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96TH CONGRESS } SENATE { REPORT
2d Session } { No. 96-1035

BANKRUPTCY TAX ACT OF 1980

REPORT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

ON

H.R. 5043

NOVEMBER 25 (legislative day, NOVEMBER 20), 1980.—Ordered to be printed

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Mr. LONG, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 5043]

The Committee on Finance, to which was referred the act (H.R. 5043) to amend the Internal Revenue Code of 1954 to provide for the tax treatment of bankruptcy, insolvency, and similar proceedings, and for other purposes, having considered the same, reports favorably thereon with amendments and recommends that the act as amended do pass.

The amendments are shown in the text of the bill in linetype and italic.

I. SUMMARY

A. Tax Treatment of Discharge of Indebtedness

In Public Law 95-598, Congress repealed provisions of the Bankruptcy Act governing Federal income tax treatment of a discharge of indebtedness in bankruptcy, effective for cases instituted on or after October 1, 1979. The bill provides tax rules in the Internal Revenue Code applicable to debt discharge in the case of bankrupt or insolvent debtors, and makes related changes to existing Code provisions applicable to debt discharge in the case of solvent debtors outside bankruptcy.

Bankruptcy or insolvency

Under the bill, no amount is to be included in income for Federal income tax purposes by reason of a discharge of indebtedness in a bankruptcy case, or outside bankruptcy if the debtor is insolvent. Instead, the amount of discharged debt which is excluded from gross income by virtue of the bill's provisions (the "debt discharge amount") is applied to reduce certain tax attributes.

Unless the taxpayer elects first to reduce basis in depreciable assets (or in real property held primarily for sale to customers in the ordinary course of a trade or business), the debt discharge amount is applied to reduce the taxpayer's net operating losses and then certain tax credits and capital loss carryovers. Any excess of the debt discharge amount over the amount of reduction in these attributes is applied to reduce asset basis (but not below the amount of the taxpayer's remaining undischarged liabilities) and then to reduce carryovers of the foreign tax credit. Any further remaining debt discharge amount is disregarded, i.e., does not result in income or have other tax consequences.

The bill provides that the taxpayer can elect to apply the debt discharge amount first to reduce basis in depreciable property (or in realty held as inventory), before applying any remaining amount to reduce net operating losses and then other tax attributes in the order stated in the bill. A debtor making this election can elect to reduce basis in depreciable property (or in realty held as inventory) below the amount of remaining liabilities (i.e., where the debtor would rather so reduce asset basis than reduce carryovers).

To the extent the debtor makes an election to reduce basis in depreciable assets, or reduces basis in assets after reduction in other tax attributes, it is anticipated that Treasury regulations prescribing the order of basis reduction among assets will generally accord with present Treasury regulations which apply in the case of basis reduction under section 270 of the (now repealed) Bankruptcy Act. If the debtor elects to reduce basis in realty held as inventory, the particular real properties the bases of which are to be reduced will be determined pursuant to Treasury regulations.

To insure that ordinary income treatment eventually will be given to the full amount of basis reduction in depreciable or nondepreciable assets, the bill provides that any gain on a subsequent disposition of reduced-basis assets is subject to "recapture" under sections 1245 or 1250 of the Internal Revenue Code.

Outside bankruptcy—solvent taxpayers

The bill modifies the existing Federal income tax election (Code secs. 108 and 1017) under which a solvent taxpayer outside bankruptcy can elect to reduce basis of assets instead of recognizing current income from debt cancellation. As with the rules of the bill applicable to bankrupt or insolvent debtors, the bill provides that the election to reduce basis allowed to solvent debtors outside bankruptcy requires reduction in basis of depreciable assets (or in realty held as inventory).

To the extent that the debtor makes an election to reduce basis, it is anticipated that Treasury regulations prescribing the order of basis reduction among the taxpayer's depreciable assets will generally accord with present Treasury regulations under section 1017 of the Code. If the debtor elects to reduce basis in realty held as inventory, the particular real properties the bases of which are to be reduced will be determined pursuant to Treasury regulations. As in the case of bankrupt or insolvent debtors, the bill provides that any gain on a subsequent disposition of reduced-basis assets is subject to "recapture" under Code sections 1245 or 1250.

The bill also provides that in the case of a solvent taxpayer outside bankruptcy, a reduction to the purchaser in the amount of a purchase-money debt, by the seller of the property, is treated for Federal income tax purposes as a purchase price reduction and not as a discharge of indebtedness.

Equity-for-debt rules

The committee bill generally does not change the present law rule developed by the courts governing whether income is recognized if a corporation issues its own stock to its creditor for outstanding debt (whether or not the debt constitutes a security for tax purposes). Therefore, no attribute reduction generally will be required where such stock is issued to discharge the debt, except where only a *de minimis* amount of stock is issued.

By contrast, the bill as passed by the House would have provided that if a corporate debtor issues stock in cancellation of short-term debt or trade credit, the debt discharge rules of the bill would apply to the extent the indebtedness exceeds the value of the stock. It is anticipated that by providing for favorable tax treatment if stock is issued to creditors in discharge of debt, the committee bill will encourage reorganization, rather than liquidation, of financially distressed companies that have a potential for surviving as operating concerns.

Because the committee bill generally retains the present law rules governing the tax treatment of debt discharge when a corporation's indebtedness is satisfied with its own stock, the committee bill also retains the present rules of Code section 382(a) relating to special limitations on net operating loss carryover on certain acquisitions of stock of a corporation. Under the House bill, the section 382(a) limitations generally would not have applied to the extent creditors received stock in exchange for their claims.

A creditor who receives stock in cancellation of debt can take a bad debt deduction to the same extent as under present law. In order properly to match the character of the gain derived on sale of such stock with its origin, the committee bill provides that any gain on a later sale of the stock by the former creditor will be "recaptured" as ordinary income up to the amount of the creditor's prior deductions against ordinary income.

The bill also provides that the debt discharge rules apply to the extent that the amount of debt transferred by a shareholder to a corporation as a contribution to capital exceeds the shareholder's basis in the debt.

Other rules concerning debt discharge

In addition, other rules in the bill concerning debt discharge relate to debt acquired by a related party, discharge of liabilities payment of which would have given rise to deductions, the tax benefit rule under Code section 111, and discharge of a partnership debt. Also, the bill provides (overturning a contrary position of the Internal Revenue Service) that if the basis of investment credit property is reduced by a debt discharge amount, no investment credit recapture will occur by reason of the reduction.

Effective date

The provisions of the bill relating to tax treatment of debt discharge apply for bankruptcy cases (or receivership, foreclosure, or similar judicial proceedings) commenced after December 31, 1980. In the case of discharge of indebtedness outside bankruptcy cases (or receivership, etc. proceedings), the debt discharge rules of the bill apply to any discharge of indebtedness occurring after December 31, 1980.

The bill also provides an effective date election for debtors in bankruptcy cases commenced on or after October 1, 1979 (but prior to January 1, 1981), and for debtors in receivership, foreclosure, or similar judicial proceedings commenced on or after October 1, 1979 (but prior to January 1, 1981). The debtor in such a case or proceeding can elect to have all the following provisions of the bill apply to all transactions in the case or proceeding: section 2 (tax treatment of discharge of indebtedness); section 4 (corporate reorganization provisions); and sections 5(a), 5(b), 5(c), 5(e), and 5(f) (miscellaneous corporate amendments). If the election is made, all provisions of sections 2 and 4 and all the above-listed provisions of section 5 of the bill are applicable to all transactions in the case or proceeding and to all parties involved in the case or proceeding.

B. Bankruptcy Estate of an Individual

In general

The bill treats the bankruptcy estate of an individual in a liquidation or reorganization case under the new bankruptcy statute as a separate taxable entity for Federal income tax purposes. Also, the bill provides that no separate taxable entity is created by commencement of a bankruptcy case in which the debtor is an individual in a case under chapter 13 of the new bankruptcy law (adjustment of debts of an individual with regular income), a partnership, or a corporation.

The Federal income tax rules set forth in the bill with respect to a bankruptcy estate of an individual which is treated as a separate taxable entity include rules for allocation of income and deductions between the debtor and the estate, computation of the estate's taxable income, accounting methods and periods of the estate, the treatment of the estate's administrative costs as deductible expenses, carryover of tax attributes between the debtor and the estate, and requirements for filing and disclosure of returns.

Debtor's election to close taxable year

Also, the bill generally gives an individual debtor an election to close his or her taxable year as of the day the bankruptcy case commences. If the election is made, the debtor's Federal income tax liability for the "short" taxable year ending on commencement of the case becomes an allowable claim against the bankruptcy estate. If the election is not made, the commencement of the bankruptcy case does not terminate the taxable year of an individual debtor.

Effective date

These provisions of the bill apply to bankruptcy cases commencing more than 90 days after the date of enactment of the bill.

C. Corporate Reorganizations in Bankruptcy

Expansion of reorganization provisions

The bill expands the categories of tax-free corporate reorganizations defined in section 368 of the Code to include a new category of "G" reorganizations. This category includes certain transfers of assets pursuant to a court-approved reorganization plan in a bankruptcy case (or in a receivership, foreclosure, or similar proceeding). Accordingly, the bill terminates the applicability of special rules of current law relating to insolvency reorganizations (Code secs. 371–374).

The bill permits a "G" reorganization to take the form of a triangular reorganization, including a "reverse merger." Also, the bill allows the acquiring corporation in a "G" reorganization to transfer the acquired assets to a controlled subsidiary. The statutory rule generally governing carryover of tax attributes in corporate reorganizations (Code sec. 381) will apply in the case of a "G" reorganization.

Since "G" reorganizations are subject to the rules governing the tax treatment of exchanging shareholders and security holders which apply generally to corporate reorganizations, a shareholder or security holder who receives securities in a "G" reorganization with a principal amount exceeding the principal amount of securities surrendered is taxed on the excess. Also, money or other "boot" property received in a "G" reorganization is subject to the dividend-equivalence tests which apply to reorganizations generally.

Property attributable to accrued interest

Under the bill, a creditor exchanging securities in any corporate reorganization described in section 368 of the Code (including a "G" reorganization) will be treated as receiving interest income on the exchange to the extent the creditor receives new securities, stock, or other property attributable to accrued but unpaid interest on the securities surrendered.

Effective date

These provisions apply to bankruptcy cases commencing after December 31, 1980, and to receivership, foreclosure, or similar judicial proceedings commencing after that date. Also, these provisions will apply to a bankruptcy case or a receivership, etc. proceeding commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election (described above) is made.

In the case of transactions outside bankruptcy cases and receivership, etc. proceedings, the amendments relating to exchanges of property for accrued interest apply to transactions occurring after December 31, 1980.

D. Miscellaneous Corporate Amendments

The bill makes a number of miscellaneous amendments to the Internal Revenue Code relating to corporate tax issues, including the following.

1. Personal holding company status.—Under the bill, a corporate debtor generally is not to be considered a personal holding company, subject to additional taxes on certain passive income, while in a bankruptcy case (or receivership, foreclosure, or similar proceeding). This provision applies to bankruptcy cases commencing after December 31, 1980, and to receivership, etc. proceedings commencing after that date. Also, this provision will apply to a bankruptcy case or a receivership, etc. proceeding commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election (as described above) is made.

2. Liquidation rule.—The corporate nonrecognition tax rules applicable to 12-month liquidations are extended by the bill to cover sales by a corporation in a bankruptcy case (or a receivership, etc. proceeding) of assets, other than assets acquired after commencement of the bankruptcy case, during the entire period from adoption (after commencement of the case) of the plan of liquidation through conclusion of the case. This provision applies to bankruptcy cases (or receivership, etc. proceedings) commencing after December 31, 1980. Also, this provision will apply to a bankruptcy case or a receivership, etc. proceeding commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election (described above) is made.

3. Subchapter S shareholder.—The bill provides that for bankruptcy cases commencing on or after October 1, 1979, the bankruptcy estate of an individual debtor can be an eligible shareholder in a subchapter S corporation.

4. Section 351 applicability.—Under the bill, transfers to a controlled corporation of indebtedness of the corporation which is not evidenced by a security, or of claims against the corporation for accrued but unpaid interest on indebtedness, are not covered by the nonrecognition rule of section 351 of the Code. Also, the nonrecognition rule does not apply in the case of a transfer to a controlled corporation of the assets of a debtor in a bankruptcy or similar case to the extent the stock or securities received in exchange for the assets are used to satisfy the indebtedness of the debtor. The effective date for these provisions is the same as for the provisions of the bill relating to tax treatment of discharge of indebtedness.

5. *Earnings and profits.*—The bill provides that to the extent the amount of discharged indebtedness is applied to reduce basis under section 1017 of the Code, such basis-reduction amount does not affect the debtor corporation's earnings and profits. Also, the bill provides that any deficit in earnings and profits is reduced by the paid-in capital of any shareholder whose interest is eliminated in a bankruptcy case. The effective date for this provision is the same as for the provisions of the bill relating to tax treatment of discharge of indebtedness.

E. Changes in Tax Procedures

The bill coordinates certain provisions of the Internal Revenue Code with the bankruptcy court procedures enacted in Public Law 95–598.[1]

[1] In 1978, the Congress enacted legislation (Public Law 95–598) which significantly revised and modernized the substantive law of bankruptcy as well as bankruptcy court procedures. Public Law 95–598 repealed the Bankruptcy Act and substituted a new title 11 in the U.S. Code, completely replacing the former provisions. The new law generally was effective for bankruptcy cases commencing on or after October 1, 1979.

The 1978 statute did not include a "short title" (although it has been designated by some commentators as the "Bankruptcy Reform Act of 1978"). This report refers to the 1978 bankruptcy statute as "P.L. 95–598." The substantive bankruptcy law which was superseded by P.L. 95–598 is referred to as the "Bankruptcy Act."

In this report, the provisions of title 11 of the U.S. Code which were enacted by P.L. 95–598 are cited as "new 11 U.S. Code sec. —." References to the "Code" are to the Internal Revenue Code of 1954, as amended.

In the bill (H.R. 5043), bankruptcy cases to which the substantive provisions of P.L. 95–598 apply—generally, cases commenced on or after October 1, 1979—are referred to as "title 11 cases."

These procedures include the automatic stay on assessment or collection of certain tax claims against the debtor, the automatic stay on institution or continuation by the debtor of deficiency litigation in the U.S. Tax Court, and the authority of the bankruptcy court to lift the stay and permit the debtor's tax liability to be determined by the Tax Court.

II. EXPLANATION OF THE BILL

A. Tax Treatment of Discharge of Indebtedness (sec. 2 of the bill and secs. 108, 111, 382(b) and 1017 of the Code)

Present Law

In general

Under present law, income is realized when indebtedness is forgiven or in other ways cancelled (sec. 61(a)(12) of the Internal Revenue Code). For example, if a corporation has issued a $1,000 bond at par which it later repurchases for only $900, thereby increasing its net worth by $100, the corporation realizes $100 of income in the year of repurchase (*United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931)).

There are several exceptions to the general rule of income realization. Under a judicially developed "insolvency exception," no income arises from discharge of indebtedness if the debtor is insolvent both before and after the transaction;[1] and if the transaction leaves the debtor with assets whose value exceeds remaining liabilities, income is realized only to the extent of the excess.[2] Treasury regulations provide that the gratuitous cancellation of a corporation's indebtedness by a shareholder-creditor does not give rise to debt discharge income to the extent of the principal of the debt, since the cancellation amounts to a contribution to capital of the corporation.[3] Some courts have applied this exception even if the corporation had previously deducted the amount owed to the shareholder-creditor.[4] Under a related exception, cases have held that no income arises from discharge of indebtedness if stock is issued to a creditor in satisfaction of the debt, even if the creditor was previously a shareholder, and even if the stock is worth less than the face amount of the obligation satisfied.[5] Further, cancellation of a previously accrued and deducted expense does not give rise to income if the deduction did not result in a reduction of tax (Code sec. 111). A debt cancellation which constitutes a gift or bequest is not treated as income to the donee debtor (Code sec. 102).[6]

A debtor which otherwise would be required to report current income from debt cancellation under the preceding rules instead may elect to reduce the basis of its assets in accordance with Treasury regulations (Code secs. 108 and 1017). This income exclusion is available if the discharged indebtedness was incurred by a corporation or

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[1] Treas. Regs. § 1.61-12(b)(1); *Dallas Transfer & Terminal Warehouse Co.* v. *Comm'r*, 70 F.2d 95 (5th Cir. 1934).

