Regarding the Advisability of a Prohibition on the Taxable Asset Sale to Creditors in Bankruptcy

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I. Introduction

Just over five years ago, the Service issued a Chief Counsel Advisory memo—CCA 2003-50-016 (CCA)—approving a reorganization transaction between a debtor corporation (Debtor) in Chapter 11 and its creditors.[1] The parties structured the transaction as a taxable sale of the Debtor's assets to its creditors, seeking to avoid application of the tax-free reorganization provisions.[2] Through a relatively complex series of transactions, the Debtor effectively transferred substantially all of its assets in return for cancellation of indebtedness and cash, retaining a small portion of presumably leasable or licensable assets. Because the IRS Chief Counsel's Office concluded that the transaction

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[1] C.C.A. 2003-50-016 (Aug. 28, 2003).

[2] The Debtor's attempt to avoid the Service's application of the provisions governing tax-free reorganizations, Code sections 354, 355, 356, and 368, is a role reversal of the normal positions. *Cf.* Intermountain Lumber Co. v. Commissioner, 65 T.C. 1025 (1976) (finding—in a ruling for a corporate taxpayer who had purchased the shares of the corporation at issue in the case—that an exchange of depreciable assets from the incorporators of a corporation for stock of the corporation did not fall within the provision governing tax-free contributions, section 351(a), because the original incorporator was under a binding obligation to sell the shares received to another shareholder, thus failing the "in control immediately after the exchange" requirement of section 351(a)).

did not fall within the definition of the reorganization provisions[3] that govern tax-free reorganizations,[4] the creditors were able to obtain a fair market value basis in the assets.[5] And because the Debtor was in a title 11 case, it did not recognize ordinary income on the cancellation of indebtedness.[6] Finally, because it had transferred substantially all of its depreciable assets to its creditors, the cancellation of indebtedness income (COD income) excluded under section 108 did not reduce the basis in any of those assets,[7] instead reducing only whatever available net operating losses (NOLs) the Debtor had left over after the asset transfer to its creditors.

Going forward, the CCA permits a significant tax ploy for Debtors in bankruptcy—at a potentially significant cost to the public fisc—assuming that certain characteristics of the reorganizing Debtor are present.[8] First, the

[3] *See* I.R.C. § 368(a)(1)(G) (defining as a "reorganization" a "transfer by a corporation of all or part of its assets to another corporation in a title 11 . . . case . . . if . . . stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, 356"). Thus, for bankruptcy cases, if the Debtor transfers its assets to another corporation and securities of that corporation are then exchanged—presumably for stock or securities in the Debtor—and if one of the tax-free provisions (sections 354, 355, or 355) applies, the transaction will constitute a "reorganization." For its part, section 354 exempts from gain or loss treatment, exchanges of "stock or securities in a corporation a party to a reorganization" if they are "exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization." I.R.C. § 354(a)(1). Section 354 can be considered the "substantially all" provision. For bankruptcy reorganizations and for D Reorganizations, sections 368(a)(1)(D) and 354(a) will not apply to the transaction unless "the corporation to which the assets are transferred acquires *substantially all* of the assets of the transferor" and the transferor liquidates. I.R.C. § 354(b)(1) (emphasis added). In contrast, section 355 can be seen as the spin-off to a controlled corporation provision. Section 355 treats as tax-free, distributions to shareholders with respect to its stock or security holders in exchange for their securities, consisting "solely [of] stock or securities of a corporation . . . which [the distributing corporation] controls immediately before the distribution" I.R.C. § 355(a)(1). Section 355 is primarily used for spin-offs. Section 356 is a boot relaxation provision that treats as tax-free transactions that would have met the section 354 or 355 requirements "but for the fact that" boot is received as well. I.R.C. § 356(a)(1). Thus, in a G Reorganization, as long as one stock or security of the distributing corporation is exchanged for one stock or security of the acquiring person(s), the transaction will qualify under section 368. Any boot received will of course be treated as gain. I.R.C. § 356 (flush language).

[4] *See* I.R.C. § 361(a)–(c) (permitting nonrecognition of gain for transferor corporations if the corporation exchanges property in exchange for stock or securities of the transferee or distributes certain property—generally, stock in the transferor or transferee corporation).

[5] In the case of a transfer of property to a corporation "in connection with a reorganization" to which the section 368 reorganization provisions apply, "the basis shall be the same as it would be in the hands of the transferor, increased by the amount of gain recognized by the transferor on such transfer." I.R.C. § 362(b). In the CCA transaction, however, this transferred basis is precisely what the parties are seeking to avoid.

[6] *See* I.R.C. § 108(a)(1)(B).

[7] *See* I.R.C. § 108(b).

[8] *See* Christopher Woll, *Post Bruno's Bankruptcy Planning: An Analysis of Taxable Emergence Structures*, 4 DePaul Bus. & Com. L.J. 277, 281 (2006) ("[T]here are two essential characteristics" that a Debtor should have "for a taxable emergence [from bankruptcy] to be beneficial.").

fair market value of the bankrupt corporation's assets should exceed the assets' tax bases.[9] Second, the debtor corporation should be at risk of losing whatever asset basis tax attributes it has as a result of application of section 108(b).[10] If the Debtor anticipates realization of COD income equal to or in excess of its non-asset basis tax attributes, it will not recognize gain on the COD income if it undertakes a taxable transaction by transferring its assets to a new corporation.[11] And if it preserves the basis in its assets by "selling" the assets to its creditors (who then receive a "step-up" in the basis of the assets), the creditors will then have the ability to take depreciation deductions on those assets in later years. It is in this not uncommon situation that the CCA's holding is beneficial to the debtor and its creditors.

The CCA garnered attention in the tax press,[12] was followed by a subsequent law review article,[13] and has not attracted any further attention or commentary from the Service. The transaction has come to be known as a "Bruno's sale" or "Bruno's transaction," presumably due to its first use having been attributed to the Bruno's reorganization,[14] and generally occupies a few pages in treatise and handbook chapters on corporate restructurings and tax attribute preservation (the remainder of this Article will use both the terms "CCA" and "Bruno's" to refer to the transaction at issue).[15]

One treatise, after noting the use of the transaction in the Bruno's reorganization and its subsequent approval by the Service, had this to say: "While it is true that the recent Chief Counsel Advice discussed above did sanction the use of a Bruno's transaction, it is unclear whether the IRS will continue to bless Bruno's transactions in the future or whether it will consider this type

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[9] *Id.*

[10] *Id.* at 282. Section 108 reduces the tax attributes of a debtor corporation to the extent of COD income received. I.R.C. § 108(b)(1). The reduction of tax attributes is applied in the following order: (1) net operating losses, (2) general business credits, (3) minimum tax credits, (4) capital loss carryovers, (5) basis reduction of depreciable assets, (6) passive activity loss and credit carryovers, and (7) foreign tax credit carryovers. I.R.C. § 108(b)(2).

[11] Woll, *supra* note 8, at 283–84.

[12] *See* Robert Willens, *'Bruno'-Type Bankruptcy Arrangement Secured IRS Seal of Approval*, 23 Tax Mgm't Wkly. Rep. (BNA) 46 (Jan. 12, 2004) [hereinafter Willens, *Seal of Approval*] (commenting on the CCA); Lee A. Sheppard, *When Is a Transaction a Tax Shelter?*, 85 Tax Notes (TA) 984 (Nov. 22, 1999) (commenting on and critiquing the Bruno's bankruptcy).

[13] Woll, *supra* note 8, at 277.

[14] *See* Second Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code as Modified December 10, 1999, at 17–19, *In re* PWS Holding Corp., No. 98-212 (SLR) (Bankr. D. Del. Dec. 10, 1999).

[15] *See, e.g.*, 10 Collier on Bankruptcy ¶ TX10.01[2] n.6 (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2007) (citing the CCA); David M. Einhorn et al., *Critical Federal Income Tax Issues Relating to Corporate Restructurings*, 789 PLI/Tax 491, 500–03 (2007); John C. Hart, *Restructuring the Bankrupt Corporation*, 790 PLI/Tax 127, 179–88 (2007); Carl M. Jenks, *Tax Attributes in Bankruptcy—2007*, 790 PLI/Tax 7, 64-–68 (2007) ("The Bruno's structure has now been employed in several public bankruptcies."); William Tatlock et al., *Discharge of Indebtedness, Bankruptcy and Insolvency: Detailed Analysis*, 540 Tax Mngt. Port. (BNA) A-78 & n.646.1 (1995).

of transaction abusive."[16]

The current literature in the tax press begs the question: was the CCA decided correctly? Will the Service eventually reverse course? What reasons would the Service *have* for reversing course?[17] And would it be wise to do so? This Article addresses these questions and ultimately concludes it would not be wise for the Service to do so.

Part II briefly describes the Bruno's arrangement at issue in the CCA. Part III addresses, in order, the principal criticisms of the Service's treatment of the Bruno's transaction. Each criticism occupies a separate Subpart within Part III. Part IV then argues that if the Service indeed intends to reverse its CCA ruling—against the advice put forth in this Article—it should do so quickly, before similarly situated debtors begin to rely on it extensively, creating potential fairness concerns.

II. A Brief Description of the Bruno's Transaction in the CCA

Before explaining why it would not be wise to reverse course on the CCA ruling, this Article looks at both the transaction itself and the Service's initial treatment of it. The CCA addressed a bankruptcy court-approved plan of reorganization, in which the following transactions were undertaken:

1. Debtor organized NewCo, a wholly-owned subsidiary, and sold certain assets to NewCo for cash;
2. Debtor sold to the Creditor Representative (acting on behalf of the creditors) a fractional interest in Debtor's remaining assets—subject to remaining Debtor liabilities—"in exchange for the cancellation of [creditor] claims . . . in an amount equal to the fair market value of" the assets (producing COD income);
3. The Creditor Representative contributed the fractional interest in the assets to NewCo;
4. Debtor sold a fractional interest in Debtor's remaining assets—subject to remaining Debtor liabilities—in exchange for shares of NewCo common stock and notes;
5. Debtor immediately transferred those shares to the Creditor

[16] Einhorn et al., *supra* note 15, at 503; *see also* Willens, *Seal of Approval*, *supra* note 12, at 46 ("[T]he approach has survived an important challenge (although perhaps not the last) to its viability.").

