RRA '93 Hastens Death Knell for Bankrupt Corporations

by Robert Wood • San Francisco

The just-passed, long-debated repeal of the stock-for-debt exception to cancellation of debt ("COD") income is seen by many as another nail in the coffin of bankrupt companies. While a taxpayer's gross income includes COD income, if a debtor corporation is in a bankruptcy case or is insolvent and issues stock in exchange for debt, it previously could qualify for the stock-for-debt exception and avoid recognizing the COD income. This favorable rule, Section 108(e)(10), was repealed by Revenue Reconciliation Act of 1993 ("RRA '93") Section 13226(a)(1)(A).

The repeal is not retroactive; it applies to stock transferred in satisfaction of debt after 1994. Moreover, it does not apply to stock transferred in a Title 11 or similar case filed before 1994. Given the predominance of stock-for-debt swaps in bankruptcy cases, the removal of this favorable rule may well be damaging to many reorganization efforts.

However, the elimination of the stock-for-debt exception does not require immediate income recognition in such a case. Rather, it requires a reduction in the debtor company's tax attributes, as would be consistent with the treatment of other COD income items in the bankruptcy. Of course, the loss or reduction in the debtor company's NOL and/or other tax attributes may make the entity less likely to successfully emerge from the bankruptcy proceeding and be rehabilitated thereafter.

Section 382(l)(5) has also been amended to conform to this change. If Section 382(l)(5) applies (*i.e.*, the old loss corporation is insolvent or bankrupt and its shareholders and qualified creditors own at least half of the stock of the new corporation), stock-for-debt gain recognition under Section 108(e)(8) will not apply to stock issued to reduce interest payments to creditors becoming shareholders under Section 382(l)(5)(B).

The new law gives the IRS authority to promulgate regulations coordinating the repeal of the stock-for-debt exception with the rules under which a corporation acquiring its own debt from a shareholder as a contribution to capital cannot exclude the debt forgiveness from income under Section 118, but is treated as paying the debt with an amount of money equal to the shareholder's adjusted basis in the debt.

More Tax Attributes to Reduce

RRA '93 also adds a pair of items to the list of tax attributes that must be reduced when a taxpayer's discharge of indebtedness is excludable from income under Section 108. The list previously included NOLs, general business credit carryovers, net capital losses and capital loss carryovers, the basis of certain depreciable property, and foreign tax credit carryovers. Now, two more items must be added: (1) minimum tax credits as of the beginning of the tax year immediately after the tax year of the discharge (to be reduced before net capital losses and capital loss carryovers); and (2) passive activity loss and credit carryovers from the tax year of the discharge (to be reduced before foreign tax credit carryovers).

Section 382(l)(5)

Meanwhile, in recent hearings on the proposed Section 382(l)(5) regulations, taxpayers argued that the proposed regulations should be made electively retroactive (see "Section 382(l)(5) Prop. Regs. Broaden Relief," p. 8, this issue). These proposed regulations were issued in May, and replace proposed regulations issued in September 1991. As written, they are to apply prospectively, and will take effect only for ownership changes occurring after the date the regulations are finalized.

This set of proposed regulations would make it easier for corporations to qualify for the exemption from NOL restrictions offered by Section 382(l)(5), giving rise to a debate about applying the regulations retroactively.

Requisite Holding Period Presumed

In contrast to the 1991 proposed regulations, the new ones add a *de minimis* rule that presumes that all former creditors that end up with less

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than 5% of the stock of the post-bankruptcy corporation will meet the 18-month holding period requirement. To qualify for Section 382(l)(5), shareholders or "qualified creditors" of the old loss corporation must own 50% or more of the stock of the corporation after the bankruptcy. A creditor is a "qualified creditor" only if the creditor acquired its debt in the ordinary course of the business of the bankrupt company, or if the creditor held the debt for at least 18 months before the bankruptcy petition was filed. Thus, the *de minimis* rule contained in the proposed regulations is decidedly favorable.

For this reason, commentators hope the IRS will allow taxpayers to elect to apply the new rules retroactively. Aside from the technical question of whether the *de minimis* rule is an interpretive or legislative regulation, the debate over effective dates focuses on the reasonable expectations of taxpayers who elected treatment under Section 382(l)(6) (thus electing out of Section 382(l)(5)), versus those who may have hoped that they satisfied the conditions of Section 382(l)(5) but may not have tracked down all debt holders to ensure compliance with the 18-month requirement.

The IRS position has been, and presumably will continue to be, that it should not disturb the positions of taxpayers who did not count on the *de minimis* rule, and who elected out of Section 382(l)(5) because they assumed they did not qualify. However, the 1991 proposed regulations did permit retroactive application if the taxpayer applied for it in a letter ruling. While this earlier set of proposed regulations did not include the *de minimis* rule, it is arguable that some retroactive treatment should be available under the revised proposed regulations.

How Do You Spell Relief?

The question of just how important Section 382(l)(5) really is can be debated. But the fact remains that it offers a way to avoid the draconian reach of Section 382. (For a recent analysis, see Levere, "Net Operating Losses Subject To Section 382 May Be Available Without Restriction in Certain Cases," 60 *Tax Notes* 3, 7/19/93, p. 349.) ■