A Cause for Distress? The Ways the Federal Income Tax Pushes Taxpayers into Bankruptcy

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Bankruptcy and the Federal Income Tax

Federal income tax law effectively "pushes" taxpayers to file for bankruptcy in various ways, some explicit and some subtle and likely unintentional. Examples include:

- Section 382(l)(5) and (l)(6);
- The difference between the bankruptcy and insolvency exclusions under section 108;
- The potential effect of a bankruptcy proceeding on:
  - The application of Treas. Reg. 1.382-2T(f)(18)(iii);
  - An IRS challenge of a transaction under section 269 and/or judicial doctrines; and
  - The characterization of an exchange for tax purposes consistent with its form, even if that form is "non-economic;" and
- The restriction of the bankruptcy exception to partners/ "regarded" owners that are also in bankruptcy.

As a result of these and other factors, there is often a federal income tax incentive to file for bankruptcy, even if bankruptcy is not a commercial necessity.

Bankruptcy “Neutrality”

On one hand, although bankruptcy is a day of reckoning for creditors of a common debtor, rights and obligations do not expand or contract as a result of the bankruptcy filing itself.

- “Whatever limitations on the debtor’s property apply outside of bankruptcy apply inside of bankruptcy as well. A debtor’s property does not shrink by **happenstance of bankruptcy**, but it does not expand, either.” *Mission Product Holdings, Inc. v. Tempnology*, LLC, 139 S. Ct. 1652 (2019) (internal quotations omitted; emphasis added).
- Thus, for example, clauses that attach consequences to the fact of a bankruptcy filing (“ipso facto” clauses) are generally unenforceable. See 11 U.S.C. §541(c)(1); 11 U.S.C. §363(*l*); 11 U.S.C. §365(e).

On the other hand, the Bankruptcy Code treats bankruptcy as a “last resort,” and thus courts interpret its rules to avoid “pushing” companies into bankruptcy.

- For example, courts have refused to disallow, as unmatured interest under the Bankruptcy Code, certain “economic” (and tax) original issue discount created by debt restructurings prior to (and in an attempt to avoid) bankruptcy, on the grounds that such a disallowance would effectively “incentivize” bankruptcy filings by penalizing creditors participating in out of court restructurings.

Contrast between Bankruptcy Law and the Federal Income Tax

The policies animating bankruptcy law can be contrasted with the incentives provided by the Federal income tax that encourage filing for bankruptcy to achieve better tax results.

- If the rights of other creditors cannot expand or contract merely because of bankruptcy, why should the tax collector be any different?
- Why encourage forum shopping? Shouldn't the choice turn instead on the one that is most cost-effective, which in many cases would be an out of court negotiated agreement?

Summary of the "Thesis"

Federal income tax law effectively "pushes" taxpayers to file for bankruptcy in various ways, some explicit and some subtle and likely unintentional.

These "pushes" towards bankruptcy should be minimized to the extent possible, consistent with the general "neutrality" policy of bankruptcy law, so that commercial and not tax considerations drive the decision of whether to file for bankruptcy.

- For example, the favorable rules under section 382(l)(5) and (l)(6) could be expanded to apply to corporations outside of bankruptcy in certain situations (e.g., where creditors acquire the equity of the corporation).
- Similarly, the insolvency exception under section 108 could be expanded (e.g., to assume full insolvency where creditors acquire the equity of the corporation).
- However, the business purpose/economic analysis of transactions inside bankruptcy should then mirror the analysis outside of bankruptcy –no special "imprimatur" should be provided by the bankruptcy court.

Tax "Pushes" Into Bankruptcy
Section 382(l)(5) and (6)

Section 382(l)(5) and (6)

Section 382(l)(5)(A): Subsection (a) shall not apply to any ownership change if

(i) the old loss corporation is (immediately before such ownership change) under the jurisdiction of the court in a title 11 or similar case, and

(ii) the shareholders and creditors of the old loss corporation (determined immediately before such ownership change) own (after such ownership change and as a result of being shareholders or creditors immediately before such change) stock of the new loss corporation (or stock of a controlling corporation if also in bankruptcy) which meets the requirements of section 1504(a)(2) (determined by substituting "50 percent" for "80 percent" each place it appears).

Section 382(l)(6): If paragraph (5) does not apply to any reorganization described in subparagraph (G) of section 368(a)(1) or any exchange of debt for stock in a title 11 or similar case (as defined in section 368(a)(3)(A)), the value under subsection (e) shall reflect the increase (if any) in value of the old loss corporation resulting from any surrender or cancellation of creditors' claims in the transaction.

Legislative History

Section 382(l)(5) and (6) enacted as part of the general revision of section 382 in the Tax Reform Act of 1986.