[17] One commentator considers the transaction abusive. *See* Sheppard, *supra* note 12, at 984. However, given the paucity of further Service guidance on the matter, many commentators are cautiously optimistic, yet notably cautious in their optimism, that the Service will choose to leave things as they are. *See, e.g.*, Jenks, *supra* note 15, at 68 (Although "Lee Sheppard did her best to muster some righteous indignation about [the Bruno's transaction] . . . her heart didn't . . . seem to be in it . . . . [T]he IRS National Office seems to have treated the Bruno's structure as nothing more than a variation on a theme that the IRS has (reluctantly perhaps) already embraced."); *see also* Woll, *supra* note 8, at 280–85 (discussing potential lines of attack against the CCA).

Representative in satisfaction of the creditors' claims.[18]

The Debtor and NewCo represented to the Service that "these transfers [constituted] a sale of [Debtor's] assets in exchange for cash, stock and notes," the stock and notes of which were transferred to the creditors in satisfaction of their claims.[19] The Service considered two different possible "recasts" of the transaction: (1) a G Reorganization;[20] and (2) a contribution in exchange for stock by a controlling person under section 351.[21]

In dismissing the G Reorganization recast, the Service noted that "there were no prepetition holders of '*securities*' within the meaning of sections 354 and 355."[22] Although the Code nowhere defines "securities"—either for purposes of applying the reorganization provisions, or otherwise—the Service presumably considered the creditors to be mere "short term creditors," and thus, under existing precedent, did not consider them to be holders of "securities."[23] Since they were not holders of "securities," section 354—which provides for nonrecognition treatment of corporate reorganizations in which "stock or *securities* [in one corporation] . . . are . . . exchanged solely for stock or securities" in another corporation—could not have made the transaction nontaxable.[24] Because the transaction did not qualify under section 354, it could not qualify as a G Reorganization under section 368(a)(1)(G).[25]

Although the Service purported to base its dismissal of the G Reorganization recast on the absence of long-term creditors or bondholders, in footnote four of the CCA it noted that "the transaction also fail[ed] to meet the requirements of section 354(b)(1)(B)" that the transferor corporation liquidate pursuant to the reorganization, distributing any stock, securities, or other property received to its shareholders.[26] Although the Debtor retained only

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[18] C.C.A. 2003-50-016 (Aug. 28, 2003). It is also worth noting that the specific transaction at issue in the Bruno's reorganization nearly precisely imitated the transaction at issue in the CCA. *See* Second Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code as Modified December 10, 1999, at 17–19, *In re* PWS Holding Corp., No. 98-212 (SLR) (Bankr. D. Del. Dec. 10, 1999).

[19] C.C.A. 2003-50-016 (Aug. 28, 2003).

[20] *See* I.R.C. § 368(a)(1)(G) (defining a reorganization to include a transfer by a debtor corporation in a Title 11 or similar case of all or part of its assets to another corporation if stock or securities of the corporation to which the assets are transferred are distributed in a section 354, 355, or 356 transaction).

[21] *See* I.R.C. § 351(a) (providing for nonrecognition if property is transferred to a corporation in exchange for stock in that corporation and immediately after the exchange the contributing person(s) are in control—as defined by section 368(c)—of the corporation).

[22] C.C.A. 2003-50-016 (Aug. 28, 2003) (emphasis added).

[23] *See* 1 Boris I. Bittker & James S. Eustice, Federal Income Taxation of Corporations and Shareholders ¶ 12.41 (7th ed. 2006) (discussing existing authority on what constitutes a "security").

[24] *See* I.R.C. § 354 (emphasis added).

[25] *See* I.R.C. § 368(a)(1)(G).

[26] C.C.A. 2003-50-016 n.4 (Aug. 28, 2003).

assets that it could later lease or license to NewCo,[27] the Service was of the view that the Debtor had "retained assets related to the [Debtor's] core business and [had] continued to operate this business."[28] Thus, *even if* the transaction had involved long-term debt or bondholders, the Service seems to have been prepared to give it its stamp of approval based upon the fact that the Debtor did not fully "liquidate."

In dismissing the section 351 recast, the Service relied on one fact and one Code provision. First, although the Debtor transferred an interest in its assets to NewCo for stock, it was under a binding obligation to transfer that stock to the creditors in satisfaction of the creditors' claims. Thus, because it was technically not in "control" for section 351 purposes "immediately after the exchange," the Service did not treat the Debtor as a "transferor" for purposes of section 351(a).[29] Second, section 351(e)(2)—which provides that section 351 will not apply to a transfer of property of a debtor in Chapter 11 pursuant to a plan of reorganization "to the extent that the stock received in the exchange is used to satisfy the indebtedness of the debtor"[30]—likewise precluded application of section 351, even if the Debtor could be considered to "control" NewCo immediately after the exchange.[31]

In summation, the Service justified taxable treatment of the transaction—and thus nonapplication of the reorganization provisions—on the following reasons:

1. Short-term debt holders do not hold "securities";
2. The Debtor did not "control" NewCo after transferring properties to it for stock; and
3. Even if long-term debt holders were present, the Debtor did not "liquidate" pursuant to the plan.[32]

III. The Criticisms of the CCA and Responses

Essentially, three principal criticisms can be made of the Service's decision in the CCA and of the Bruno's transaction in general.

First, the CCA *must* rely on one of two key facts: (1) the reorganization involved only short-term creditors who were not "security holders"; or (2) there was no "liquidation" of the Debtor. As to the first ("short-term creditors

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[27] The facts demonstrating that the Debtor intended to lease or license to NewCo its retained assets appear not in the CCA, but in Bruno's Plan of Reorganization. Second Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code as Modified December 10, 1999, at 17–19, *In re* PWS Holding Corp., No. 98-212 (SLR) (Bankr. D. Del. Dec. 10, 1999) ("New Bruno's shall lease from the Reorganized Debtors the owned real property and buildings included in the Retained Assets.").

[28] C.C.A. 2003-50-016 n.4 (Aug. 28, 2003).

[29] *See* I.R.C. § 351(a) (property must be "transferred" from person(s) to corporation in exchange for stock); *see also* C.C.A. 2003-50-016 (Aug. 28, 2003).

[30] I.R.C. § 351(e)(2).

[31] C.C.A. 2003-50-016 (Aug. 28, 2003).

[32] *Id.*

who are not 'security holders'"), there is no justification for the distinction between short-term and long-term debt. Thus, the creditors should be treated as "security" holders and the transaction should be nontaxable under section 354. As to the second ("no liquidation"), the Debtor is really liquidating, and thus section 354(b)(1)(B) is satisfied.

Second, even if one entertains the "liquidation" fiction, the Debtor is really just splitting a trade or business, and the transaction should be nontaxable under section 355; thus, the Service should close this loophole by interpreting section 355 (divisive D reorganizations) and section 354 (other nondivisive reorganizations) broadly because the Code already provides statutorily-approved procedures for sales of proprietary interests[33] in both taxable and nontaxable transactions.

Third, someone should be taxed on the COD income. Section 108 permits the Debtor to avoid taxation on COD income but requires a corresponding reduction in the Debtor's asset basis. Because the Debtor gets rid of the assets in the transaction, this is tax avoidance, plain and simple.

The first criticism (regarding the Service's interpretation of "security holders" and "liquidation") involves factual-technical questions of tax analysis, while the second and third criticisms constitute appeals to broader tax principles of fairness, neutrality, consistency, and other principles.

Although the three principal criticisms—and not this Article's responses to them—define the skeletal structure of the Article, a brief summary of the content of seven principal responses to these criticisms, is as follows:

First, Congress has explicitly expressed its intent that short-term creditors be treated differently than long-term creditors for purposes of the reorganization provisions, and thus, the CCA's reliance on that distinction to grant taxable treatment to the Bruno's transaction was valid.

Second, there was a real business purpose to retaining the Debtor's corporate existence and not distributing its assets to the creditor-shareholders, and thus, the Service's finding that the Debtor did not liquidate—which debtors in bankruptcy must do under section 354(b)(1)(B) in order for the G Reorganization provisions to apply—was valid.

Third, even if there really is not a "business purpose" in some isolated instances, the C Corporation laws and regulations are meant to be predictive, useful, and bright-line. It therefore makes no sense to interpret the terms "security holders" and "liquidate" more broadly than the Service interpreted them in the CCA.

Fourth, Congress has restricted the usefulness of debtor reorganizations through (1) repeal of the stock-for-debt exception, (2) effective imposition of trading restrictions in section 382 through limitation of NOL use, and (3) application of the section 108 NOL use limitation to consolidated groups. But Congress did not do so here. Thus, the negative implication is they did not mean to.

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[33] I.R.C. §§ 338, 382(1)(5).

Fifth, Congress had a good reason *not* to restrict the transaction at issue in the CCA, because of (1) the Bankruptcy Code's "fresh start" principle and (2) avoiding anti-industry distortion.

Sixth, both Congress and the Treasury have taken steps that seem to be in explicit contradiction to the criticisms of the CCA, for example: (1) explicit preservation of the short-term long-term distinction; (2) a realistic interpretation of "active trade or business" in recently passed regulations; (3) enactment of the Net Value Regulations, which *deny* tax-free treatment to transactions structured very much like the CCA; (4) enactment of section 351(d), which secures a bad debt deduction for short-term creditors; and (5) enactment of section 351(e)(2), which the Service relied on in the CCA and which removes from tax-free treatment a portion of the transaction at issue in the CCA.

Seventh, one argument for treating G Reorganizations as tax-free is the fact that the creditors—by virtue of being creditors of a debtor that is restructuring—have a historic proprietary interest in the corporation. The reality, however, is that vulture funds more often than not purchase this "proprietary" interest, rendering it anything but "historical." Thus, it makes no sense to apply tax-free treatment—which is normally reserved for mere corporate readjustments—to a transaction in which the original creditors may not even have control of the company. This Article responds to the criticisms in the subsections that follow, using a combination of the responses that are listed directly above.

