Bankruptcy tax practice reference guide

American Institute of Certified Public Accountants. Tax Division. Small Business Committee

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Tax Division

MARCH 1992

AICPA

American Institute of Certified Public Accountants

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Tax practice guides are designed as educational and reference material for the members of the Tax Division and others interested in the subject. They do not establish standards or preferred practices.

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PURPOSE

The primary purpose of this Bankruptcy Tax Practice Reference Guide ("guide") is to assist practitioners in dealing with the problems that arise when an entity is involved in a bankruptcy proceeding. The guide also includes references to certain aspects of related nonbankruptcy debt restructurings, workouts and reorganizations. Discussions of these related situations will generally be more limited in scope than discussion of bankruptcy topics. The guide is designed as educational and reference material for members of the AICPA Tax Division and others interested in the subject, and is distributed with the understanding that the AICPA Tax Division is not rendering any tax or legal advice.

PREFACE

Tax practice in the area of bankruptcy and insolvency requires a working knowledge of both tax laws and bankruptcy laws. Accordingly, practitioners should have available and become familiar with the United States Bankruptcy Code, in addition to existing federal tax reference material. The guide is intended to provide information that is current and accurate. It is not presently intended that the AICPA Tax Division will update this guide as routine changes are made in either the Internal Revenue Code or the Bankruptcy Code. As such, users of the guide should review all references to ensure that any subsequent statutory changes, interpretations, guidance, or court decisions are considered in light of the advice being rendered to their clients. Practitioners should be aware that the property laws of the various states (e.g., separate property or community property) will be important in determining whether one or both parties in a marriage should file for protection under the Bankruptcy Code, and will also affect the treatment and allocation of assets and liabilities in a bankruptcy proceeding. The impact of these laws in each state is beyond the scope of this guide.

Since the focus of this guide is taxation, references to the Internal Revenue Code (26 U.S.C.) will be by use of "§" only. The following additional references will be used throughout this guide:

The United States Bankruptcy Code - 11 U.S.C. §
(As amended through the end of the 1990 Session of Congress)
Federal Rules of Bankruptcy Procedure - Fed.R.Bankr.P
Treasury Regulations - Treas. Reg. §
Internal Revenue Service Revenue Rulings - Rev. Rul.
Internal Revenue Service Revenue Procedures - Rev. Proc.
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1. GENERAL INFORMATION REGARDING BANKRUPTCY PROCEEDINGS

A. ELIGIBILITY

11 U.S.C. §109 details who may be a debtor in a bankruptcy proceeding. Generally, any "person," as defined in 11 U.S.C. §101(41), with a residence, domicile, place of business or property in the United States is able to file for liquidation under Chapter 7 or for reorganization under Chapter 11. "Person" includes individuals, partnerships, and corporations, but does not include governmental units. An individual not engaged in business is able to file for relief under Chapter 11 (*In re* Toibb, 111 S. Ct. 2197 (1991)). A decedent's estate cannot initiate a bankruptcy filing (*In re* Georg, 844 F.2d 1562 and *In re* Estate of Whiteside, 64 B.R. 99 (Bankr. E.D. Cal. 1986)). However, under Fed.R.Bankr.P. 1016, the Bankruptcy Court will generally continue to administer a case involving an individual who dies after the start of proceedings.

11 U.S.C. §109(b)(2) - (b)(3) and (d) provide that the following are not eligible to file under Chapter 7 or Chapter 11:

(a) Domestic insurance companies, banks, savings banks, cooperative banks, savings and loan associations, building and loan associations, homestead associations, credit unions, industrial banks or insured banks as defined by the Federal Deposit Insurance Act.

(b) Foreign insurance companies, banks, savings banks, cooperative banks, savings and loan associations, building and loan associations, homestead associations or credit unions engaged in business in the United States.

Stockbrokers and commodity brokers are eligible to file only for liquidation under Chapter 7. Railroads are eligible to file only for reorganization under Chapter 11.

Under 11 U.S.C. §109(f), only a "family farmer" with regular annual income and whose debts do not exceed $1,500,000 may file under Chapter 12. By definitions in 11 U.S.C. §101(18) - (19), a family farmer includes certain individuals, partnerships and corporations. The Bankruptcy Code does not make any reference to S corporations in the definitions. As such, it is generally assumed that an S corporation is treated the same as a C corporation for bankruptcy purposes.

Under 11 U.S.C. §109(e), only an individual with regular income, whose unsecured debts are less than $100,000 and whose secured debts are less than $350,000 may file under Chapter 13.

Once filed, cases will proceed under the appropriate Chapter, unless dismissed or converted. Under 11 U.S.C. §§706, 1112, 1208 and 1307, cases can be converted to other Chapters if the debtor is eligible for relief under that Chapter. Under 11 U.S.C. §348(a), conversion changes the Chapter, but not the date of commencement of the case.

Under 11 U.S.C. §104, the Judicial Conference of the United States shall transmit to Congress and to the President before May 1, 1985, and before May 1 of every sixth year after that, a recommendation for the uniform percentage adjustment of each dollar amount in the Bankruptcy Code. As such, practitioners should periodically review those areas (such as the debt limits above) that might impact tax planning opportunities for their clients.

B. FILINGS - VOLUNTARY OR INVOLUNTARY

Filings under Chapters 7 and 11 may be either voluntary or involuntary. The provisions for involuntary filings are found in 11 U.S.C. §303. Filings under Chapters 12 and 13 may be voluntary only.

C. CHARACTERISTICS OF FILINGS UNDER VARIOUS CHAPTERS

1. Chapter 7

In a filing under Chapter 7, a trustee will be appointed and an individual's non-exempt assets will be liquidated for the benefit of creditors. Creditors' claims are determined by the Bankruptcy Court to be allowed and to be secured or unsecured. Allowed secured claims are treated in accordance with 11 U.S.C. §506. Allowed unsecured claims are entitled to distributions from the estate in the order of priorities delineated in 11 U.S.C. §726. After such distributions, the individual debtor is granted a discharge as described in Section E, below. As such, the debtor obtains what is commonly referred to as a "fresh start."

2. Chapter 11

In a filing under Chapter 11, the debtor will generally remain in control of the estate as a "debtor-in-possession." A debtor-in-possession has essentially the same rights and obligations as a trustee in a bankruptcy proceeding and is allowed to continue to operate the debtor's business while a plan of reorganization is formulated.

The requirements of a plan of reorganization are found in 11 U.S.C. §1123. The debtor-in-possession or trustee, if one is appointed, will generally prepare and file a disclosure statement that will provide creditors and stockholders with information that would be adequate for a reasonable investor to make an informed judgment about the plan of reorganization. 11 U.S.C. §1129(a) provides the requirements necessary for a plan of reorganization to be confirmed. After confirmation, the reorganized debtor is allowed to continue operating its business.

3. Chapter 12

Chapter 12 was enacted by Congress to be effective from November 26, 1986 through October 1, 1993, to deal with the special problems of "family farmers." Chapter 12 is intended to be more streamlined and efficient in handling matters related to smaller farm and ranch activities.

Only the debtor may file a plan in a Chapter 12 proceeding. Under 11 U.S.C. §1222, the plan must provide for the debtor to submit all or a portion of future income to the supervision and control of the trustee as is necessary to execute the plan, that is, for full payment (via deferred cash payments) of all claims entitled to priority under 11 U.S.C. §507 and for equal treatment of all creditors within a particular class of creditors. The rights of secured and unsecured creditors can be altered under the plan if the restrictions set forth in 11 U.S.C. §1222(b) are met. A plan in a Chapter 12 proceeding will generally provide for payments to be made over a three-year period and the Bankruptcy Court may not approve a plan for payments to be made over a period longer than five years. Upon completion of payments provided for under the plan, the debtor is granted a discharge as described in Section E, below.

4. Chapter 13

Chapter 13 is designed to provide for the efficient and expeditious administration of the debts of an individual with regular income. The individual or "wage earner" is allowed to propose a plan that provides for full or partial payment of claims over a period of not more than three to five years.

As in Chapter 12, only a debtor may file a plan in a Chapter 13 proceeding. Under 11 U.S.C. §1322, the plan must provide for the debtor to submit all or a portion of future income to the supervision and control of the trustee as is necessary to execute the plan, that is, for full payment (via deferred cash payments) of all claims entitled to priority under 11 U.S.C. §507 and for equal treatment of all creditors within a particular class of creditors. Under 11 U.S.C. §1325(b), if the trustee or an unsecured creditor objects to confirmation of the plan, then the plan must provide that all of the debtor's projected disposable income for three years will be applied to make payments under the plan. Upon completion of all payments provided for under the plan, the debtor is granted a discharge as described in Section E, below.

D. CLAIMS AND PROOFS OF CLAIMS

Fed.R.Bankr.P. 3002(a) provides that, except as provided in Fed.R.Bankr.P. 3003, 3004 and 3005, an unsecured creditor must file a proof of claim for the claim to be allowed. If the creditor fails to file a proof of claim, the debtor can file one on the creditor's behalf to ensure that a creditor who has a nondischargeable debt is paid through the bankruptcy.

In a Chapter 11 case, under 11 U.S.C. §1111(a), a proof of claim is deemed filed if listed by the debtor in schedules filed under 11 U.S.C. §521(1) or 11 U.S.C. §1106(a), except for a claim listed as disputed, contingent or unliquidated. Upon conversion of a case to Chapter 7, a proof of claim must be filed even if the claim was properly listed in the debtor's schedules filed in the preconversion chapter proceeding. Under Fed.R.Bankr.P. 1019(3), all claims actually filed in a superseded case are deemed filed in the Chapter 7 case.

E. THE EFFECT OF "DISCHARGE"

The culmination of a bankruptcy proceeding is the "discharge" granted to a debtor. As described below, there is no discharge for a corporation or partnership in a Chapter 7 case or in a liquidation in a Chapter 11 case. The essential effect of a discharge granted in a bankruptcy proceeding is an order of the Bankruptcy Court barring the debtor from being held personally liable for claims allowed to be adjudicated by the Bankruptcy Court. The specific provisions dealing with the effect of discharge are detailed in 11 U.S.C. §524. The "persons" who can be granted a discharge in bankruptcy proceedings are summarized as follows:

(a) Chapter 7 - Individuals.

(b) Chapter 11 - All "persons" eligible to file under Chapter 11, except for corporations and partnerships liquidating all or substantially all property of the estate. See 11 U.S.C. §1141(d)(3).

(c) Chapter 12 - All "family farmers" eligible to file under Chapter 12.

(d) Chapter 13 - Individuals.

F. EXCEPTIONS TO DISCHARGE

Claims discharged in bankruptcy proceedings differ under the various Chapters and are summarized as follows:

(a) Chapter 7 - Prepetition debts, other than those nondischargeable under 11 U.S.C. §523. In voluntary cases, claims arising after the filing of the petition are not discharged. See 11 U.S.C. §727(b).

(b) Chapter 11 - Debts that arose before the date of confirmation of the plan of reorganization, other than those nondischargeable for individuals under 11 U.S.C. §523(a). See 11 U.S.C. §1141(d)(1).

(c) Chapter 12 - Debts that are provided for in the plan of reorganization, other than those nondischargeable for individuals under 11 U.S.C. §523(a). See 11 U.S.C. §1228.

(d) Chapter 13 - Debts that are provided for in the plan of reorganization, other than those nondischargeable for individuals under 11 U.S.C. §523(a)(5), (8), (9) or for criminal restitution under 11 U.S.C. §1328(a)(2) or (3). See 11 U.S.C. §1328.

G. DISCHARGEABILITY OF TAXES

1. Individuals

The discharge of a particular tax obligation depends on the nature of the tax, the priority status granted to tax obligations under the Bankruptcy Code, and the Chapter of the Bankruptcy Code under which the case is filed or to which a case may later be converted. 11 U.S.C. §523(a) details debts of an individual, including various taxes, that, unless paid, are not discharged in a bankruptcy proceeding under Chapter 7, Chapter 11, Chapter 12 or by a debtor who receives a "hardship" discharge under Chapter 13. See 11 U.S.C. §1328(b).