The House Report to the 1986 Act included a provision similar to section 382(l)(6). In discussing this provision, the House Report noted:

- That an insolvent corporation generally has $0 382 limitation, although creditors of such a corporation are the true owners (cites to *Alabama Asphaltic*) and generally bear losses reflected in NOLs; and
- That a blanket exception from section 382 for insolvent corporations was not justified, as creditor may also engage in transactions to accelerate use of NOLs.

The House Report version of section 382(l)(6) appears to reflect a compromise between these two considerations.

Legislative History (cont.)

The Senate Report to the 1986 Act included a provision similar to section 382(l)(5). The Senate Report contains similar comments to the House Report, but adopts a different “solution.”

- The interest “haircut” appears to be based on the notion that if creditors effectively held equity in the corporation, a deduction for interest was not appropriate.
- The zero limitation on a second ownership change apparently was based on the notion that the equity value on first ownership change was $0, and that any subsequent value increases would reflect capital contributions that generally would be disregarded under section 382.

Legislative History (cont.)

Both the House and Senate proposals are enacted in the final legislation.

The Conference Report noted that "[t]he special bankruptcy provisions do not apply to informal workouts" and "the conference agreement directs the Secretary of the Treasury to report informal bankruptcy [*sic*] workouts under sections 108 and 382, and report to the tax-writing committees of Congress before January 1, 1988."

- No report was ever issued and the requirement for a report was repealed in 1990.

Section 382(l)(5) – Current Application

The section 382(l)(5)(B) “interest haircut” – does this serve its intended policy purpose?

- Reduction of section 163(j) carryforwards often is not a bad answer for taxpayers (particularly if, as the statute provides, section 163(j) switches to “EBIT” for tax years beginning after December 31, 2021).
- What “indebtedness” is converted into stock for purposes of section 382(l)(5)? For example, are interest deductions attributable to debt that was refinanced with new or existing lenders subject to section 382(l)(5)(B)?
  - The deduction disallowance only applies to the extent of interest deductions attributable to the portion of the debt that is exchanged for stock.

The section 382(l)(5)(D) second ownership change limitation -

- Is the two-year “lock-up” period unduly restrictive (e.g., changes in valuation may be due to more than capital contributions)?

Section 382(l)(5) and (6) – Current Application

- Both (l)(5) and (l)(6) appear to have been drafted to strike a balance between the same policies (*i.e.,* the harshness of a $0 section 382 limitation for an insolvent corporation where creditors have born a portion of the losses versus the general concern to protect against trafficking).
  - Is it appropriate to provide both benefits only in the context of “title 11 or similar cases,” when the same policies could be said to also apply to insolvent corporations generally?
  - Consideration should be given to narrowing the gap between the bankruptcy and non-bankruptcy results.
    - For example, a significant exchange of debt for equity by creditors suggests both that the debtor is insolvent and that the creditors have borne a portion of the debtor’s losses, perhaps justifying the extension of section 382(l)(5) and (l)(6) to such an exchange occurring outside of bankruptcy.

Tax "Pushes" Into Bankruptcy

Treas. Reg. 1.382-2T(f)(18)(iii)

Bankruptcy and Treas. Reg. 1.382-2T(f)(18)(iii)

In general, Treas. Reg. 1.382-2T(f)(18)(iii) provides that an interest that is not stock (e.g., a debt instrument) may be treated as stock if *inter alia* "[a]s of the time of its issuance **or transfer** to (or by) a 5-percent shareholder (or a person who would be a 5-percent shareholder if the interest not constituting stock were treated as stock), such interest offers a potential significant participation in the growth of the corporation." (emphasis added)

T.D. 8149 (discussing Treas. Reg. 1.382-2T(f)(18)(iii)): "Thus, for example, a financial instrument that generally is treated as debt for Federal income tax purposes nevertheless may be treated as stock under the temporary regulations if such debt offers a potential significant participation in the growth of the loss corporation."

Bankruptcy and Treas. Reg. 1.382-2T(f)(18)(iii) (continued)

Treas. Reg. 1.382-2T(f)(18)(iii), if applied in light of the language of T.D. 8149, could result in ownership changes arising from the trading of distressed debt (inside or outside of the bankruptcy context).

However, such an interpretation would by inconsistent with the framework of section 382(l)(5) and (6), and thus practitioners generally appear to ignore (or conclude they do not have an issue under) Treas. Reg. 1.382-2T(f)(18)(iii) during a bankruptcy restructuring.

Bankruptcy and Treas. Reg. 1.382-2T(f)(18)(iii) (continued)

Query: If an insolvent corporation engages in a restructuring outside of Bankruptcy, does the same implicit "exemption" from Treas. Reg. 1.382-2T(f)(18)(iii) apply?

- There is no strong policy reason that the application of Treas. Reg. 1.382-2T(f)(18)(iii) should turn on whether a restructuring takes place inside or outside of bankruptcy.
- In this case, limiting the scope of Treas. Reg. 1.382-2T(f)(18)(iii) to debt instruments that provide significant participation in corporate growth **<u>on issuance</u>** (inside and outside of bankruptcy) would both provide a clear, uniform result in both cases and appears justifiable from a policy/practicality perspective.