A. *The CCA Must Rely on One of Two Key Facts, Neither of Which Is Correct: (1) The Reorganization Involved Only Short-Term Creditors Who Are Not "Security Holders"; or (2) There Was No "Liquidation" of the Debtor*

1. *Because There Is No Justification for the Distinction Between Short-Term and Long-Term Debt, and Since No Justification Can Be Made, the Creditors Should Be Treated as "Security" Holders and the Transaction Should Therefore Be Nontaxable Under Section 354*

A certain inconsistency pervades the reorganization provisions: although short-term creditors are treated like "security holders" for some purposes, they are not for others. For example, whereas short-term creditors are counted as "security holders" both for purposes of the nonstatutory "continuity of inter-

est" (COI) requirement[34] implicit in the reorganization provisions[35] and for purposes of a debtor's section 382(l)(5) NOL preservation election,[36] they are not counted as "security holders" for purposes of determining whether their respective exchanges of their nonsecurity debt obligations in a tax-free reorganization are actually treated as tax-free. A basic criticism of the CCA, therefore, is that holders of nonsecurity debt obligations should receive the same treatment as holders of debt obligations evidenced by a security in tax-free reorganizations, and that recent Service decisions have eroded the differ-

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[34] The basic purpose of the COI requirement is to prevent those transactions that look like sales—where the original owners of a corporation dispose of their ownership (their proprietary interest) for consideration—from receiving nonrecognition treatment under the reorganization provisions. Reg. § 1.368-1(e) (as amended in 2007) ("The purpose of the continuity of interest requirement is to prevent transactions that resemble sales from qualifying for nonrecognition of gain or loss available to corporate reorganizations."); 1 Bittker & Eustice, *supra* note 23, at ¶ 12.21[6] ("[T]he principal function of the continuity-of-interest doctrine has been to separate sales from reorganizations . . . . [S]ome form of proprietary interest . . . [must be] retained by the transferors."). Generally, the Service has ruled that if the value of stock in the acquiring corporation received by target corporation shareholders represents at least 40-50% of the value of the target corporation stock exchanged, the COI requirement is met. *See id.*, at ¶ 12.21[2][b] (citing various Service documents, including Rev. Rul. 1966-224, 1966-2 C.B. 114 (holding a 50% equity continuity of interest as fulfilling the COI requirement)); T.D. 9316, 2007-1 C.B. 962, Ex. (1) (indicating that a reorganization in which 40 Acquirer shares and $60 are exchanged for all the Target shares would meet the COI requirement). The fiction that arises in a bankruptcy organization is that creditors are treated as proprietary interest holders for the COI requirement regardless of whether the debt obligations they hold are securities or not. *See, e.g.*, Helvering v. Ala. Asphaltic Limestone Co., 315 U.S. 179 (1942); Atlas Oil & Refining Corp. v. Commissioner, 36 T.C. 675 (1961), *acq.* 1962-2 C.B. 3 (holding that "shareholders," for purposes of the COI requirement, include both creditors who actually receive stock in the acquiring corporation as well as any creditors junior to a class receiving stock); Tatlock et al., *supra* note 15, at A-58 to A-60.

[35] The "continuity of interest" requirement is not spelled out explicitly in the reorganizations provisions. *See* I.R.C. § 361 ("No gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization."); I.R.C. § 368(a)(1) (defining "reorganization" as (A) a statutory merger, (B) a stock swap purchase, (C) a stock for assets purchase, (D) a spin-off or split-off, (E) a recapitalization, (F) a corporate charter amendment, or (G) a stock purchase of a debtor in bankruptcy); I.R.C. § 368(a)(1)(G) (including within the definition of "reorganization" a transaction in which a debtor corporation transfers all or part of its assets to another corporation if stock or securities of that corporation are distributed in a section 354, 355, or 356 transaction). It is, however, generally regarded as an additional nonstatutory requirement to meet the definition of a tax-free reorganization. 1 Bittker & Eustice, *supra* note 23, at ¶ 12.21; *see also* Reg. § 1.368-1(b) (as amended in 2007); Jeffrey L. Kwall, The Federal Income Taxation of Corporations, Partnerships, Limited Liability Companies, and their Owners 499 (3d ed. 2005) ("In addition to the statutory requirements, the transaction must satisfy certain common law doctrines that still represent the essence of a reorganization.").

[36] *See infra* note 196. In short, if after the debtor's reorganization at least 40-50% of the reorganized debtor's equity interests are held by former shareholders or creditors or both (whether long- or short-term), the debtor avoids the restrictions on the use of NOLs imposed under sections 381 and 382.

ence between the two categories.[37]

Historically, Congress and the Service have maintained the distinction in treatment of short-term and long-term creditors, counting them *both* toward a reorganizing debtor's fulfillment of the COI requirement as well as for the debtor's section 382(l)(5) NOL preservation election.[38] At the same time, Congress and the Service permitted *only* long-term—but not short-term—creditors to receive tax-free treatment in a tax-free reorganization (that is, short-term debt does not meet the definition of "security" for purposes of the reorganization provisions, which require an exchange of stock or "securities").[39] Since only holders of "securities" can participate tax-free in a tax-free reorganization,[40] this indicates that Congress chose to treat "short term creditors" as "security holders" and thus as "proprietors" for COI purposes but not for gain-loss purposes on their actual exchange in the reorganization. A recent Revenue Ruling has muddied this distinction somewhat,[41] making the criticisms of the short-term-long-term distinction appear more salient. Does the distinction continue to make sense, and does it make sense to apply it to the Bruno's transaction in the CCA?

For starters, Congress's original determination that debt obligations held by short-term creditors do not constitute "securities" for purposes of tax-free treatment of their exchange in a reorganization was in conformity with the then-current case law.[42] As a rule of thumb, under the current rules, taxpayers are safe in assuming that debt obligations with maturity dates of ten years or more will be considered "securities,"[43] but that debt obligations with maturity dates of less than five years will not.[44] The "security" status of debt obligations with maturity periods between five and ten years is determined

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[37] *See infra* text accompanying notes 39–44.

[38] *See* S. Rep. No. 96-1035, at 36–37 (1980), *as reprinted in* 1980 U.S.C.C.A.N. 7017, 7051. ("[T]he most senior class of creditor to receive stock, together with all equal and junior classes (including shareholders who receive any consideration for their stock) should generally be considered the proprietors of the insolvent corporation for 'continuity' purposes.").

[39] *Id.* at 37 ("[S]hort term creditors who receive stock for their claims may be counted toward satisfying the continuity of interest rule . . . any gain or loss realized by such creditors will be recognized for income tax purposes.").

[40] *See* I.R.C. § 361 ("No gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization."); I.R.C. § 368(a)(1)(G)(including within the definition of "reorganization" a transaction in which a debtor corporation transfers all or part of its assets to another corporation if stock or securities of that corporation are distributed in a section 354, 355, or 356 transaction).

[41] *See infra* note 47.

[42] *See* Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 468–69 (1933) (short-term notes received in exchange for property do not constitute "securities" for purposes of the reorganization provisions).

[43] Rev. Proc. 1985-22, 1985-1 C.B. 500, 554.

[44] *See Pinellas*, 287 U.S. at 468–69.

through application of a multi-factor test[45] to ascertain the level of "participatory interest" inherent in the securities.[46]

The five year-ten year rule of thumb approach is not always rock-solid, however. As alluded to above, a recent Revenue Ruling concluded that debt securities with two years until maturity qualified as "securities" for purposes of the reorganization provisions.[47] The Ruling addressed a transaction under section 368(a)(1)(A) in which the debt holder exchanged its debt obligations—which had been issued ten years previously and had two years until maturity—for "debt instruments with [identical terms] . . . except that the interest rate [was] changed" to "reflect the difference in creditworthiness between Target Corporation and Acquiring Corporation."[48] Although the Ruling discussed the existing precedent defining "security" for purposes of the reorganization provisions, it concluded that the debt instruments had been exchanged for debt instruments bearing essentially the same terms and in essentially the same form.[49] Thus, in the Service's view, the debt instruments were securities. In effect, the Ruling recognized the existing precedent but disregarded it.

What did the Ruling seek to accomplish? Should taxpayers no longer pay heed to the five year-ten year guidelines?[50] Or is the Ruling a mere aberration?

If anything, the Ruling ensures the courts and taxpayers will be forced to pay greater attention to the nature of the instrument and the role of the debt holder in the corporation, which, admittedly, comports with the origi-

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[45] *See* 1 Bittker & Eustice, *supra* note 23, ¶ 12.41[3].

> Later decisions . . . seem to have adopted a continuity-of-creditor approach, stating that time alone is not decisive and that what is required is an overall evaluation of the nature of the debt, degree of participation and continuing interest in the affairs of the business, the extent of proprietary interest . . . and the purpose of the advances.

Id.; *see also infra* note 51 (discussing the multi-factor *Camp Wolters* test).

[46] *See* Gregory E. Stern et al., *Tax Aspects of Restructuring Financially Troubled Businesses: Detailed Analysis*, 541 Tax Mngt. Port. (BNA) A-50 (1994) (citing Rev. Rul. 1959-98, 1959-1 C.B. 76 (finding secured bonds with an average term of six and one-half years to constitute securities)).

[47] Rev. Rul. 2004-78, 2004-2 C.B. 108.

[48] *Id.*

[49] *Id.*

[50] *See, e.g.*, Simon Friedman, *Debt Exchanges After Rev. Rul. 2004-78*, 2004 Tax Notes Today 221-31 (Nov. 16, 2004) ("*Rev. Rul. 2004-78* is significant in preventing any mechanical application of a five-year minimum for debt instruments to be characterized as securities.").

nal formulation of the "security" test.[51] Instead of mechanically taking note of the maturity date of debt instruments, parties to a reorganization will be forced to analyze the interest relinquished and the interest received by the debt holder.[52] Simon Friedman has even suggested that counting a creditor's active role in a bankruptcy restructuring toward a finding that a debt obligation is a "security" would create a "presumption[] that exchanges of nontrade debt in bankruptcies and reorganizations should be treated as exchanges of securities."[53]

This is precisely the point that critics of the CCA seek to make. Some short-term creditors in bankruptcy reorganizations—because of the expectation of receipt of an equity interest and because of their more intensive participation in the affairs of the debtor—possess an interest no different from that of long-term creditors. Furthermore, the interest they are receiving in exchange—stock in the reorganized debtor—makes their interest a *proprietary* one that should be treated as *holding* a proprietary interest for purposes of the nonrecognition of gain-loss provisions.[54] The COI requirement (which treats short-term nonsecurity holding creditors as proprietary interest holders) and the recognition of gain-loss on nonsecurities rule (which does not) thus seem to conflict with each other.

The criticisms run deeper than that, however. For debtor corporations to take advantage of the reorganization provisions, at least one security holder

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[51] In much-quoted language, the Tax Court in *Camp Wolters Enterprises, Inc. v. Commissioner*, 22 T.C. 737, 750 (1954), *aff'd,* 230 F.2d 555 (5th Cir. 1956), *cert. denied,* 352 U.S. 826 (1956), stated that

> the test as to whether notes are securities is not a mechanical determination of the time period of the note. . . . [T]he controlling consideration is an over-all evaluation of the nature of the debt, degree of participation and continuing interest in the business, the extent of proprietary interest compared with the similarity of the note to a cash payment, the purpose of the advances, etc.