Taxes exempted from discharge include instances when a debtor failed to file a required return, filed a late return within two years of filing the bankruptcy petition, filed a fraudulent return, or willfully attempted to evade such tax. In a case filed under Chapter 13 and upon completion by the debtor of all payments under the plan, the court will grant the debtor discharge of all debts provided for in the plan, including taxes (including those related to unfiled returns or fraud) (See 11 U.S.C. §1328(a)). Prepetition penalties and interest related to taxes which are not discharged are likewise not discharged.

Priority taxes under 11 U.S.C. §507(a)(2) that are exempted from discharge relate to taxes incurred by a debtor in an involuntary proceeding between the date the involuntary petition is filed and the date the Bankruptcy Court enters an order for relief. Priority taxes under 11 U.S.C. §507(a)(7) that are exempted from discharge include the following:

(a) Income taxes due within three years of the filing of the petition, assessed within 240 days of the filing of the petition, or unassessed but assessable as of the filing of the petition. See 11 U.S.C. §507(a)(7)(A).

(b) Property taxes. See 11 U.S.C. §507(a)(7)(B).

(c) Withholding taxes, such as income tax or FICA and "collected" taxes, such as telephone excise tax, airport ticket tax and windfall profits tax. See 11 U.S.C. §507(a)(7)(C).

(d) Certain employment taxes, such as FICA and Federal and state unemployment taxes due on wages earned or paid before the petition is filed. See 11 U.S.C. §507(a)(7)(D).

(e) Excise taxes for a return, if required, that are past due within three years of the filing of the petition. See 11 U.S.C. §507(a)(7)(E).

(f) Certain customs duties. See 11 U.S.C. §507(a)(7)(F).

(g) Penalties that represent compensation for actual pecuniary loss for a governmental unit involving a tax listed in items A through F above. See 11 U.S.C. §507(a)(7)(G).

2. Partnerships and Corporations

In a case filed under Chapter 7, 11 U.S.C. §727(a)(1) provides that only an individual can be granted a discharge. As such, partnerships and corporations involved in a proceeding under Chapter 7 are not granted a discharge. Therefore, if shareholders keep dormant a corporate shell for later reactivation, the unpaid tax liabilities remain in existence.

In a case filed under Chapter 11, 11 U.S.C. §1141(d) provides that upon confirmation of a plan of reorganization, unless otherwise provided for in the plan, in the order confirming the plan or in that subsection of the statute, a debtor is discharged from any debt that arose before the date of confirmation. The historical notes to 11 U.S.C. §1141 clearly indicate that nondischargeable taxes in such reorganizations are priority taxes under 11 U.S.C. §507 and postpetition payments are due under agreements reached with the tax authorities before the commencement of the case.

In a case filed under Chapter 12, 11 U.S.C. §1228(a) provides that after completion by the debtor of all payments under the plan, the debtor is discharged from all debts provided for by the plan, except any debt (e.g., taxes as described above) specified in 11 U.S.C. §523(a). Since the "family farmer" debtors eligible to file under Chapter 12 include partnerships and corporations, it would appear that this discharge, which is not as comprehensive as that under Chapter 11, applies to partnerships and corporations that are eligible and choose to file under Chapter 12 instead of Chapter 11.

H. PAYMENT OF TAXES - PRIORITY

11 U.S.C. §507 establishes the priority for payment of expenses and claims of the bankruptcy estate. While 11 U.S.C. §507(a)(3)-(6) deals with other claims and expenses, those of significance related to tax obligations include:

(a) First Priority - Administrative expenses allowed under 11 U.S.C. §503(b) (See 11 U.S.C. §507(a)(1)). First priority taxes include income taxes, employee's withholdings and related employer employment taxes, certain penalties and interest, property taxes and excise taxes.

(b) Second Priority - Unsecured claims allowed in an involuntary case under 11 U.S.C. §502(f) for expenses and claims arising after commencement of the proceeding but before an order for relief is granted. These expenses and claims are routinely referred to as "involuntary gap" claims. See 11 U.S.C. §507(a)(2). Second priority taxes include taxes incurred by the debtor during this period.

(c) Seventh Priority - Unsecured tax claims of governmental units for income or gross receipts taxes, provided the tax return, including extension, was due within the three-year period preceding the filing of the bankruptcy petition (See 11 U.S.C. §507(a)(7)(A)(i)); provided that the tax was assessed within 240 days (plus additional time if an offer in compromise was pending) before the filing of the petition (See 11 U.S.C. §507(a)(7)(A)(ii)); or provided that it is other than for unfiled, late filed, or fraudulent returns not assessed before, but assessable under law or by agreement, after the commencement of the case (See 11 U.S.C. §507(a)(7)(A)(iii)). Seventh priority taxes include most income taxes, gross receipt taxes, withholding taxes, employer payroll taxes, property taxes and excise taxes.

After the filing of a bankruptcy petition and during the period the assets of the debtor or the bankruptcy estate are under the jurisdiction of the court, the assets are not subject to levy for taxes. However, assets of the estate can be used to pay ongoing administrative expenses, which may include certain postpetition tax obligations (See 11 U.S.C. §362(a)(6)). Generally, once a bankruptcy petition is filed, to collect any taxes, the IRS must file a proof of claim in the bankruptcy as would any other creditor (See 11 U.S.C. §501). The IRS claim may be presented to the Bankruptcy Court even though the taxes have not yet been assessed or are subject to a tax court proceeding (See 11 U.S.C. §502(i)). To allow for prompt administration of cases, 11 U.S.C. §502(c) provides for the estimation of claims.

First priority administrative expenses include any tax incurred by the bankruptcy estate or any tax attributable to any adjustment that the estate received from a tentative carryback allowance. If a penalty relates to a tax incurred under this first priority administrative expense category, the penalty is given the same administrative expense treatment (See 11 U.S.C. §503(b)(1)). Under 11 U.S.C. §503(b)(1)(B)(i), first priority administrative expenses do not include any seventh priority tax assessment or liability.

Second priority claims, which as previously noted are sometimes referred to as "involuntary gap" claims, are those which arise in the ordinary course of a debtor's business after an involuntary case has commenced (via the filing of an involuntary petition) but before an order for relief is entered by the court. Any tax liability arising during this period receives second priority treatment. See 11 U.S.C. §502(f).

Bankruptcy reorganizations under Chapter 11 must provide for full payment of all allowed claims for taxes before the reorganization plan can be confirmed. Taxes classified as first priority administrative expenses and second priority involuntary gap taxes must be paid in full in cash on the effective date of the plan (See 11 U.S.C. §1129(a)(9)(A)). Claims for seventh priority taxes may be satisfied with deferred cash payments over a period not to exceed six years after the date of assessment of such claims (See 11 U.S.C. §1129(a)(9)(C)). The value (e.g., present value of these deferred cash payments) as of the effective date of the plan must be equal to the allowed amount of the tax claims. Generally these deferred payment plans require payment of interest at a prevailing market rate to the taxing authority.

I. FEDERAL TAX LIENS

Section 6321 gives the IRS the ability to create a lien for unpaid federal taxes. A lien is created when a tax assessment has been made, a notice has been given of the assessment stating the amount and demanding its payment, and the amount assessed is not paid within 10 days after notice and demand. In order for the IRS to have priority over the interests of other creditors in a bankruptcy case, the IRS must file a notice of lien.

In re Donald E. Morris (No. CV-F-87-314; Lexis, 89TNT 191-19, (Bankr. E.D. Cal. 1989)) the Bankruptcy Court held that government liens are not valid until all administrative steps necessary to create a lien are completed. Lien filings must follow state or local law. Federal Form 668, titled "Notice of Tax Lien," is currently used by the IRS. No specific mention of property is made on the Form. The IRS takes the position that by statute, the lien is applicable to all property, both real and personal, of the taxpayer.

At the time of a bankruptcy petition filing, a corporation's tax liabilities may be characterized as: (1) not assessed; (2) assessed but not a lien; (3) an unperfected lien; or (4) a perfected lien. If a tax liability is not a lien because assessment or demand has not occurred, the IRS is an unsecured creditor with the same rights as any other unsecured creditor against the trustee or debtor-in-possession. Any distribution to pay the tax liability is governed by 11 U.S.C. §726.

To protect a trustee's rights regarding unperfected tax liens, 11 U.S.C. §544(a) provides that at the time a voluntary or involuntary bankruptcy petition is filed, a trustee is given (1) the rights and powers of a creditor holding a judicial lien on the debtor's property, or a creditor with a right of execution on the debtor's property that was returned unsatisfied; (2) a bona fide right of execution on the debtor's property that was returned unsatified; or (3) a bona fide right of purchase of real property from the debtor against whom applicable laws permit a transfer to be perfected. To preserve any rights against unperfected tax liens, a trustee must begin an action under 11 U.S.C. §544(a) by the earlier of two years after the appointment of the trustee or the time the case is closed or dismissed. See 11 U.S.C. §546(a).

The trustee has another important right against a federal tax lien. 11 U.S.C. §542(a) allows the trustee to recover, via an adversary proceeding, debtor's property which is in the possession of a third party and which was previously confiscated, unless the property is of inconsequential value or benefit to the estate.

In Chapter 7 bankruptcy proceedings, 11 U.S.C. §724(a) gives a right to the trustee to avoid liens that are for fines, penalties or forfeitures that arose prior to the filing of the petition that are not compensation for actual pecuniary losses. 11 U.S.C. §544(a) allows the trustee to avoid any tax lien that was not filed prior to the filing of the bankruptcy petition. In a Chapter 7 liquidation, property subject to tax liens may be sold. 11 U.S.C. §724(b) provides for the treatment of certain liens, including tax liens. Property (or the proceeds from such property) that is subject to a lien and that secures an allowed claim for a tax is distributed in the following order:

(a) Secured lienholders superior to tax liens.

(b) First six priorities of 11 U.S.C. §507(a) to the extent of the amount of the allowed claimed that is secured by the tax lien.

(c) Tax claims secured by tax liens to the extent that tax claims exceed the amount paid under item b above.

(d) Lienholders with claims junior to tax liens.

(e) Tax claims not previously satisfied.

(f) Balance to the estate.

In summary, claims of both unsecured and secured creditors that are not perfected are subordinated to all tax liens. In cases where multiple liens have been filed, the doctrine of "first in time, first in right" is applied. This doctrine provides that the order of lien perfection applies in the payment of a claim for a lien (*In re* Pearlstein, 719 F.2d 1169 (D.C. cir. 1983)).

The U.S. Supreme Court held that the IRS generally could not keep property seized prior to the filing of a Chapter 11 bankruptcy petition (*In re* Whiting Pools, Inc. 103 S.Ct. 2309 (1983)). A reorganization under Chapter 11 must provide payment of both secured and unsecured tax claims. All tax liens that were properly perfected are treated as secured claims. If a tax lien is properly perfected and the tax authority does not accept the reorganization plan, the taxing authority may, under a cram-down plan under 11 U.S.C. §1129(b)(2)(A), retain the lien securing the claim receiving deferred cash payments equal to the allowed amount of the claim or receive the "indubitable" equivalent of the claim. The Court held that the IRS interest in property is adequately protected under the Bankruptcy Code.

J. DETERMINATION OF TAXES

1. In General

With respect to a debtor, under 11 U.S.C. §505(a), the Bankruptcy Court has the authority to determine the amount of any tax or penalty related to a tax whether previously assessed or paid and whether previously contested. However, if the tax claim has been contested before and adjudicated by a judicial or administrative tribunal in a prebankruptcy proceeding, 11 U.S.C. §505(a) prevents the claim from being relitigated in the Bankruptcy Court.

11 U.S.C. §505(b) gives the trustee (or debtor-in-possession) the ability to seek a prompt determination of the power to determine tax matters that fall outside the terms of a plan of reorganization. To provide for effective administration of bankruptcy proceedings, this section provides an expedited procedure for determining the estate's tax liability. 11 U.S.C. §505 applies to all types of taxes, including income taxes, excise taxes, sales taxes, unemployment and compensation taxes, etc. Once the Bankruptcy Court has determined the tax liability under 11 U.S.C. §505, the IRS can assess the tax against the debtor.