[2] *Lakeland Grocery Co.*, 36 B.T.A. 289 (1937).

[3] Treas. Regs. § 1.61-12(a).

[4] *Putoma Corp.* v. *Comm'r*, 66 T.C. 652 (1978), *aff'd*, 604 F. 2d 734 (5th Cir. 1979).

[5] *Comm'r* v. *Motor Mart Trust*, 156 F. 2d 122 (1st Cir. 1946).

[6] Debt discharge that is only a medium for some other form of payment, such as a gift or salary, is treated as that form of payment rather than under the debt discharge rules. Treas. Regs. § 1.61-12(a).

by an individual in connection with property used in his trade or business. These provisions were intended to allow the tax on the debt discharge income to be deferred and collected through lower depreciation deductions for the reduced-basis assets, or greater taxable gains on sale of the assets.

The Internal Revenue Service takes the position that a reduction in the basis of qualified investment credit property resulting from an income-exclusion election under sections 108 and 1017 of the Code is *pro tanto* a disposition of the property the basis of which was reduced, resulting in partial recapture of the investment credit allowed upon its purchase (Rev. Rul. 74–184, 1974–1 C. B. 8).

Bankruptcy proceedings

The Bankruptcy Act contains certain rules relating to the Federal income tax treatment of discharge of indebtedness in bankruptcy proceedings. However, these rules have been repealed by P.L. 95–598 effective for bankruptcy cases instituted on or after October 1, 1979.

Under the Bankruptcy Act provisions, no income is recognized on cancellation of indebtedness in an insolvency reorganization (under chapter X). The Act requires the debtor corporation to reduce the basis of its assets by the amount of indebtedness discharged, but not below the fair market value of such assets as of the date the bankruptcy court confirms the reorganization plan.[7] However, under section 372 of the Internal Revenue Code, no basis reduction is required if the corporation's property is transferred to a successor corporation as part of the bankruptcy reorganization.[8]

Similar rules apply in the case of an "arrangement" (under chapter XI), a "real property arrangement" (under Chapter XII), and a wage earner's plan (under chapter XIII), except that no basis reduction is required under a wage earner's plan.[9] In addition, in the case of a Bankruptcy Act discharge other than under an insolvency reorganization or an arrangement described above, income is not realized to the extent the general "insolvency exception" applies.[10]

Reasons for Change

Overview

In P.L. 95–598, Congress repealed provisions of the Bankruptcy Act governing Federal income tax treatment of debt discharge in bankruptcy, effective for cases instituted on or after October 1, 1979. The committee's bill provides tax rules in the Internal Revenue Code applicable to debt discharge in the case of bankrupt or insolvent debtors, and makes related changes to existing Code provisions applicable to debt discharge in the case of solvent debtors outside bankruptcy.

The rules of the bill concerning income tax treatment of debt discharge in bankruptcy are intended to accommodate bankruptcy policy

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[7] Secs. 268 and 270 of the Bankruptcy Act.

[8] While under present law no basis reduction is required if a successor corporation is used in the insolvency reorganization, the Code under present law does not permit the carryover of tax attributes, such as net operating losses, from the debtor to the successor corporation (except possibly in certain situations where the reorganization meets the requirements of secs. 368 and 381 of the Code, in which case net operating losses may be limited by section 382 of the Code).

[9] Secs. 395, 396, 520, 522, and 679 of the Bankruptcy Act.

[10] Treas. Regs. § 1.61–12(b). See text accompanying notes 1 and 2.

and tax policy. To preserve the debtor's "fresh start" after bankruptcy, the bill provides that no income is recognized by reason of debt discharge in bankruptcy, so that a debtor coming out of bankruptcy (or an insolvent debtor outside bankruptcy) is not burdened with an immediate tax liability. The bill provides that the debt discharge amount thus excluded from income is applied to reduce the taxpayer's net operating losses and certain other tax attributes, unless the taxpayer elects to apply the debt discharge amount first to reduce basis in depreciable assets (or in realty held as inventory).

In the case of solvent debtors outside bankruptcy, the bill modifies the election (under Code secs. 108 and 1017) permitting such debtors to reduce asset basis in lieu of reporting ordinary income from debt cancellation, as on repurchase of bonds at a discount. Under the bill, a solvent taxpayer can elect to reduce basis only in depreciable assets (or in realty held as inventory).

Debtors given flexibility

The committee believes that these attribute-reduction provisions of the bill give flexibility to the debtor to account for a debt discharge amount in a manner most favorable to the debtor's tax situation. For example, a bankrupt or insolvent debtor which wishes to retain net operating losses and other carryovers will be able to elect to reduce asset basis in depreciable property (or in realty held as inventory). On the other hand, a debtor having an expiring net operating loss which otherwise would be "wasted" will be able (by not making the election) to apply the debt discharge amount first against the net operating loss. Similarly, a solvent debtor can continue to defer recognition of income by electing to reduce basis of depreciable assets (or in realty held as inventory), or (by not electing) can include all or part of the debt discharge amount in income (for example, in order to offset an expiring net operating loss).

At the same time, in developing the rules of the bill, the committee recognized that the basis-reduction mechanism of present law fails to effectuate the Congressional intent of deferring, but eventually collecting tax on, ordinary income realized from debt discharge.

Thus present law permits both solvent and insolvent taxpayers to apply the amount of their discharged debts to reduce the basis of nondepreciable assets which may never be sold, such as stock in a subsidiary corporation or the land on which the company operates its business, thereby avoiding completely, rather than deferring, the tax consequences of debt discharge. Also under present law, a related party (such as the parent corporation of a debtor) can acquire the taxpayer's debt at a discount and effectively eliminate it as a real liability to outside interests, but the debtor thereby avoids the tax treatment which would apply if the debtor had directly retired the debt by repurchasing it. In other cases, the debtor may be able to convert ordinary income from discharge of indebtedness into capital gain, as where the debtor reduces basis in a nondepreciable capital asset.

Deferral of ordinary income on debt discharge

Accordingly, the rules of the bill are intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge. Thus in the case of a bankrupt or insolvent debtor, the debt discharge amount is applied to reduce the taxpayer's net operating losses and certain other tax attributes, unless the taxpayer elects to apply the amount first to reduce basis in depreciable assets. In the case of a solvent debtor outside bankruptcy, the debtor can defer recognition of income, but only by reducing basis in depreciable assets. Similarly, the debtor can defer immediate tax consequences of debt discharge by reducing basis in real property held as inventory. A subsequent disposition of such reduced-basis realty will result in recognition of a larger amount of ordinary income, just as reduction in basis of depreciable assets results in lower depreciation deductions to offset ordinary income.

To insure that the debt discharge amount eventually will result in ordinary income (and cannot be converted to capital gain), the bill provides that any gain on a subsequent disposition of the reduced-basis property will be subject to a "recapture" under rules similar to those now applicable with respect to depreciation recapture. Also, the bill contains rules relating to discharge of indebtedness as a capital contribution, acquisition of debt by a related party, discharge of partnership debt, and other income tax aspects of discharge of indebtedness.

Stock-for-debt rules to encourage reorganizations

The committee bill generally does not change the present law rule developed by the courts governing whether income is recognized if a corporation issues its own stock to its creditor for outstanding debt (whether or not the debt constitutes a security for tax purposes). Therefore, no attribute reduction generally will be required where such stock is issued to discharge the debt. The bill as passed by the House would have provided that if a corporate debtor issues stock in cancellation of short-term debt or trade credit, the debt discharge rules of the bill would have applied to the extent the indebtedness exceeded the value of the stock.

The committee believes that by providing for favorable tax treatment if stock is issued to creditors in discharge of debt, the committee bill encourages reorganization, rather than liquidation, of financially distressed companies that have a potential for surviving as operating concerns. However, the committee does not believe that these rules should apply if only a *de minimis* amount of stock is issued for the outstanding debt, so that the general rules on debt forgiveness cannot thereby be circumvented.

The deduction available under present law for certain creditors receiving stock in cancellation of a debt remains unchanged. However, the committee bill provides that any gain on a later sale of the stock by the former creditor will be "recaptured" as ordinary income up to the amount of the creditor's prior deductions against ordinary income.

Because the committee bill generally retains the present law rules governing the tax treatment of debt discharge when a corporation's indebtedness is satisfied with its own stock, the committee bill also retains the present rules of Code section 382(a) relating to special limitations on net operating loss carryover on certain acquisitions of stock of a corporation. Under the House bill, the section 382(a) limitations generally would not have applied to the extent creditors received stock in exchange for their claims.

Postponement of effective dates for bankruptcy cases

Under the bill as introduced and passed by the House, the provisions relating to tax treatment of debt discharge (section 2), corporate reorganizations in bankruptcy (section 4), and certain miscellaneous corporate amendments (section 5) would have applied for bankruptcy cases (or receivership, foreclosure, or similar judicial proceedings) commenced on or after October 1, 1979. In light of the time that has elapsed since introduction of the bill, the committee believes that the provisions of sections 2, 4, and 5 of the bill should apply to bankruptcy cases (or receivership, etc. proceedings) commenced after December 31, 1980.

However, some taxpayers may have entered into bankruptcy reorganizations with the expectation that the bill would be enacted with the original retroactive effective dates. Accordingly, the committee bill allows a bankrupt or insolvent debtor, in the case of proceedings commenced on or after October 1, 1979, to elect to have all the debt discharge and related provisions of the bill (sections 2, 4, and 5), apply retroactively as under the original effective date. No change would be made in the effective date for rules applicable to debt discharge, etc. outside bankruptcy (i.e., transactions occurring after December 31, 1980).

Explanation of Provisions

Debt discharge in bankruptcy

In general

Under the bill, no amount is to be included in income for Federal income tax purposes by reason of a discharge of indebtedness in a bankruptcy case.[11] Instead, the amount of discharged debt which is excluded from gross income by virtue of the bill's provisions (the "debt discharge amount") is to be applied to reduce certain tax attributes.

Unless the taxpayer elects first to reduce basis in depreciable assets (or in real property held primarily for sale to customers in the ordinary course of a trade or business), the debt discharge amount is applied to reduce the taxpayer's tax attributes in the following order:

(1) net operating losses and carryovers;

(2) carryovers of the investment tax credit (other than the ESOP credit), the WIN credit, the new jobs credit, and the credit for alcohol used as a fuel;

(3) capital losses and carryovers;

(4) the basis of the taxpayer's assets (both depreciable and nondepreciable); and

(5) carryovers of the foreign tax credit.[12]

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[11] For purposes of these rules, the term "bankruptcy case" (referred to in the bill as a "title 11 case") means a case under new title 11 of the U.S. Code, but only if the taxpayer is under the jurisdiction of the court in the case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.

[12] For purposes of the attribute reduction rules, credits are reduced at the rate of 50 cents for each dollar of debt discharge amount. This flat-rate reduction avoids the complexity of determining a tax on the debt discharge amount and determining how much of the amount would be used up by the credits for purposes of determining other reductions. Except for reductions in credit carryovers, the specified tax attributes are reduced one dollar for each dollar of debt discharge amount.

The reduction in each category of carryovers is made in the order of taxable years in which the items would be used, with the order determined as if the debt discharge amount were not excluded from income.[13] For this purpose, any limitations on the use of credits that are based on the income of the taxpayer are disregarded.

After reduction of the attributes specified in categories (1), (2), and (3) above, any remaining debt discharge amount is applied to reduce asset basis, but not below the amount of the taxpayer's remaining undischarged liabilities. (Thus, a sale of all the taxpayer's assets immediately after the discharge generally will not result in income tax liability unless the sale proceeds and cash on hand exceed the amount needed to pay off the remaining liabilities.) Any amount of debt discharge which remains after such reduction in asset basis, including any debt discharge amount which remains unapplied solely by virtue of the limitation just described with respect to undischarged liabilities, is applied to reduce carryovers of the foreign tax credit.

Any amount of debt discharge which is left after attribute reduction under these rules is disregarded, i.e., does not result in income or have other tax consequences.

Election to reduce basis in certain property

The bill provides that the taxpayer can elect, in accordance with Treasury regulations, to apply all or a portion of the debt discharge amount first to reduce basis (but not below zero) in depreciable property[14] or in real property held primarily for sale to customers in the ordinary course of a trade or business (within the meaning of Code sec. 1221(1)). Any remaining amount is then applied to reduce net operating losses and other tax attributes in the order described above. A debtor making this election can elect to reduce basis (but not below zero) in depreciable property or in realty held as inventory below the amount of remaining liabilities (i.e., where the debtor would rather reduce basis in such assets than reduce carryovers).

In addition, the bill provides that, for purposes of this election, stock held by a parent corporation in a subsidiary is treated as depreciable property (or as realty held as inventory) if the parent and subsidiary file a consolidated return for the taxable year in which the discharge occurs, and if the subsidiary agrees to reduce its basis in depreciable property (or in real property held as inventory) which the subsidiary holds.[15] Thus, if the debtor is a parent corporation which files

[13] Thus in the case of net operating losses or capital losses, the debt discharge amount first reduces the current year's loss and then reduces the loss carryovers in the order in which they arose. The investment credit carryovers are reduced on a FIFO basis, and the other credit carryovers also are reduced in the order they would be used against taxable income. These reductions are made after the computation of the current year's tax.

[14] For this purpose, the term "depreciable property" means any property of a character subject to the allowance for depreciation, but only if the basis reduction would reduce the amount of depreciation or amortization which otherwise would be allowable for the period immediately following such reduction. Thus, for example, a lessor could not reduce the basis of leased property where the lessee's obligation in respect of the property will restore to the lessor the loss due to depreciation during the term of the lease, since the lessor cannot take depreciation in respect of that property. See *Harry H. Kem, Jr.*, 51 T.C. 455 (1968), *aff'd*, 432 F.2d 961 (9th Cir. 1970).

[15] This rule can be applied successively through a chain of corporations so long as the lowest tier subsidiary reduces its basis in actual depreciable property (or realty which it holds as inventory).

a consolidated return with a subsidiary, the debtor can elect to apply the debt discharge amount, in accordance with Treasury regulations, to reduce the basis of stock it holds in the subsidiary to the extent the subsidiary consents to reduce the basis of depreciable property which it holds (or realty which it holds as inventory).

An election first to reduce basis in depreciable property in realty held as inventory must be made on the taxpayer's return for the year in which the discharge occurs, or at such time as permitted by Treasury regulations. Once made, the election can be revoked by the taxpayer only with the consent of the Internal Revenue Service.

Recapture rule

If the basis of property is reduced pursuant to the attribute reduction rules in the bill, any gain on a subsequent disposition of the property is subject to "recapture" under section 1245 of the Code or, in the case of depreciable realty, under section 1250. (This recapture rule applies to any reduced-basis asset, whether depreciable or nondepreciable, and whether or not a disposition of such asset otherwise would be subject to recapture under Code sections 1245 or 1250.) The computation of the amount of straight-line depreciation (under sec. 1250(b)) is determined as if there had been no reduction of basis under section 1017.

Basis reduction—general rule

To the extent a debtor makes an election to reduce basis in depreciable property, or reduces basis in assets after reduction of other attributes, the particular properties the bases of which are to be reduced will be determined pursuant to Treasury regulations. It is anticipated that the order of reduction prescribed in such regulations will generally accord with present Treasury regulations which apply in the case of basis reduction under section 270 of the (now repealed) Bankruptcy Act (Treas. Regs. §§ 1.1016–7 and 1.1016–8). If the debtor elects to reduce basis in realty held as inventory, the particular real properties the bases of which are to be reduced will be determined pursuant to Treasury regulations.

In order to avoid interaction between basis reduction and reduction of other attributes, the bill provides that the basis reduction takes effect on the first day of the taxable year following the year in which the discharge took place. If basis reduction is required in respect of a discharge of indebtedness in the final year of a bankruptcy estate, the reduction is to be made in the basis of assets acquired by the debtor from the estate at the time so acquired.