[52] *See, e.g.*, 1 Bittker & Eustice, *supra* note 23, at ¶ 12.21[6] (criticizing *Neville Coke & Chemical Co. v. Commissioner*, 148 F.2d 599 (3d Cir. 1945) (holding that the exchange of nonsecurity debt instruments for stock did not qualify for nonrecognition treatment under section 354)). Bittker and Eustice argue that *Neville* contradicts the "general thrust of the continuity-of-interest doctrine," which is to "prevent a tax-free shift from an ownership interest to a less permanent creditor interest," because in *Neville*, the "taxpayer was shifting from a less permanent (short-term creditor) to a more permanent (long-term creditor and shareholder) interest." *Id.*

[53] Friedman, *supra* note 50.

[54] *See* 1 Bittker & Eustice, *supra* note 23, at ¶ 12.21[6] ("[T]he approach of the *Neville Coke* decision [taxing short-term creditors in a transaction deemed to constitute a tax-free reorganization] could render many recapitalization exchanges, and most creditor reorganizations, taxable to short-term creditors.").

of the debtor corporation must receive stock in the acquiring corporation.[55] As a result, smaller debtors with only short-term trade debt and whose shareholders receive nothing in the reorganization will be unable to undertake a G Reorganization. One authority has opined that the fact that "a chapter 11 reorganization involving only short-term creditors cannot qualify as a tax-free G [Reorganization]" is largely "due to a technical flaw in the statute."[56]

Finally, as alluded to above, the Code treats short-term creditors as equity holders for certain purposes in other Code sections as well. In a reorganization qualifying for nonrecognition treatment under section 368, the acquiring corporation succeeds—subject to certain limitations—to the debtor's historic tax attributes by operation of section 382.[57] Additionally, if 50% of the shareholders *or creditors*—including short-term creditors—control the debtor following the reorganization, the debtor can elect under section 382(l)(5) to remove the limitations on the use of NOLs in section 382,[58] as long as a change in ownership does not occur in the subsequent two years.[59]

As noted above, the developments subsequent to Congress's enactment of the 1980 Bankruptcy Reform Act and the criticisms described in the foregoing paragraphs beg the question of whether the distinction between long-term and short-term debt for gain-loss recognition purposes in the reorganization provisions continues to make sense. The criticisms may not be as strong as they initially appear, however. First, the distinction is what Congress has explicitly prescribed,[60] and neither the Treasury nor the Service has done anything to change it. Second, section 351—another nonrecognition Code provision that applies to contributions to corporations by controlling persons—expressly contemplates treating as taxable a portion of the transaction at issue in the CCA.[61] Third, the criticism that debtors with only short-term creditors will not be able to take advantage of G Reorganizations runs aground on the fact that other options are available to obtain favorable tax treatment. Fourth, and perhaps most importantly, treating nonsecurity holders as "security" holders in order to recharacterize a transaction as nontaxable ignores the reality of the context in which the transaction takes place by disregarding the role that bad

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[55] I.R.C. § 354(a) (requiring as a condition for tax-free treatment of a reorganization that stock or securities are "exchanged solely for stock or securities" of the acquiring corporation); I.R.C. § 356(a) (permitting sections 354 and 355 to apply to an exchange if at least one stock or security of the acquiring corporation is exchanged for at least one stock or security of the acquired corporation); 10 Collier, *supra* note 15, ¶ 10.03[3] ("If a holder of securities in the acquired corporation actually receives stock or securities . . . in the acquiring corporation . . . the plan should qualify as a 'G' Reorganization even if the value of the stock or securities . . . represents a small percentage of the . . . total equity consideration . . . .").

[56] 10 Collier, *supra* note 15, ¶ 10.03[3].

[57] I.R.C. § 382.

[58] I.R.C. § 382(l)(5).

[59] I.R.C. § 382(l)(5)(D).

[60] S. Rep. No. 96-1035, at 36–37 (1980), *as reprinted in* 1980 U.S.C.C.A.N. 7017, 7050–51.

[61] *See* I.R.C. § 351(e)(2).

debt deductions play for short-term debt holders.

As to the first argument, it must be noted that Congress did not muddy the waters of the security-nonsecurity analysis. The Service did. As noted above, in the Senate Report accompanying the Bankruptcy Tax Act of 1980, Congress expressly stated that short-term creditors exchanging their debt holdings for stock in the newly reorganized debtor must recognize gain on that exchange.[62]

When given additional chances to extend "security" status to short-term debt, Congress declined. In considering a bill to provide favorable tax treatment to the Consolidated Rail Corporation, for example, the House had this to say about the short-term-long-term debt distinction:

> Under present law, shareholders or security holders in a bankrupt railroad are not subject to the excess principal amount rule of sec. 354(a)(2); the bill follows the same treatment in the ConRail reorganization. Thus, if a shareholder of a transferor receives ConRail debt securities (as possibly could be ordered by the special court), he will also receive nonrecognition treatment. The bill makes no change in the rule under present law that a creditor's claim against the debtor company must be a "security" interest in order that he will not recognize gain or loss on exchanging his interest for ConRail stock in an acquiring company. A short-term note holder or general creditor who is not considered to hold a "security" interest will therefore recognize gain or loss on such an exchange.[63]

Finally, Congress has been consistent in its treatment of transactions that more closely resemble sales than readjustments of corporate structures. Congress has, for example, maintained suspicion of transactions involving preferred stock, finding that because it does not represent an investment-interest in growth, it should not qualify for nonrecognition treatment under the organization provisions.[64]

In effect, Congress is simply ratifying the principle underlying the distinction between long-term and short-term debt, allowing it to reflect the reality of the context in which a bankruptcy reorganization occurs. Trade creditors and other short-term creditors do not extend credit for purposes of investment, and their resulting claims in bankruptcy do not reflect invest-

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[62] S. Rep. No. 96-1035, at 36–37 (1980), *as reprinted in* 1980 U.S.C.C.A.N. 7017, 7050–51. ("[C]reditors 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 [which will] . . . accord with the treatment of these creditors on an exchange under a plan of reorganization.").

[63] H.R. Rep. No. 94-940, at 8–9 n.11 (1976), *as reprinted in* 1976 U.S.C.C.A.N. 476, 482–83.

[64] H.R. Rep. No. 105-220, at 543–45 (1997) (Conf. Rep.); *see also* I.R.C. § 354(a)(2)(C) (excluding from the definition of "stock or securities" for purposes of the section 354 reorganization provisions "nonqualified preferred stock"); I.R.C. § 351(g) (excluding nonqualified preferred stock from the definition of "stock" for purposes of the section 351 nonrecognition provisions for property transferred to a corporation by controlling persons who receive stock for the property contributed).

ment interests. They simply have an interest in getting paid on the amount lent.[65] To the extent that their participation in the restructuring has made their claim resemble more of a participatory investment than an ordinary course trade debt, the oft-cited *Camp Wolters* test[66] for determining "security" status is more than adequate to adjust and make flexible the five year-ten year guidelines.

As to the second argument, the Service itself considered a recast of the transaction at issue in the CCA under another nonrecognition provision, section 351, which treats contributions to controlled corporations for stock as nontaxable. However, section 351(e)(2) states that "transfer[s] of property of a debtor pursuant to a plan while the debtor is" in Chapter 11 shall not qualify for nonrecognition treatment under section 351 "to the extent that the stock received in the exchange is used to satisfy the indebtedness of the debtor."[67] Thus, in a specific instance, Congress has contemplated that a sale of assets by a debtor corporation to a reorganized corporation may in fact *not qualify* for certain tax-free treatment. If the reorganization does *not* qualify for G Reorganization or section 351(a) treatment, Congress has explicitly provided section 351(e)(2) governs the consequences of the nonqualification.[68] This argument is also made in the CCA itself, which indicates that the Service saw a distinction between mere readjustments of the corporate form and true sales of the debtor's assets as was at issue in the CCA.[69]

As to the third argument, several methods exist by which nonsecurity holders in debtor corporations can obtain reorganization treatment despite their not holding actual securities.[70] In Revenue Ruling 1959-222, for instance, the Service permitted creditors to exchange their claims for stock of the debtor prior to the reorganization and then exchange that stock for stock of the reorganized debtor in a transaction that qualified as a tax-free reorganization.[71] Further, the Service allowed this transaction to occur without an *actual* exchange of the claims for stock, under the theory that it would have been a "meaningless gesture."[72] As one treatise notes, however, this approach may

[65] For example, in Revenue Ruling 1959-98, 1959-1 C.B. 76, discussed in Friedman, *supra* note 50, the Service discussed the "purpose of the advances" as a relevant factor in determining whether debt constituted a "security" or a "non-security." The Ruling found that a debt obligation purchased by the debt holder for "investment purposes" would be more likely to deserve security treatment than a debt obligation arising out of the debt holder's trade or business.

[66] *See supra* note 51 (discussing the *Camp Wolters* test).

[67] I.R.C. § 351(e)(2).

[68] *See, e.g.*, P.L.R. 1983-03-079 (Oct. 20, 1982) (holding contribution of assets by debtor corporation in bankruptcy and subsequent retention of the stock as security for the claims of creditors qualified for section 351(a) treatment, and thus, section 351(e)(2) need not apply to the contributions of assets).

[69] *See* C.C.A. 2003-50-016 (Aug. 28, 2003).

[70] *See* Tatlock et al., *supra* note 15, at A-54 to A-56.

[71] Rev. Rul. 1959-222, 1959-1 C.B. 80.

[72] *Id.*

not be consistent with prior Supreme Court precedent.[73] As the treatise also notes, another possible approach would be for the debtor to allow shareholders to participate in the reorganization, so that the transaction would qualify under sections 354, 355, and 356 for tax-free treatment.[74] Although the exchange with creditors would still be taxable to the creditors, it would be tax-free to the debtor corporation.[75] The Service has permitted such transactions liberally. In Private Letter Ruling 96-29-016, for instance, a debtor contributed its assets to a newly formed corporation for stock of the newly formed corporation.[76] It then distributed 95% of that stock to its noteholders and five percent of the stock to its current shareholders pursuant to a merger with the newly formed corporation.[77] The Service ruled that "[n]o gain or loss will be recognized by [the debtor] upon . . . the distribution of Newco stock by [the debtor] to its shareholders and Noteholders."[78] Thus, it is not completely the case that smaller debtors who perhaps lack long-term security holdings are completely deprived of use of the reorganization provisions by the Service's treatment of short-term creditors in the CCA.