2. Effect of the "Automatic Stay"

11 U.S.C. §362 sets forth rules governing the automatic stay. The automatic stay is the strongest mechanism available to stop IRS tax collection. In general, these rules preclude the IRS from assessing tax, filing a notice of federal tax lien, serving a levy, seizing property, continuing a Tax Court case or lien-related judicial proceeding or attempting any other affirmative collection action.

A bankruptcy petition filing also stops a running of the statute of limitations for assessment and collection of federal tax liabilities. 11 U.S.C. §6503(i) provides that the period during which the IRS can assess or collect taxes is suspended for the time that the automatic stay is pending and furthermore is extended for an additional 60 days for assessments and an additional 6 months for collection after the stay is lifted.

Under the automatic stay provisions, the IRS may:

(a) Issue a Notice of Deficiency to the debtor, as provided by 11 U.S.C. §362(b)(9).

(b) Assess a prepetition tax which is reflected on the debtor's voluntarily filed return.

(c) Assess the tax liability of the bankruptcy estate following the determination of tax by the Bankruptcy Court under 11 U.S.C. §505(c).

(d) Refile a Notice of Federal Tax Lien.

(e) Setoff a tax refund against another tax liability in accordance with 11 U.S.C. §553.

The automatic stay provisions also preclude a debtor from initiating an action in the Tax Court. If the debtor files a petition with the Tax Court during the pendency of the bankruptcy proceedings, the Tax Court will dismiss the action (*In re* Thompson, 84 T.C. 645 (1985)). 11 U.S.C. §362(d) does empower the Bankruptcy Court to lift the automatic stay to allow a Tax Court proceeding to continue. Under these circumstances, §7464 allows the trustee to intervene on behalf of the bankrupt estate in these Tax Court proceedings.

The automatic stay continues until the property is no longer a part of the bankrupt estate. In Chapter 7 cases, the property generally remains part of the estate until the case is closed or dismissed. In Chapter 11 or Chapter 13 cases property generally ceases to be property of the estate and title revests with the debtor upon the effective date of the plan of reorganization.

3. Tax Aspects of a Chapter 11 Reorganization Plan

11 U.S.C. §1146 gives the proponent of a Chapter 11 plan the right to request a determination of the state and local tax effects of the plan for the debtor. The determination, however, is limited to questions of law. A request for determination of the tax impact of a plan is not available for federal income taxes. The Bankruptcy Court has authority to resolve issues if the determination is objected to by any parties.

4. Proof of Claims Related to Taxes

Once a proof of claim has been filed, the claim is deemed to be allowed unless a party in interest objects in a timely fashion (See 11 U.S.C. §502(a)). Two reasons for objecting to an IRS proof of claim are:

(a) The tax claim has been improperly classified.

(b) The amount of the claim has been overstated.

Fed.R.Bankr.P. 3007 provides that a debtor or trustee may file a written objection to the allowance of the IRS's claim with the Bankruptcy Court. Fed.R.Bankr.P. 3001(f) provides that the objecting party has the initial burden of coming forward with evidence that the claim should not be allowed. Once substantial evidence is introduced, the ultimate burden of proof shifts to the IRS, particularly with respect to unassessed taxes (*In re* Kontaratos, 36 B.R. 928 (Bankr. D. Me. 1984)).

If a debtor, in addition to objecting to the claim, files a complaint to determine the dischargeability of the tax or seeks any other relief specified in Fed.R.Bankr.P. 7001, the matter is treated as an adversary proceeding rather than as a contested matter. See Fed.R.Bankr.P. 3008, Committee Notes.

Under 11 U.S.C. §503(a), the IRS may also file a request for payment of postpetition taxes that are considered to be administrative expenses. These administrative expense tax claims may be allowed after notice and hearing on the matter.

5. Tax Penalties in Bankruptcy Cases

Section 6658 provides relief from penalties for failure to file returns or to pay tax, failure by an individual to pay estimated tax or failure by a corporation to pay estimated tax (§§6651, 6654 or 6655) if the case is under Title 11 of the United States Code. This relief is available if the Bankruptcy Court issues an order prohibiting such payments and the tax liability was one that was incurred by the estate. The Bankruptcy Court also must find that there are insufficient funds to pay the administrative expenses of the estate. Relief is also available if the debtor incurred the tax liability. The tax must have been incurred before the earlier of:

(a) The order for relief; or

(b) The appointment of the trustee.

In addition, the bankruptcy petition must have been filed before the due date of the return, including extensions, or the date for making an addition to tax must have occurred on or after the date on which the petition was filed.

6. Tax Offset

Generally, 11 U.S.C. §553 allows a creditor to offset or "setoff" against his claim against a debtor a mutual debt owed by the creditor to the debtor. Setoff is not allowed to the extent that the creditor's claim is disallowed or if the creditor acquired the claim from a party other than the debtor within 90 days of the filing (while the debtor is presumed to be insolvent). Setoff is also not allowed if the creditor's claim arose more than 90 days before the filing, when the debtor was actually insolvent, and if the claim was executed with the intent of obtaining a right to setoff. At the time a bankruptcy petition is filed, the automatic stay prevents an immediate setoff (See 11 U.S.C. §362(a)(7)). The right of setoff also exists for taxes. With the approval of the court, the actual setoff of a tax liability may take place.

The Bankruptcy Court has the right to determine if the estate is entitled to a tax refund. A trustee must file a claim for refund and either receive a determination from the IRS or allow 120 days to pass after the claim was filed. If the 120-day period expires and the IRS has not made a determination, the Bankruptcy Court can then determine the right of the estate to a tax refund. See 11 U.S.C. §505(a)(2)(8).

K. PAYROLL TAXES

1. Individuals

Payroll taxes in an individual's bankruptcy proceeding should reflect the liability of the debtor, for prepetition amounts, and the liability of the estate, as a separate entity, for postpetition amounts. The party responsible for administering the estate, either the debtor-in-possession or the trustee, is charged with withholding and making payment, within the normal time periods, of the various payroll taxes (See §3401 and *In re* Otte, 419 US 43 (1974)). The estate filings will reflect the "new" entity's federal employer identification number. Depending on the circumstances, the debtor's filings may reflect that they are to be considered final returns. Both the debtor for prepetition activity and the estate for postpetition activity will file the required periodic reports with the taxing authorities and the employees.

2. Partnerships and Corporations

The filing of a bankruptcy petition by a partnership or corporation does not create a new taxable entity. The debtor entity continues to be responsible for filing the required periodic reports and making payment, within the normal time periods, of the various payroll taxes. If a trustee is appointed, the trustee is responsible for filing the required periodic returns for the prepetition and the postpetition periods. The trustee is also responsible to withhold, report and make payments to the various taxing authorities for any wages that continue to be paid by the trustee.

The Supreme Court has affirmed rulings that the Bankruptcy Court has the authority to order the IRS to treat tax payments made by a debtor corporation in Chapter 11 as payments of a trust fund portion of tax liabilities. This authority, regardless of whether such payment was considered to be voluntary or involuntary, would occur in situations where the court felt that such a designation was necessary for the success of a plan of reorganization

(*In re* Energy Resources Co., 110 S.Ct. 2139). To protect trustees from unwarranted liability, a Bankruptcy Court ruling has provided that a trustee may, in special circumstances, direct the IRS to allocate postpetition payments of trust fund taxes to those incurred during the trustee's administration of the estate (*In re* ABA Recovery Service, Inc., 110 B.R. 484(Bankr, S.D. Cal. 1990)). The area of directed payments and responsible person liability under §6672 continues to be the subject of much litigation and, as such, a review of recent legislation and case rulings is advisable.

L. CANCELLATION OF DEBT ("COD") INCOME

1. In General

Section 61 and Treas. Reg. §1.61-12(a) provide that the discharge of indebtedness may in whole or in part result in the recognition of income. Section 108(a)(1)(A) provides that gross income does not include any amount which would be includable in gross income by reason of discharge (in whole or in part) of indebtedness of the taxpayer if the discharge occurs in a Title 11 case.

For the benefits of the bankruptcy provisions of §108 to apply, the debtor must be under the jurisdiction of Bankruptcy Court under Title 11 of the United States Code and the discharge must be granted by the Court or be pursuant to a plan approved by the Court (See §108(d)(2)). This provision is not elective. Title 11 cases take precedence over other income exclusions provided under §108 for insolvent taxpayers and for qualified farm indebtedness. Modification to the terms of debt including altering interest rates or maturity dates will not generally result in the application of COD income rules. Modification of principal will generally result in the application of COD income rules. See §108(e)(11).

Indebtedness means any indebtedness for which the taxpayer is liable or subject to which the taxpayer holds property (See §108(d)(1)). Bankrupt taxpayers are required to exclude COD income from gross income and apply the amount of debt reduction against certain tax attributes. Alternatively, a debtor in a bankruptcy proceeding can elect to reduce the basis of depreciable property.

2. Reduction of Tax Attributes

Tax attributes are required to be reduced dollar for dollar by the amount of the excluded COD income. Tax credits are reduced by 33-1/3 cents for each dollar of excluded COD income (See §108(b)(3)). The reduction of tax attributes occurs after the determination of tax liability for the year of the discharge giving the taxpayer one more opportunity to absorb any net operating loss, capital loss or credit carryforwards if income is earned in the year debt discharge occurs.

The reduction is to be made in the following order:

(a) Reduce any NOLs for the taxable year of the discharge and then any NOL carryovers to the taxable year of the discharge.

(b) Any carryover to or from the taxable year of discharge of an amount for purposes for determining the amount allowable as a credit under §38 (relating to general business credit).

(c) Any net capital loss for the taxable year of the discharge and any capital loss carryover to such taxable year under §1212.

(d) The basis of debtor property, but only to the extent that the aggregate basis of the debtor's property over the total liabilities, computed immediately after the discharge (See §1017(b)(2)). Section 1017(c)(1) provides that the basis of the debtor's exempt property is not reduced.

(e) Foreign tax credit carryovers.

The reduction in net operating and capital losses is made first in the loss of the year of the discharge and then to loss carryovers in the order of taxable years in which the losses occurred. The reduction of tax credits is made in the order the carryovers are considered for the taxable year of the discharge. To the extent the bankrupt debtor's discharged liabilities exceed the tax attributes to be reduced, the remaining COD income amount is excluded from income.

Bankrupt taxpayers may first elect to apply any portion of excluded COD income to reduce, dollar for dollar, the basis of depreciable property, including real property, held as inventory (under proper election); a partner's proportionate interest (with a corresponding reduction in the partnership's basis) in depreciable property owned by a partnership in which the partner holds an interest; and stock in certain subsidiaries if the subsidiary consents (See §108(b)(5)(A)). The reduction is limited to the adjusted basis of depreciable property held on the first day of the taxable year immediately following the discharge (See §108(b)(5)(B)). This provision has no aggregate liability limitation. Basis of depreciable assets can be reduced to zero even if subject to liabilities. This provision also provides flexibility in planning since there is no requirement to reduce basis to zero before reducing tax attributes. A debtor may elect to reduce some basis in depreciable property first and then reduce tax attributes with the remaining debt discharge income.

Basis reduction of depreciable property is treated as depreciation and is required to be recaptured as ordinary income upon subsequent disposition of the property at a gain under §1245 or §1250.

The election to reduce basis of depreciable property first is made on the federal income tax return for the year in which the discharge occurs. Form 982 is completed to make the election. Regulations provide that if the taxpayer establishes to the satisfaction of the Commissioner reasonable cause for failure to file the election with the original return for the taxable year of the discharge, the taxpayer may file the election with an amended return or a claim for credit or refund (See Temp. Treas. Reg. §7a.1(d)). The election is irrevocable unless the Internal Revenue Service consents to the change (See §108(d)(9)(B)).

COD income requires no adjustment to corporate earnings and profits to the extent of basis reductions under §1017. In order to reduce recordkeeping problems, a debtor may enter a closing agreement to reduce basis of selected property (See Rev. Proc. 85-44). Under the tax benefit approach, COD income results from cancellation of indebtedness attributable to an expense item only if a tax benefit was previously received from the expense item (See §108(e)(2)). Also, to the extent the basis of depreciable assets has been reduced, appropriate changes are made for depreciation calculation in future taxable periods.