Tax "Pushes" Into Bankruptcy

Section 108 – Difference Between Bankruptcy and Insolvency Exceptions

Section 108 General Rules

Section 108(a)(1)(A) (the "Bankruptcy Exception").

- In general, all otherwise includible CODI discharged in a title 11 case pursuant to a court order or court approved plan is excluded from gross income.

Section 108(a)(1)(B) (the "Insolvency Exception")

- In general, all otherwise includible CODI is excludible for an insolvent taxpayer **only** to the extent the taxpayer is insolvent immediately before the discharge of the debt.

The application of the Insolvency Exception to a taxpayer with contingent liabilities is unclear.

Contingent Liabilities and *Merkel*

In *Merkel*, the Tax Court stated that a liability is taken into account in determining solvency only if "it is more probable than not" that the taxpayer will be required to pay the liability in the amount claimed. Further, under the approach in *Merkel* the full amount of the liability is taken into account if "it is more probable than not" that the liability will be paid.

- The *Merkel* decision was subsequently affirmed by the Ninth Circuit.

Contingent Liabilities and *Merkel (cont.)*

The application of the "all or nothing" standard articulated in *Merkel* to many contingent liabilities is unclear, and arguably inappropriate even in cases where it can be easily applied.

- For example, the "all or nothing" approach means that a difference between a 49% versus a 51% likelihood that a contingent liability will be paid causes either 0% or 100% of that liability to be taken into account for purposes of calculating solvency. This is true even though the economic position of the taxpayer in the 49% versus the 51% case is similar (and taking into account either 0% or 100% of the contingent liability does reflect the economic position of the taxpayer).
- It is not clear how the *Merkel* standard applies when not only the liability, but the amount of the liability, is uncertain (which is often the case).
- It is also not clear how the *Markel* standard applies to a "mass liability" – e.g., if a taxpayer estimates that 2% of its sales will be returned for refunds, is the relevant liability determined by the small probability that a particular sale is returned, or the estimated aggregate liability?

Contingent Liabilities and Bankruptcy

The uncertainty regarding the application of the insolvency exception pushes taxpayers to file for bankruptcy and take advantage of the Bankruptcy Exception.

What alternatives to the *Merkel* standard could be applied for the Insolvency Exception?

- New York State Bar Association 2012 Report recommendation – estimate the "fair market value" of any contingent liabilities within a given range of likelihood (e.g., liabilities with < 20% chance of being realized are ignored, and liabilities with a > 80% chance of being realized are treated as non-contingent liabilities).
- Similar to the approach taken by Treas. Reg. 1.752-7(b)(3)(ii) (valuing certain contingent and other liabilities based on the amount that would need to be paid to an unrelated person to assume such liabilities).

Measuring Insolvency – Practical Considerations

Distressed companies generally do not want to acknowledge that they are insolvent/the extent of their insolvency.

Therefore, methods for the calculation of insolvency (including the estimation of contingent liabilities) that are not "self-assessed" may be more useful from a practical perspective.

- For example, if a corporation issues 100% of its stock to its creditors in satisfaction of their debt, any difference between the value of the stock and the amount of the debt is often assumed to reflect the insolvency of the corporation (as well as the amount of CODI). The amount of any contingent liabilities, although not quantified, is presumably reflected in the (lower) value of the stock.
- Similarly, if a company has (first priority) distressed debt trading at $60, does this imply that the company has $60 of assets (net of contingent liabilities)?
  - Or are there too many other variables (e.g., the lack of any equity cushion for the distressed debt) to use this as a proxy for the asset value?
  - "Market" prices arguably are less susceptible to manipulation than a company's own calculations.

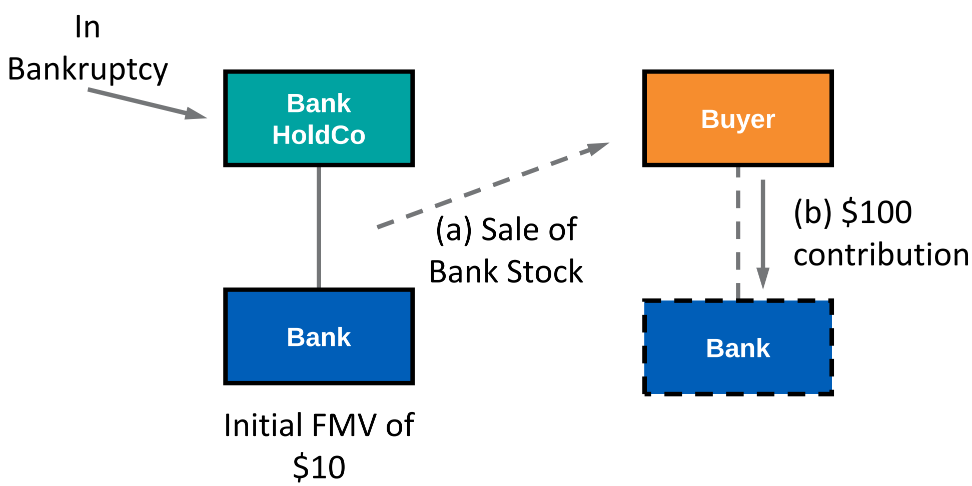
Measuring Insolvency – Practical Considerations (cont.)