As to the fourth argument, the CCA itself noted that treating the short-term creditors as "transferors" and their debt obligations as "securities" would have defeated the purposes of section 351(d),[79] which permits a deduction to short-term creditors for bad debt.[80] Section 351(d) excepts from the definition of "issued in return for property" stock issued for "indebtedness of the transferee corporation which is not evidenced by a security."[81] Because such stock is not deemed to be "issued in return for property," section 351(a) does not treat such an issuance as tax-free.[82] This entitles short-term creditors—"creditor[s] that hold[] an account receivable or other 'open indebtedness'"—who transfer their indebtedness to a "debtor corporation in a . . . transaction otherwise [qualifying as a section 351 exchange] to a bad debt deduction

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[73] Tatlock et al., *supra* note 15, at A-54 to A-56 (citing Helvering v. Sw. Consol. Corp., 315 U.S. 194, 201–03 (1942) (holding that creditors of a transferor corporation cannot be treated as shareholders for purposes of the requirement that the transferor or its shareholders be in control of a transferee corporation immediately after the transfer)).

[74] *Id.*

[75] *See* I.R.C. § 356(a)(1) (permitting nonsecurities to be exchanged in a transaction otherwise qualifying under sections 354 or 355, but providing that "the gain, if any, to the recipient shall be recognized . . . in an amount not in excess of the" amount of nonsecurities received).

[76] P.L.R. 1996-29-016 (July 19, 1996).

[77] *Id.*

[78] *Id.*

[79] C.C.A. 2003-50-016 (Aug. 28, 2003). *See generally* S. Rep. No. 96-1035, at 43 (1980), *as reprinted in* 1980 U.S.C.C.A.N. 7017, 7051. ("[C]reditors 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.").

[80] I.R.C. § 351(d).

[81] I.R.C. § 351(d).

[82] I.R.C. § 351(a) (treating exchanges of property for stock in a controlled corporation as tax-free).

[under section 166] with respect to that indebtedness."[83] If section 351(d)—which explicitly contemplates differing treatment for indebtedness "not evidenced by a security"[84]—did not exist, short-term creditors, who often extend debt for reasons of business expedience rather than investment intent, would be left with depreciated holdings, yet no deduction for the loss.

In effect, wiping out the distinction would wipe out an entire Code section. Section 166 entitles creditors to a bad debt deduction for wholly or partially worthless debt.[85] But section 166 does *not* apply to debt "evidenced by a security."[86] Instead, section 165(g) governs deductions for securities (stocks, bonds, debentures, notes, certificates, or other evidence of indebtedness issued by a corporation) that become *wholly* worthless during a taxable year.[87] Although the judicial definition of "security" and the section 165 definition of security may not match up precisely, it is clear that Congress foresaw *some* distinction between long-term and short-term debt (*i.e.*, "securities" and "nonsecurities"). Otherwise, there would be no reason for the existence of section 165(g), which would run contrary to various canons of statutory construction.

One commentator has argued that the advantage that the reorganization rules give to short-term debt holders is unjustified because it favors shorter-term investors over longer-term investors.[88] Additionally, as is often the case, the distinction between what constitutes a security, what constitutes equity,

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[83] Howard J. Rothman et al., *Transfers to Controlled Corporations: In General*, 758 Tax Mngt. Port. (BNA) A-6 (1997).

[84] I.R.C. § 351(d).

[85] I.R.C. § 166(a)(1)-(2).

[86] I.R.C. § 166(e).

[87] I.R.C. § 165(g).

[88] *See* Meredith R. Conway, *"Clowns to the Left of Me, Jokers to the Right, Here I Am, Stuck in the Middle with You": The Inconsistent Tax Treatment of Security Holders in Tax-Free Reorganizations*, 56 Cath. U. L. Rev. 99, 119–21 (2006). Basically, the author argues that because security holders in a tax-free reorganization must in fact recognize gain on securities received in exchange for former securities held *if* the "principal amount of such securities received exceeds the principal amount of such securities surrendered" plus any amounts of unpaid interest, I.R.C. § 356(d)(2)(B), long-term securities holders are disadvantaged in tax-free reorganizations, whereas short-term security holders will be treated the same whether there is a tax-free reorganization or not. However, this rule makes sense when one considers the principal role that the tax reorganization provisions play: nonrecognition of gain on transactions that resemble mere readjustment of the corporate form. If substantially different securities are exchanged—for example, where a security holder exchanges a security with a higher or lower principal amount than the security received—the transaction begins to more resemble a sale, and is indeed treated like one. *See, e.g.*, Cottage Savings Ass'n v. Commissioner, 499 U.S. 554, 561–62 (1991). Congress has probably therefore deemed that such transactions will be subject to the gain and loss provisions. Additionally, the likelihood that creditors in a bankruptcy reorganization will receive securities with principal amounts greater than their claims seems unlikely.

what constitutes debt, and what does not, will often be a matter of degree.[89] On the other hand, longer-term investors have assumed more of a risk with their investment, whereas short-term creditors extend credit principally as a matter of ordinary course and business motive, lacking true investment intent.[90] If the distinction between long term and short-term debt is to be abolished, short-term trade creditors—who had no real intention to profit from an investment over the long term, but only sought to enable a business relationship with the debtor—could be left holding the bag by losing their deduction for worthless debt. While a colorable argument could be made that the distinction should be narrowed—and indeed, Revenue Ruling 2004-78 seems to point in that direction[91]—in no way should it be completely eliminated. In all likelihood, however, even if the distinction between short-term and long-term debt *were* abolished, its abolition would not be likely to make much difference anyway.[92] The Service is not agonizing[93] over application of a "facts and circumstances" analysis to the problem.[94] Most decisions reflect a willingness to accommodate taxpayers' treatment of debt obligations as either short-term or long-term towards the end of allowing tax planning flexibility,[95]

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[89] *See* 1 Bittker & Eustice, *supra* note 23, ¶ 12.41[5]. This argument basically amounts to saying that because of the diversity of investment options and the dependence of the characterization of a debt-equity instrument on the ex post participation of the debt holder in the affairs of the corporation and the investment intent he exhibits both in his purchase and subsequent action, an ex post determination is often all that will be possible. Thus, in the interest of predictability, as the argument goes, we should abolish the distinction altogether.

[90] *See* Tax Section, New York State Bar Association, Report No. 1043, Report on Reorganizations Involving Insolvent Subsidiaries, (Oct. 29, 2003) (finding that short-term "debt is often in the form of an informal advance with no stated maturity, a demand note, or shorter-term note . . . ."); William W. Bratton, Corporate Finance 182–83 (5th ed. 2003) (discussing the business exigency characteristics of short-term borrowing and the issuance of commercial paper).

[91] *See* Rev. Rul. 2004-78, 2004-2 C.B. 108.

[92] Admittedly, the original Bruno's transaction was a transaction between short-term banks (note holders) and the debtor corporation. Second Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code as Modified December 10, 1999, at 17–19, *In re* PWS Holding Corp., No. 98-212 (SLR) (Bankr. D. Del. Dec. 10, 1999). The transaction took place, however, before the Service issued Revenue Ruling 2004-78. Thus, under today's "security" standards, the bank creditors may have counted as long-term creditors due to their presumably higher level of participation in the affairs of the debtor corporation. As argued in the next section, however, the real force behind the CCA's holding was its finding that the Debtor did not completely "liquidate" and thus could not meet the definition of a "reorganization."

[93] *See* 1 Bittker & Eustice, *supra* note 23, ¶ 12.41[3] ("The question of whether a debt obligation constitutes a security has long been shrouded in confusion . . . .").

[94] *See* P.L.R. 1980-49-025 (1980) (granting tax-free reorganization treatment and dispensing with discussion of whether mortgage and income bonds of a bankrupt corporation constitute "securities").

[95] *See id.* (perfunctorily citing Rev. Rul. 1959-98, 1959-1 C.B. 76 without analysis of the maturity date of the securities or level of participation or investment motive of the holders, and permitting nonrecognition of gain or loss in an exchange of debtor common stock for bonds of the debtor).

with fully realistic consideration of the type of bond at issue.[96]

2. *Even if the CCA Understands the Transaction as Being with Long-Term Creditors, the Debtor Is Really Liquidating; Thus, Section 354(b)(1)(B) Is Satisfied.*

Even if it were determined that the distinction between short-term and long-term debt really did present a distortion or neutrality problem, the characterization of a debt obligation as "long-term" would likely not affect the CCA's ultimate outcome. As noted above, the Service—although it did not fully elaborate on the point—had an additional justification for treating the event as taxable: the Debtor corporation did not completely liquidate.[97] If there is no complete liquidation, there can be no true corporate reorganization.[98] In reality, that is where the principal objection to the CCA must lie if the criticisms are to have any force. In most large bankruptcies, it will be long-term bondholders, not short-term creditors, who will stand to benefit most from the rule announced in the CCA.

Section 354(b)(1)(B) provides that the nonrecognition provisions shall not apply to D or G Reorganizations[99] unless "the stock, securities, and other properties received by such transferor, *as well as* the other properties of such transferor, are distributed in pursuance of the plan of reorganization."[100] Treatises and handbooks commonly refer to this requirement—both inside and outside the context of the CCA—as the "liquidation" requirement.[101] That the principal basis for a Bruno's transaction for large public companies that undertake a Bruno's transaction with short-term creditors should reside in a footnote of a Chief Advisory Counsel memorandum[102] is perhaps somewhat less than comforting and thus warrants closer scrutiny.

A cynic analyzing the CCA transaction would undoubtedly point to the fact that the Debtor, for all intents and purposes, *has in fact* liquidated, because retention of a few insubstantial assets that it then leases to the reorganized corporation can in no way constitute nonliquidation. The key issue is, however, whether the Debtor has "liquidated" as that term is used in the

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[96] *See* 1 BITTKER & EUSTICE, *supra* note 23, ¶ 12.41[3] ("A term of five years or less seems to be too short to qualify a note as a security, while a term of ten years or more is apparently sufficient to bring a note within the statute."). Bittker and Eustice also note that "[l]ater decisions . . . have adopted a continuity-of-creditor interest approach, stating that time alone is more decisive." *Id.* That is presumably where the *Camp Wolters* approach, discussed above, becomes relevant. *See supra* note 51.

[97] C.C.A. 2003-50-016 (Aug. 28, 2003).

[98] *See* I.R.C. § 354(b)(1)(B).

[99] In other words, "reorganizations within the meaning of subparagraph (D) or (G) of section 368(a)(1)." I.R.C. § 354(b)(2)(B).

[100] I.R.C. § 354(b)(1)(B) (emphasis added).

[101] *See, e.g.*, Hart, *supra* note 15, at 183–84 n.56 (discussing the Service's ruling in the CCA that, because the Debtor did not comply with the requirement in section 354(b)(1)(B) "that the transferor corporation liquidate," the transaction failed the G Reorganization provisions).

[102] C.C.A. 2003-50-016 n.4 (Aug. 28, 2003).

section 354(b)(1)(B) context.