3. Corporate Indebtedness

Section 108(e)(6) provides that for purposes of determining COD income, a debtor corporation may acquire its indebtedness from a shareholder as a contribution of capital. Such a corporation will be treated as having satisfied the indebtedness with an amount of money equal to the shareholder's adjusted basis in indebtedness.

With certain exceptions as described in §108(e)(10)(B), a corporate debtor in a Title 11 case or an insolvent corporate debtor (to the extent insolvent) who transfers stock to a creditor in satisfaction of its indebtedness is not subject to the general rules that treat debtors who make such transfers as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock. These rules provide that a corporation that transfers its own stock in exchange for its debt obligations realizes no gain and does not have to reduce the basis of its assets by the amount of the indebtedness that exceeds the value of the stock. The transfer is viewed as a substitution of a capital stock liability for indebtedness.

4. The "Stock for Debt" Exception

The stock for debt exception to the debt cancellation rules for debtors in bankruptcy does not apply if only a nominal or token amount of stock is issued for debt or where the ratio of the value of the stock received by an unsecured creditor is less than 50% of the similar ratio computed for "all unsecured creditors participating in the workout." See §108(e)(8)(B) and PLR 9105042.

Section 108(e)(10) provides that for purposes of determining COD income, if the debtor corporation transfers stock to a creditor in satisfaction of its indebtedness, then such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of stock.

Section 108(e)(10)(B) provides an exception for certain stock received in bankruptcy cases. This exception provides that the general rule of §108(e)(10) shall not apply to a debtor in a bankruptcy case or insolvent taxpayers. The exception also does not apply to a transfer of stock of the debtor if that stock is "disqualified stock." "Disqualified stock" means any stock with a stated redemption price if such stock has a fixed redemption date, the issuer of such stock has the right to redeem such stock at one or more times, or the holder of such stock has the right to require redemption at one or more times.

In summary, a corporate debtor in bankruptcy shall not recognize COD income if stock is issued in exchange for indebtedness as long as the stock is not a "disqualified stock" issue and the amount of stock is not nominal or token.

In addition, the de minimis rule of §108(e)(8)(A) provides that the stock for debt exception does not apply to the issuance of token or nominal shares. Neither statute nor legislative history indicates a quantum of shares that would be considered token or nominal. In the Senate Committee Report, it was stated that nominal or token shares would be determined according to all the facts and circumstances. TAM 8837001 (May 10, 1988) provides some guidance from the Service's position on facts and circumstances by stating that "consideration must be given to those factors which indicate arm's length bargaining, including such elements as the existence of sufficiently adverse economic interests on each side of the exchange, the value of the stock exchanged in comparison to the face amount of the debt canceled, and the value of the stock received in comparison to total consideration received in a discharge of debt."

In *The Stock-For-Debt De Minimis Exception* (41 Tax Notes 1325 December 1988), David J. Shakow suggests that "a good test would rely on objective criteria, but would set requirements that are at least as difficult to comply with if stock is given to creditors to preserve NOL's rather than to give them a meaningful equity interest in the corporation." Shakow lists four factors that should be considered together in evaluating the facts and circumstances on a case-by-case basis:

(a) The percentage of the total consideration received in stock: If only a small percent of the consideration is paid in stock, it is unlikely that the creditors care about that aspect of the arrangement. A token amount of stock is serving merely to preserve net operating losses ("NOLs").

(b) The percentage of the creditors' claims paid in stock: The claims are very large compared to the value of the stock issued to the creditors. The application of the stock for debt rule will be of great importance to those who will take over the company. This test is simply surrogate for a more complicated examination to determine the purpose of issuing the stock. In any event, the stock issued in these circumstances is appropriately referred to as "nominal."

(c) The value of the stock received: If the stock is only of small value, it is easy to conclude that only "nominal" stock was issued to the creditor. Whether the stock should be considered of little value for this purpose will depend on how the first two tests were complied with: Is the stock a small percentage of the consideration received or of the unsatisfied debts?

(d) The creditors' percentage interest in the corporation: The larger the creditors' interest, the harder it is to say that they have "no real equity interest in the corporation."

Section 108(e)(8)(B) provides that the stock for debt exception for bankruptcy debtors also does not apply to debt of an unsecured creditor if that creditor receives an amount of stock that is less than 50% of the amount of stock that such creditor would receive if all the corporation's unsecured creditors receive a pro rata amount of the stock issued to the extent that their debts would be canceled or satisfied with the debtor's stock.

5. Alternative Minimum Taxes

One issue in dealing with COD income for a corporation involves the alternative minimum tax. Gain on discharge of indebtedness is an extraordinary item and as such is a component of net income for book purposes. Even though the income is not taxable, it may increase book income for purposes of the alternative minimum tax. Section 56(g) provides for the calculation of Adjusted Current Earnings ("ACE"). ACE means alternative minimum taxable income for the year adjusted for items specifically identified in §56(g)(4). Section 56(g)(4)(B) provides that gain excluded from gross income under §108 is not included in the calculation of adjusted current earnings.

2. INDIVIDUALS

A. IN CHAPTER 7 AND CHAPTER 11 PROCEEDINGS

1. General

Upon the filing of a petition by an individual ("debtor") under either Chapter 7 or Chapter 11 of the United States Bankruptcy Code, a new taxable entity is created (See §1398(a)). The separate taxable entity rule under §1398 does not apply if the case is later dismissed by the Bankruptcy Court.

Under Chapter 7, a trustee is appointed by the Bankruptcy Court to administer the estate and liquidate the nonexempt assets of the debtor. Under Chapter 11, the debtor generally remains in control (as "debtor-in-possession") of its property and interests. However, a trustee may also be appointed by the Bankruptcy Court.

The entity created by the bankruptcy filing (the "estate") is composed of all legal and equitable property or interests of the debtor; property brought back into the estate by the trustee via preference avoidance actions; any bequest, devise or inheritance that the debtor acquires or becomes entitled to acquire within 180 days after the date of filing; proceeds (e.g., rents, profits, etc.) related to property of the estate; and any interest in property acquired by the estate after the filing. See §541(a).

2. Filing Requirements

The estate is subject to gross income filing requirements established under §6012(a)(9) or the sum of the exemption amount and the basic standard deduction. For 1990, 1991 and 1992 these amounts are $4,775, $5,000 and $5,300, respectively.

Under §6012(b)(4), the responsibility for filing returns is that of the fiduciary, e.g., either the trustee or the debtor-in-possession. The trustee in a Chapter 7 or Chapter 11 proceeding and the debtor-in-possession in a Chapter 11 proceeding is required to compute the tax in the same manner as an individual (See §1398(c)(1)), at the rates applicable to a married individual filing separately (See §1398(c)(2) and (3)), and pay the tax (See §§1398(c)(1) and 6151).

The estate, as a new taxable entity, is required to obtain a taxpayer identification number ("TIN"). Form SS-4 is used on a case-by-case basis or a number can be designated from a block assigned to a trustee or other party under the provisions of Rev. Proc. 89-37.

The return is to be filed using a Form 1041 as a cover sheet. The form will show the debtor's name, address, TIN of the estate, taxable period and the tax liability of the estate. The income reported and tax computation are attached as a supporting schedule using Form 1040. See IRS Announcement 81-96.

3. Notification to IRS

Under Treas. Reg. §301.6036-1, the Treasury has determined that the notice provisions of the Federal Rules of Bankruptcy Procedures are sufficient to eliminate a previous requirement that separate notice had to be provided. However, to protect the interests of the estate, the trustee or debtor-in-possession should ensure that such notice has been provided to the IRS.

Under §6872, the statute of limitations for examination of returns and assessment of taxes for years prior to the filing is suspended for as much as two years or until notified as described above. 11 U.S.C. §362 also serves to suspend the statute of limitations. See §6503(i).

4. Transfer of Debtor's Tax Attributes to Estate

Under §1398(g), the estate succeeds to the following tax attributes of the debtor, determined as of the first day of the debtor's taxable year in which case commences:

(a) Net operating loss carryovers.

(b) Charitable contributions carryovers.

(c) Recovery of tax benefit items.

(d) Credit carryover, etc.

(e) Capital loss carryovers.

(f) Basis, holding period, and character of assets.

(g) Method of accounting.

(h) Other attributes to the extent provided by the Treasury Secretary.

Section 1398(f)(1) provides that a transfer, other than by sale or exchange, from the debtor to the estate is not treated as a disposition for tax purposes. Similarly, §1398(f)(2) provides that a transfer at the termination of an estate, other than by sale or exchange, from the estate to the debtor is not treated as a disposition for tax purposes. The tax attributes of the debtor transferred to the estate are subject to being written down in accordance with §§108 and 1017 relating to income from the cancellation of indebtedness.

11 U.S.C. §554 prescribes the means by which property of a bankruptcy estate may be abandoned if the property is either burdensome or of inconsequential value and benefit to the estate. In PLR 9017075, the IRS, in interpreting the provisions of §1398(f)(2), has indicated that abandonment of estate property during the case is not treated as a disposition for tax purposes. However, in a recent case, *In re* A.J. Lane & Co., Inc., 133 B.R. 264 (Bankr. D. Mass. 1991), the court determined that abandonment of mortgaged property to the debtor prior to a scheduled foreclosure and prior to termination of the case, is a transfer taxable to the bankruptcy estate.

As later described in Section 3, "Partnerships," it is presently unclear whether gains and losses from a partnership interest are reported on the individual's bankruptcy estate return or are split between the bankruptcy estate and the individual. It generally has been thought that regardless of when the individual files a bankruptcy petition, the bankruptcy estate tax return will reflect partnership income, gains and losses for the entire year. Income, gains and losses passing through to an individual from an S corporation, however, are prorated based on the date the bankruptcy petition is filed.

5. The Estate's Taxable Year

The taxable year of the estate does not necessarily need to be a calendar year. Treas. Reg. §1.441-1(b)(2) can be applied since the estate is a new taxable entity. The period can be no longer than 12 months and the return is to be filed on or before the 15th day of the fourth month following the close of the fiscal year as provided in §6072(a). Treas. Reg. §1.441-1(b)(2) further provides that the fiscal year can be adopted only by timely filing the estate's first return and not with an extension request.

If the estate files its first return for a period of less than 12 months, Treas. Reg. §1.443-1(a)(2) provides that the income reported is not annualized and the regular standard deduction and exemption amounts are used.

Section 1398(j)(1) allows, without regard to §442, the estate the opportunity to change its taxable year once, without approval of the Secretary.

6. Income and Expense Activity of the Estate

Section 1398(c)(1) provides that the taxable income of the estate shall be computed in the same manner as for an individual. Section 1398(e) provides that the estate's gross income includes the gross income of the debtor to which the estate is entitled under the Bankruptcy Code on or after the commencement date of the case.

Section 1398(e)(3) provides that the estate is to treat deductions, credits and payment of wages by the estate the same as if it were the debtor engaged in the debtor's business before the commencement of the case.

Although not specifically indicated in the Internal Revenue Code, it would seem that the debtor would be subject to self-employment taxes on payments made by the estate to the debtor for services rendered, but only to the extent of the self-employment earnings computed on the estate's return. See PLR 8728056.

7. Administration, Liquidation and Reorganization Expenses and Net Operating Losses ("NOLs")

Section 1398(h) allows a deduction for any administrative expense allowed under 11 U.S.C. §503, to the extent not disallowed under some other section of the Internal Revenue Code. Operations of a debtor's business can result in a loss that includes the normally calculated NOL increased further by the bankruptcy administrative expenses deducted.

Section 1398(h)(2)(B) provides that the administrative expense-loss portion of the overall loss shall be an administrative expense carryback for three years and a carryforward for seven years. The carryback and carryover is only allowed to the estate under §1398(h)(2)(D) and terminates upon termination of the estate.

The NOL portion of the estate's overall loss is not limited to use only by the estate. Section 1398(j)(2) provides that only the estate's NOLs and not the debtor's postpetition NOLs may be carried back to debtor's taxable years before the year in which the case was commenced.