In a bankruptcy case involving an individual debtor to which new section 1398 of the Code (as added by the bill) applies, any attribute reduction required under the bill applies to the attributes of the bankruptcy estate (except for purposes of applying the basis-reduction rules of section 1017 to property transferred by the estate to the individual) and not to those attributes of the individual which arise after commencement of the case. Also, the bill provides that in a bankruptcy case involving an individual debtor, no reduction in basis is to be made in the basis of property which the debtor treats as exempt property under new 11 U.S. Code section 522.

Debt discharge outside bankruptcy—insolvent debtors

The bill provides that if a discharge of indebtedness occurs when the taxpayer is insolvent (but is not in a bankruptcy case), the amount of debt discharge is excluded from gross income up to the amount by which the taxpayer is insolvent.[16] The excluded amount is applied to reduce tax attributes in the same manner as if the discharge had occurred in a bankruptcy case. Any balance of the debt discharged which is not excluded from gross income (because it exceeds the insolvency amount) is treated in the same manner as debt cancellation in the case of a wholly solvent taxpayer.

Debt discharge outside bankruptcy—solvent debtors

In the case of a solvent taxpayer outside bankruptcy, the bill modifies the present rule (secs. 108 and 1017 of the Code) permitting an election to reduce the basis of assets in lieu of reporting income from discharge of indebtedness. Under the election as modified, income from debt discharge will not currently be recognized by a solvent debtor outside bankruptcy to the extent the debtor elects to reduce basis in depreciable property or in real property held primarily for sale to customers in the ordinary course of a trade or business (within the meaning of Code sec. 1221(1)).[17]

If the debtor elects to reduce basis in depreciable property, the particular depreciable assets the bases of which are to be reduced (but not below zero) will be determined pursuant to Treasury regulations. It is anticipated that the order of reduction among depreciable assets of the taxpayer will generally accord with present Treasury regulations (Treas. Regs. §§ 1.1017–1 and 1.1017–2). If the debtor elects to reduce basis in realty held as inventory, the particular real properties the bases of which are to be reduced (but not below zero) will be determined pursuant to Treasury regulations. The bill provides that the basis reduction takes effect on the first day of the taxable year following the year in which the discharge takes place.

In addition, the bill provides that, for purposes of this election, stock held by a parent corporation in a subsidiary is treated as depreciable property (or as realty held as inventory) if the parent and subsidiary file a consolidated return for the taxable year in which the discharge occurs, and if the subsidiary agrees to reduce its basis in depreciable property (or in real property held as inventory) which the

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[16] The bill defines "insolvent" as the excess of liabilities over the fair market value of assets, determined with respect to the taxpayer's assets and liabilities immediately before the debt discharge. The bill provides that except pursuant to section 108(a)(1)(B) of the Code (as added by the bill), there is to be no insolvency exception from the general rule that gross income includes income from discharge of indebtedness.

[17] The exclusion from gross income under section 108(a) of the Code (as amended by the bill) applies, in the case of a discharge which does not occur in a title 11 case and which does not occur when the taxpayer is insolvent, where the indebtedness discharged is "qualified business indebtedness." The latter term means indebtedness of the taxpayer if both (1) the indebtedness was incurred or assumed by a corporation, or by an individual in connection with property used in his trade or business, and also (2) the taxpayer makes an election to reduce the basis of depreciable assets or realty held as inventory).

For this purpose, the term "depreciable property" is defined the same way as in the case of the election by a bankrupt or insolvent taxpayer to reduce the basis of depreciable property (see note 14, *supra*).

subsidiary holds.[18] Thus, if the debtor is a parent corporation which files a consolidated return with a subsidiary, the debtor can elect to apply the debt discharge amount, in accordance with Treasury regulations, to reduce the basis of stock it holds in the subsidiary to the extent the subsidiary consents to reduce the basis of depreciable property which it holds (or realty which it holds as inventory).

An election first to reduce basis in depreciable property or in realty held as inventory must be made on the taxpayer's return for the year in which the discharge occurs, or at such time as permitted by Treasury regulations. Once made, the election can be revoked by the taxpayer only with the consent of the Internal Revenue Service.

To the extent a solvent taxpayer outside bankruptcy does not make an election to reduce basis in depreciable property (or in realty held as inventory) in lieu of reporting income from debt discharge, or to the extent the debt discharge amount exceeds the maximum reduction which can be made through an election, the excess constitutes income from discharge of indebtedness which constitutes gross income for Federal income tax purposes (sec. 61(a)(12) of the Code).

Recapture rule

To ensure that ordinary income treatment eventually will be given to the full amount of basis reduction, the bill provides that any gain on a subsequent disposition of reduced-basis property is subject to "recapture" under section 1245 of the Code or, in the case of depreciable realty, under section 1250. (This recapture rule applies to any reduced-basis property, whether or not a disposition of such property otherwise would be subject to recapture under Code sections 1245 or 1250.) The computation of the amount of straight-line depreciation (under sec. 1250(b)) is determined as if there had been no reduction of basis under section 1017.

Certain reductions as purchase price adjustments

The bill provides that if the seller of specific property reduces the debt of the purchaser which arose out of the purchase, and the reduction to the purchaser does not occur in a bankruptcy case or when the purchaser is insolvent, then the reduction to the purchaser of the purchase-money is to be treated (for both the seller and the buyer) as a purchase price adjustment on that property. This rule applies only if but for this provision the amount of the reduction would be treated as income from discharge of indebtedness.

This provision is intended to eliminate disagreements between the Internal Revenue Service and the debtor as to whether, in a particular case to which the provision applies, the debt reduction should be treated as discharge income or a true price adjustment. If the debt has been transfererd by the seller to a third party (whether or not related to the seller), or if the property has been transferred by the buyer to a third party (whether or not related to the buyer), this provision does not apply to determine whether a reduction in the amount of purchase-money debt should be treated as discharge income or a true price adjustment. Also, this provision does not apply where the debt is reduced

[18] This rule can be applied successively through a chain of corporations so long as the lowest tier subsidiary reduces its basis in actual depreciable property (or realty which it holds as inventory).

because of factors not involving direct agreements between the buyer and the seller, such as the running of the statute of limitations on enforcement of the obligation.

Equity-for-debt rules

Issuance of stock

The committee bill generally does not change the present law rule developed by the courts governing whether income is recognized if a corporation issues its own stock to its creditor for outstanding debt (whether or not the debt constitutes a security for tax purposes). Therefore, no attribute reduction generally will be required where such stock is issued to discharge the debt.

However, the general "stock-for-debt exception" will not apply if only a nominal or token amount of stock is issued for the debt, to be determined according to all the facts and circumstances, so that the forgiveness rules may not be circumvented by the issuance of nominal or token shares to a creditor who had no real equity interest in the corporation.

Also, the general "stock-for-debt exception" will not apply to the debt of an unsecured creditor [19] in a workout [20] if that creditor receives an amount of stock (by value) which is less than one-half the amount of stock that such creditor would receive if all the corporation's unsecured creditors, to the extent their debts are either cancelled or satisfied with the debtor's stock in the workout, received a pro-rata amount of the stock issued.

Thus, for example, if creditor A held $1,000 of unsecured debt against a debtor corporation and if, in a workout, the debtor corporation fully satisfied $10,000 of its unsecured debt (including the debt to A) by the transfer of $6,000 of its stock, A must receive at least $300 of stock in satisfaction of its claim (assuming no other property is transferred) in order for the debtor to rely, with respect to the stock issued to A, on the general rule of present law that no debt discharge income is recognized and no attribute reduction is required when a corporation's debt is satisfied by the issuance of its own stock. If creditor A receives only $100 of stock for his $1,000 debt under these facts, then the debtor corporation will have a debt discharge amount of $900 with respect to issuance of stock to creditor A. If creditor A receives $300 or more of stock for his $1,000 debt under these facts, then the debtor corporation will not have any debt discharge amount with respect to issuance of stock to creditor A.

If a corporate debtor issues a package of stock and other property in cancellation of debt, the cash and other property are to be treated as satisfying an amount of debt equal to the amount of cash and the value of other property, and the stock is to be treated as satisfying the remainder of the debt. Consequently, there will be no debt discharge amount recognized by the debtor (unless the *de minimis* exception applies) on issuance of stock and other property for debt.

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[19] For this purpose, a claim is considered as secured by a lien on property only to the extent of the fair market value of the creditor's interest in such property. Any claim in excess of such value is treated as a separate claim of an unsecured creditor. This is consistent with the approach taken in new 11 U.S. Code sec. 506.

[20] A "workout" includes a title 11 case (within the meaning of Code sec. 368(a)(3)(A)) or other transaction or series of transactions involving a significant restructuring of the debt of a corporation in financial difficulty.

Because the committee bill generally retains the present law rules governing the tax treatment of debt discharge when a corporation's indebtedness is satisfied with its own stock, the committee bill also retains the present rules of Code section 382(a) relating to special limitations on net operating loss carryover on certain acquisitions of stock of a corporation. Under the House bill, the section 382(a) limitations generally would not have applied to the extent creditors received stock in exchange for their claims.

Recapture on disposition of stock

The committee bill provides that if a creditor acquires stock of the debtor corporation in exchange for the corporation's indebtedness, then upon subsequent disposition of the stock, any deduction taken with respect to the debt either as a bad debt deduction (under Code secs. 166 (a) or (c)), reduced by any gain on the exchange, or as an ordinary loss on the exchange shall be subject to "recapture" under the rules of Code section 1245.[20a]

Thus, for example, assume that corporation A made a $1,000 short-term loan to corporation B on July 1, 1980, and that corporation A, for its taxable year 1982, takes an $800 deduction for partially worthless bad debt under Code section 166(a). Assume further that on March 1, 1983, B satisfies the principal of the debt with B stock worth $500, resulting in a gain to A of $300. If A later disposes of the B stock for $1,500, $500 of A's gain will be treated as ordinary income ($800 bad debt deduction less $300 gain on receipt of the stock). In addition, if the stock is disposed of in a tax-free transaction (for example, by reason of secs. 354 or 1306), the potential recapture will carry over to the stock received.

In the case of a cash-basis creditor, any amount not taken into account by reason of his method of accounting shall be treated the same as a deduction allowed with respect to the debt. A special rule is provided in the bill for taxpayers on the reserve method for bad debts under Code section 166(c).

Capital contributions

The bill provides that the discharge of indebtedness rules apply to the extent that the amount of debt transferred to a corporation as a contribution to capital exceeds the shareholder's basis in the debt.[21]

[20a] For purposes of these recapture rules, the bill provides that the term "debtor corporation" includes a successor corporation, and that stock of a corporation in control of the debtor corporation is treated as stock of the debtor. Also, the bill provides that similar recapture rules apply in the case of discharge of partnership indebtedness.

[21] For example, assume a corporation accrues and deducts (but does not actually pay) a $1,000 liability to a shareholder-employee as salary, and the cash-basis employee does not include the $1,000 in income. In a later year, the shareholder-employee forgives the debt.

Under the bill, the corporation must account for a debt discharge amount of $1,000. If the corporation is insolvent or in bankruptcy, it must apply the $1,000 debt discharge amount to reduce tax attributes pursuant to the rules discussed in the text above. If the debtor is a solvent corporation outside bankruptcy, it can elect to reduce basis of depreciable assets (or of realty held as inventory) by $1,000 in lieu of recognizing $1,000 of income in the year of discharge.

On the other hand, if the shareholder-employee were on the accrual basis, had included the salary in income, and his or her basis in the debt was still $1,000 at the time of the contribution, there would be no debt discharge amount, and no attribute reduction would be required.

Thus, the discharge of indebtedness rules apply when a cash-basis taxpayer contributes to the capital of an accrual-basis corporation a debt representing an accrued expense previously deducted by the corporation.[22]

Debt acquired by related party

The bill provides that, for purposes of determining income of the debtor from discharge of indebtedness, an outstanding debt acquired from an unrelated party by a party related to the debtor is treated as having been acquired by the debtor to the extent provided in regulations issued by the Treasury Department.

For purposes of this rule, a person is treated as related to the debtor if the person is (1) a member of a controlled group of corporations (as defined for purposes of Code sec. 414(b)) of which group the debtor is a member; (2) a trade or business treated as under common control with respect to the debtor (within the meaning of Code secs. 414(b) or 414(c)); (3) either a partner in a partnership treated as controlled by the debtor or a controlled partnership with respect to the debtor (within the meaning of Code sec. 707(b)(1); or (4) a member of the debtor's family or other person bearing a relationship to the debtor specified in Code section 267(b). The definition of "family" for this purpose also includes a spouse of the debtor's child or grandchild.

This rule is intended to treat a debtor as having its debt discharged if a party related to the debtor purchases the debt at a discount (for example, where a parent corporation purchases at a discount debt issued by its subsidiary).[23]

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[22] This contribution-to-capital rule reverses the result reached in *Putoma Corp. v. comm'r*, 66 T.C. 652 (1976). *aff'd*, 601 F.2d (5th Cir. 1979). Moreover, it is intended that the result reached in *Putoma* could not alternatively be sustained on the ground that the shareholder has made a "gift" to the corporation, since it is intended that there will not be any gift exception in a commercial context (such as a shareholder-corporation relationship) to the general rule that income is realized on discharge of indebtedness.

Whether a cancellation of indebtedness by a shareholder-creditor is a contribution to capital depends upon the facts of the particular case. In order for the contribution to capital rule to apply, the shareholder's action in cancelling the debt must be related to his status as a shareholder. If the shareholder-creditor acts merely as a creditor attempting to maximize the satisfaction of a claim, such as where the stock and bonds are publicly held and the creditor simply happens also to be a shareholder, the cancellation of the indebtedness on exchange of the bonds for stock is not to be treated as a contribution to capital by a shareholder for purposes of this rule.

[23] It is intended that the Treasury Department has authority to and will issue regulations providing for the following income tax consequences on repayment or capital contribution of debt which had been acquired by a related party subject to the rule of the bill treating the debtor as having acquired the debt.

If the debtor subsequently pays the debt to the related party, the entire transaction is to be treated generally the same as if the debtor had originally acquired the debt. For example, assume a parent corporation purchases for $900 on the open market a $1,000 bond issued at par by its wholly owned subsidiary. Under the bill, the debtor (the subsidiary) must account for a debt discharge amount of $100 for its taxable year during which the debt was so acquired. In the following year when the debt matures, assume the subsidiary pays its parent the full principal amount ($1,000). The Treasury regulations are to provide that the debtor is treated as having paid a dividend of $100 ($1,000 payment to the parent less the $900 paid by the parent to acquire the debt) to its parent corporation.

If a related party transfers to a corporaton as a contribution to capital debt issued by the corporation and the debtor corporation thereby would otherwise

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Other rules concerning debt discharge

No disposition on basis reduction.—If the basis of qualified investment credit property is reduced by a debt discharge amount under the rules of the bill, no investment credit recapture tax is incurred, because the reduction would not be considered a disposition. This rule overturns the position taken by the Internal Revenue Service in Rev. Rul. 74–184, *supra*, in the case of a solvent debtor making an election under sections 108 and 1017 of the Code (as amended by the bill), and precludes extension of that position to bankrupt or insolvent debtors.[24]

Indebtedness of taxpayer.—The debt discharge rules of the bill apply with respect to discharge of any indebtedness for which the taxpayer is liable or subject to which the taxpayer holds property.

Unamortized premium and discount.—The bill provides that the amount taken into account with respect to any discharge of indebtedness is to be properly adjusted for unamortized premium and unamortized discount with respect to the indebtedness discharged.[25]

"Lost" deductions.—The bill provides that if the payment of a liability would have given rise to a deduction, the discharge of that liability does not give rise to income or require reduction of tax attributes. For example, assume a cash-basis taxpayer owes $1,000 to its cash-basis employee as salary and has not actually paid such amount. If later the employee forgives the debt (whether or not as a contribution to capital), then the discharge does not give rise to income or require any reduction of tax attributes.