It bears mentioning that neither the word "liquidation" nor the phrase "complete liquidation" is specifically stated as a requirement in section 354(b)(1)(B). As Bittker and Eustice have pointed out, however, "the requisite distribution of all of the transferor's properties will have that effect."[103] As their treatise notes, interpretation by the courts and the Service of "complete liquidation" should seem to have some bearing on whether the requirement of section 354(b)(1)(B) has been met.[104] A handy definition of "complete liquidation" cannot be found in the Code.[105] The regulations under section 332—governing liquidations of subsidiaries—explain that liquidation occurs "when the corporation ceases to be a going concern and its activities are merely for the purposes of winding up its affairs."[106] However, the "mere retention of a nominal amount of assets for the sole purpose of preserving the corporation's legal existence [will not] disqualify the transaction"[107] from being treated as a "liquidation."

Although it may seem clear that such language gets at the heart of the CCA transaction,[108] it may just be present for the purposes of providing a safe harbor to those corporations, who, for reasons of state law or due to contractual obligations, are not able to distribute all of their property in a reorganization.[109] For those corporations, a strictly interpreted definition of "complete liquidation" would bar them from *ever* engaging in a tax-free reorganization, even if the purpose of engaging in it were to merely readjust its corporate

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[103] 1 Bittker & Eustice, *supra* note 23, ¶ 12.26[3].

[104] *Id.* ¶ 12.26[3] n.341 (referencing the Service's interpretations of "complete liquidation" in the context of fulfilling the section 354(b)(1)(B) distribution requirement).

[105] *Id.* ¶ 10.02; *see also* Rendina v. Commissioner, 72 T.C.M. (CCH) 474, 478, 1996 T.C.M. (RIA) ¶ 96,392, at 2792 ("Neither the Code nor the regulations to section 331 define the term 'complete liquidation.' However, . . . the regulations under section 332 . . . contain a definition of 'complete liquidation' . . . that equally applies to section 331."). The court in *Rendina* went on to hold that a "complete liquidation" can occur despite "continu[ation of] some activities . . . [and] despite an extended liquidation process." *Rendina*, 72 T.C.M. (CCH) at 479, 1996 T.C.M. (RIA) ¶ 96,392 at 2742.

[106] Reg. § 1.332-2(c). It should be noted that courts nearly universally look to the regulations promulgated under section 332 when interpreting section 331, a Code provision containing the word "liquidation" but lacking an accompanying definition in either its provisions or its regulations. *See also Rendina*, 72 T.C.M. (CCH) at 478, 1996 T.C.M. (RIA) ¶ 96,392 at 2742.

[107] Reg. § 1.332-2(c).

[108] *See* C.C.A. 2003-50-016 n.4 (Aug. 28, 2003) (explaining that the debtor corporation intended to retain some nominal assets); Second Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code as Modified December 10, 1999, at 17–19, *In re* PWS Holding Corp., No. 98-212 (SLR) (Bankr. D. Del. Dec. 10, 1999) (structuring the plan of reorganization such that the debtor corporation retained $25 million dollars of property assets that it would then lease to the reorganized corporation).

[109] *See* Dale A. Oesterle, The Law of Mergers & Acquisitions, 259–303 (3d ed. 2005) (discussing contractual obligations in licensing agreements that prevent licenses from being transferred to another owner in the context of a merger or acquisition).

structure.[110]

Nevertheless, the section 354(b)(1)(B) "liquidation" requirement remains—to be avoided or otherwise. As the Fifth Circuit has put it, the formal adoption of a plan of liquidation—or even the immediate and simultaneous liquidation of all the debtor's assets, rather than a piecemeal dismemberment of the corporation—is not required:

> What really counts, as we and others have many times said, is whether in actual point of fact it is the intent of the corporation to wind up its affairs, gather in its resources, settle up its liabilities, cease taking on new business, and then distribute to its stockholders all that is left over.[111]

Thus, the Fifth Circuit in *Shore* rejected the Tax Court's findings that loans made by a corporation—that then liquidated seven months later—to its shareholders in proportion to their holdings were not part of the corporation's liquidation, because they were not made pursuant to a plan of liquidation.[112] It thereby demonstrated that, even though distributions and payments may not be *styled* as a "complete liquidation" of a corporation, courts will not shy from interpreting "liquidation" broadly as long as the taxpayer intended it.[113]

Many of the battles over whether a corporation "liquidated" or not arose before the 1986 amendments to the Code rendered irrelevant the historically abusive liquidation-reincorporation transactions recharacterized by the Service as D Reorganizations.[114] In *Grubbs v. Commissioner*, for instance, a California corporation transferred its assets to a Tennessee corporation for cash, whereupon the cash—along with shares of the Tennessee corporation in equal proportion to the shares held by shareholders in the California corporation—was distributed to all of the shareholders except one.[115] Although the remaining shareholder still retained his shares (that is, although the corporation had not completely "liquidated"), the Tax Court held that the transaction should be treated as a Type D reorganization and that the cash distributions should be treated as dividends.[116]

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[110] *See, e.g.*, Rev. Rul. 1954-518, 1954-2 C.B. 142 (retention of the corporate charter to protect the corporation's name against appropriation by a potential trademark competitor did not prevent a reorganization transaction from qualifying as tax-free).

[111] Shore v. Commissioner, 286 F.2d 742, 745 (5th Cir. 1961).

[112] *Id.*

[113] *See also* H.R. Rep. No. 83-1337, at A112 (1954), *as reprinted* in 1954 U.S.C.C.A.N. 4017, 4250 (deeming a corporation to completely liquidate "even though the business previously carried on by it is continued in partnership or sole proprietorship or other noncorporate form").

[114] *See* 1 Bittker & Eustice, *supra* note 23, ¶ 10.08 ("As amended in 1986 . . . § 336(a) provides for the recognition of gain or loss on liquidating distributions of appreciated or depreciated property . . . [thus] fewer taxpayers are likely to attempt such liquidation-reincorporation transactions.").

[115] 39 T.C. 42, 45–46 (1962).

[116] *Id.* at 48–49.

Similarly, in *Tasco v. Commissioner*, the Tax Court ignored the intent of the taxpayer in order to get at the form of the transaction.[117] The taxpayer in *Tasco*, seeking to avoid taxation on the sale of its subsidiary, sought instead to liquidate pursuant to former section 377, which provided for nonrecognition treatment of any sales by a liquidating corporation during the 12-month period following announcement of a plan of liquidation.[118] The taxpayer therefore organized another subsidiary, sold its target subsidiary, and then transferred its remaining assets and cash to the newly created subsidiary.[119] The Tax Court held that, in substance, the taxpayer had not really liquidated at all:

> The business which petitioner directly operated were continued without interruption by New TASCO, with substantial continuity of shareholder interest. The only result of the transaction was to place the North American stock and a sizable amount of cash in the shareholders' hands. New TASCO was merely the alter ego of petitioner with respect to all of its directly owned business assets; its formation and utilization served no purpose other than masking a distribution as one in complete liquidation.[120]

Other examples of the abusive transaction abound. In *J.E. Smothers v. United States*, for instance, the Fifth Circuit held that where a corporation transferred important assets, including reputation, sales staff, and managerial services of the corporation's owners to another corporation owned by the very same shareholders in exchange for cash, the transaction would be denied liquidation treatment.[121] In *Smothers*, the court focused on the fact that the transfer had been followed by a liquidation of the remaining assets. Thus, it followed that the shareholders would be taxed at ordinary income rates.[122] Likewise in *Davant v. Commissioner*, the Fifth Circuit held that stockholders would be taxed at ordinary income rates given the transaction at issue.[123] The stockholders had held stock in both a warehouse corporation and a water corporation, whose warehouse stock was sold to a purchaser. The purchaser later sold the warehouse assets to the water corporation, thereafter liquidating the warehouse corporation.[124] The court ruled that reorganization treatment—rather than liquidation treatment—would result, because the principal motivation for the transaction was to extract earnings and profits at capital gains rates.[125]

These cases illustrate the true evil at which the "liquidation" requirement is aimed, which should be contrasted with the alleged "evil" at issue in the

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[117] *See* Tel. Answering Serv. Co. v. Commissioner (*Tasco*), 63 T.C. 423, 434 (1974).
[118] *See* I.R.C. § 337.
[119] *Tasco*, 63 T.C. at 425–27, 431.
[120] *Id.* at 435.
[121] 642 F.2d 894 (5th Cir. 1981).
[122] *Id.* at 901.
[123] 366 F.3d 874 (5th Cir. 1966).
[124] *Id.* at 881–82.
[125] *Id.* at 884.

CCA: reactivation of a purportedly liquidated corporation for the purpose of extracting earnings and profits from the corporation at capital gains rates.[126] Thus, these cases represent a substance-over-form rationale that depends upon an exact identity of interests between the old and new corporations.[127] In the bankruptcy context, by contrast, the "continuity of identity" between the old shareholders and the new creditors is a complete fiction.[128] The mere fact that the Supreme Court in its landmark *Alabama Asphaltic* opinion treated creditors who had assumed control over the insolvent corporation as shareholders[129] does not make a subsequent sale to those creditors abusive. The truly abusive "sales to oneself" arise only in the type D liquidation-reincorporation context, discussed above, where shareholders are seeking to extract earnings and profits from the corporation without a corresponding tax. Creditor-shareholders of the sort in *Alabama Asphaltic* are merely attempting to "extract" what remains of their initial investment.[130] The transaction at issue in the CCA is not an instance of controlling shareholders who have run the company historically and now want to extract earnings from it abusively by liquidating it to reduce the rate of taxation of the extraction to capital gains rates. Creditors of a corporation in bankruptcy, while self-interested, seek any compensation they possibly can from the reorganized corporation, and in all likelihood (absent a solvent debtor) will not be compensated in full.[131]

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[126] *See* 1 Bittker & Eustice, *supra* note 23, ¶¶ 10.02, 10.08.

[127] *Tasco* went even so far as to hold that a court need not even find that a type D reorganization has occurred to recharacterize a transaction from "liquidation" to "selling to oneself." *See* Jasper Cummings, *Liberalization of Rules Governing Tax-Free Reorganizations and Corporate Acquisitions Remains an Ongoing Process*, 24 Tax Mngt Wkly. Rep. (BNA) 1649 (Nov. 7, 2005) which states:

> The significance of *Tasco*, according to the dissent, is that it was the first time the court denied liquidation treatment without finding the transaction to be a reorganization. The IRS had argued that the transaction was a Type D reorganization. The majority was content to rule only that there was no complete liquidation, and specifically did not find a reorganization . . . .

Id.

[128] *See* Helvering v. Ala. Asphaltic Limestone Co., 315 U.S. 179, 183 (1942).