- A significant exchange of debt for equity by creditors could be treated as establishing insolvency at least equal to any CODI realized (viewing such an exchange as (similar to a bankruptcy filing) a sufficient signal of financial distress to justify a result similar to the Bankruptcy Exclusion).

<u>Tax "Pushes" Into Bankruptcy</u>

Transaction "Purpose" and Bankruptcy Court Approved Restructurings

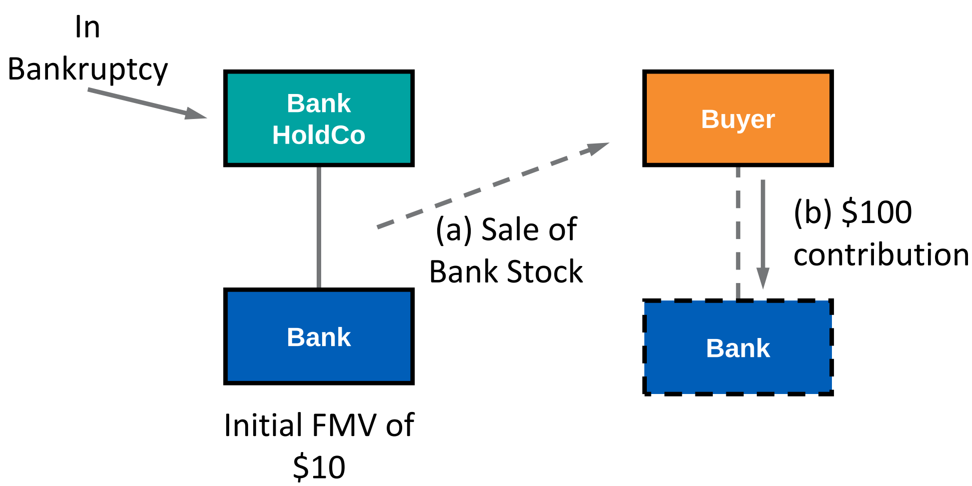
Section 382(l)(6) and Bank Restructurings



<u>Fact pattern</u>:

- A bank holding company (Bank HoldCo) is in bankruptcy. Bank HoldCo owns Bank worth $10.
- As a condition of approving any sale of Bank, the bankruptcy court will require that additional capital is contributed to Bank to satisfy applicable regulatory standards.
- Pursuant to the bankruptcy court approved restructuring plan, the following transactions happen simultaneously: (a) Bank HoldCo sells Bank to unrelated Buyer, and (b) Buyer contributes $100 to Bank to facilitate Bank's compliance with relevant regulatory standards.

Section 382(l)(6) and Bank Restructurings (cont.)



<u>Analysis</u>:

- Under section 382(l)(6), as interpreted by Treas. Reg. 1.382-9(j), the section 382 limitation for Bank appears to be based on $110 of value (the value of the stock immediately after the ownership change).
- The $100 contribution by Buyer reflects new assets contributed to Bank. However, does section 382(l)(6) and the general imprimatur of the bankruptcy court insulate this transaction from potential judicial challenge?

Treas. Reg. 1.269-3(d) and Section 382(l)(5)

Treas. Reg. 1.269-3(d) provides that "[a]bsent strong evidence to the contrary, a requisite acquisition of control or property in connection with an ownership change to which section 382(l)(5) applies is considered to be made for the principal purpose of evasion or avoidance of Federal income tax unless the corporation carries on more than an insignificant amount of an active trade or business during and subsequent to the title 11 or similar case (as defined in section 382(l)(5)(G))."

- **Query**: Does this mean that, if the "unless" clause is satisfied (*i.e.,* the corporation carries on more than an insignificant amount of business activities), the taxpayer automatically does not have the "bad" principal purpose? Or does a taxpayer that satisfies the "unless" clause avoid the presumption (rebuttable with strong evidence to the contrary) of the "bad" principal purpose but still need to establish that the taxpayer does not have the "bad" principal purpose?
- **Query**: As acknowledged elsewhere, creditors of the bankruptcy corporation often effectively have "control" of the corporation and have born the economic losses reflected in the tax attributes. Thus, is there an acquisition of control that warrants the application of section 269 on emergence?