Tax benefit rule.—The bill clarifies present law by providing that in applying the tax benefit rule of Code section 111 in order to determine if the recovery of an item is taxable, a deduction is treated as having produced a reduction in tax if the deduction increased a carryover that had not expired at the end of the taxable year in which the recovery occurs. Thus, if an accrual-basis taxpayer incurs a deductible obligation to pay rent in 1980, and that obligation is forgiven in 1981, the rent deduction is treated as having produced a reduction in tax even if it had entered into the calculation of a net

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have a debt discharge amount pursuant to the rules of the bill, the bill provides that no such income shall arise a second time. For example, assume a parent corporation purchases for $900 on the open market a $1,000 bond issued at par by its wholly owned subsidiary. Under the bill, the debtor (the subsidiary) must account for a debt discharge amount of $100 for its taxable year during which the debt was so acquired. In the following year, assume the parent transfers the debt to its subsidiary as a contribution to capital (i.e.. forgives the debt). The Treasury regulations are to provide that the amount treated as a debt discharge amount under the capital contribution rules of the bill ($100 in the example given, assuming the parent's basis in the bond is still $900) is to be reduced by the debt discharge amount previously taken into account by the subsidiary ($100) and thus no additional amount is to be taken into income.

[24] No inference is intended, by virtue of adoption of the no-disposition rule of the bill as described in the text above, as to whether the position taken by the Internal Revenue Service in Rev. Rul. 74–184, *supra*, represents a correct interpretation of Federal income tax law prior to the effective date of the bill's no-disposition rule.

A purchase price adjustment (whether or not described in new sec. 108(e)(5) of the Code, as added by this bill) continues to constitute an adjustment for purposes of the investment credit rules of the Code.

[25] This provision of the bill is not intended to be a change from the rules of current law as to adjustments for unamortized premium and discount.

operating loss that had not expired at the end of 1981 but had not been used as of that time.

Real estate investment trusts.—To qualify as a real estate investment trust (REIT), an organization must satisfy, among other requirements, source-of-income tests establishing that it has primarily passive income from real estate investments (Code sec. 856). The bill provides that income from cancellation of indebtedness is not to be taken into account for these source-of-income tests. For example, if a solvent REIT investing primarily in mortgages has debt cancellation on redemption of bonds, and such amount would be includible in gross income under the rules of the bill (absent an election to apply such amount to reduce the basis of depreciable assets or realty held as inventory), the amount of such income is not to be taken into account for purposes of Code section 856.

Amendment to Code section 382(b).—The committee bill provides that creditors of a debtor corporation are to be treated as shareholders in applying the continuity rules of Code section 382(b) in a title 11 or similar case (within the meaning of Code sec. 368(a)(3(A), as added by the bill). The House bill would have limited this rule to reorganizations under Code section 368(a)(1)(G), as added by the bill.

Partnerships

The bill provides that the rules of exclusion from gross income and reduction of tax attributes in section 108 of the Code (as amended by the bill) are to be applied at the partner level and not at the partnership level.[26] Accordingly, income from discharge of a partnership debt is not excludable at the partnership level under amended section 108. Instead, such income is treated as an item of income which is allocated separately to each partner pursuant to section 702(a) of the Code.

This allocation of an amount of debt discharge income to a partner results in that partner's basis in the partnership being increased by such amount (sec. 705). At the same time, the reduction in the partner's share of partnership liabilities caused by the debt discharge results in a deemed distribution (under sec. 752), in turn resulting in a reduction (under sec. 733) of the partner's basis in the partnership. The section 733 basis reduction, which offsets the section 705 basis increase, is separate from any basis reduction pursuant to the attribute-reduction rules of the bill.

The tax treatment of the amount of discharged partnership debt which is allocated as an income item to a particular partner depends on whether that partner is in a bankruptcy case, is insolvent (but not in a bankruptcy case), or is solvent (and not in a bankruptcy case). For example, if the particular partner is bankrupt, the debt discharge amount is excluded from gross income pursuant to amended section 108 and is applied to reduce the partner's net operating losses and other tax attributes, unless the partner elects to apply the amount first to reduce basis in depreciable property.[27] If the particular partner is

[26] The effect of these provisions of the bill is to overturn the decision in *Stackhouse* v. *U.S.*, 441 F.2d 465 (5th Cir. 1971).

[27] For purposes of this explanation of the partnership rules, the term "depreciable property" also refers to real property held for sale to customers in the ordinary course of business.

solvent (and not in a bankruptcy case), the amount allocated to tht partner is included in that partner's gross income except to the extent the partner elects to reduce basis of depreciable assets.

The bill provides that, in connection with these attribute-reduction rules, a partner's interest in a partnership is to be treated as depreciable property to the extent of such partner's proportionate interest in the depreciable property held by the partnership if the partnership agrees to make a corresponding reduction in the basis of the partnership property with respect to such partner (in a manner similar to that which would be required if the partnership had made an election under Code section 754 to adjust basis in the case of a transfer of a partnership interest).[28]

Technical amendments

The bill amends section 703(b) of the Code, relating to elections of a partnership, to provide that any election under sections 108(b)(5) or 108(d)(4) of the Code (as amended by the bill) with respect to income from discharge of indebtedness is to be made by each partner separately and not by the partnership. Section 118(c) of the Code, relating to cross references, is amended to add a reference to the rules of the bill on capital contributions of indebtedness.

Effective Date

General rule

The amendments to the Internal Revenue Code made by section 2 of the bill apply to transactions in a bankruptcy case if the case com-

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[28] For example, assume that a partnership is the debtor in a bankruptcy case which begins March 1, 1981, and that in the bankruptcy case a partnership liability in the amount of $30,000 is discharged. The partnership has three partners. The three partners have equal distributive shares of partnership income and loss items under section 702(a) of the Code. Partner A is the debtor in a bankruptcy case; partner B is insolvent (by more than $10,000), but is not a debtor in a bankruptcy case; and partner C is solvent, and is not a debtor in a bankruptcy case.

Under section 705 of the Code, each partner's basis in the partnership is increased by $10,000, i.e., his distributive share of the income of the partnership (The $30,000 debt discharge amount constitutes income of the partnership for this purpose, inasmuch as the income exclusion rules of amended sec. 108 do not apply at the partnership level.) However, also by virtue of present law, each partner's basis in the partnership is decreased by the same amount (Code secs. 752 and 733). Thus, there is not net change in each partner's basis in the partnership resulting from discharge of the partnership indebtedness except by operation at the partner level of the rules of sections 108 and 1017 of the Code (as amended by the bill).

In the case of bankrupt partner A, the $10,000 debt discharge amount must be applied to reduce net operating losses and other tax attributes as specified in the bill, unless A elects first to reduce the basis of depreciable assets. The same tax treatment applies in the case of insolvent partner B. In the case of solvent partner C, such partner can elect to reduce basis in depreciable assets in lieu of recognizing $10,000 of income from discharge of indebtedness.

If A, B, or C elects to reduce basis in depreciable assets, such partner may be permitted, under the Treasury regulations, to reduce his basis in his partnership interest (to the extent of his share of partnership depreciable property), because the bill treats that interest as depreciable property. However, a partner may reduce basis in his interest in the partnership only if the partnership makes a corresponding reduction in the basis of the partnership property with respect to such partner (in a manner similar to that which would be required if the partnership had made an election under section 754 to adjust basis in the case of a transfer of a partnership interest).

mences after December 31, 1980; to transactions in a receivership, foreclosure, or similar proceeding if the proceeding commences after December 31, 1980; and to other transactions which occur after December 31, 1980 (except that the provisions of section 2 do not apply to any transaction in a bankruptcy case which began prior to January 1, 1981 or in a receivership, foreclosure, or similar proceeding which proceeding began before January 1, 1981, even if such transaction occurs after December 31, 1980).[29]

Special effective date election

The bill also provides an effective date election for debtors in bankruptcy cases commenced on or after October 1, 1979 (but prior to January 1, 1981), and for debtors in receivership, foreclosure, or similar judicial proceedings commenced on or after October 1, 1979 (but prior to January 1, 1981).

The debtor (or debtors, if there is more than one debtor in the case) in such a case or proceeding can elect, with the approval of the court, to have the following provisions of the bill apply to transactions in the case or proceeding, notwithstanding the general effective date of the bill:

section 2 (tax treatment of discharge of indebtedness);

section 4 (corporate reorganization provisions; and

sections 5(a), 5(b), 5(c), 5(e), and 5(f) (miscellaneous corporate amendments).

If the election is made, all provisions of sections 2 and 4 and all the above-listed provisions of section 5 of the bill are applicable to all transactions in the case or proceeding and to all parties involved in the case or proceeding. Thus, the debtor may not elect to have only certain of these provisions apply to transactions in the case or proceeding, and may not elect to have the provisions apply only to certain transactions in the case or proceeding.

An effective date election is to be made at such time and in such manner as prescribed by Treasury regulations, taking into account the need for all parties involved in the case or proceeding to be aware of the election. The election, once made, is irrevocable.

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[29] Where the new recapture rules for stock apply (generally, to stock acquired after December 31, 1980), those rules apply without regard to when the deductions to be recaptured were allowed.

B. Rules Relating to Title 11 Cases for Individuals (sec. 3 of the bill; new secs. 1398 and 1399 and secs. 6012 and 6103 of the Code)

Effect of Bankruptcy Law

Under bankruptcy law, the commencement of a liquidation or reorganization case involving an individual debtor creates an "estate" which consists of property formerly belonging to the debtor. The bankruptcy estate generally is administered by a trustee for the benefit of creditors, and it may derive its own income and incur expenditures. At the same time, the individual is given a "fresh start"—that is, wages earned by the individual after commencement of the case and after-acquired property do not become part of the bankruptcy estate, but belong to the individual, and certain property may be set aside as exempt.

Reasons for Change

At present, there are no rules in the Internal Revenue Code specifying whether the bankruptcy estate constitutes a taxable entity apart from the individual debtor; and, if so, how tax attributes are to be allocated between the estate and the debtor. This has resulted in uncertainty and litigation concerning the Federal income tax liability of the bankruptcy estate and the debtor. The provisions of section 3 of the bill, adding new sections 1398 and 1399 to the Internal Revenue Code, provide the first comprehensive statutory treatment of these issues.

In addition, the committee has concluded that an individual debtor in a bankruptcy case generally should be given an election to close his or her taxable year at the date of bankruptcy. If a debtor makes such an election, the debtor's Federal income tax liability for the "short" taxable year ending with commencement of the bankruptcy case becomes collectible out of the bankruptcy estate as a liability incurred before bankruptcy, to the extent the estate has assets with which to pay debts of that priority. Since income items (or benefits of prebankruptcy transactions that gave rise to tax liability) may have passed to the bankruptcy trustee, it is appropriate that the tax liability be collectible out of estate assets as a prebankruptcy liability. To the extent that assets of the bankruptcy estate are not sufficient to pay any tax due for that year, the bankruptcy statute provides that the remaining liability is not dischargeable in the bankruptcy case and hence can be collected from the individual debtor after the case.

Explanation of Provisions

1. Debtor and bankruptcy estate as separate entities

Present law

For Federal income tax purposes, the estate created on commencement of a bankruptcy proceeding with respect to an individual debtor is treated as a new taxable entity, separate from the individual (Rev. Rul. 72–387, 1972–2 C.B. 632). Accordingly, the trustee must file a tax return (Form 1041) for the bankruptcy estate if the gross income of the estate, for the period beginning with filing of the petition or for any subsequent taxable year, is $600 or more.

The taxable year of the individual debtor is not terminated on commencement of the bankruptcy proceeding. On the individual's return (Form 1040 or 1040A) for the year in which the bankruptcy proceeding commenced, the individual reports all income earned by him or her during the entire year (including income earned by the individual before commencement of the proceeding, even though any assets derived from such income pass to the bankruptcy estate), but does not report any income earned by the bankruptcy estate.

General provisions of bill

The bill, like present law, treats the bankruptcy estate of an individual as a separate taxable entity for Federal income tax purposes. The separate entity rules under the bill (new Code sec. 1398)[1] apply if a bankruptcy case involving an individual debtor is brought under chapter 7 (liquidation) or chapter 11 (reorganization) of title 11 of the U.S. Code, as amended by P.L. 95–598. No separate taxable entity is created on commencement of a case under chapter 13 of new 11 U.S. Code (adjustment of debts of an individual with regular income).[2]

Exception

If a bankruptcy case involving an individual is commenced but subsequently dismissed by the bankruptcy court, the estate is not treated as a separate entity (new Code sec. 1398(b)(1)). In this situation, where the bankruptcy case does not run to completion, it is appropriate to treat the debtor's tax status as if no proceeding had been brought.[3]

Partnerships, corporations

The bill provides that no taxable entity results from commencement of a bankruptcy case involving a partnership or corporation. This rule

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[1] In this report, provisions of the Internal Revenue Code which are added by section 3 of the bill are cited as "new Code sec. —".

[2] The rationale for generally treating the individual debtor and the bankruptcy estate as separate entities is that the individual may obtain new assets or earn wages after transfer of the pre-bankruptcy property to the trustee and thus derive income independent of that derived by the trustee from the transferred assets of the individual debtor and assets of the bankruptcy estate as in chapter 7 and exempt property may be used to make payments to creditors, and hence the bankruptcy law does not create the same dichotomy between after-acquired assets of the individual debtor and assets of the bankruptcy estate as an chapter 7 or chapter 11 cases.

For purposes of the separate entity rules under new Code section 1398, a partnership is not treated as an individual. The interest in a partnership of a debtor who is an individual is taken into account under new Code section 1398 in the same manner as any other interest of the debtor (new Code sec. 1398(b)(2).)

[3] If the estate is not treated as a separate entity because the bankruptcy case was dismissed, the debtor includes on his or her return(s), for the year(s) the estate was in existence, any gross income, deductions, or credits which otherwise would be tax items of the estate. The estate, although temporarily in existence under bankruptcy law prior to dismissal of the case, does not constitute a taxable entity for Federal income tax purposes.

(new Code sec. 1399) reverses current Internal Revenue Service practice as to partnerships, under which the estate of a partnership in bankruptcy is treated as a taxable entity (Rev. Rul. 68–48, 1968–1 C.B. 301), but is the same as present law with respect to commencement of a bankruptcy case involving a corporation (Treas. Reg. § 1.641(b)-2(b)).

Accordingly, the bankruptcy trustee of a partnership in a bankruptcy case is required to file annual information returns (under section 6031 of the Code) for the partnership. Also, the bankruptcy trustee of a corporation in a bankruptcy case, as under present law, is required to file annual income tax returns and pay corporate income tax for the corporation (sec. 6012(b)(3) of the Code; Rev. Rul. 79–120, 1979–1 C.B. 382).

2. *Debtor's election to close taxable year*

In general

The bill gives an individual debtor an election to close his or her taxable year as of the day before the date on which the bankruptcy case commences (the "commencement date"). If the election were made, the debtor's taxable year which otherwise would include the commencement date is divided into two "short" taxable years of less than 12 months. The first such year ends on the day before the commencement date; the second such year begins on the commencement date (new Code sec. 1398(d)(3)(A)). If the election were not made, the commencement of the bankruptcy case does not affect the taxable year of an individual debtor (new Code sec. 1398(d)(2)).

As a result of the debtor's making the election, his or her Federal income tax liability for the first short taxable year becomes (under bankruptcy law) an allowable claim against the bankruptcy estate as a claim arising before bankruptcy. Accordingly, any tax liability for that year is collectible from the estate, depending on the availability of estate assets to pay debts of that priority. Inasmuch as any such tax liability for an electing debtor's first short taxable year is not dischargeable, the individual debtor remains liable for any amount not collected out of the bankruptcy estate (new 11 U.S. Code sec. 523(a)(1)). If the debtor does not make the election, no part of the debtor's tax liability from the year in which the bankruptcy case commences is collectible from the estate, but is collectible directly from the individual debtor.

If the election is made, the debtor is required to annualize his or her taxable income for each short taxable year in the same manner as if a change of annual accounting period had been made (new Code sec. 1398(d)(3)(F)).