[129] *Id.*

[130] *See also* Prop. Reg. § 1.368-1(e)(6)(i), 70 Fed. Reg. 11903-01 (2005) (treating creditors' claims against a Title 11 target corporation as a proprietary interest for the COI requirement, thus negating the rule that the creditor must take affirmative steps to convert their claims into equity interests to be considered "shareholders" for COI purposes); Lisa M. Zarlenga, *Restructuring Troubled Companies*, 789 PLI/Tax 769, 823–25 (2007) (comparing the proposed regulations to the former rule in G.C.M. 33,895 (June 25, 1968)). The Proposed Regulations demonstrate the Service's view that creditors, for the purposes of determining whether the debtor corporation's assets remain within the circle of "proprietary interests" that justify tax-free treatment, should be looked at as equity holders, even though their original investment intent may have differed greatly.

[131] Mark S. Scarberry et al., Business Reorganization in Bankruptcy 9 (3d ed. 2006) ("The only real hope the unsecured creditors have is for the debtor to continue in business and earn enough money to pay something on their debts.").

Although the usefulness of the liquidation-reincorporation transaction has been lessened by the repeal of the *General Utilities* doctrine and the lowering of the tax rates on dividends to that of capital gains rates,[132] the basic contrast between it and the CCA transaction—given the rationale that the Service formerly used to recharacterize liquidation-reincorporations and its relative presence or absence in the CCA transaction—remains valid.

An additional argument that critics of the CCA might make—and indeed, have made[133]—is that the transaction is really just a sham.[134] The debtor corporation is really just selling to itself and the creditor-shareholders are taking over. In one sense, this is just a reformulation of the "liquidation" argument: the debtor has no true economic reason for not liquidating and should therefore be deemed to have actually liquidated. Seen from that perspective, the argument is that the debtor has no business purpose for remaining in existence, and thus, for purposes of applying the reorganization provisions, its existence should be ignored.[135]

As Bittker and Eustice note, "[t]he regulations under [the] § 368 [reorganization provisions] take seriously the business-purpose requirement," and thus, by implication perhaps, the regulations also take seriously the business purpose of parties who seek to avoid the reorganization requirements.[136] The regulations regarding "business purpose" largely mirror the language from the Supreme Court's *Gregory v. Helvering* decision,[137] from which the "business purpose doctrine" arose, reflecting the attitude that "a transaction should not be given effect for tax purposes unless it serves a purpose other than tax avoidance."[138]

For example, in *ACM Partnership v. Commissioner*, a much discussed "business purpose" case from the 1990s, a taxpayer partnership purchased pri-

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[132] The *General Utilities* doctrine had allowed corporations to liquidate without recognizing gain or loss on the distribution of its assets, with its shareholders recognizing only capital gains rather than dividends. *See* Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200, 206 (1935). After the Tax Reform Act of 1986, however, corporations distributing assets in liquidations—whether under section 331 (to individual shareholders) or under section 332 (to controlling corporations)—must recognize gain on appreciated assets. And since dividends are now taxed at capital gains rates, there is a lessened incentive for shareholders to seek liquidation treatment over dividend treatment in the presence of large amounts of earnings and profits.

[133] Sheppard, *supra* note 12 (arguing that section 269 should deny the sought tax effect of the Bruno's sale).

[134] *See* I.R.C. § 269 (permitting the Service to disallow deductions, credits, or other allowances if the purpose of an acquisition from which such deduction, credit, or other allowance was made, was the "evasion or avoidance of Federal income tax by securing the benefit of a deduction, credit, or allowance which such person or corporation would not otherwise enjoy . . . .").

[135] *But see* United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 455 (1950) (stating that the presence or absence of a tax avoidance objective is irrelevant in determining when a "complete liquidation" has occurred for tax purposes).

[136] 1 Bittker & Eustice, *supra* note 23, ¶ 12.61[1].

[137] 293 U.S. 465 (1935).

[138] 1 Bittker & Eustice, *supra* note 23, ¶ 12.61[1].

vate placement notes and thereafter exchanged them for contingent payment installment notes, generating a capital loss for the partnership.[139] The court found that the exchanges lacked economic substance, distinguishing *Cottage Savings*—which just seven years earlier had permitted a taxpayer savings and loan corporation to avoid section 1031 nonrecognition treatment on an exchange of mortgages with different underlying collateral[140]—because

> the disposition in *Cottage Savings* precipitated the realization of actual economic losses arising from a long term, economically significant investment, while the disposition in this case was without economic effect as it merely terminated a fleeting and economically inconsequential investment, effectively returning ACM to the same economic position it had occupied before the notes' acquisition 24 days earlier.[141]

The *ACM Partnership* case generated heated discussion concerning the continued relevance of the economic substance and business purpose tests.[142] Its proponents argued that the doctrine still had a role to play in preventing abusive transactions, so long as the transactions are not primarily tax motivated, had meaningful economic consequences, or that the tax consequences are reasonable and justified.[143] In *ACM Partnership*, the problem with the transaction was that the parties undertook no risk. Two banks—one domestic and one foreign—contributed funds to a partnership that purchased a non-readily-marketable note and subsequently sold the note to another bank in exchange for cash and contingent payments over a period of years.[144] The gain from the year of sale was then allocated to the foreign bank, while the domestic bank took the losses.[145] As one commentator noted, the "transaction was a more complicated means of temporarily investing the partnership's funds . . . which . . . was a more complicated means of doing nothing."[146]

While it is clear that *ACM Partnerships* is a somewhat cut-and-dried case, one could easily question whether the benefits to the public fisc from disallowing such transactions actually outweigh the loss in predictability on the part of taxpayers. As long as economic substance is still a viable option for the

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[139] 157 F.3d 231, 245–46 (3d Cir. 1998).

[140] 499 U.S. 554 (1991).

[141] *ACM Partnership*, 157 F.3d at 251–52.

[142] *See, e.g.*, Robert Willens, *Form and Substance in Subchapter C–Exposing the Myth*, 84 Tax Notes (TA) 739 (Aug. 2, 1999) [hereinafter Willens, *Exposing the Myth*]; David P. Hariton, *Sorting Out the Tangle of Economic Substance*, 52 Tax Law. 235 (1998); Menachem Rosenberg, *ACM Partnership v. Commissioner—Its Implications for Corporate Tax Shelters and Beyond*, 25 J. Corp. Tax'n 3 (1998).

[143] Hariton, *supra* note 142, at 268–70.

[144] *ACM Partnership*, 157 F.3d at 238–40.

[145] *Id.* at 243–44, 252.

[146] Hariton, *supra* note 142, at 264. For further discussion of a series of contingent installment sale cases in which the Service successfully argued for recharacterization based on business purpose grounds, see Kevin M. Keyes, *Evolving Business Purpose Doctrine*, 793 PLI/Tax 643, 650–57 (2007).

Service, there is always a chance that a choice of transaction will be deemed abusive merely because it obtained the best tax advantage for the taxpayer in complete compliance with the letter of Congress's duly-enacted tax laws. Indeed, that is the issue with its application to the transaction in the CCA. Is it really the case that the parties to a Bruno's transaction are engaging in a sale for the purpose of generating losses? Clearly they are seeking to avoid the gains arising from COD income. But that is precisely what the statute allows.[147]

Even in the *ACM Partnership* example, the transacting parties were only able to structure their transaction in this way because the Treasury's regulations had not been detailed or stringent enough to deter it.[148] As the dissent in *ACM Partnership* noted:

> ACM, like all taxpayers, has the absolute right to decrease or to avoid the payment of taxes so long as that goal is achieved legally.
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> . . . .
>
> ACM's sales of the Citicorp Notes for cash and LIBOR Notes resulted in the exchange of materially different property with "legally distinct entitlements.". [sic] Consequently, the sales were substantive dispositions, and the tax effects of those transactions should be recognized. *Cottage Savings,* as well as the plain language of IRC § 1001, demands that result.
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> . . . .
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> I can't help but suspect that the majority's conclusion to the contrary is, in its essence, something akin to a "smell test." If the scheme in question smells bad, the intent to avoid taxes defines the result as we do not want the taxpayer to "put one over." However, the issue clearly is not whether ACM put one over on the Commissioner, or used LIBOR notes to "pull the wool over his eyes." The issue is whether what ACM did qualifies for the tax treatment it seeks under § 1001. The fact that ACM may have "put one over" in crafting these transactions ought not to influence our inquiry. Our inquiry is cerebral, not visceral. To the extent that the Commissioner is offended by these transactions he should address Congress and/or the rulemaking process, and not the courts.[149]

Clearly the dissent believed that *Cottage Savings* controlled the outcome of the case, and, indeed, *Cottage Savings*, with its extremely deferential stance toward the taxpayer's characterization of the transaction, can very nearly be read as dismissal and *sub silentio* overruling of *Gregory*, if not in general, then

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[147] *See* I.R.C. § 108.

[148] *ACM Partnership*, 157 F.3d at 245–47. ACM contended that it had complied with all the strictures the Service had placed on the transaction—that is, that it was simply employing what the Service had made available. *Id.; see also* Hariton, *supra* note 142, at 262–63.

[149] *ACM Partnership*, 157 F.3d at 263–65 (McKee, J., dissenting).

at least in the C Corporation context.[150] After *ACM Partnerships*, of course, that last statement is that much more uncertain.

Maybe the context of C Corporations is what makes these transactions distinct. As one commentator has noted, "[t]he area of the tax law dealing with corporation/shareholder relationships, Subchapter C, is replete with instances in which altering the form for effectuating a transaction, without correspondingly varying its economic outcome, can produce dramatic changes in its tax results."[151] Is it realistic for the Service to clamp down on all taxpayers that choose the more tax-advantageous route rather than the alternative?

Some courts have moved away from a strict economic substance analysis,[152] which has been cause for celebration among economic substance doctrine opponents.[153] Even those commentators who support vigorous use of the economic substance test recognize that the "ability [of judges and the Service] to recharacterize transactions introduces considerable uncertainty and confusion into a system that is based on the application of objective rules."[154] Congress seems to have recognized the uncertainty as well. Although Congress has considered codifying the economic substance doctrine in various proposed pieces of legislation, as one commentator has noted, "it is unlikely that any such proposal, if enacted, would produce any greater certainty in the application of" the doctrine.[155] With proposed tests such as "substantial" nontax purpose and "reasonable means" of accomplishing the purpose, it is unlikely to be of any help, and may in fact bind courts and the Service to strict analysis under the doctrine, even where undeserved.[156] Luckily, none of these proposals has been acted upon, perhaps due to the fear of losing the predictability with which the C Corporation rules are administered.