Treas. Reg. 1.269-3(e) and 11 U.S.C. 1129(d)

Bankruptcy Code (11 U.S.C. 1129(d)): “Notwithstanding any other provision of this section, on request of a party in interest that is a governmental unit, the court may not confirm a plan if the principal purpose of the plan is the avoidance of taxes or the avoidance of the application of section 5 of the Securities Act of 1933. In any hearing under this subsection, the governmental unit has the burden of proof on the issue of avoidance.”

Treas. Reg. 1.269-3(e): “In determining for purposes of section 269 of the Internal Revenue Code whether an acquisition pursuant to a plan of reorganization in a case under title 11 of the United States Code was made for the principal purpose of evasion or avoidance of Federal income tax, the fact that a governmental unit did not seek a determination under 11 U.S.C. 1129(d) is not taken into account and any determination by a court under 11 U.S.C. 1129(d) that the principal purpose of the plan is not avoidance of taxes is not controlling.”

Query: Does the approval of a restructuring plan by a bankruptcy court, because of 11 U.S.C. 1129(d) or otherwise, provide additional ammunition against a claim that a taxpayer had the “bad” principal purpose?

Transaction “Purpose” and the “Happenstance of Bankruptcy”

In practice, 11 U.S.C. 1129(d) is rarely invoked.

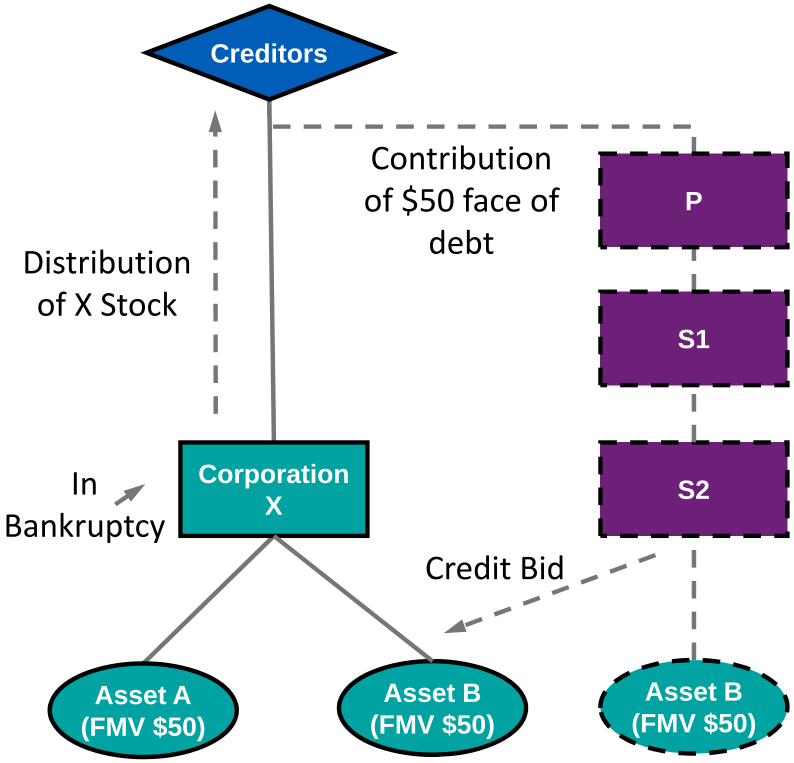
- Note that, in part for the reasons described herein, the choice of bankruptcy as the path for a restructuring is often motivated by tax considerations.

Conceptually, it does not seem appropriate for the potential application of section 269 or other judicial doctrines to depend on whether a transaction occurs inside or outside of bankruptcy.

- This is consistent with the Service’s position in Treas. Reg. 1.269-3(e).
- A potential countervailing consideration is the bankruptcy policy that claims should be resolved within the bankruptcy process, consistent with a “fresh start” on emergence.
- Relatedly, to what extent should bankruptcy procedure allow debtors to have these tax issues litigated and determined within the bankruptcy process by (at least initially) bankruptcy courts?

Tax “Pushes” Into Bankruptcy Transaction “Economics” and Bankruptcy Court Approved Restructurings