Availability of election

The election provided under the bill is available in cases to which new section 1398 of the Code applies. Accordingly, the election is available to an individual debtor in a bankruptcy case under chapter 7 (liquidation) or chapter 11 (reorganization) of title 11 of the U.S. Code, as amended by P.L. 95–598, except where such case is commenced but subsequently dismissed by the bankruptcy court. Also, the bill provides that the election is not available to a debtor who has no assets other than property which he or she may treat as exempt property under new 11 U.S. Code section 522 (new Code sec. 1398 (d)(3)(C)). In the latter instance, since there would be no assets in the bankruptcy estate out of which the debtor's tax liability for the period prior to the commencement date could be collected, there is no reason to authorize termination of the taxable year.

Due date, manner of election

The election must be made on or before the 15th day of the fourth month following the commencement date—i.e., by the date on which a return would be due for the first short taxable year if the election were made, determined without regard to any extension for filing such return. For example, if the bankruptcy case commences on March 10, the election must be made by July 15 of that year. The election is to be made in such manner as prescribed by Treasury regulations, but an election is not conditioned on approval of the Internal Revenue Service, as under section 442 of the Code. The election, once made, is irrevocable (new Code sec. 1398(d)(3)(D)).

Spousal election

If the debtor making the election was married on the date the bankruptcy case involving him or her commenced, the debtor's spouse can join in the election to close the taxable year, but only if the debtor and the spouse file a joint return for the first short taxable year (new Code sec. 1398(d)(3)(B)). The filing of a joint return for the first short taxable year does not require the debtor and the spouse to file a joint return for the second short taxable year.

If during the same year a bankruptcy case involving the debtor's spouse were commenced, the spouse can elect to terminate his or her then taxable year as of the day before the commencement date, whether or not the spouse previously had joined in the debtor's election. If the spouse previously had joined in the debtor's election, or if the debtor had not made an election, the debtor can join in the spouse's election. But if the debtor had made an election and the spouse had not joined in the debtor's election, the debtor cannot join in the spouse's election, inasmuch as the debtor and the spouse, having different taxable years, could not file a joint return for a year ending with the spouse's commencement date (sec. 6013 of the Code).

Illustrative example

The rules relating to spousal elections under the bill are illustrated by the following example.

Assume that husband and wife are calendar-year taxpayers, that a bankruptcy case involving only the husband commences on March 1, 1982, and that a bankruptcy case involving only the wife commences on October 1, 1982.

If the husband does not make an election, his taxable year would not be affected; i.e., it does not terminate on February 28. If the husband does make an election, his first short taxable year would be January 1 through February 28; his second short taxable year would begin March 1. The wife could join in the husband's election, but only if they file a joint return for the taxable year January 1 through February 28.

The wife could elect to terminate her then taxable year on September 30. If the husband had not made an election, or if the wife had not joined in the husband's election, she would have (if she made the election) two taxable years in 1982—the first from January 1 through September 30, and the second from October 1 through December 31. If the husband had not made an election to terminate his taxable year on February 28, the husband could join in an election by his wife, but only if they file a joint return for the taxable year January 1 through September 30. If the husband had made an election but the wife had not joined in the husband's election, the husband could not join in an election by the wife to terminate her taxable year on September 30, since they could not file a joint return for such year.

If the husband had made the election and the wife had joined in it, she would have two additional taxable years with respect to her 1982 income and deductions (if she makes the election relating to her own bankruptcy case)—the second short taxable year would be March 1 through September 30, and the third short taxable year would be October 1 through December 31. The husband could join in the wife's election if they file a joint return for the second short taxable year. If the husband does so join in the wife's election, they could file joint returns for the short taxable year ending December 31, but would not be required to do so.

3. Computation of bankruptcy estate's tax liability

Gross income

Under the bill, the gross income of the bankruptcy estate of an individual consists of (1) any gross income of the individual debtor, other than any amount received or accrued as income by the debtor before the commencement of the case, which under bankruptcy law (new 11 U.S. Code) constitutes property of the bankruptcy estate, and (2) the gross income of the estate beginning on and after the date the case commenced (new Code sec. 1398(e)(1)).

Attribute carryover

The estate succeeds to the following income tax attributes of the debtor (determined as of the first day of the debtor's taxable year in which the case commences):

(*a*) net operating loss carryovers;

(*b*) capital loss carryovers;

(*c*) credit carryovers;

(*d*) charitable contribution carryovers;

(*e*) recovery exclusions (under sec. 111 of the Code);

(*f*) the debtor's basis in and holding period for, and the character in the debtor's hands of, any asset acquired (other than by sale or exchange) from the debtor;

(*g*) the debtor's method of accounting; and

(*h*) other tax attributes, to the extent provided by Treasury regulations (new Code sec. 1398(g)). For example, the regulations could allow the estate the benefit of section 1341 of the Code if the estate repays income which the debtor received under claim of right.

Character of expenditures

Under present law, it is not clear whether certain expenses or debts paid by the trustee are deductible if the trustee does not actually operate the debtor's trade or business (and if such expenses are not incurred in a new trade or business of the estate.) To alleviate this problem, the bill provides that an amount paid or incurred by the bankruptcy estate is deductible or creditable by the estate to the same extent as that item would be deductible or creditable by the debtor had the debtor remained in the same trades, businesses, or activities after the case commenced as before and had the debtor paid or incurred such amount. The same test is applied to determine whether amounts paid by the estate constitute wages for purposes of Federal employment taxes (new Code sec 1398(e)(4)).

Administrative expenses

Under present law, it is unclear in certain circumstances whether administrative and related expenses of the bankruptcy estate are deductible by the estate (see Rev. Rul. 68-48, 1968-1 C.B. 301). The bill provides (new Code sec. 1398(h)(1)) that the estate can deduct (a) any administrative expense allowed under new 11 U.S. Code sec. 503 and (b) any fee or charge assessed against the estate under 28 U.S. Code, ch. 123 (court fees and costs). Such deductions are available whether or not considered trade or business expenses or investment expenses, but are subject to disallowance under other provisions of the Internal Revenue Code, such as section 263 (capital expenditures), 265 (expenses relating to tax-exempt interest), or 275 (certain taxes).

Under present law, any deduction otherwise available for administrative or related expenses may be lost, since no carryover deduction is permitted for expenses not incurred in a trade or business. The trustee often cannot pay administrative expenses until the end of the bankruptcy proceeding; unless considered trade or business expenses, the unused amount cannot be carried back and deducted against income of the bankruptcy estate received in earlier years.

To alleviate this problem, the bill provides that any amount of the new deduction for administrative, etc. expenses not used in the current year can be carried back by the estate three years (but only to a taxable year of the estate) and forward seven years (new Code sec. 1398(h)(2)). These carryovers are "stacked" after the net operating loss deductions (allowed by sec. 172 of the Code) for the particular year. An administrative, etc, expenses which is deductible solely under new Code sec. 1398(h)(1), or a carryover deduction for such expense, is allowable only to the estate (new Code sec. 1398(h)(2)(D)).

Carryback of estate's net operating losses

If the bankruptcy estate itself incurs a net operating loss (apart from losses passing to the estate from the individual debtor), the bill provides that the bankruptcy estate can carry back its net operating losses not only to previous taxable years of the estate, but also to taxable years of the individual prior to the year in which the case commenced (new Code sec. 1398(j)(2)). Similarly, the bill allows the bankruptcy estate to carry back excess credits, such as the investment tax credit, to pre-bankruptcy taxable years of the individual debtor.

Tax rate schedule, etc.

Except as otherwise provided in new Code section 1398, the taxable income of the bankruptcy estate is computed in the same manner as in the case of an individual. The estate is allowed a deduction of $1,000 under section 151 of the Code as its personal exemption. Under the bill, the zero bracket amount for the estate and the tax rate schedule applicable to the estate are the same as for married individuals filing separate returns (new Code sec. 1398(c)). The estate is not eligible for income averaging.

Returns of estate

Under the bill, the trustee is required to file a Federal income tax return on behalf of the bankruptcy estate for any year in which the estate's gross income is $2,700 or more (sec. 3(b) of the bill and new sec. 6012(a)(9) of the Code), and to pay the estate's tax liability due for that year (new Code sec. 1398(c)(1)). No return need be filed and no income tax would be due if gross income for the year is less than $2,700.

Change of accounting period

The estate is permitted to change its annual accounting period (taxable year) one time without obtaining approval of the Internal Revenue Service as otherwise required under section 442 of the Code (new Code sec. 1398(j)(1)). This rule permits the trustee to effect an early closing of the estate's taxable year prior to the expected termination of the estate, and then to submit a return for such "short year" for an expedited determination of tax liability pursuant to new 11 U.S. Code sec. 505.

Disclosure of returns

The bill provides that the estate's Federal income tax return is open (upon written request) to inspection by or disclosure to the individual debtor (sec. 3(c) of the bill and amended sec. 6103(e) of the Code). Such disclosure is necessary so that the debtor can properly determine any amount of tax attributes to which the debtor would succeed on termination of the bankruptcy estate.

No-disposition rule

Under the bill, a transfer (other than by sale or exchange) of an asset from the bankruptcy estate to the individual debtor on termination of the estate would not be treated as a disposition giving rise to recognition of gain or loss, recapture of deductions or credits, or acceleration of income or deductions (new Code sec. 1398(f)(2)).

4. Computation of individual's tax liability

Gross income, deductions, credits

If any item of gross income of the debtor realized after commencement of the bankruptcy case is treated under new Code section 1398(e)(1) as gross income of the bankruptcy estate (because under bankruptcy law such income constitutes property of the estate), that item is not included by the debtor as gross income on his or her return or a joint return with the debtor's spouse (new Code sec. 1398(e)(2)).

This provision of the bill, treating such income items as gross income of the estate rather than of the individual, is intended to override otherwise applicable "assignment of income" principles of tax law. For example, if the estate were entitled under bankruptcy law to a salary payment earned by the debtor before the case commences but paid after that date, the amount of the payment is included in the estate's gross income and is not to be included in the debtor's gross income.

If any item of deduction or credit of the debtor is treated under new Code section 1398(e)(3) as a deduction or credit of the bankruptcy estate that item is not allowable to the debtor as a deduction or credit on his or her return or a joint return with the debtor's spouse (new Code section 1398(e)(3)). This rule is intended to insure that no particular item of deduction or credit can be allowable to both the debtor and the estate.

No-disposition rule

Under the bill, a transfer (other than by sale or exchange) of an asset from the individual debtor to the bankruptcy estate is not treated as a disposition giving rise to recognition of gain or loss, recapture of deductions or credits, or acceleration of income or deductions (new Code sec. 1398(f)(1)). For example, such a transfer of an installment obligation is not treated as a disposition giving rise to acceleration of gain under section 453(d) of the Code.

Carryback of net operating loss

The bill provides that an individual debtor cannot carry back, to a year that preceded the year in which the case was commenced, any net operating loss or credit carryback from a taxable year ending after commencement of the bankruptcy case (new Code sec. 1398(j)(2)(B)). As noted above, the bill would permit the bankruptcy estate to carry back its net operating loss deduction to offset the pre-bankruptcy income of the individual debtor.

Attribute carryover

On termination of the bankruptcy estate, the debtor would succeed to the following tax attributes of the estate (including such attributes which first arose during administration of the estate):

(*a*) net operating loss carryovers;
(*b*) capital loss carryovers;
(*c*) credit carryovers;
(*d*) charitable contribution carryovers;
(*e*) recovery exclusions (under sec. 111 of the Code);
(*f*) the estate's basis in and holding period for, and the character in the estate's hands of, any asset acquired (other than by sale or exchange) from the estate;[4] and
(*g*) other tax attributes, to the extent provided by Treasury regulations (new Code sec. 1398(i)).

Disclosure of returns

In a bankruptcy case to which new Code section 1398 applies (determined without regard to whether the case is dismissed), the Federal

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[4] In a bankruptcy case to which new Code sec. 1398 applies, any attribute reduction under section 2 of the bill applies to tax attributes of the bankruptcy estate (except for purposes of applying the basis-reduction rules of section 1017 to property transferred by the estate to the individual) and not to those attributes of the individual which arose after commencement of the case. Also, the bill provides that in a bankruptcy case involving an individual debtor, no reduction in basis is to be made in the basis of property which the debtor treats as exempt property under new 11 U.S. Code section 522. The tax attributes to the estate, as so reduced, carry over (to the extent unused on termination of the estate) to the individual debtor pursuant to new Code sec. 1398(i).

income tax returns of the debtor for the taxable year in which the bankruptcy case commenced and preceding years are open (upon written request) to inspection by or disclosure to the trustee of the bankruptcy estate. (This disclosure is necessary so that the trustee properly may determine attribute carryovers to the estate and may carry back deductions to preceding years of the debtor.) In an involuntary case, however, no such disclosure of the trustee could be made prior to the time the bankruptcy court has entered an order for relief unless that court finds that such disclosure is appropriate for purposes of determining whether an order for relief should be entered (sec. 3(c) of the bill and amended sec. 6103(e) of the Code).

Also under the bill, prior year returns of the debtor in a bankruptcy case, or of a person whose property is in the hands of a receiver, are open (upon written request) to inspection by or disclosure to the trustee or receiver, but only if the Internal Revenue Service finds that such trustee or receiver, in his fiduciary capacity, has a material interest which would be affected by information contained in the return.

5. Technical amendment

Section 443(c) of the Code, relating to cross references, is amended by adding a cross reference to new Code section 1398(d)(3)(E), with respect to returns for a period of less than 12 months in the case of a debtor's election to terminate a taxable year.

6. Effective date

The amendments made by section 3 of the bill apply to bankruptcy cases commencing more than 90 days after the date of enactment of the bill.

C. Corporate Reorganization Provisions (sec. 4 of the bill and secs. 354, 355, 357, 368, and 381 of the Code)

Present Law

Definition of reorganization

A transfer of all or part of a corporation's assets, pursuant to a court order in a proceeding under chapter X of the Bankruptcy Act (or in a receivership, foreclosure, or similar proceeding), to another corporation organized or utilized to effectuate a court-approved plan may qualify for tax-free reorganization treatment under special rules relating to "insolvency reorganizations" (secs. 371–374 of the Internal Revenue Code).

These special rules for insolvency reorganizations generally allow less flexibility in structuring tax-free transactions than the rules applicable to corporate reorganizations as defined in section 368 of the Code. Also, the special rules for insolvency reorganizations do not permit carryover of tax attributes to the transferee corporation, and otherwise differ in important respects from the general reorganization rules.[1] While some reorganizations under chapter X of the Bankruptcy Act may be able to qualify for nonrecognition treatment under Code section 368, other chapter X reorganizations may be able to qualify only under the special rules of sections 371–374 and not under the general reorganization rules of section 368.

Triangular reorganizations

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of Code sections 371–374, the stock or securities used to acquire the assets of the corporation in bankruptcy must be the acquiring corporation's own stock or securities. This limitation generally precludes corporations in bankruptcy from engaging in so-called triangular reorganizations, where the acquired corporation is acquired for stock of the parent of the acquiring corporation. By contrast, tax-free triangular reorganizations generally are permitted under the general rules of Code section 368.

Transfer to controlled subsidiary

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of Code sections

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[1] Under present law, it is not clear to what extent creditors of an insolvent corporation who receive stock in exchange for their claims may be considered to have "stepped into the shoes" of former shareholders for purposes of satisfying the nonstatutory "continuity of interest" rule, under which the owners of the acquired corporation must continue to have a proprietary interest in the acquiring corporation. Generally, the courts have found the "continuity of interest" test satisfied if the creditors' interests were transformed into proprietary interests prior to the reorganization (e.g., *Helvering* v. *Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942); Treas Reg. § 1.371-1(a)(4)). It is unclear whether affirmative steps by the creditors are required or whether mere receipt of stock is sufficient.

371–374, it is not clear under present law whether and to what extent the acquiring corporation may transfer assets received into a controlled subsidiary. In the case of other corporate reorganizations, the statute expressly defines the situations where transfers to subsidiaries are permitted (Code sec. 368(a)(2)(C)).

Carryover of tax attributes

In the case of an insolvency reorganization which can qualify for nonrecognition treatment only under the special rules of Code sections 371–374, court cases have held that attributes (such as net operating losses) of the corporation in bankruptcy do not carry over to the new corporation. In the case of other corporate reorganizations, however, specific statutory rules permit carryover of tax attributes to the surviving corporation (Code sec. 381).