Treatment of alternative minimum tax NOLs is guided by TAM 8932002. The alternative tax net operating losses of the estate may be carried back to a taxable year of the debtor which corresponds to a carryback year of the estate. Further, neither a NOL nor an alternative minimum tax NOL of the estate may be deducted by the debtor for a taxable year which corresponds to a taxable year of the estate. If, for example, the bankruptcy estate was closed on September 30, 1991, any surviving NOL would pass out to the debtor. The surviving NOL of the bankruptcy estate for the 1991 short year would be available for use in the debtor's 1991 Form 1040.

8. Determination of Tax Liability and Payment

11 U.S.C. §505(b) provides that the trustee (or debtor-in-possession), upon the filing of tax returns for the period of administration of a case, may request a prompt determination of any liability reported. Generally, in the absence of fraud and upon payment of the tax shown on such return, the estate, the trustee and the debtor are discharged from any liability

for the tax. Rev. Proc. 81-17 provides guidance to the trustee (or debtor-in-possession) on how to file and obtain a prompt determination in this situation. Once the determination has been made, this procedure will prevent the IRS from assessing any additional tax against the bankruptcy estate or the trustee for the periods covered.

9. Adjustment of Tax Attributes

Certain of the debtor's tax attributes transferred to the estate are subject to adjustment during the administration of a case in bankruptcy. Under §108, the exclusion of COD income requires the reduction of certain tax attributes. This reduction is recorded before any transfer of remaining attributes from the estate to the debtor upon termination of a case.

Treas. Reg. §1.641(b)-3(a) which generally concerns a decedent's estate provides that for Federal income tax purposes, an estate is considered terminated when all assets have been distributed except for a reasonable amount set aside for the payment of unascertained or contingent liabilities and expenses. Although not specifically noted, it might be assumed that these expenses do not include the payment of the allowed claims of creditors other than administrative expense claimants.

Section 108(b) provides for the order in which tax attributes are affected and the method of reducing them. The method and order of reduction are discussed in more detail in Section 1, Item L - Cancellation of Debt ("COD") Income.

10. State and Local Taxes

11 U.S.C. §346(b)(2) provides that except as otherwise provided in 11 U.S.C. §728, State and local income taxes on the estate shall be computed in the same manner as for an estate. 11 U.S.C. §728, which applies only in cases filed under or converted to Chapter 7, provides that the trustee shall file State and local income tax returns only if the estate has net taxable income for the entire period after the filing.

11. Special Considerations for the Debtor

Under 11 U.S.C. §728, for State and local tax purposes, the debtor's taxable year terminates on the date the order for relief is granted by the Bankruptcy Court (typically, the date the petition is filed), unless converted from either Chapter 11 or 12. In the latter case, the debtor's taxable year would terminate when the estate created by the filing first becomes a separate taxable entity.

12. Election to Terminate Debtor's Taxable Year

Under §1398(d)(2), the debtor may elect to treat its taxable year, which includes the date of commencement of a case filed under Chapter 7 or 11, as two separate taxable years; the first ending the day before the commencement of the case and the second beginning on the commencement date and ending on the date the debtor's normal taxable year would have ended. In cases where only one party of a married couple is in a bankruptcy proceeding, §1398(d)(2)(B) provides that the debtor's spouse may join in the election.

Under §1398(d)(2)(F), the returns for both taxable periods, if elected, shall be annualized under the provisions of §443(a)(1). The election can be made, under §1398(d)(2)(C), only when the debtor has assets other than exempt assets under 11 U.S.C. §522.

The election to make short-year filings is subject to the provisions of §1398(d)(2)(D) which require it to be made on or before the due date for filing the return for the first short taxable period. The election is irrevocable. Temporary Treas. Reg. §7a.2 provides that the election can be made with the filing of an application for extension of time for filing the return for the first short taxable period. The tax liability for the short taxable period ending the day before the commencement of the case is a prepetition claim. As such, debtors should carefully consider the effects of making an election under §1398(d).

B. IN CHAPTER 12 PROCEEDINGS

1. General

Section 1398 does not apply to cases filed under Chapter 12. As such, no separate taxable entity is created for Federal income tax purposes and there is no short-year tax option available for the individual debtor.

2. Filing Requirements

The debtor is required to file the same federal returns as had been filed previously. Since no separate taxable estate is created, no Form 1041 is required to be prepared and filed.

3. Notification to IRS

Under Treas. Reg. §301.6036-1, Treasury has determined that the notice provisions of the Federal Rules of Bankruptcy Procedure are sufficient to eliminate a previous requirement that separate notice had to be provided. However, to protect the interests of the estate, the trustee or debtor-in-possession should ensure that such notice has been provided to the IRS.

4. The Debtor's Taxable Year

The debtor continues to use the same taxable year and accounting method as had previously been used.

5. Net Operating Losses ("NOLs")

NOLs are determined in accordance with §172, without regard to any different treatment for bankruptcy administrative, liquidation and reorganization expenses.

6. Determination of Tax Liability and Payment

11 U.S.C. §505(b) provides that the trustee (or debtor-in-possession), upon filing tax returns for the period of administration of a case, may request a prompt determination of any liability reported. Generally, in the absence of fraud and upon payment of the tax shown on such return, the trustee and the debtor are discharged from any liability for the tax. Rev. Proc. 81-17 provides guidance to the trustee (or debtor-in-possession) on how to file and obtain a prompt determination in this situation. Once the determination has been made, this procedure will prevent the IRS from assessing any additional tax against the debtor or the trustee for the periods covered.

7. Adjustment of Tax Attributes

Section 108(d)(2) provides that the discharge of indebtedness must be granted by the bankruptcy court or be pursuant to a plan approved by the bankruptcy court. Discharge for a debtor in Chapter 12 does not necessarily occur upon confirmation of the plan of reorganization and could occur as long as five years later. The plan of reorganization will specify the timing of payments and upon completion of such payments, 11 U.S.C. §1228 then provides for the court to grant the debtor a discharge of the debts provided for in the plan.

Section 108(b) provides for the order in which tax attributes are affected and the method of reducing them. The method and order of reduction are discussed in more detail in Section 1, Item L - Cancellation of Debt ("COD") Income.

8. State and Local Taxes

11 U.S.C. §346(b)(2) provides that in a Chapter 12 case concerning an individual and except as otherwise provided in 11 U.S.C. §728, State or local income taxes shall be computed in the same manner as for an estate.

Under 11 U.S.C. §1231, for State or local income tax purposes, the taxable period of the debtor terminates on the date the petition under Chapter 12 was filed. The trustee or debtor-in-possession is required to file State and local income tax returns for all taxable periods during which the case is pending. At the time of this publication, there was legislation pending in Congress to eliminate 11 U.S.C. §1231.

C. IN CHAPTER 13 PROCEEDINGS

1. General

Section 1398 does not apply to cases filed under Chapter 13. As such, no separate taxable entity is created for Federal income tax purposes and there is no short-year tax option available to the individual debtor.

2. Filing Requirements

The debtor is required to file the same federal returns as had been filed previously. Since no taxable estate is created, no Form 1041 is required to be prepared and filed.

3. Notification to IRS

Under Treas. Reg. §301.6036-1, Treasury has determined that notice provisions of the Federal Rules of Bankruptcy Procedure are sufficient to eliminate a previous requirement that separate notice be provided. However, to protect the interests of the estate, the trustee or debtor-in-possession should ensure that such notice has been provided to the IRS.

4. The Debtor's Taxable Year

The debtor continues to use the same taxable year and accounting method as had previously been used.

5. Net Operating Losses ("NOLs")

NOLs are determined in accordance with §172, without regard to any different treatment for bankruptcy administrative, liquidation and reorganization expenses.

6. Determination of Tax Liability and Payment

11 U.S.C. §505(b) provides that the trustee (or debtor-in-possession), upon filing tax returns for the period of administration of a case, may request a prompt determination of any liability reported. Generally, in the absence of fraud and upon payment of the tax shown on such return, the trustee and the debtor are discharged from any liability for the tax. Rev. Proc. 81-17 provides guidance to the trustee (or debtor-in-possession) on how to file and

obtain a prompt determination in this situation. Once the determination has been made, this procedure will prevent the IRS from assessing any additional tax against the debtor or the trustee for the periods covered.

7. Adjustment of Tax Attributes

Section 108(d)(2) provides that the discharge of indebtedness must be granted by the bankruptcy court or is pursuant to a plan approved by the bankruptcy court. Discharge for a debtor in Chapter 13 does not necessarily occur upon confirmation of the plan of reorganization, but occurs upon completion of all payments under the plan (which could be as long as five years). The plan of reorganization will specify the timing of payments and upon completion of such payments, 11 U.S.C. §1328 then provides for the court to grant the debtor a discharge of the debts provided for in the plan.

Section 108(b) provides for the order in which tax attributes are affected and the method of reducing them. The method and order of reduction are discussed in more detail in Section 1, Item L - Cancellation of Debt ("COD") Income.

8. State and Local Taxes

There is no provision under Chapter 13 of the Bankruptcy Code that requires any different treatment for State or local income taxes than under nonbankruptcy circumstances. As such, the debtor is required to continue to file returns for the same taxable periods as had been required prior to the commencement of the bankruptcy case.

3. PARTNERSHIPS

A. FILING REQUIREMENTS

The filing of a partnership petition creates a separate estate for bankruptcy purposes (See 11 U.S.C. §541), but, under the provisions of §1399, no new estate (entity) is created for income tax purposes. A partnership may file a petition under Chapter 7, 11, or 12.

When a Chapter 7 petition is filed, the estate's assets are turned over to the trustee. The trustee is obligated to protect the assets of the partnership, liquidate the partnership in an orderly manner and distribute the proceeds according to the priority order provided in the Bankruptcy Code (See 11 U.S.C. §726). While the partnership is liquidated, its debts are not discharged. Only an individual can obtain a discharge in a Chapter 7 proceeding.

If the estate is deficient in paying all creditors' claims, then each general partner is liable to the estate for the full amount of the deficiency (See 11 U.S.C. §723(a)). If any general partner wants to be granted a discharge under the provisions of the Bankruptcy Code, such a partner must file a separate bankruptcy petition. 11 U.S.C. §723(b) provides that the trustee, whenever practical, is to seek recovery from the general partners that are not debtors in a Title 11 case.

The Bankruptcy Tax Act of 1980 added §§1398 and 1399 to the Internal Revenue Code in order to clarify the issues of new entity creation pursuant to a bankruptcy petition. These sections are more narrow in focus than that of §108. Section 1399 provides that no new entity is created when a partnership or corporation files a petition under Title 11 of the United States Code. Section 108 applies in Title 11 and insolvency scenarios and application of its provisions includes individuals as well as partnerships and corporations. Section 1398 is generally applicable if the debtor is an individual. A separate taxable entity is created with respect to individuals upon the filing of a voluntary or involuntary petition in bankruptcy. No new entity is created when a bankruptcy petition is filed by a partnership.

Pursuant to §1398, property characteristics and tax attributes flow to the estate upon the filing of a bankruptcy petition. Upon termination of the estate, certain remaining items revert back to the debtor. When an individual who is a partner files for bankruptcy protection, it is presently unclear whether gains and losses from the partnership for the year in which the individual's bankruptcy petition is filed are reported on the individual's bankruptcy estate return or are split between the bankruptcy estate and individual. It would appear, however, that pursuant to §1398(f)(1), the interim cutoff rules of §706(c)(2) will not apply.

B. GENERAL RULES APPLICABLE TO PARTNERSHIPS AND PARTNERS

1. Background

Section 61(a)(12) includes COD income in the definition of gross income. This provision of the Internal Revenue Code codified the U.S. Supreme Court decision in Kirby Lumber, 284 US 1 (1931), that the satisfaction of an indebtedness by repaying less than the amount borrowed creates taxable income to the extent of the difference. Indebtedness is defined as any indebtedness for which the taxpayer is liable and any indebtedness subject to which the taxpayer holds property.

2. Exclusion of COD Income Under §§108 and 1017

It is important to distinguish between discharge of debt by having a liability canceled or reduced without payment by a compromise settlement with a creditor and relief of debt in exchange for property. A transfer of property to a creditor in settlement of a debt is considered a sale. Gain would be realized where the amount of the debt exceeds the basis of the property. The amount of the gain may depend on whether the debt is recourse or nonrecourse. For a transfer that is nonrecourse debt, all of the gain is related to the transfer and there would be no COD income as determined by the U.S. Supreme Court in Tufts, 461 US 300 (1983).