Example 1 – "Basis Bifurcation" Transaction

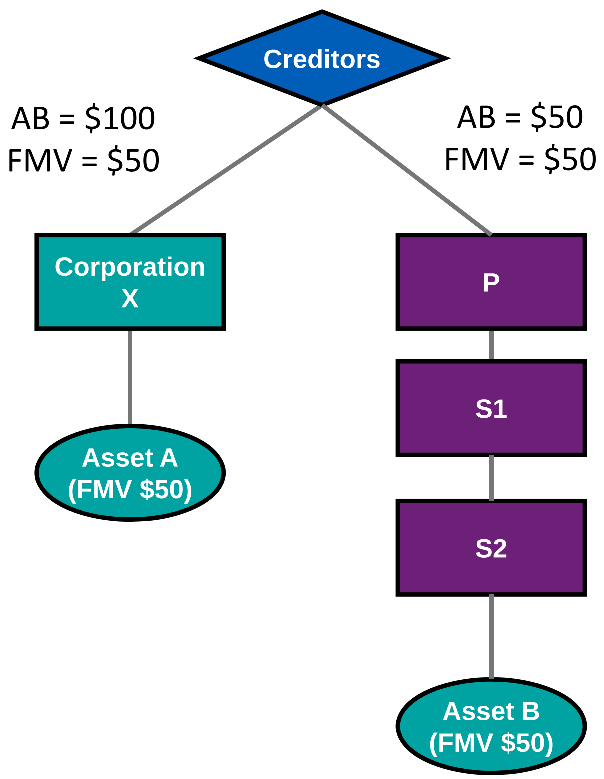


Starting facts: Corporation X is in bankruptcy. X owes $150 to a single class of creditors (the "X Debt"). The X Debt is not a security for purposes of sections 351 and 354. The creditors have an adjusted basis of $150 in the X Debt. X owns two assets, Asset A and Asset B, each with $50 FMV. The X Debt is secured by Assets A and B.

Proposed restructuring: as part of the plan -

- Creditors form corporation P, which forms corporation S1, which forms corporation S2.
- Creditors contribute $50 of the X Debt obligation to P (creditors continue to hold $100 of X's obligation on the X Debt), which contributes $50 of the X Debt obligation to S1, which contributes $50 of the X Debt to S2.
- S2 credit bids its $50 of X Debt for Asset B.
- Creditors exchange their remaining directly held X Debt of $100 for all of the stock of X (the previously outstanding stock of X is canceled).

Example 1 – "Basis Bifurcation" Transaction (cont.)

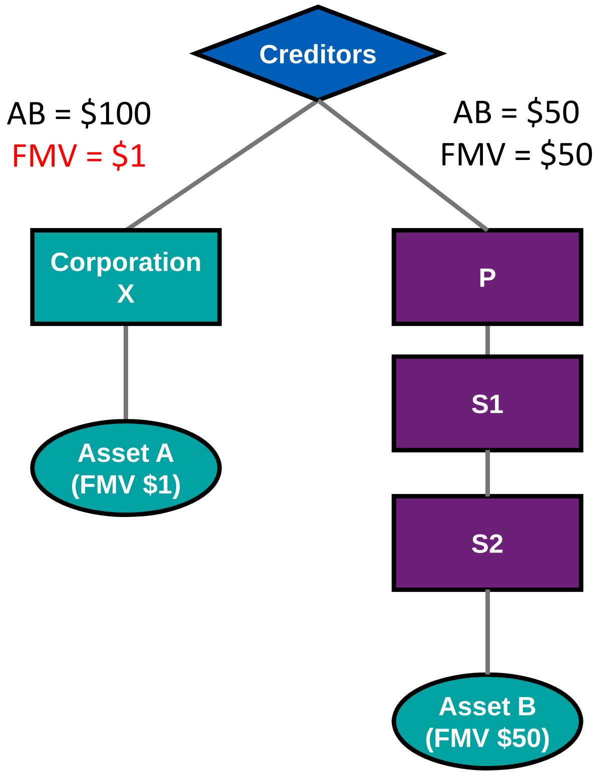


Economic and/or general tax principles view: $150 (face) of X Debt was exchanged for (i) P stock worth $50 and (ii) X stock worth $50. Therefore, appropriate to treat $75 (face) of X Debt as exchanged for P stock and $75 (face) of X Debt as exchanged for Asset B.

Bankruptcy plan characterization:

- Creditors take a $50 basis in P equal to the basis in the contributed portion of the X Debt.
- P takes a $33 basis in the contributed portion of the X Debt pursuant to section 362(e)(2). As an indirect consequence, S2 will recognize $17 of gain on the credit bid for Asset B.
- Creditors have a $50 loss on the exchange of the remaining portion of the X Debt (basis of $100) for stock of X worth $50.

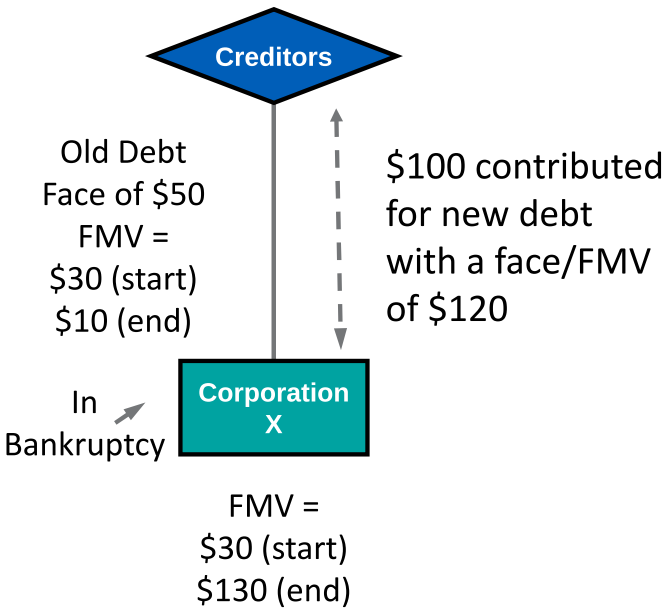
Example 1 – "Basis Bifurcation" Transaction (cont.)