"Principal amount" rule; "boot" test

In a corporate reorganization, generally the exchange of stock or securities of one corporation for those of another corporation is not tax-free to the extent the principal amount of the securities received exceeds the principal amount of the securities surrendered, or to the extent of the principal amount of the securities received if no securities are surrendered (Code secs. 354(a)(2)(B) and 356(d)(2)). Also, "boot" (money or property other than stock and securities permitted to be received without recognition of gain) received in a corporate reorganization is subject to the dividend-equivalence test of Code section 356. These rules do not apply under present law to insolvency reorganizations qualifying only under Code sections 371–374.

Treatment of accrued interest

Under present law, a claim for unpaid interest is treated as an integral part of the security to which it relates, so that the surrender of the security together with the claim for unpaid interest is treated only as the surrender of a security. Thus, the nonrecognition provisions apply to an exchange of a security with accrued but unpaid interest although the unpaid interest would have been taxable as ordinary income if paid separately.[2]

Reasons for Change

The committee believes that the provisions of existing Federal income tax law which are generally applicable to tax-free corporate reorganizations should also apply to reorganizations of corporations in bankruptcy or similar proceedings, in order to facilitate the rehabilitation of financially troubled businesses.

Also, the committee believes that a creditor who exchanges securities in a corporate reorganization (including an insolvency reorganization) should be treated as receiving interest income on the exchange to the extent the creditor receives new securities, stock, or any other property for accrued but unpaid interest on the securities surrendered.

Explanation of Provisions

Section 4 of the bill generally conforms the tax rules governing insolvency reorganizations with the existing rules applicable to other

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[2] *Carman* v. *Comm'r*, 189 F. 2d 363 (2nd Cir. 1951); Rev. Rul. 59–98, 1959-1 C.B. 76.

corporate reorganizations. These provisions are the same as section 4 of the House bill.

Definition of reorganization

In general

The bill adds a new category—"G" reorganizations—to the general Code definition of tax-free reorganizations (sec. 368(a)(1)). The new category includes certain transfers of assets pursuant to a court-approved reorganization plan in a bankruptcy case under new title 11 of the U.S. Code, or in a receivership, foreclosure, or similar proceeding [3] in a Federal or State court.[4]

The special tax rules (Code secs. 371–374) now applicable to insolvency reorganizations continue to apply only to bankruptcy proceedings commenced prior to October 1, 1979, except that the bill does not terminate the applicability of the rules in sections 374(c) and 374(e) of the Code governing tax-free exchanges under the final system plan for ConRail.

In order to facilitate the rehabilitation of corporate debtors in bankruptcy, etc., these provisions are designed to eliminate many requirements which have effectively precluded financially troubled companies from utilizing the generally applicable tax-free reorganization provisions of present law. To achieve this purpose, the new "G" reorganization provision does not require compliance with State merger laws (as in category "A" reorganizations), does not require that the financially distressed corporation receive solely stock of the acquiring corporation in exchange for its assets (category "C"), and does not require that the former shareholders of the financially distressed corporation control the corporation which receives the assets (category "D").

The "G" reorganization provision added by the bill requires the transfer of assets by a corporation in a bankruptcy or similar case, and the distribution (in pursuance of the court-approved reorganization plan) of stock or securities of the acquiring corporation in a transaction which qualifies under sections 354, 355, or 356 of the Code. This distribution requirement is designed to assure that either substantially all of the assets of the financially troubled corporation, or assets which consist of an active business under the tests of section 355, are transferred to the acquiring corporation.

"Substantially all" test

The "substantially all" test in the "G" reorganization provision is to be interpreted in light of the underlying intent in adding the new "G" category, namely, to facilitate the reorganziation of companies in bankruptcy or similar cases for rehabilitative purposes. Accordingly, it is intended that facts and circumstances relevant to this intent, such as the insolvent corporation's need to pay off creditors or to sell

[3] For this purpose, the definition of a receivership, foreclosure, or similar proceeding is the same as under present section 371 of the Code.

[4] Under the bill, asset transfers in a receivership, foreclosure, or similar proceeding involving a financial institution (to which section 585 or 593 of the Code applies) before a Federal or State agency are treated in the same manner as transfers in such a proceeding before a court. Thus, for example, asset transfers in a proceeding under 12 U.S.C. sec. 1729 involving a savings and loan association can qualify as a "G" reorganization.

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 purposes of the new "G" category 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.[5]

Relation to other provisions

A transaction which qualifies as a "G" reorganization is not to be treated as also qualifying as a liquidation under section 332, an incorporation under section 351, or a reorganization under another category of section 368(a)(1) of the Code.[6]

A transaction in a bankruptcy or similar case which does not satisfy the requirements of new category "G" is not thereby precluded from qualifying as a tax-free reorganization under one of the other categories of section 368(a)(1). For example, an acquisition of the stock of a company in bankruptcy, or a recapitalization of such a company, which transactions are not covered by the new "G" category, can qualify for nonrecognition treatment under sections 368(a)(1)(B) or (E), respectively.

Continuity of interest rules

The "continuity of interest" requirement which the courts and the Treasury have long imposed as a prerequisite for nonrecognition treatment for a corporate reorganization must be met in order to satisfy the requirements of new category "G". Only reorganizations—as distinguished from liquidations in bankruptcy and sales of property to either new or old interests supplying new capital and discharging the obligations of the debtor corporation—can qualify for tax-free treatment.

It is expected that the courts and the Treasury will apply to "G" reorganizations continuity-of-interest rules which take into account the modification by P.L. 95–598 of the "absolute priority" rule. As a result of that modification, shareholders or junior creditors, who might previously have been excluded, may now retain an interest in the reorganized corporation.

For example, if an insolvent corporation's assets are transferred to a second corporation in a bankruptcy case, the most senior class of creditor to receive stock, together with all equal and junior classes (including shareholders who receive any consideration for their stock),

[5] Because the stated intent for adding the new "G" category is not relevant to interpreting the "substantially all" test in the case of other reorganization categories, the comments in the text as to the appropriate interpretation of the "substantially all" test in the context of a "G" reorganization are not intended to apply to, or in any way to affect interpretations under present law of, the "substantially all" test for other reorganization categories.

[6] However, if a transfer qualifying as a "G" reorganization also meets the requirements of section 351 or qualifies as a reorganization under section 368(a)(1)(D) of the Code, the "excess liability" rule of section 357(c) applies if any former shareholder of the transferor corporation receives consideration for his stock, but does not apply if no former shareholder of the transferor corporation receives any consideration for his stock (i.e., if the corporation is insolvent). This rule parallels present law, under which insolvency reorganizations under sections 371 or 374 are excluded from the application of section 357(c).

should generally be considered the proprietors of the insolvent corporation for "continuity" purposes. However, if the shareholders receive consideration other than stock of the acquiring corporation, the transaction should be examined to determine if it represents a purchase rather than a reorganization.

Thus, short-term creditors who receive stock for their claims may be counted toward satisfying the continuity of interest rule, although any gain or loss realized by such creditors will be recognized for income tax purposes.

Triangular reorganizations

The bill permits a corporation to acquire a debtor corporation in a "G" reorganization in exchange for stock of the parent of the acquiring corporation rather than for its own stock.

In addition, the bill permits an acquisition in the form of a "reverse merger" of an insolvent corporation (i.e., where no former shareholder of the surviving corporation receives any consideration for his stock) in a bankruptcy or similar case if the former creditors of the surviving corporation exchange their claims for voting stock of the controlling corporation which has a value equal to at least 80 percent of the value of the debt of the surviving corporation.[7]

Transfer to controlled subsidiary

The bill permits a corporation which acquires substantially all the assets of a debtor corporation in a "G" reorganization to transfer the acquired assets to a controlled subsidiary without endangering the tax-free status of the reorganization. This provision places "G" reorganizations on a similar footing with other categories of reorganizations.

Carryover of tax attributes

Under the bill, the statutory rule generally governing carryover of tax attributes in corporate reorganizations (Code sec. 381) also applies in the case of a "G" reorganization. This eliminates the so-called "clean slate" doctrine.[8]

"Principal amount" rule; "boot" test

Under the bill, "G" reorganizations are subject to the rules governing the tax treatment of exchanging shareholders and security holders which apply to other corporate reorganizations.

Accordingly, an exchanging shareholder or security holder of the debtor company who receives securities with a principal amount exceeding the principal amount of securities surrendered is taxable on the excess, and an exchanging shareholder or security holder who surrenders no securities is taxed on the principal amount of any securities received. Also, any "boot" received is subject to the general dividend-equivalence test of Code section 356.

Treatment of accrued interest

Under the bill, a creditor exchanging securities in any corporate reorganization described in section 368 of the Code (including a "G"

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[7] Priority claims described in new 11 U.S. Code section 1129(a)(9) which are paid in cash may be excluded from this determination.

[8] The bill also provides that creditors of a debtor corporation in a title 11 or similar case are to be treated as shareholders in applying the continuity rules of Code sec. 382(b).

reorganization) is treated as receiving interest income on the exchange to the extent the security holder receives new securities, stock, or any other property attributable to accrued but unpaid interest (including accrued original issue discount) on the securities surrendered. This provision, which reverses the so-called *Carman* rule,[9] applies whether or not the exchanging security holder realizes gain on the exchange overall. Under this provision, a security holder which had previously accrued the interest (including original issue discount) as income recognizes a loss to the extent the interest is not paid in the exchange.

Example

The reorganization provisions of the bill are illustrated in part by the following example.

Assume that Corporation A is in a bankruptcy case commenced after December 31, 1980. Immediately prior to a transfer under a plan of reorganization. A's assets have an adjusted basis of $75,000 and a fair market value of $100,000. A has a net operating loss carryover of $200,000. A has outstanding bonds of $100,000 (on which there is no accrued but unpaid interest) and trade debts of $100,000.

Under the plan of reorganization, A is to transfer all its assets to Corporation B in exchange for $100,000 of B stock. Corporation A will distribute the stock, in exchange for their claims against A, one-half to the security holders and one-half to the trade creditors. A's shareholders will receive nothing.

The transaction qualifies as a reorganization under new section 368(a)(1)(G) of the Code, since all the creditors are here treated as proprietors for continuity of interest purposes. Thus, A recognizes no gain or loss on the transfer of its assets to B (Code sec. 361). B's basis in the assets is $75,000 (sec. 362), and B succeeds to A's net operating loss carryover (sec. 381).

Under the bill, the pro-rata distribution of B stock to A's creditors does not result in income from discharge of indebtedness or require attribute reduction.

Assume the same facts as above except that B also transfers $10,000 in cash, which is distributed by A to its creditors. Although A would otherwise recognize gain on the receipt of boot in an exchange involving appreciated property, the distribution by A of the $10,000 cash to those creditors having a proprietary interest in the corporation's assets for continuity of interest purposes prevents A from recognizing any gain (Code sec. 361(b)(1)(A)).[10]

Technical and conforming amendments

Section 4(h) of the bill makes technical and conforming amendments to the Internal Revenue Code.

1. *Amendment of section 354(b)*.—Paragraphs (1) and (2) of Code section 354(b), relating to exception to general rule on exchanges of stock and securities in certain reorganizations, are amended by adding references to new subparagraph "G" of section 368(a)(1).

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[9] See note 2, *supra*.

[10] See Code sec. 371(a)(2)(A) and Treas. Reg. § 1.371-1(b) for a similar rule relating to distribution of boot to creditors in an insolvency reorganization under present law.

2. Amendment of section 357(c)(2).—Code section 357(c)(2), providing exceptions to the general rule with respect to liabilities in excess of basis on transfers to controlled corporations, is amended to add an exception for any exchange pursuant to a plan of reorganization under new category "G" of section 368(a)(1) if no former shareholder of the transferor corporation receives any consideration for his stock.[11]

3. Amendment of section 368(a)(1).—A conforming amendment is made to Code section 368(a)(1) to take into account the addition of new category "G" reorganizations.

4. Amendment of section 368(b).—Code section 368(b), defining "party to a reorganization", is amended to include references to new category "G" reorganizations.

5. Technical change.—A change is made in the table of sections for part IV of subchapter C of chapter 1 of the Code.

Effective Date

The amendments made by section 4 of the bill apply to bankruptcy cases commencing after December 31, 1980 and to receivership, foreclosure, or similar judicial proceedings commencing after that date. Also, these amendments will apply to a bankruptcy case or a receivership, etc. proceeding commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election provided by the bill is made (see explanation of effective date election under part II-A of the report).

In the case of transactions outside bankruptcy cases and receivership, etc. proceedings, the amendments made by section 4(e) of the bill, relating to exchanges of property for accrued interest, apply to transactions occurring after December 31, 1980.

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[11] See note 6, *supra*.

D. Miscellaneous Corporate Amendments (sec. 5 of the bill)

1. Exception from personal holding company status (sec. 5(a) of the bill and sec. 542 of the Code)

Present Law

Under present law, a corporation in a bankruptcy or insolvency proceeding may become subject to the personal holding company tax on certain passive income (sec. 541 of the Internal Revenue Code) if its assets are converted to investments which produce passive income before the corporation is liquidated.

Reasons for Change

The committee believes that the personal holding company tax generally should not apply to corporations in bankruptcy or insolvency proceedings, since financially troubled corporations under court supervision generally are not used to avoid income tax on their shareholders.

Explanation of Provision

Under this provision, a corporation subject to court jurisdiction in a bankruptcy or similar case [1] is not to be considered a personal holding company. This exception is not available, however, if a major purpose in commencing or continuing the case is avoidance of the personal holding company tax. This provision is the same as section 5(a) of the House bill.

Effective Date

The amendment made by this provision applies to bankruptcy cases commencing after December 31, 1980 and to similar cases commenced after that date. Also, the amendment will apply to a bankruptcy or similar case commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election provided by the bill is made (see explanation of effective date election under part II–A of this report).

2. Repeal of special treatment for certain railroad stock redemptions (sec. 5(b) of the bill and sec. 302 of the Code)

Present Law

Present law provides that any distribution in redemption of stock issued by a railroad corporation pursuant to a reorganization plan under section 77 of the Bankruptcy Act gives rise to capital gain, even if under the general redemption distribution tests the stockholder would realize ordinary income (sec. 302(b)(4) of the Code).

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[1] The terms "bankruptcy case" and "similar case" refer, respectively, to (1) cases under new 11 U.S. Code and (2) receivership, foreclosure, or similar proceedings in a Federal or State court (or, in the case of a financial institution, a Federal or State agency).

Reasons for Change

The committee believes that the Federal income tax treatment of redemption of certain railroad corporation stock should be the same as applies in the case of redemption of all other stock.

Explanation of Provision

This provision repeals the special rule giving automatic capital gain treatment in the case of redemptions of certain stock issued by railroad corporations in bankruptcy. This provision is the same as section 5(b) of the House bill.

Effective Date

The amendment made by this provision applies to a redemption of stock issued after December 31, 1980 (other than stock issued pursuant to a plan of reorganization approved on or before that date). Also, the amendment will apply to a bankruptcy or similar case commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election provided by the bill is made (see explanation of effective date election under part II–A of this report).

3. Application of section 337 liquidation rule to corporations in bankruptcy (sec. 5(c) of the bill and sec. 337 of the Code)

Present Law

Under present law, a corporation which adopts a plan of liquidation and within 12 months thereafter liquidates in a distribution to shareholders generally does not recognize gain or loss on sales within that period (sec. 337 of the Code). The Internal Revenue Service has ruled that this provision does not apply if, as in the case of an insolvency proceeding, the assets are transferred on liquidation to creditors rather than to shareholders (Rev. Rul. 56–387, 1956–2 C.B. 189).

Reasons for Change

The committee believes that nonrecognition treatment should be extended to sales of certain assets by liquidating corporations in bankruptcy or similar cases. In addition, inasmuch as insolvency proceedings may last longer than 12 months, the committee believes that the nonrecognition period should likewise be extended to the termination of the case. Because the nonrecognition period thus would extend to termination of the case, the committee believes that, in order to preclude tax-free "churning" of assets, nonrecogntion treatment should not be available on sales of property (other than bulk sales of inventory) acquired after adoption of the liquidation plan.