In the case of recourse debt, the difference between the market value of the property and its basis is gain on transfer. The balance is COD income if the balance of the debt is forgiven and the amount of the debt exceeds the market value of the property. This situation is discussed in LTR 8928012 (July 24, 1989).

COD income may be allocated differently than the debt might have been allocated under §752. Generally, however, cancellation of partnership debt by the partnership is handled as follows:

(a) Each partner's basis in the partnership is increased by his or her distributive share of COD income under §705.

(b) There will be a decrease in partnership liabilities resulting in a distribution under §752, decreasing each partner's basis in the partnership under §733. This basis reduction will, in the aggregate, offset the increase under §705.

Whether COD income is excludable under §108 is determined at the partner level. The tax treatment of the individual partner will depend upon the financial status of each individual partner. A solvent partner who has not filed a bankruptcy petition would recognize COD income unless the discharge occurred prior to January 1, 1987 and the partner elected to reduce basis of depreciable property under the qualified business indebtedness provision. An insolvent partner or partner in bankruptcy would be subject to the COD income rules, but can exclude such income under §§108 and 1017.

Under §108, the exclusion of income from the discharge of indebtedness requires the reduction of tax attributes. Section 108(b) provides for the order in which tax attributes are affected and the method of reducing them. The method and order of reduction are discussed in more detail in Section 1, Item L - Cancellation of Indebtedness ("COD") Income.

Section 108(a) generally provides for the exclusion of COD income if:

(a) The debtor is in a Title 11 (bankruptcy) proceeding.

(b) The debtor is insolvent.

(c) The debt discharged is qualified farm indebtedness ("QFI").

Under (a) above, if a partner is in a Title 11 case, all COD income is excluded, even if it is in excess of insolvency. The bankruptcy exception takes precedence over the insolvency exception. To be under a Title 11 case, the taxpayer must be under the jurisdiction of the court and discharge must be granted by the court or be pursuant to a plan approved by the court.

Under (b) above, if the partner is under the Bankruptcy Court jurisdiction in a Title 11 case, the insolvency and qualified farm indebtedness rules do not apply. The insolvency exclusion takes precedence over the qualified farm indebtedness exclusion. If a partner is insolvent, COD income is excluded to the extent of insolvency. Insolvency is defined as the excess of liabilities over the fair market value of assets and is measured immediately before the discharge of indebtedness that gives rise to the COD income. The fair market value of the debtor's exempt assets are not included in determining solvency (See LTR 9125010). For these purposes, a debtor's exempt assets will generally be determined under state law.

Under (c) above, the QFI exception, the exclusion is limited to the sum of the partner's tax attributes plus the aggregate adjusted basis of qualified property held by the partner as of the beginning of the taxable year following the year in which the discharge occurred. Tax attributes and basis of qualified property are determined after any adjustments are made due to the insolvency of the farmer. Qualified property means any property used in a trade or business or for the production of income.

The basis reduction rules apply to both depreciable and nondepreciable property. The basis is not reduced below the partner's remaining undischarged liabilities unless §108(b)(5) applies. A partner's interest in a partnership is treated as depreciable property to the extent of such partner's proportionate interest in the partnership's depreciable property. If a partner elects to reduce basis in partnership interest, the partnership will be required to make a basis reduction of partnership assets with respect to that partner. This would be similar to a reduction under §754.

In reference to the order of reducing tax attributes, a partner may elect under §108(b)(5) to reduce under §1017 the basis of his or her depreciable property first. This election is revocable only with the consent of the Commissioner and is made at the partner level on his or her return for the year of discharge. The election may be made on all or part of the reduction, but shall not exceed the aggregate adjusted basis of depreciable property held by the taxpayer as of the beginning of the taxable year following the year of discharge.

While the rules in §108(a), (b) and (g) apply at the partner level, some rules still apply at the partnership level:

(a) Under §108(e)(4) relating to acquisition of debt by a related party to the debtor, the debt is treated as acquired by the debtor, thereby generating COD income.

(b) Under §108(e)(5), purchase money debt reduction is treated as a purchase price adjustment of the partnership asset.

C. NONBANKRUPTCY WORKOUTS

1. Property Transfers

One of the most common planning methods utilized by partnerships in structuring workouts is the transfer of property. The transfer of property with debt can be deemed to be a sale or to have triggered COD income depending on several factors including the type of debt. These issues and the differing tax results are discussed above in subsection B - General Rules Applicable to Partnerships and Partners.

2. Debt Restructuring

Debt may be restructured by substituting new debt for old. As always, careful attention should be given to the issue of debt substitutions within partnerships. Is the allocation of new and old debt between partners going to create a taxable transaction where the new and old debts differ as to recourse versus nonrecourse, etc.? A further discussion of this topic is provided below in Subsection C(4) - Debt Exchanges.

When there is a debt reduction and there is no consideration, the following rules apply. Where the creditor is not the seller there is a general rule that states when there is an "accretion to wealth," the entire relief of debt should be COD income. If there is no accretion to wealth, the answers are less clear. If the adjusted basis of property exceeds the amount of the debt discharged and there is in fact no "accretion to wealth" it is assumed that the Service would assert the tax benefit rule (*Consequence of Nonrecourse Indebtedness*, 67 Journal of Taxation 18, at 23).

Reduction of debt is a discharge of indebtedness; thus, there should be COD income under §61(a)(12). Income is recognized when a residential mortgage is fully discharged by paying less than the face amount of the mortgage (See Rev. Rul. 82-202 and Rev. Rul. 91-31). Even though the debt was "recourse," cancellation of gambler's debts did not give rise to COD income because debts were unenforceable under state law. Therefore, there was no debt to be canceled. See *In re* Zarin, 916 F.2D 110 (3d Cir. 1990), rev's 92 TC 1084 (1989).

Where there is a decrease in debt and there has been no COD or deemed sale, there is an important caveat regarding §752(b) deemed distribution and §731 gain.

3. Purchase Money Mortgage Debt Reduction

When the creditor is the seller of the property securing the reduced debt the reduction in debt should be treated as a purchase price adjustment. If the partnership is insolvent, §108(e)(5) does not apply, thus triggering COD income. If the partnership is solvent, the mandatory rules under §108(e)(5) apply and, therefore, no COD income is triggered. However, there may be §731 gain. Is this to be applied at the partner or partnership level? The correlation of the rules of §108(e)(5) can create a pitfall for the unwary. Where the partnership is insolvent, §108(e)(5) is not effective since one of the requirements is that the debtor is neither in bankruptcy nor insolvent. If all of the partners in the partnership are also in bankruptcy or insolvent they can find relief under another provision of §108.

However, if any of the partners are not in bankruptcy and are solvent, what would otherwise be a reduction in basis due to a purchase price reduction becomes currently taxable debt discharge income. Section 108(e)(5) is applicable only if the reduction does not occur either in a Title 11 case, or when the purchaser is insolvent and if, without regard to §108(b)(5), such reduction would be treated as COD income to the purchaser. The benefits of §108(a)(1) are only available if the partner, and not the partnership, is in bankruptcy under Title 11 or is insolvent. A solvent partner in an insolvent partnership would achieve better tax results had the property been purchased individually.

4. Debt Exchanges

Rev. Rul. 90-16 provides guidance regarding debt-for-property exchanges. If the debt is nonrecourse, then the face amount of liabilities is the amount realized. However, if the debt is recourse, then the face amount of the debt minus the fair market value ("FMV") of the property is COD income and the difference between the property's FMV and it's adjusted basis is gain or loss. For example, assume the following facts. An insolvent taxpayer transferred property to the lender in full satisfaction of recourse debt of $12,000. The taxpayer's adjusted basis in the property was $8,000. To the extent that the fair market value of the property, $10,000, exceeds its adjusted basis of $8,000, the taxpayer realizes and recognizes a gain on the transfer of $2,000. To the extent that the amount of canceled debt, $12,000, exceeds the fair market value of the property, $10,000, the taxpayer realizes COD income. However, §108(a) will permit the exclusion of COD income because that amount does not exceed the amount by which the taxpayer was insolvent. If it is determined that there is COD income, look to §108 to see whether the income is excludable.

Caution should be exercised when exchanging new debt instruments for old debt. Swaps of debt might give rise to gain. Unintended tax consequences under §752 and Original Issue Discount ("OID") rules may be created by such exchanges. If new debt is substituted for old debt, a grandfathering classification may be lost. The previously grandfathered debt may then be subject to OID rules. The IRS has amended proposed regulations for §1274 to clarify the exchange of nonrecourse debt for an outstanding debt instrument or the modification of an outstanding nonrecourse debt instrument would not be deemed to be a "potentially abusive situation" where such exchange or modification is treated as an exchange under Treas. Reg. §1.1274-1(c).

It appears that a creditor's exchange of debt for an interest in the partnership is tax free under §721(a). Even if the partnership capital account received in exchange for debt is less than the face of the liability, there should be no COD income since §108(e)(10) evidently applies only to corporations. However, the reduction in partnership debt as a result of the exchange will be treated as a distribution to the partners other than the partner(s) converting his debt. Caution should be given to the application of the at-risk rules in the above situation since the financing is now provided by a related party.

5. Debt Paydowns

Partner contributions and/or admission of new partners may be affected when partners contribute cash to the partnership to be used to pay debt. Revaluation, §704(c) issues, shifting of liabilities, and other similar issues should be considered in this context.

If a partner purchases partnership debt, §108(e)(4) is applied for purposes of determining COD income. Acquisition of debt by a person related to the debtor from a person not related is treated as the acquisition of debt by the debtor. Related parties are defined by reference to §§267(b) and 707(b)(1) with certain modifications. Regulations proposed in March 1991 (as amended in June, 1991) provide guidance on the application of §108(e)(4) where debt is acquired in a direct acquisition or if the debt holder becomes related to the debtor in an indirect acquisition. Indirect acquisitions of debt are transactions in which a holder of outstanding debt becomes related to the debtor, if the holder is treated as having acquired the debt in anticipation of becoming related to the debtor.

4. CORPORATIONS AND S CORPORATIONS

A. TAX REPORTING RESPONSIBILITIES OF THE DEBTOR AND TRUSTEE

1. Notification to the IRS

Section 6036 requires every trustee in a case under Title 11, court appointed receiver, assignee for the benefit of creditors, other fiduciary, and every executor to give notice of qualification to the Secretary of Treasury. Reg. §301.6036-1 provides notice is not required if, prior to or within 10 days of the date of an appointment or authorization to act, any notice regarding the proceeding has been given under any provision of the Bankruptcy Code to the Secretary. In Chapter 11 proceedings, the clerk of the bankruptcy court is required to mail a copy of the petition to the District Director for the district in which the case is filed.

Failure to give proper notice suspends the period of limitations on the assessment of taxes from the date the proceeding is instituted to the date the notice is received by the District Director and for an additional 30 days thereafter (See Treas. Reg. §301.6036-1).

2. No Separate Tax Entity Created

Under §1399, no separate taxable entity results from the commencement of a bankruptcy case for a corporation. Since a separate taxable entity is not created, a corporation's tax attributes and its taxable year are not affected by the commencement of a bankruptcy proceeding. A corporation will continue to file its corporate tax return in the same manner as it did preceding the bankruptcy filing (See §§1399 and 6012(a)).

The receiver, trustee in bankruptcy, or assignee who has possession of all or substantially all property must ensure returns are filed even if the corporation has no income (See §6012(b)(3)). Returns are filed using the corporation identification number. Returns should be continued until the corporation disposes of its assets, terminates business operations and all or substantially all assets are distributed to the creditors and other interest holders.

3. Withholding and Employment Tax Reporting

The trustee in bankruptcy must withhold taxes from any payment of claims for wages, salaries, commissions, dividends, interest or other payment, or collect any amount required to be withheld or collected under applicable tax law. This rule applies both to wages earned and paid during bankruptcy and wages earned before bankruptcy but paid after bankruptcy commences (See 11 U.S.C. §346(f) and *In re* Otte, 419 US 43 (1974)).