Alternative:

- Same facts as above, except that Asset A has an FMV of $1. Effectively, the $99 of built-in loss in the X Debt at the creditor level has all been shifted to the X stock (S2 would also recognize additional gain on the credit bid).

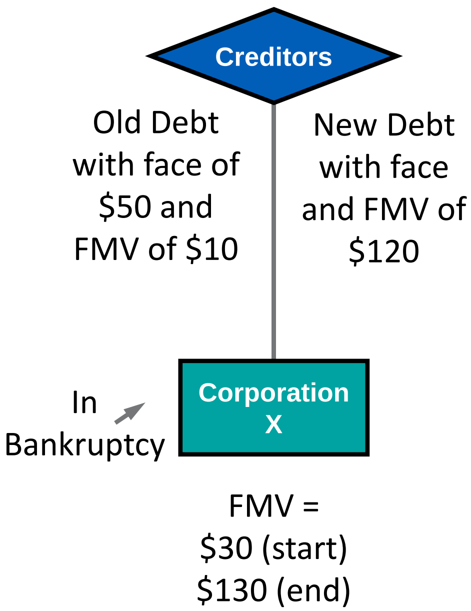
Example 2 – DIP Financing Transaction



Starting facts: Corporation X is in bankruptcy. The FMV of X is $30. A single class of X debt is outstanding with a face amount of $50.

Proposed restructuring: as part of the plan, the creditors of X are given the right to participate in a DIP financing, in which the creditors will contribute $100 to X (increasing FMV of X to $130) in exchange for new senior debt with a face amount/FMV of $120. The existing debt (face of $50, FMV following the transaction of $10) remains in place.

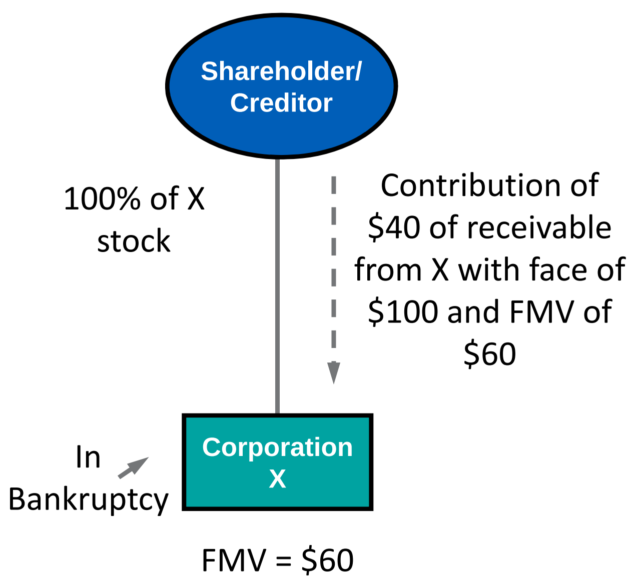
Example 2 – DIP Financing Transaction (cont.)



Economic and/or general tax principles view: The creditors have "shifted" $20 of value from their old debt (which is now worth $10) to the new debt. This could be viewed as an exchange of (i) an old debt worth $30 and $100 of cash for (ii) a new debt worth $120 and a "new" debt worth $10. Does this exchange result in $20 of CODI and $0 of OID (or $40 of CODI and $20 of OID on the new debt worth $120)?

Bankruptcy plan characterization: The creditors take new debt in X with $20 of OID. The old debt in X is unaffected by the transaction. No CODI is realized.

Example 3 – Partial Contribution of Debt to Capital



Starting facts: Shareholder owns 100% of the stock of corporation X, and holds $100 receivable owed by X. When X is worth $60, Shareholder contributes $40 of the receivable to the capital of X.

Economic and/or general tax principles view:

- Likely constitutes a significant modification under Treas. Reg. § 1.1001-3.
- Unclear that the debt can be bifurcated into contributed and a non-contributed segments; thus, potential application of § 108(e)(10) and recognition of $40 of CODI by X on the exchange of the "new" debt for "old" debt.

Bankruptcy plan characterization:

- What if the bankruptcy court specifically states that the receivable is bifurcated and that only the $40 segment is contributed to X? Does that change the analysis above?

Example 4 – Payment Ordering Rule

Facts: Creditors are owed unpaid principal and accrued and unpaid interest from a debtor in bankruptcy. The bankruptcy court order provides that all payments to the creditors are to be treated as made first on account of unpaid principal, with any remainder made on account of unpaid interest.