Explanation of Provision

This provision allows a corporation in a bankruptcy or similar case [2] to sell certain of its assets tax-free where the corporation, after the case commences, adopts a plan of complete liquidation and completes the liquidation before the termination of the case.

The period of nonrecognition begins on the date of adoption (after commencement of the case) of a plan of liquidation and ends on the date the case terminates. It is intended that under the provision, the

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[2] See note 1, *supra*.

liquidating corporation could retain sufficient assets to pay administrative claims following the close of the case. This provision does not apply to assets acquired on or after the date of adopting the liquidation plan, other than to inventory sold in bulk.[3]

Effective Date

The amendment made by this provision applies to bankruptcy cases commencing after December 31, 1980 and to similar cases commencing after that date. Also, the amendment will apply to a bankruptcy or similar case commenced on or after October 1, 1979 (but prior to January 1, 1981) if the special effective date election provided by the bill is made (see explanation of effective date election under part II-A of this report).

4. Estate of individual in bankruptcy as subchapter S shareholder (sec. 5(d) of the bill and sec. 1371 of the Code)

Present Law

Under present law, only individuals, estates, and certain trusts are permitted to be shareholders of subchapter S corporations (sec. 1371 of the Code). Failure to satisfy this rule disqualifies the election of the corporation under subchapter S.

The Internal Revenue Service has ruled that an "estate" for subchapter S purposes includes only the estate of a decedent and not the estate of an individual in bankruptcy (Rev. Rul. 66-266, 1966-2 C.B. 356). Accordingly, the Revenue Service also has ruled that the filing of a voluntary petition in bankruptcy by a shareholder terminates the subchapter S election as of the beginning of the taxable year in which the petition is filed (Rev. Rul. 74-9, 1974-1 C.B. 241). However, the U.S. Tax Court has held that the filing of a petition seeking financial rehabilitation of a debtor under the debt arrangement provisions of the Bankruptcy Act does not create a new entity apart from the debtor and does not cause the termination of a subchapter S election.[4]

Reasons for Change

The committee is concerned that if bankruptcy of an individual shareholder causes termination of a subchapter S election, other shareholders may be adversely affected by an event over which they had no control. The committee believes that the estate of an individual in a bankruptcy case should be permitted to be an eligible shareholder for purposes of the provisions of subchapter S.

Explanation of Provision

Under the bill, the bankruptcy estate of an individual is permitted to be an eligible shareholder in a subchapter S corporation. Thus, a corporation's subchapter S election is not terminated because of commencement of a bankruptcy case involving an individual who is a shareholder in the corporation. In addition, the bankruptcy estate of an individual which owns stock in a corporation can consent to an election under subchapter S made by the corporation after commencement of the bankruptcy case. This provision is the same as section 5(d) in the House bill.

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[3] Only one bulk sale in any case can qualify for this treatment.

[4] *CHM Company*, 68 T.C. 31 (1977).

Effective Date

The amendment made by this provision applies to bankruptcy cases commenced on or after October 1, 1979.

5. Certain transfers to controlled corporations (sec. 5(e) of the bill and sec. 351 of the Code)

Present Law

Under present law, if property is transferred to a corporation controlled by the transferor, no gain or loss is recognized on the transfer (sec. 351 of the Code). For this purpose, property includes (1) indebtedness of the transferee corporation not evidenced by a security [5] and (2) a claim for accrued interest on indebtedness of the transferee corporation.[6]

Reason for Change

The committee believes that creditors holding debt not evidenced by a security who exchange their claims against a debtor corporation for stock of the corporation should recognize gain or loss on the exchange. This treatment will accord with the treatment of these creditors on an exchange under a plan of reorganization.

In addition, the committee believes that a transfer of assets to a corporation by a debtor in a bankruptcy or insolvency proceeding where the stock received is transferred to creditors should be treated in the same manner as if the property had been transferred to the creditors, who then transferred the property to a controlled corporation. This rule is designed to prevent the incorporation by a debtor of high-basis, low-value assets where a transfer of the assets directly to the creditors followed by a transfer by the creditors to a controlled corporation would result in a fair market value basis to the corporation.

Explanation of Provision

Under the provision, transfers to a controlled corporation of indebtedness of the corporation which is not evidenced by a security, or of claims against the corporation for accrued but unpaid interest on indebtedness, are not covered by the nonrecognition rule of section 351 of the Code.

Also, the nonrecognition rule does not apply in the case of a transfer to a controlled corporation of the assets of a debtor in a bankruptcy or similar case [7] to the extent the stock or securities received in exchange for the assets are used to satisfy the indebtedness of the debtor. Accordingly, gain or loss is recognized to the debtor upon the debtor's transfer of assets to the controlled corporation if the stock is then transferred to creditors pursuant to a plan approved in a bankruptcy or similar case. (If less than all the stock is transferred to creditors, a proportionate share of gain or loss is recognized.) Since the basis of the stock received is adjusted for any gain or loss recognized, the amount recognized on the transfer of the stock to the creditors reflects any amount recognized on the incorporation transfer.

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[5] *Alexander F. Duncan*, 9 T.C. 468 (1947), acq. 1948-2 C.B. 2; Rev. Rul. 77-81, 1977-1 C.B. 97.

[6] See *Carman* v. *Comm'r.*, 189 F.2d 363 (2d Cir. 1951).

[7] See note 1. *supra*.

Thus, the sum total of income or loss to the debtor in the two transfers is the same as if the assets had been transferred directly to the creditors. However, the basis of the assets in the hands of the corporation also is adjusted by any gain or loss recognized on the transfer to the corporation, thus reducing any "built-in" loss on assets which had depreciated in value.[8]

This provision is the same as section 5(e) of the House bill.

Effective Date

The effective date for this provision is the same as for section 2 of the bill, relating to income from discharge of indebtedness.

6. Effect of discharge of indebtedness on earnings and profits (sec. 5(f) of the bill and sec. 312 of the Code)

Present Law

Under present law, the effect of discharge of indebtedness on the earnings and profits of a corporation in a bankruptcy proceeding is unclear.[9]

Reason for Change

The committee believes that income from discharge of indebtedness should increase earnings and profits whether or not current tax is imposed on that income. The bankruptcy considerations underlying deferral of recognition of such income by a debtor in a bankruptcy case do not justify extending tax forgiveness to shareholders receiving nonliquidating distributions from the corporation. Also, the committee believes that a corporation's deficit in earnings and profits should be reduced by the amount of the paid-in capital of any stockholder whose interest is extinguished in a bankruptcy or similar case, since it represents no part of the stock of the creditors who become the owners of the corporation.

Explanation of Provision

The bill provides that to the extent that income from discharge of indebtedness (including an amount excluded from gross income pursuant to section 108 of the Code, as amended by this bill) is applied to reduce basis under section 1017 of the Code, such basis-reduction amount does not affect the debtor corporation's earnings and profits (although reduced depreciation deductions or increased gains on sales of reduced-basis assets would affect earnings and profits in the years such deductions are taken or sales made). Otherwise, discharge of indebtedness income, including amounts excluded from gross income (pursuant to section 108 of the Code, as amended by this bill), increases the earnings and profits of the corporation (or reduces a deficit).

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[8] This rule does not apply to a transfer under a plan of reorganization, since no gain or loss is recognized by reason of section 361 of the Code.

[9] In the case of *Meyer* v. *Comm'r*, 383 F.2d 883 (8th Cir. 1967), the Eighth Circuit held that earnings and profits did not arise where indebtedness was discharged under the Bankruptcy Act. The Internal Revenue Service has announced that it will not follow the *Meyer* decision to the extent that the amount of debt discharged exceeds the reduction in basis of the taxpayer's assets (Rev. Rul. 75-515, 1975-2 C.B. 117).

In addition, the committee bill provides that any deficit in earnings and profits is reduced (but positive earnings and profits will not be created) by the paid-in capital of any shareholder whose interest is eliminated in a bankruptcy or similar case.

Effective Date

The effective date for this provision is the same as for section 2 of the bill, relating to income from discharge of indebtedness.

E. Changes in Tax Procedures (sec. 6 of the bill)

1. Coordination with bankruptcy court procedures (secs. 6(a), (b), (c), (d), and (g) of the bill and secs. 6213, 6503, 6871, and 7464 of the Code)

Procedures Under Bankruptcy Act

Bankruptcy court jurisdiction

In the case of an individual debtor, the commencement of a bankruptcy proceeding creates an estate. This estate, which is under control of the bankruptcy court, consists of all assets of the individual other than exempt property and certain assets acquired after the proceeding begins. The assets of the bankruptcy estate are not subject to levy by the Internal Revenue Service for the debtor's prepetition income tax liabilities, and generally can be reached only through the Service's filing of a proof of claim in the bankruptcy court.

The bankruptcy court has jurisdiction to determine the debtor's liability for any unpaid tax, whether or not assessed, unless the liability was adjudicated prior to bankruptcy by a court of competent jurisdiction (sec. 2a(2A) of the Bankruptcy Act). In proceedings under the Bankruptcy Act,[1] a determination by the bankruptcy court of a prepetition tax liability of an individual debtor is binding on the Internal Revenue Service and on the trustee of the bankruptcy estate. However, the determination might not settle the personal liability of an individual debtor for the amount, if any, of prepetition nondischargeable tax claims which are not satisfied out of the assets of the bankruptcy estate. Accordingly, if the bankruptcy court rules in favor of the Revenue Service with respect to a nondischargeable tax claim, the debtor may be able to force the Service to relitigate the issue if the claim cannot be fully paid out of estate assets.

Effect on Tax Court jurisdiction

Under present Federal income tax law (sec. 6871 of the Code) as applicable to Bankruptcy Act proceedings, the Internal Revenue Service is authorized, on institution of a bankruptcy proceeding, immediately to assess any income tax liabilities against the debtor. The Service is not required to follow the normal procedure under which a deficiency notice is issued to the taxpayer and the taxpayer may challenge an asserted income tax liability in the U.S. Tax Court without payment of the tax.

Even if a statutory deficiency notice had been issued and the time for filing a Tax Court petition had not expired before commencement of the bankruptcy proceeding, the debtor still is barred from contest-

[1] The Bankruptcy Act was repealed by P.L. 95-598, effective for bankruptcy cases commencing on or after October 1, 1979, but remains in effect for bankruptcy proceedings commenced prior to that date.

ing the asserted liability in the Tax Court (i.e., from litigating without first paying the disputed amount) if the Revenue Service exercises its immediate assessment authority. Present income tax law likewise provides that any portion of a claim for nondischargeable taxes allowed in a bankruptcy proceeding but not satisfied out of assets in the estate shall be paid by the taxpayer after termination of the bankruptcy proceeding (sec. 6873 of the Code).

Under the law applicable to Bankruptcy Act proceedings, the U.S. Tax Court thus loses jurisdiction to determine the debtor's personal liability for prepetition taxes unless a Tax Court case had been filed prior to the bankruptcy proceeding. Accordingly, unless the debtor can invoke the jurisdiction of the bankruptcy court and that court makes a determination, the debtor is precluded from prepayment review of an asserted income tax liability. The debtor's only recourse is to pay the tax and then contest the issue through the refund claim procedure of the Internal Revenue Service and subsequent refund litigation in the U.S. District Court or U.S. Court of Claims.

If a notice of deficiency had been issued and a Tax Court case filed prior to institution of the bankruptcy proceeding, but the Tax Court had not reached a decision as to the debtor's income tax liability, both the bankruptcy court and the Tax Court have jurisdiction to determine the tax liability issue. A decision by the Tax Court would not necessarily bind the estate of the bankrupt, unless the trustee had intervened in the Tax Court litigation. A decision by the bankruptcy court might not necessarily bind the individual debtor, unless the debtor individually had invoked the bankruptcy court's jurisdiction.

Thus, under the law applicable to Bankruptcy Act proceedings, in certain circumstances there may be duplicative litigation concerning the debtor's tax liability. In other circumstances, the debtor may be precluded from obtaining prepayment review of prepetition tax liabilities.

New Bankruptcy Statute (P.L. 95–598)

New 11 U.S. Code section 505(a) continues the jurisdiction of the bankruptcy court to determine liability for a tax deficiency, regardless of whether it has been assessed, unless it has been adjudicated by a court of competent jurisdiction prior to filing of the bankruptcy petition.[2] The new law, effective for bankruptcy cases commenced on or after October 1, 1979, also seeks to resolve the problems mentioned above by giving the bankruptcy court, in effect, the authority to determine whether the tax liability issue should be decided in the bankruptcy court or in the U.S. Tax Court.

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[2] Under the law applicable to Bankruptcy Act proceedings, the trustee of a bankruptcy estate must proceed in courts other than the bankruptcy court to seek a refund of Federal taxes paid by the debtor. While the trustee succeeds to any right to refund for tax overpayments, the bankruptcy court has jurisdiction only to allow claims against the bankruptcy estate, and not to enforce claims against third parties.

New 11 U.S. Code sec. 505(a) expands the jurisdiction of the bankruptcy court to include determination of refund claims. To invoke the bankruptcy court's jurisdiction, the trustee must file an administrative claim for refund with the Internal Revenue Service (if the debtor had not done so prior to commencement of the bankruptcy case). If a claim filed by the trustee is denied or if 120 days elapse without action by the Internal Revenue Service, the court has jurisdiction to determine the refund issue.

Under new 11 U.S. Code section 362(a)(8), commencement of a bankruptcy case triggers an automatic stay of institution or continuation of any U.S. Tax Court proceedings to challenge an asserted tax deficiency of the debtor. Also under the new law, in order to maintain orderly judicial proceedings in any situation where a controversy might arise between a taxpayer and the Internal Revenue Service, assessment or collection of a prepetition tax claim against the debtor is automatically stayed by commencement of the bankruptcy case (sec. 362(a)(6)).[3] Unless the stay is lifted by the bankruptcy court, or a discharge is granted or denied, the stay continues until termination of the bankruptcy case (sec. 362(c)).

The new statute authorizes the bankruptcy judge to lift the stay and permit the debtor to institute a Tax Court case (if a notice of deficiency has been issued and the period for filing such case has not expired) or to continue a pending Tax Court case involving the debtor's tax liability (new 11 U.S. Code sec. 362(d)). The bankruptcy court, for example, could lift the stay if the debtor seeks to litigate in the Tax Court and the trustee wishes to intervene in that proceeding. In such a case, the merits of the tax controversy will be determined by the Tax Court, and the Tax Court's decision will bind both the individual debtor as to any taxes which are nondischargeable and the intervenor trustee as to the tax claim against the estate.

However, if the bankruptcy court does not lift the automatic stay, but instead itself decides the tax issue and (at the request of the Revenue Service or of the debtor) determines the debtor's personal liability for a nondischargeable tax, then the bankruptcy court's decision will bind both the individual debtor and the estate as well as the government.[4]

Reasons for Change

The committee believes that the provisions of the Internal Revenue Code relating to assessment and collection procedures should be coordinated with rules enacted in the new bankruptcy statute (P.L. 95-598) for determination of tax liabilities in bankruptcy cases.

Explanation of Provisions

Sections 6(a), 6(b), 6(c), 6(d), and 6(g) of the bill coordinate certain provisions of the Internal Revenue Code with the bankruptcy court procedures enacted in P.L. 95-598, as described above. These procedures include the automatic stay on assessment or collection of

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[3] The stay does not preclude the Internal Revenue Service from issuing a deficiency notice during the bankruptcy case (new 11 U.S. Code sec. 362(b)(8)).