The trustee also has responsibility to file employment tax returns and reports. Such items as Federal Forms 940 and 941 must be prepared along with Forms W-2.

4. Deduction of Expenses

No specific provisions are made for the deductibility of expenses by bankrupt corporations. Bankruptcy expenses generally are deductible by a bankrupt corporation pursuant to §§162 or 212. Reorganization and liquidation bankruptcy expenses must be analyzed to determine deductibility. No guidance is provided in the Bankruptcy Tax Act for these types of expenses. Expenses incurred in reorganization of a bankrupt corporation are capital expenditures because they will benefit future years. Liquidation expenses, except for expenses connected with the sale of assets that must be offset against sales proceeds, are deductible by the corporation as ordinary and necessary business expenses (See Rev. Rul. 77-204).

5. Interest and Penalties

Section 6672 provides for a penalty equal to the tax evaded, not collected, or not accounted for and paid over, to be imposed on any person required to collect, truthfully account for, and pay over such tax but who willfully fails to do so. The penalty is assessed and required to be paid in the same manner as taxes. The penalty is treated as a tax and therefore cannot be discharged in bankruptcy (See 11 U.S.C. §§523(a) and 507(a)(7)(G)). A responsible person may be an officer or employee of a corporation who is under a duty to perform the required act. A responsible person may also be a director, the organizer of the corporation or a corporate shareholder. Liability may be limited in certain situations where an individual assumes control of a corporation with existing delinquencies.

Other penalties continue to apply to a bankrupt entity. The fraud penalty of §6653(b) and the negligence penalty of §6653(a) may be assessed if an underpayment of tax exists. If the fraud penalty is asserted, the negligence penalty cannot be raised.

Delinquency penalties for failure to file a timely return or failure to pay tax pursuant to §6651 can be assessed if a bankrupt entity fails to file a timely return (including extensions) or fails to pay the amount shown as tax liability on the return when the return is filed. A bankrupt taxpayer is only subject to the delinquency penalties if a tax liability exists for the year.

Interest is required to be paid on any unpaid taxes after the due date of the return. The interest is assessed, collected and paid in the same manner as taxes.

6. Federal Unemployment Tax Computation

The Federal Unemployment Tax Act (FUTA) generally allows two types of credits to be offset against the Federal unemployment tax. Section 3302(a) provides for the 90% credit. This is a credit for contributions actually paid into a state unemployment fund. This credit requires that contributions to the certified state unemployment fund are paid on or before the due date of the Federal unemployment tax return. If contributions to state unemployment funds are paid after the due date of the federal return, this credit is reduced to 90% of the amount that would have been allowed had the state contributions been timely paid (See §3302(a)(3)).

Section 3302(a)(5) provides a special relief rule to a trustee in bankruptcy. The normal credit is reduced to either 90% or 81% if wages are paid by the trustee and the failure to pay the state unemployment tax by the due date of the federal unemployment tax return was "without fault by the trustee."

A claim for prepetition employment tax liabilities, however, is affected by the provisions of 11 U.S.C. §502(b)(8). That section provides that such a claim does not include the effect of a reduction, due to late payment, in the amount of an otherwise applicable credit available to the debtor.

B. REORGANIZATIONS

1. General Recognition Rules

Under general income tax rules, a stockholder or holder of corporate debt securities who exchanges his stock or securities for stock or securities of the same corporation or another corporation recognizes gain or loss resulting from the transaction. (See §1001.)

The nonrecognition provisions of §§1031 through 1039 do not apply to exchanges of securities for stock or securities. Nor do they apply to exchanges of stock for stock or securities except to the limited extent provided in §1036, which permits stock of a corporation to be exchanged for stock tax-free, but only if the stock received is stock of the same corporation and of the same class.

At the corporate level, when a corporation transfers assets to another corporation, it generally recognizes any realized gain or loss. Moreover, any gain realized generally must be reported by the transferor as ordinary income to the extent of depreciation recapture.

2. Exception for Reorganizations

The corporate reorganization provisions of the Internal Revenue Code provide exceptions to the general recognition rules above. The central provision is §368, which describes the various types of transactions eligible for tax-free reorganization treatment.

(a) Common Requirements for all Reorganizations under §368:

(1) Plan of reorganization.

(2) Business purpose.

(3) Continuity of interest.

(4) Continuity of business enterprise.

However, see discussion for reorganizations under §368(a)(1)(G) below.

3. Types of Reorganization Under §368

The three general types of reorganization provided for in §368 are asset acquisitions, stock acquisitions and same corporation reorganizations.

(a) Asset Acquisitions

(1) Statutory Merger or Consolidation Under §368(a)(1)(A) - In a merger, one existing corporation acquires all the assets and liabilities of a target corporation in return for its stock, and continues to operate the target's business. The target goes out of existence as a result of the reorganization.

In a consolidation, two existing corporations pool their assets and liabilities, which is accomplished by having a new corporation acquire the existing corporation's assets and liabilities.

(2) Transfer of Assets to a Controlled Subsidiary Under §368(a)(1)(D) ("Divisive D") - A corporation transfers all or part of its assets to another corporation and, immediately after the transfer, the acquired corporation or its shareholders are in control of the transferee corporation. Section 368(a)(1)(D) also requires that the stock or securities received for the assets be distributed in a transaction qualifying under §§355 and 356.

(3) Statutory Merger into a Controlled Subsidiary Under §368(a)(1)(D) ("Acquisitive D") - One corporation acquires substantially all of another corporation by merger under §368(a)(1)(A) in exchange for stock of a corporation which is in control of the acquiring corporation, provided no stock of the acquiring corporation is used in the transaction and the merger would have qualified (by reason of business purpose, continuity of business enterprise and continuity of interest) under §368(a)(1)(A) if it had been merged into the controlled corporation.

(4) "C" Reorganization - Similar to a statutory merger under §368(a)(1)(A). In a reorganization under §368(a)(1)(C), one corporation acquires substantially all of the assets of a target solely in exchange for the acquirer's voting stock or voting stock of a corporation controlled by the acquirer. (A difference between "C" reorganizations and "A" and "D" reorganizations is that "C" reorganizations generally require a specific conveyance of the assets and separate action to dissolve the acquired corporation rather than having these steps take place by operation of law.

(5) Reorganization in Title 11 or Insolvency Under §368(a)(1)(G) - In a "G" reorganization, a corporation must transfer all or part of its assets to another corporation in a bankruptcy or similar case, but only if, pursuant to a plan, stock or securities of the transferee corporation are distributed in a transaction which qualifies under §§354 through 356.

(b) Stock Reorganizations

(1) "B" Reorganization - Acquisition of stock solely for voting stock. One corporation must acquire stock of another corporation solely in exchange for voting stock of the acquiring corporation or a corporation in control of the acquiring corporation and, immediately after the acquisition, the acquiring corporation must be in control of the acquired corporation. Acquisition of any amount of stock of the acquired corporation can qualify as long as the acquiring corporation is in control immediately after the exchange.

(c) Same Corporation Reorganizations

(1) Recapitalization - Alterations of the existing capital structure under §368(a)(1)(E). This can include exchanges of stock for stock, securities for stock, securities for securities and stock for securities.

(2) "F" Reorganization - A mere change in the identity, form or place of organization under §368(a)(1)(F).

4. Reorganizations of Insolvent Corporations Under §368(a)(1)(G)

"G" reorganizations are reorganizations in a bankruptcy case under Title 11 of the United States Bankruptcy Code and similar laws. "G" reorganizations were added by Congress in an attempt to make it easier for a financially distressed corporation to undergo a tax-free reorganization, but in cases when the reorganization would not have been able to meet the more rigorous tests imposed on the other §368(a)(1) reorganizations. As a result "G" reorganizations may also qualify as another type of reorganization described above. However, in these situations, the transaction will be considered a "G" reorganization only. See §368(a)(3)(C).

(a) Effect of a "G" Reorganization - Participants in "G" reorganizations generally receive the same tax treatment as other reorganizations, with minor exceptions. The tax effect to the participants in a "G" reorganization may be summarized as follows:

(1) Under §1032, the acquiring corporation recognizes no gain or loss on the issuance of its stock in return for the target's assets.

(2) The acquiring company receives a carryover basis in the target's assets subject to adjustment under §§108 and 1017.

(3) The target corporation will not recognize any gain or loss upon its receipt of stock or securities or generally on the assumption of its liabilities by the acquiring corporation.

(b) General Requirements for a "G" Reorganization

As indicated above, in a "G" reorganization, a corporation must transfer all or part of its assets to another corporation in a Title 11 bankruptcy or similar case, but only if, pursuant to a plan, stock or securities of the transferee corporation are distributed in a transaction which qualifies under §§354 through 356. This asset transfer must be made pursuant to a court approved plan.

(c) Cases Eligible for "G" Reorganization Treatment

Title 11 and similar cases eligible for §368(a)(1)(G) treatment are defined in §368(a)(3) as:

(1) Title 11 bankruptcies; or

(2) Receivership, foreclosure or similar proceeding in a Federal or State court.

(d) Differences in Bankruptcy Reorganizations

Because "G" reorganizations are designed to make the tax favorable reorganization rules available to financially distressed corporations, a number of the requirements for qualification that apply to other reorganizations under §368 have been relaxed for "G" reorganizations. In addition, other qualification rules do not apply.

The following general reorganization requirements have been relaxed for a "G" reorganization:

(1) "Substantially All" - In a "G" reorganization there must be a distribution that qualifies under §§354 through 356. This is the same rule that applies in a "D" reorganization, which requires the acquiring corporation to acquire substantially all of the assets of the acquired corporation, and the acquired corporation then liquidates. The term "substantially all" in the case of "D" reorganizations is unclear. However, the IRS provides a safe harbor stating that "substantially all" means at least 90 percent of the fair market value of the acquired corporation's assets and 70 percent of the fair market value of the gross assets (See Rev. Proc. 77-37). Outside the safe harbor, smaller percentages would often meet this test.

However, for "G" reorganizations Congress indicated that the "substantially all" test should be relaxed to take into account the realities of reorganizations involving financially distressed corporations. Congress made the following statement:

> "... it is intended that facts and circumstances relevant [to the intent of facilitating bankruptcy reorganization], such as the insolvent corporation's need to pay off creditors or to sell assets or divisions to raise cash, are to be taken into account in determining whether a transaction qualifies as a "G" reorganization. For example, a transaction is not precluded from satisfying the "substantially all" test [for a "G" reorganization] merely because, prior to a transfer to the acquiring corporation, payments to creditors and asset sales were made in order to leave the debtor with more manageable operating assets to continue in business." See S. Rept. No. 1035 to P.L. 96-589, 96th Cong., 2d Sess. 35 (1980), 35-36.

This statement seems to mean that a much smaller percentage might be retained and still qualify for "G" treatment.

(2) Continuity of Interest - In other reorganizations, the original owners of an acquired enterprise must retain a continuing interest in the reorganized entity. This continuing interest can be broken down into two basic elements:

(a) Character of the consideration - A sufficient portion of the consideration received must represent an interest in the affairs of the resulting entity that is proprietary in nature. See *In re* Southwest Natural Gas Co., 189 F.2d 332 (5th Cir. 1951).

(b) Retention of the Interest - A sufficient portion of the consideration received must be retained for a sufficient period of time to conclude that its ownership is "definite and substantial." See Rev. Rul. 66-23.

However, in the context of a "G" reorganization, Congress again stated that the rules should be relaxed to take into account situations where creditors play a more active role in the financial situation of financially distressed corporations, such as where a corporation's liabilities exceed its assets, leaving the shareholders in a position in which they might not be entitled to consideration. Under these rules for "G" reorganizations, the creditors may be viewed as proprietors for purposes of applying the proprietary of interest rule. This standard is applied in the following way:

The most senior class of creditor to receive stock, together with all equal or junior classes (including former shareholders) who receive any consideration in the transaction will be considered proprietors of the acquired corporation.

In situations where these creditors are considered proprietors, and thus can be considered for purposes of satisfying the continuity of interest requirement, the tax treatment to the creditors may differ from that applicable to shareholders. For example, if a proprietor receives stock in exchange for stock or securities of the acquired corporation, there generally will be no gain recognized by the proprietor. However, if the proprietor receives consideration for accrued interest on a security of the acquired corporation, this is taxed as interest income. See §354(a)(2) and 3(B).