Economic and/or general tax principles view:

- Treas. Reg. § 1.446-2(e)(1) generally provides that each payment <u>under</u> a loan is treated as a payment of interest to the extent of accrued and unpaid interest.
- Treas. Reg. § 1.1275-2(a) generally provides that each payment <u>under</u> a debt instrument is treated first as a payment of OID to the extent of accrued OID that has not been allocated to prior payments.

Bankruptcy plan characterization:

- Is the allocation provided by the bankruptcy court order controlling for Federal income tax purposes?

Example 4 – Payment Ordering Rule (cont.)

The House Report to the Bankruptcy Tax Act provided as follows:

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

No equivalent provision in Senate Report.

Note that the Bankruptcy Tax Act predates the payment ordering rules under Treas. Reg. § 1.446-2(e)(1) and Treas. Reg. § 1.1275-2(a).

Transaction “Economics” and the “Happenstance of Bankruptcy”

Bankruptcy restructuring plans can involve transactions which, while negotiated between unrelated parties and economic overall, include components that are not themselves economic (e.g., component exchanges that are not value-for-value).

If a restructuring plan would be recharacterized outside of bankruptcy in accordance with its substance as consisting of economic, value-for-value exchanges, why does the involvement of a bankruptcy court warrant a different result?

- There is no specific statutory or other rule providing that non-economic transactions in bankruptcy are more likely to be respected – it is based more on the expectations of the parties.
- One option to “reset” those expectations would be a statutory enactment specifically stating Congress’ intent that the tax consequences of transactions are to be determined based on generally applicable tax standards (e.g., the substance over form doctrine) regardless of whether transactions occur as part of a bankruptcy or are approved by a court order therein.
- Similar to the transaction “purpose” discussion, this proposal would potentially create uncertainty regarding tax consequences extending beyond emergence from bankruptcy, which could be considered contrary to bankruptcy policy favoring a “fresh start” on emergence.

In addition, it does not seem appropriate for the application of the payment ordering rule to turn on whether a bankruptcy court is involved – the rule either should or should not apply to settlements of distressed debt generally.

Tax "Pushes" Into Bankruptcy
Section 108(a)(1)(A) and Partners/Disregarded Entity Owners

Section 108 Application

Section 108(d)(6) provides that, in the case of a partnership, the bankruptcy exception of section 108(a)(1)(A) applies at the partner, not the partnership, level.

Treas. Reg. 1.108-9(a)(2): “If indebtedness of a grantor trust or a disregarded entity is discharged in a title 11 case, section 108(a)(1)(A) applies to that discharged indebtedness only if the owner of the grantor trust or the owner of the disregarded entity is under the jurisdiction of the court in a title 11 case **as the title 11 debtor**. If the grantor trust or the disregarded entity is under the jurisdiction of the court in a title 11 case as the title 11 debtor, but the owner of the grantor trust or the owner of the disregarded entity is not, section 108(a)(1)(A) does not apply to the discharge of indebtedness income.” (Emphasis added).

Background to Provisions

Section 108(d)(6) was enacted by Bankruptcy Tax Act of 1980.

- However, limited insight in legislative history as to reason for enactment.

Treatment of partnerships contrasts with treatment of S corporations, where Bankruptcy and Insolvency Exceptions are applied at the corporate level. Section 108(d)(7)(A).

- Originally, the Subchapter S Revision Act of 1982 had applied a “shareholder” level test for the Bankruptcy and Insolvency Exceptions – treating S corporation shareholders akin to partners.
- However, this was changed by the 1984 Deficit Reduction Act, which enacted current section 108(d)(7)(A).
- The House Report for the 1984 Deficit Reduction Act stated that the change was enacted “[i]n order to treat all shareholders in the same manner.”

Background to Provisions (cont.)

Section 108(d)(2): “the term “title 11 case” means a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.”

- In four memorandum decisions in 2004, the Tax Court held that, where a bankruptcy court discharged a non-debtor partner’s obligation to guarantee the debts of a bankrupt partnership, the partner qualified for the Bankruptcy Exception, finding that the partner was under the jurisdiction of the bankruptcy court with respect to the discharge.
- In a 2015 A.O.D., the Service indicated that it disagrees with these decisions, and believes that the Bankruptcy Exception applies only to the party that is a debtor in a bankruptcy case (consistent with Treas. Reg. 1.108-9(a)(2)).

Policy Implications of the Section 108(a)(1)(A) Guidance

Do these rules "push" partners in partnerships and owners of disregarded entities to also file for bankruptcy to avail themselves of the Bankruptcy Exclusion?

Is an alternative regime in which insolvency is determined at the partnership/disregarded entity level, triggering attribute reduction at that level (and perhaps the partner/disregarded entity owner level as well) appropriate?