[4] 124 Cong. Rec. H-11,111 (daily ed. Sept. 28, 1978) (remarks of Mr. Edwards); 124 Cong. Rec. S-17,427 (daily ed. Oct. 6, 1978) (remarks of Sen. DeConcini). In the case of a corporate debtor, the commencement of a bankruptcy proceeding does not create a separate taxable entity, and (unlike in the case of an individual debtor) the debtor corporation is considered to be personally before the bankruptcy court. Accordingly, a decision by the bankruptcy court as to the corporate debtor's prepetition income tax liability is binding on the corporation, which cannot thereafter institute a Tax Court case to relitigate the issue. However, under P.L. 95-598. the bankruptcy judge is authorized to lift the automatic stay under new 11 U.S. Code sec. 362 and permit the tax issue to be determined in the U.S. Tax Court (if a case involving the issue is already pending in that Court, or if a deficiency notice has been issued and the period for filing such case has not expired).

certain tax claims against the debtor, the automatic stay on institution or continuation by the debtor of deficiency litigation in the U.S. Tax Court, and the authority of the bankruptcy court to lift the stay and permit the debtor's tax liability to be determined by the Tax Court. These provisions are the same as the corresponding sections of the House bill.

Immediate assessment

General rule

Section 6(g) of the bill generally repeals the present rule (in sec. 6871(a) of the Code) authorizing the Internal Revenue Service to assess certain prepetition tax deficiencies of the debtor immediately on institution of bankruptcy proceedings. Accordingly, if the bankruptcy court lifts the automatic stay under new 11 U.S. Code section 362(a)(8), the debtor is not precluded from filing a petition (if timely) in the Tax Court to challenge an asserted prebankruptcy tax deficiency.

Exceptions

The bill authorizes the Revenue Service to make an immediate assessment (1) of tax imposed on the bankruptcy estate of an individual debtor, or (2) of tax imposed on a debtor if liability for such tax has become res judicata against the debtor pursuant to a bankruptcy court determination.

These two exceptions reflect bankruptcy situations in which there is no need to require the Revenue Service to follow the normal deficiency notice procedure. In the case of taxes imposed on the bankruptcy estate of an individual (i.e., where the estate is treated as a separate taxable entity), the estate's own tax liability is determined by the bankruptcy court and cannot be litigated in the Tax Court. In the case where an individual debtor's personal liability for nondischargeable tax claims has been litigated in the bankruptcy court, and under the doctrine of res judicata the debtor would be precluded from relitigating the issue in any court, no purpose would be served by requiring issuance of a deficiency notice prior to assessment. For the same reason, the bill permits immediate assessment of a corporate debtor's tax liabilities once the bankruptcy court has made a determination which is res judicata.

Conforming rules

The bill also amends section 6871 of the Code to delete the prohibition in current law on filing a Tax Court petition after commencement of a bankruptcy proceeding. This change likewise conforms to the provisions of P.L. 95–598 which stay the debtor, on commencement of a bankruptcy case, from instituting a Tax Court proceeding to challenge an asserted tax deficiency, but authorize the bankruptcy judge to lift the stay and permit the debtor to institute a Tax Court case (if a notice of deficiency has been issued and the period for filing such case has not expired). Also, the bill restates the rule of present law that claims for certain tax deficiencies, etc. may be presented for adjudication before the bankruptcy court, notwithstanding the pendency of any Tax Court proceedings for redetermination of the deficiency.

Receiverships

The bill does not modify the present law rules in section 6871 of the Code relating to receivership proceedings. To the extent immediate assessment authority is retained for receivership proceedings, and for the two bankruptcy situations described above, the bill expands the category of taxes which could be so assessed to include taxes under Internal Revenue Code chapters 41 (public charities), 42 (private foundations and black lung benefit trusts), 43 (qualified pension, etc., plans), 44 (real estate investment trusts), and 45 (windfall profit tax).

Collection

Section 6(g) of the bill amends section 6873(a) of the Code to delete the rule that any portion of a claim for nondischargeable taxes allowed in a bankruptcy case but not satisfied out of assets in the estate must be paid by the taxpayer upon notice and demand by the Internal Revenue Service after termination of the bankruptcy case. (No change is made in section 6873 with respect to payment of claims for taxes allowed in a receivership proceeding.) As described above, if the bankruptcy court has made a determination of the debtor's tax liability which (under the doctrine of res judicata) precludes the debtor from relitigating the issue in any other court, the Revenue Service can make an immediate assessment of such liability without issuing a deficiency notice. Thereafter, the provisions of the Code relating to collection of assessed taxes apply.

Tax Court petition

Section 6(b) of the bill provides that if the stay under new 11 U.S. Code section 362(a)(8) precludes a debtor from filing a petition in the U.S. Tax Court after receipt of a deficiency notice, the running of the normal 90-day period for filing the petition is suspended during the stay and for 60 days thereafter. Also, the bill clarifies that the filing of a proof of claim, the filing of request for payment, or other action taken by the Internal Revenue Service in the bankruptcy case (such as a request that the court determine the personal liability of an individual debtor for a nondischargeable tax) is not to be treated as prohibited under section 6213(a) of the Code (relating to certain restrictions generally applicable to assessment of a tax deficiency).

Tax Court intervention

Section 6(c) of the bill provides that the trustee of the bankruptcy estate of a debtor may intervene, as a matter of right, on behalf of the estate in any proceeding before the U.S. Tax Court to which the debtor is a party. This provision applies where the bankruptcy judge lifts the automatic stay under new 11 U.S. Code section 362 so that the debtor's prepetition tax liability can be determined in the Tax Court.

Assessment and collection limitations

Section 6(a) of the bill provides that if the automatic stay under the Internal Revenue Service is prohibited for a period of time by reason of a bankruptcy case from assessment or collection of tax (for example, because of the automatic stay under new 11 U.S. Code sec. 362(a)(6)), the running of the period of limitations is suspended, for assessment, for the prohibition period and for 60 days thereafter; and for collection, for the prohibition period and for six months thereafter.

Cross references

Section 6(d) of the bill adds cross references in sections 6212, 6512, 6532, and 7430 of the Code to new 11 U.S. Code section 505 (relating to jurisdiction of the bankruptcy court).

2. Relief from certain failures to pay tax when due (sec. 6(e) of the bill and new sec. 6658 of the Code)

Present Law

The Internal Revenue Code (secs. 6651, 6654, and 6655) imposes penalties for failure timely to pay certain taxes, unless the taxpayer can establish that the failure was due to reasonable cause and not due to willful neglect. Under bankruptcy rules, a debtor or the trustee of a bankruptcy estate may be precluded from timely paying certain taxes after commencement of the bankruptcy proceedings.

Reasons for Change

The committee believes that penalties should not be imposed for failure timely to pay certain taxes to the extent that bankruptcy proceedings preclude payment of such taxes when due.

Explanation of Provision

Section 6(e) of the bill relieves the debtor or the trustee from penalties which otherwise might be applicable under sections 6651, 6654, or 6655 of the Code for failure timely to pay certain taxes, with respect to a period during which a bankruptcy case is pending, to the extent that the bankruptcy case precludes payment of such taxes when due.[5] This provision is the same as section 6(e) of the House bill.

In the case of a tax incurred by the estate, the relief is granted if the failure occurs pursuant to a court order finding probable insufficiency of funds to pay such taxes. In the case of a tax incurred by the debtor before commencement of the bankruptcy case, the relief provision of the bill applies if either the bankruptcy petition is filed before the tax return due date, or the date for imposing the penalty occurs after commencement of the bankruptcy case.

These relief rules do not, however, apply with respect to liability for penalties for failure timely to pay or deposit any employment tax required to be withheld by the debtor or trustee.

3. Preservation of FUTA credit (sec. 6(f) of the bill and sec. 3302 of the Code)

Present Law

Present law provides a credit against the Federal unemployment tax imposed on an employer for amounts paid by the employer into a State unemployment compensation fund (sec. 3302 of the Internal Revenue Code). A reduction in the otherwise allowable credit is re-

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[5] No inference is intended, by virtue of adoption of the rules in section 6(e) of the bill, that under present law such penalties should be imposed where a debtor or the trustee of a bankrupty estate is precluded from timely paying such taxes by virtue of bankruptcy proceedings.

quired in the case of late contributions to a State fund (sec. 3302(a)(3) of the Code).

Reasons for Change

The committee believes that if because of the pendency of bankruptcy proceedings, the trustee of a bankruptcy estate is precluded from making timely payment of contributions to a State unemployment compensation fund, it is not appropriate to require a reduction in the credit against the Federal unemployment tax.

Explanation of Provision

Section 6(f) of the bill amends section 3302(a) of the Code to provide that there is no reduction in the credit against the FUTA tax if the failure to make timely contributions to a State unemployment compensation fund, with respect to wages paid by the trustee of a bankruptcy estate, is without fault of the trustee on account of the bankruptcy case. This provision is the same as section 6(f) of the House bill.

4. Repeal of deadwood provision (sec. 6(h) of the bill and sec. 1018 of the Code)

Present Law

Section 1018 of the Internal Revenue Code provides certain basis adjustment rules which apply if, in a bankruptcy proceeding under section 77B of the Bankruptcy Act which concluded before September 22, 1938, indebtedness was cancelled in pursuance of a plan of reorganization consummated by adjustment of the capital or debt structure of the insolvent corporation.

Reasons for Change

The committee believes that inasmuch as section 1018 of the Code applies only with respect to certain bankruptcy proceedings concluded before September 22, 1938, that provision should be deleted from the statute as deadwood.

Explanation of Provision

Section 6(h) of the bill repeals section 1018 of the Internal Revenue Code. This provision is the same as section 6(h) of the House bill.

5. Technical and conforming amendments (sec. 6(i) of the bill)

Section 6(i) of the bill makes technical and conforming amendments to the Internal Revenue Code, principally to substitute references to bankruptcy cases under new title 11 of the U.S. Code for references to bankruptcy proceedings under the now-repealed Bankruptcy Act.

1. Amendment of section 128(a).—In section 128(a) of the Code, relating to cross references to other Acts, the reference to the Bankruptcy Act is deleted.

2. Amendment of section 354(c).—Section 354(c) of the Code, relating to exchanges of stock and securities in certain railroad reorganizations, is amended to substitute a reference to plans of reorganization confirmed under new 11 U.S. Code section 1173, for a reference to plans approved by the Interstate Commerce Commission under section 77 of the Bankruptcy Act.

3. Amendment of section 422(c).—Section 422(c)(5) of the Code, relating to certain transfers by insolvent individuals of stock acquired pursuant to exercise of a qualified stock option, is amended by substituting a reference to new 11 U.S. Code for a reference to the Bankruptcy Act.

4. *Amendment of section 1023.*—Section 1023 of the Code, relating to cross references, is amended by deleting a cross reference to the Bankruptcy Act.

5. *Amendment of section 6012(b).*—Section 6012(b)(3) of the Code, relating to returns made by receivers, trustees, and assignees for corporations, is amended by substituting a reference to a trustee in a bankruptcy case under new 11 U.S. Code for a reference to a trustee in a bankruptcy proceeding (under the Bankruptcy Act).

6. *Amendment of section 6036.*—Section 6036 of the Code, relating to notice of qualification as executor or receiver, is amended by substituting a reference to a trustee in a bankruptcy case under new 11 U.S. Code for a reference to a trustee in a bankruptcy proceeding (under the Bankruptcy Act).

7. *Amendment of section 6155(b).*—Section 6155(b)(2) of the Code, relating to cross references, is amended by deleting the reference to section 6873 of the Code with respect to bankruptcy proceedings (under the Bankruptcy Act).

8. *Amendment of section 6161(c).*—Section 6161(c) of the Code, relating to extension of time for payment of tax claims in bankruptcy or receivership proceedings, is amended by substituting references to bankruptcy cases under new 11 U.S. Code for references to bankruptcy proceedings (under the Bankruptcy Act.)

9. *Amendment of section 6216(1).*—Section 6216(1), relating to cross references, is amended by deleting a reference to subchapter B of chapter 70 of the Code with respect to bankruptcy procedures.

10. *Amendment of section 6326.*—Section 6326 of the Code, relating to cross references, is amended by deleting references to the Bankruptcy Act and adding references to new 11 U.S. Code.

11. *Amendment of section 6503(i).*—Section 6503(i)(2), relating to cross references, is amended by deleting a reference to subchapter C of chapter 70 of the Code with respect to suspension of running of period of limitation in a bankruptcy proceeding (under the Bankruptcy Act).

12. *Amendment of section 6872.*—Section 6872 of the Code, relating to suspension of period on assessment, is amended by substituting a reference to a bankruptcy case under new 11 U.S. Code for a reference to a bankruptcy proceeding under the Bankruptcy Act.

13. *Amendment of section 7430.*—Section 7430 of the Code, relating to cross references, is amended by deleting references to the Bankruptcy Act and adding references to new 11 U.S. Code.

14. *Amendment of section 7508(d).*—Section 7508(d)(1) of the Code, relating to time for performing certain acts postponed by reason of service in combat zone, is amended by substituting a reference to bankruptcy cases under new 11 U.S. Code for a reference to bankruptcy proceedings (under the Bankruptcy Act).

6. Effective date for provisions of section 6 of the bill

The provisions of section 6 of the bill (relating to changes in tax procedures) are effective October 1, 1979, except that such provisions do not apply to any Bankruptcy Act proceeding commenced before October 1, 1979.

III. EFFECT OF THE BILL ON THE BUDGET AND VOTE OF THE COMMITTEE IN REPORTING THE BILL AS AMENDED

Budget Effect

In compliance with paragraph 11(a) of Rule XXVI of the Standing Rules of the Senate, the following statement is made about the effect on the budget of this bill, H.R. 5043, as amended.

The revenue effect of the provisions of the bill, other than of those provisions of section 2 (tax treatment of discharge of indebtedness) which apply to solvent taxpayers outside bankruptcy, cannot be estimated with precision. However, it is estimated that the provisions of section 2 other than those applicable to solvent taxpayers outside bankruptcy will result in some revenue gain; that the provisions of section 3 (rules relating to title 11 cases for individuals) and of section 6 (changes in tax procedures) will have a negligible revenue effect; and that the provisions of section 4 and 5 (corporate reorganization provisions and miscellaneous corporate amendments) will result in some revenue loss.

It is not expected that these revenue effects will be significant during the next few fiscal years. This is because the provisions of the bill generally apply only to bankruptcy cases or similar court proceedings beginning after December 31, 1980, to transactions occurring more than 90 days after the date of enactment, or to transactions occurring after December 31, 1980; because it can take considerable time for completion of bankruptcy cases or similar proceedings and of corporate insolvency reorganizations; and because the debt discharge rules of the bill generally will affect revenues in years subsequent to the year in which the debt discharge occurs.

It is estimated that those provisions of section 2 of the bill which apply to solvent taxpayers outside bankruptcy, and which modify the election under sections 108 and 1017 of the Code to reduce basis of assets in lieu of recognizing income from discharge of indebtedness, will increase tax revenues by less than $5 million annually.

The Treasury Department agrees with this statement.

New Budget Authority and Tax Expenditures

In accordance with section 308 of the Budget Act, after consultation with the Director of the Congressional Budget Office, the committee states that the changes made to existing law by this bill involve no new or increased budget authority or new or increased tax expenditures.

Consultation with Congressional Budget Office on Budget Estimates

In accordance with section 403 of the Budget Act, the committee advises that the Director of the Congressional Budget Office has examined the committee's budget estimates (as indicated above) and agrees with the methodology used and the resulting revenue estimates.

Vote of the Committee

In compliance with paragraph 7(c) of Rule XXVI of the Standing Rules of the Senate, the following statement is made about the vote of the committee on the motion to report the bill, as amended. The bill, H.R. 5043, as amended, was ordered favorably reported by voice vote.

IV. REGULATORY IMPACT OF THE BILL

In compliance with paragraph 11(b) of Rule XXVI of the Standing Rules of the Senate, the following statement is made regarding the provisions of this bill, H.R. 5043, as reported by the committee.

Individuals and businesses regulated and economic impact of regulation.—The bill does not regulate any individuals or businesses, but modifies certain provisions of the tax law principally relating to the treatment of discharge of indebtedness (inside and outside bankruptcy), insolvency reorganizations, the bankruptcy estate of an individual debtor, and tax assessment and collection procedures in bankruptcy cases.

Impact on personal privacy.—The provisions of the bill will have minimal impact on personal privacy.

Determination of paperwork involved.—The provisions of the bill will have minimal impact on paperwork.

V. CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In the opinion of the committee, it is necessary, in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of Rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill, H.R. 5043, as reported by the committee).