(3) Provisions not Applicable - According to the committee reports to P.L. 96-589, the following requirements need not be met in a "G" reorganization:

(a) The receipt solely of stock in the acquiring corporation in exchange for assets (required under §368(a)(1)(C)).

(b) Compliance with state merger laws (required under §368(a)(1)(D)).

(c) Maintenance of control over the acquired corporation by the former shareholders of the acquired corporation (required under §368(a)(1)(D)).

(e) Triangular Reorganizations under §368(a)(1)(G)

Triangular reorganizations (where the acquired corporation is acquired for stock of the parent of the acquiring corporation) are generally permitted for other reorganizations under §368(a)(1). Triangular reorganizations are also permitted in the case of "G" reorganizations, where §368(a)(1)(D) permits forward triangular reorganizations.

In addition, §368(a)(3)(E) permits a reverse triangular merger, with the following qualifications:

(1) No former shareholder of the target corporation may receive any consideration in return for their stock.

(2) The former creditors of the target corporation must exchange at least 80% of the fair market value of the debt solely for voting stock of the controlling corporation.

C. §382 IN BANKRUPTCY SITUATIONS

1. Attribute Carryovers in General - §381

Under §381, an acquiring corporation in a tax-free acquisition generally succeeds to or takes into account the net operating loss carryovers and other tax attributes of the distributor or transferor company.

Under §381(a), acquisitions that are eligible for this carryover treatment are limited to the types of reorganizations under §368(a) as well as nontaxable subsidiary liquidations under §332.

2. Limitations on Attribute Carryover - §382

To prevent trafficking in NOLs, §382 generally provides that if there is a change in ownership of a corporation that has a NOL, the use of the NOL will be limited. These §382 limitations also apply to built-in and capital losses of the corporation. In addition, the §382 limitations are used to compute a corporation's §383 limitations on the use of minimum tax, general business and foreign tax credits. However, the §382 limitations are increased for any unrealized built-in gains of the loss corporation. See §382(h)(1)(A).

(a) Ownership Change Defined

Under §382(g), two types of ownership changes will trigger §382 limitations: (1) ownership shifts involving 5% shareholders and (2) equity structure shifts.

If either of these changes takes place, losses will be limited if, immediately after the change, the percentage of stock of the new loss corporation owned by one or more 5% shareholders has increased by more than 50% (by value) relative to the lowest percentage of stock in the old loss corporation owned by the same shareholders at any time during the testing period (See §382(g)(1)). This testing period is generally three years (See §382(i)).

(1) Changes Involving 5% Shareholders

If there is a change in the corporation's ownership that results in a change in the percentage of the corporation's stock owned by any person who is a 5% shareholder before or after the change, there is an owner shift involving 5% shareholders. See §382(g)(2).

Shareholders owning less than 5% of the stock are aggregated and treated as a 5% shareholder for purposes of applying this test. See §382(g)(4)(A).

(2) Equity Structure Shifts

Any reorganization within §368 except for the following:

(a) "F" reorganizations (mere change in form), or

(b) "D" and "G" reorganizations unless the requirements of §354(b)(1) are met (divisive reorganizations).

When applying the equity structure shift rule, the rule for aggregating less-than-5% shareholders (described above) applies separately to each group of shareholders of each corporation involved in the equity structure shift.

(b) Limitations Imposed - Calculating the §382 Limitation

The §382 limitation for any post-change year is an amount equal to the value of the old loss corporation multiplied by the long-term tax-exempt rate (See §382(b)(1)). If the §382 limitation exceeds taxable income for a post-change year, the unused limitation will increase the limitation for the next year. For example: The value of the old loss corporation is $1 million, while the long-term tax-exempt rate is 6%. The §382 limitation is $60,000. Therefore, $60,000 of income may be offset by NOL's from the old loss corporation in any one year.

While the above calculation places a limit on the annual loss that may be deducted, it does not reduce the overall NOL carryforward. Therefore, the NOL carryforward survives intact, and is usable for 15 years, subject to the annual limitation calculated above.

(1) Long-Term Tax Exempt Rate Defined

Under §382(f), the long-term rate applicable to §382 calculations is the highest of the adjusted Federal long-term rates determined under §1274(d) (as adjusted to reflect differences between rates on long-term taxable and tax-exempt obligations) in effect for any month in the 3 calendar-month period ending in the month of the change date.

(c) Continuity Required

If the new loss corporation does not continue the business of the old loss corporation for two years, the §382 limitation is zero. See §382(c)(1).

3. Exceptions from §382 Limitation in Bankruptcy

Section 382(l)(5) provides special rules that state that loss carryforwards of a loss corporation that is in a bankruptcy proceeding will not be subject to the general §382 limitation explained above. Specifically, §382(l)(5) provides that no ownership change occurs if the loss corporation was under the jurisdiction of a court in a Title 11 or similar case immediately before the change, and certain owner continuity requirements were met. In addition, the reorganization must be ordered by the court or under a plan approved by the court.

This exception generally provides significant tax cash flow relief to the surviving corporation, allowing it to offset future earnings by attributes that would otherwise have been suspended under general §382 provisions.

(a) Cost of §382(l)(5) Relief

Section 382(l)(5)(C) requires that the tax attributes of the loss corporation, including NOLs, be reduced by 50% of the excess of the discharged debt over the value of stock transferred to creditors (in other words, 50% of the cancellation of indebtedness income that the corporation would have recognized under §108(e)(10) had the corporation not been in bankruptcy).

(b) Owner Continuity Required

The shareholders or creditors of the old loss corporation (determined immediately before the ownership change) must own 50% or more of the stock of the new loss corporation (immediately after the ownership change) using value and voting power under §1504(a)(d).

Under §382(l)(5)(E), stock held by creditors may only be used for purposes of satisfying the 50% test if:

(1) It arose from conversion of indebtedness generated in the ordinary course of business and is held by the person who at all times held the beneficial interest in the corporate indebtedness, or

(2) The creditor held the stock at least 18 months before the date the bankruptcy case was filed.

Debt is treated as having arisen in the ordinary course of the loss corporation's business only if the debt was incurred by the loss corporation in connection with the normal, usual and customary conduct of its business. It is not relevant for this purpose whether the debt was related to ordinary or capital expenditures. See Conf. Rept. No. 99-841, Vol. II (PL 99-514) p. II-92.

(c) Other Issues

(1) Multiple Ownership Changes

The relief provided by §382(l) applies only to ownership changes every two years. A second ownership change within a two year period after the initial change that gave rise to §382(l)(5) relief will cause the carryover attributes to be reduced from 50 percent to 0 percent of the initial amount for any post-change year ending after the date of the second ownership change. See §382(l)(5)(D).

(2) Alternative Minimum Tax and §382(l)

Under §382(l)(7), the concepts imposed by §382(l) apply to the alternative minimum tax.

(3) Bankruptcy Defined

Under §382(l)(5)(G), a Title 11 or similar case has the same meaning as in §368(a)(3)(A), which includes Title 11 proceedings under the United States Bankruptcy Code as well as receiverships, foreclosures or similar proceedings in a Federal or State court.

(4) Preferred Stock

In Notice 88-67, the IRS stated that preferred stock that is not treated as stock under §382(k)(6) (by reference to §1504(a)(4)) will be treated as a creditor's claim against the loss corporation and the owner of the preferred stock will be treated as a creditor for purposes of the continuity requirements explained above. Preferred stock under §1504(a)(4) is stock which:

(a) Is not entitled to vote.

(b) Is limited and preferred as to dividends and does not participate in corporate growth to any significant extent.

(c) Has redemption and liquidation rights which do not exceed the issue price of such stock (except for a reasonable redemption or liquidation premium).

(d) Is not convertible into another class of stock.

(5) Reduction of Interest Expense

Under §382(l)(5)(B), if a loss corporation is subject to the bankruptcy exception, pre-change losses and excess credits which are carried forward to a post-change year are computed as if no deduction was allowable for interest paid or accrued by the old loss corporation on indebtedness that was converted into stock under a Title 11 or similar case during:

(a) Any taxable year ending during the 3 year period before the taxable year in which the ownership change occurs.

(b) The period of the taxable year in which the ownership change occurs on or before the change date.

As a result, no interest expense deduction may be taken for interest paid or accrued during the period beginning three years prior to the change year up to the change date.

(d) Electing Out of the §382 Bankruptcy Exception

A new loss corporation may elect, subject to IRS terms and conditions, not to have the bankruptcy exception under §382 apply to their corporation. See §382(l)(5)(H).

(1) Election Mechanics

This election is made by the due date of the tax return including extensions) for the first tax year to which the election applies. See Treas. Reg. §5h(a)(2)(i). This election is revocable only with the IRS's consent. See Treas. Reg. §5h.5(a)(4)(ii). The election is made by attaching a statement to the return for the tax year to which it is to be effective. Under Treas. Reg. §5h.5(a)(3)(i), the statement must:

(a) Contain the name, address and TIN of the electing taxpayer.

(b) Identify the election.

(c) Indicate that it is a §382(l)(5)(H) election.

(d) Specify the period for which the election is to be effective and/or the property or other items to which the election is to apply.

(e) Provide information to show that the taxpayer is entitled to the election.

4. §382 and Stock Worthlessness

(a) General

Section 382(g)(4)(D) provides that if any 50% shareholder:

(1) Treats any stock as becoming worthless during any taxable year of such shareholder, and

(2) Holds such stock at the end of such taxable year, then, for purposes of determining whether an ownership change occurs after the close of such taxable year, that shareholder is treated as having acquired the stock at the beginning of the shareholder's next taxable year and, not having owned it during any preceding taxable year.

(b) 50% Shareholder Defined

A 50% shareholder is any shareholder who owned at least 50% of the loss corporation's stock at any time during the three year period ending on the last date of the taxable year in which the stock becomes worthless.

A recent U.S. Court of Appeals decision, *In re* Prudential Lines, 928 F.2d. 565 (U.S.C.A., 2nd Cir., March 20, 1991), ruled that such a 50% shareholder was enjoined from taking a postconfirmation worthless stock deduction for a wholly owned subsidiary in bankruptcy. The Court determined that such a deduction would render the NOL of the subsidiary worthless and thus affected the value of an asset of the subsidiary. Users of this guide are again cautioned to review subsequent court decisions before relying on this statutory provision.

D. S CORPORATIONS

S corporations present an unusual situation for debt discharge. Section 108(d)(7) provides that exclusions from gross income under §108(a), reductions of tax attributes under §108(b) and the application of special rules for discharge of qualified farm indebtedness under §108(g) are applied at the corporate level. Because attribute reduction is applied at the corporate level rather than at the shareholder level, debt discharge in a Title 11 case will not affect net operating loss carryovers of its shareholders, even though such carryovers may be attributable to earlier losses of the S corporation. No pass-through of debt discharge income to the shareholders in a bankrupt S corporation results, even if debt discharge income exceeds tax attributes, subject to reduction under §108.

In the year of debt discharge income in a Title 11 case for an S corporation, any loss or deduction disallowed for the taxable year to shareholders because of limitations under §1366(d)(1) is treated as a net operating loss for the year. Section 1366(d)(1) limits the aggregate amount of losses and deductions taken into account by a shareholder, for any year, to the adjusted basis of the shareholder's stock and debt in the corporation. Section 108(d)(7)(B) treats the amount of loss that can be carried forward as an amount subject to attribute reduction under §108(b)(2)(A) by debt discharge income.

Debt contributed to capital of an S corporation by a shareholder may not generate debt discharge income. Section 108(e)(6) provides debt discharge income is generated by the debtor corporation to the extent that the amount of debt exceeds the shareholder's adjusted basis of the debt. Section 108(b)(7)(C) provides that adjustments made to shareholder's debt under §1367(b)(2) are not to be considered for purposes of §108(c)(6). These basis adjustments are distributions, losses, separately stated deductions and certain other items after the shareholder's stock basis has been reduced to zero. The effect of this provision prevents debt discharge income at the S corporation level due to debt basis reductions from previously passed through loss items when debt is contributed to capital of the S corporation.