rule pertaining to tax claims against a partner and a partnership in a case under chapter 7 of title 11. To the extent that the income tax liability arose from the inclusion of undistributed earnings in the partner's taxable income, the court is required to disallow the tax claim against the partner's estate and to allow such claim against the partnership estate. No burden is placed on the Government; the Government should file a complete proof of claim in each case and the court will execute the marshaling. If the partnership's assets are insufficient to satisfy partnership creditors in full, then section 723(c) of title 11 will apply, notwithstanding this subsection, to allow any unsatisfied tax claims to be asserted by the partnership trustee against the estate of the partner. The marshaling rule under this subsection applies only for purposes of allowance and distribution. Thus the tax claim may be nondischargeable with respect to an individual partner.

Subsection (d) requires the court to apportion any tax refund or reduction of tax between the estate of a partner and the estate of his partnership. The standard of apportionment entitles the partnership estate to receive that part of the tax refund or reduction that is attributable to losses sustained by the partnership that were deducted by the partner but for which the partner never reimbursed the partnership. The partner's estate receives any part not allocated to the partnership estate. The section applies notwithstanding section 541 of title 11, which includes the partner's right to a tax refund or to reduction of tax as property of the partner's estate.

Subsection (b) of section 302 of the bill indicates that the amendment made by section 302(a) is effective beginning on October 1, 1978.

Section 303 of the bill is entitled "Amendment to 11 U.S.C. 1146."

Subsection (a) expands section 1146 of title 11 to encompass federal taxes in addition to State and local taxes.

Section 1146 of title 11 specifies five subsections which embody special tax provisions that apply in a case under chapter 11 of title 11. Subsection (a) indicates that the tax year of an individual debtor terminates on the date of the order for relief under chapter 11. Termination of the taxable year of the debtor commences the tax period of the estate. If the case was converted from chapter 7 of title 11 then the estate is created as a separate taxable entity dating from the order for relief under chapter 7. If multiple conversion of the case occurs, then the estate is treated as a separate taxable entity on the date of the order for relief under the first chapter under which the estate is a separate taxable entity.

Subsection (b) requires the trustee of an estate of an individual debtor to file an income tax return for each taxable period during which the case is pending.

Subsection (c) exempts from Federal, State, or local stamp taxes the issuance, transfer, or exchange of a security, or the making or delivery of an instrument of transfer under a plan. The subsection is derived from section 267 of the Bankruptcy Act.

Subsection (d) permits the court to authorize the proponent of a plan to request a taxing authority to declare the tax effects of such plan. In the event of an actual controversy, the court may declare the tax effects of the plan of reorganzation at any time after the earlier of action by such taxing authority or 270 days after the request. Such a declaration, unless appealed, becomes a final judgment and binds any tax authority that was requested by the proponent to determine the tax effects of the plan.

Subsection (e) permits a taxing authority to assess any priority tax after confirmation of a plan but before the year after the date of the filing of the petition. The subsection is derived from sections 271, 397, and 523 of the Bankruptcy Act. The right of assessment against the estate may be foreclosed, if the debtor is an individual, by an expedited determination of liability of the estate under section 505(c) of title 11. The right of assessment is also subject to satisfaction of any conditions precedent required by applicable tax law.

Subsection (b) of section 303 of the bill indicates that the amendment made by section 303(a) is effective on or after October 1, 1978.

Section 304 of the bill is entitled "Amendment to Section 1331 of title 11, United States Code." Subsection (a) expands section 1331 of title 11 to encompass Federal taxes as well as State and local taxes.

Section 1331 of title 11 gives a taxing authority 1 year after the date of the filing of the petition to assess a priority tax or a postpetition tax payable by the debtor. If the assessment occurs after confirmation of the plan, then it may be assessed against and collected from the debtor, unless the taxing authority has accepted a plan that provides for the disposition of such tax claim. The right of assessment may be exercised only if the taxing authority first satisfies conditions precedent under applicable tax law.

Subsection (b) of section 304 of the bill indicates that the amendment made by section 304(a) is effective on or after October 1, 1978.

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