Even if we assume that the economic substance test has vitality, however, it seems to target to a greater extent those transactions that would *never* come to fruition *absent* tax motivated consequences, rather than transactions—such as that at issue in the CCA—that will be undertaken, but which provide tax-

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[150] Of course, such bold proclamations should be taken with a grain of salt. Although various commentators have called for an end to the economic substance and business purpose doctrines, neither the Treasury, nor the Service, nor certainly Congress have made any intimations to that effect. *See, e.g.*, Heather M. Rothman, *Economic Substance Codification, Clarification Popular Offset, CRS Says*, Daily Tax Rep. (BNA), Mar. 26, 2008, at G-1 (noting that "clarification or codification of the economic substance doctrine has been a popular provision in legislation introduced during the 110th Congress").

[151] Willens, *Exposing the Myth*, *supra* note 142, ¶ 1.

[152] *See, e.g.*, Esmark, Inc. v. Commissioner, 90 T.C. 171 (1988) (respecting corporate sale of subsidiary stock followed by a self-tender in which a third party acquired taxpayer's stock in a public tender offer and then the taxpayer distributed the subsidiary stock in redemption of the tendered shares, which under the literal wording of the then-current law was a nontaxable transaction, rejecting Service's economic substance arguments).

[153] *See* Robert Willens, *Tax & Accounting Issues Biannual*, 784 PLI/Tax 577, 802 (2007) ("[T]he 'substance over form' doctrine has been rendered moribund.").

[154] Hariton, *supra* note 142, at 239.

[155] Keyes, *supra* note 146, at 673.

[156] *See id.* at 674.

advantageous and tax-disadvantageous means to do so. If I, after all, choose to invest my earnings in a principal residence that I expect will appreciate over the next 10 years at a rate greater than any comparable investments, I am not thereby penalized for having chosen the more tax advantageous means of investment.[157] A common test for "economic substance" is, after all: (1) benefits arising "from a discrete set of tax-motivated transactions"; (2) transactions that do not alter the taxpayers economic position "*as compared to not undertaking them*"; (3) the tax benefits are unreasonable compared to the objective rules giving rise to them.[158] The last prong is obviously subjective and depends entirely upon one's disposition towards corporations in bankruptcy, and perhaps, upon what one had for breakfast. The second prong, however, clearly contemplates that the transacting party or parties either will or will not undertake a transaction, whereas the debtor in a Bruno's transaction *will clearly reorganize*. It only remains to be seen whether it will structure its reorganization as taxable (outside the scope of the nonrecognition provisions) or tax-free (within their scope).

Furthermore, the CCA-Bruno's structure may *actually have* a distinct economic effect. Splitting the Debtor into two subsidiary corporations has practical effects. As demonstrated in the CCA, the creditors receive both stock of the reorganized Debtor and stock of NewCo.[159] Thus, in form—but not, as shown below, for section 355 tax purposes—the transaction resembles a spin-off, with the shares held subsequently by "semi-public" owners. Although the "ownerships groups of [the two corporations] begin in identity" they will inevitably "differentiate themselves over time as ownership turns over through stock trading."[160] Because in the CCA the creditors and the debtor have not made a section 382(l)(5) election—pursuant to which the NOLs of the Debtor would be carried over to NewCo, but also pursuant to which, an ownership change within two years would wipe out the NOLs[161]—the creditor-shareholders have no restrictions on the trading of their stock interests. Thus, the debtor and NewCo assume a very real risk that public ownership of the two corporations could begin to differentiate itself.

That the criticisms of the CCA are far afield becomes even more apparent upon comparison to truly abusive transactions that Congress and the Treasury have worked to prevent. In the Preamble to the 1998 Continuity of Interest regulations, for example, the Service specifically noted that it was directing its efforts at transactions "where the former T shareholders treat the transaction as a tax-free reorganization, and P later disavows reorganization to step up its basis in the T assets based on the position that sales of P stock by the former T shareholders did not satisfy the COI requirement."[162]

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[157] *See generally* I.R.C. § 163(h)(3).
[158] Hariton, *supra* note 142, at 241 (emphasis added).
[159] *See* C.C.A. 2003-50-016 (Aug. 28, 2003).
[160] Bratton, *supra* note 90, at 585.
[161] *See* I.R.C. § 382(l)(5).
[162] T.D. 8760, 1998-14 I.R.B. 4.

That is not what is happening in the CCA transaction. The creditors and the debtor attempt no post-transaction semantic acrobatics in the CCA and specify their treatment of the transaction up front.[163] There is thus no danger of Service-whipsaw here because both parties have a consistent understanding as to how the transaction will be taxed.[164] Debtors and creditors who utilize the Bruno's transaction merely take advantage of the clear bright-line rules upon which taxation in the C Corporation context is premised. Other deemed-abusive transactions that Congress and the Treasury have targeted in the reorganization context—including the *General Utilities* doctrine,[165] the stock-for-debt exception,[166] and the carryforward of loss corporation NOLs[167]—also touch on matters substantially different from the CCA transaction and demonstrate Congress's intent to direct its ire elsewhere.

Finally, even if the business purpose doctrine still has vitality and even if the Service were to show a renewed vigor in looking past technical compliance with the Code, there may very well exist valid reasons for maintaining the debtor's operations in a separate subsidiary. For example, the acquiring creditors may want to avoid contingent or undisclosed liabilities, or preserve the corporate entity due to nontransferable rights or privileges.[168] As Bittker and Eustice have noted: "An important business reason to acquire assets rather than stock is to reduce or eliminate the business risk of becoming subject to undisclosed liabilities of the target corporation. . . . This mode of acquisition also ordinarily makes it easier to exclude unwanted assets from

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[163] *See* C.C.A. 2003-50-016 (Aug. 28, 2003) (specifying the specific steps); *cf.* Second Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code as Modified December 10, 1999, at 17–19, *In re* PWS Holding Corp., No. 98-212 (SLR) (Bankr. D. Del. Dec. 10, 1999) (specifying that the Debtor will not liquidate and that the claims will be satisfied with stock).

[164] *Cf.* Arnes v. United States (*Arnes I*), 981 F.2d 456, 457 (9th Cir. 1992) (upholding, on the basis of section 1014, wife taxpayer's nondeclaration of redemption of interest from an S Corporation—jointly owned with her former husband—pursuant to a decree of divorce); Arnes v. Commissioner (*Arnes II*), 102 T.C. 522, 530 (1994) (finding the Ninth Circuit opinion nonbinding and that the S Corporation's redemption of wife's stock was pursuant to an obligation of the *corporation*, not of the husband *taxpayer*, and thus, that the Ninth Circuit should have ruled for the Service in its case); Reg. § 1.1041-2 (closing the loophole created by *Arnes I* and *Arnes II*).

[165] *See* Gen. Utils. & Operating Co. v. Helvering, 296 U.S. 200, 206 (1935); *cf.* I.R.C. § 311 (repealing the *General Utilities* doctrine).

[166] *See* Capento Sec. Corp. v. Commissioner, 47 B.T.A. 691 (1942) (origin of the stock-for-debt exception), *aff'd*, 140 F.2d 382 (1st Cir. 1944); *see also* Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (codified as amended in scattered sections of 26 U.S.C.) (repealing the stock-for-debt exception for insolvent corporations); Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389 (codified as amended in scattered sections of 26 U.S.C.) (repealing the stock-for-debt exception for non-insolvent corporations).

[167] *See* I.R.C. § 382(l)(5) (permitting debtor in bankruptcy to carry forward its losses to a reorganized corporation if former creditors and shareholders of the debtor control the new reorganized corporation, but depriving the debtor of the carryforwards if an "ownership change" occurs within two years of the reorganization); *see also infra* note 188.

[168] *See* 1 Bittker & Eustice, *supra* note 23, ¶ 12.05[1].

the transaction."[169]

The fact that in some isolated instances, a pre-conceived business purpose is not present should not make the CCA transaction categorically prohibited. As shown in the subsequent two sections, such a ruling—coupled with previous rulings and legislations—would impede restructuring through bankruptcy and reduce the role played by Chapter 11 in rejuvenating downtrodden corporations.

B. *Even If One Entertains the "No Liquidation" Fiction, the Debtor Is Really Just Splitting a Trade or Business and the Transaction Should Be Nontaxable Under Section 355. Thus, the Service Should Close This Loophole by Interpreting Section 355 (Divisive D Reorganizations) and Section 354 (Other Nondivisive Reorganizations) Broadly Because the Code Already Provides Statutorily-Approved Procedures for Sales of Proprietary Interests (Sections 338, 382(l)(5), 108(a)) in Both Taxable and Nontaxable Transactions*

Under normal circumstances, when a debtor in bankruptcy seeks to reorganize, it is most beneficial to do so in a tax-free manner. Two possible statutory methods exist by which a debtor in bankruptcy can accomplish this—a one-corporation E Reorganization or a two-corporation G Reorganization.[170] An E Reorganization is a recapitalization.[171] The debtor issues stock in exchange for the stock or securities of existing stockholders or creditors, who receive the stock tax-free.[172] A G Reorganization involves an actual transfer of the debtor's assets or stock.[173] The debtor transfers its assets or stock to another corporation and in return receives stock or securities of the acquiring corporation which it must distribute in "a transaction which qualifies under section 354, 355, or 356."[174]

As noted above, section 108 permits a taxpayer to exclude COD income if the discharge "occurs in a title 11 case."[175] However, the exclusion is often merely a deferral of tax. In exchange for deferring tax on the COD income, the debtor must reduce its tax attributes in the year following[176] the receipt of

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[169] *Id.* at ¶ 10.40[1].

[170] 10 Collier, *supra* note 15, at ¶¶ 10.01[1]-[2]. Additionally, if a reorganization fails to qualify as a G Reorganization, it may qualify as another type of reorganization. However, if a reorganization qualifies as *both* a G Reorganization and any other type of reorganization, the G Reorganization treatment will govern the transaction. *See* I.R.C. § 368(a)(3)(C).

[171] I.R.C. § 368(a)(1)(E).

[172] 10 Collier, *supra* note 15, at ¶ 10.01[1].

[173] I.R.C. § 368(a)(1)(G).

[174] I.R.C. § 368(a)(1)(G); 10 Collier, *supra* note 15, at ¶ 10.01[2].

[175] I.R.C. § 108(a)(1)(A).

[176] *See* Gitlitz v. Commissioner, 531 U.S. 206, 218 (2001) (holding that section 108(b)(4)(A) expressly requires the reduction of tax attributes to occur *after* the determination of taxes for the year of COD income realization, and thus, attribution reduction will not act on assets that are no longer present in the corporation at the start of the following taxable year).

COD income.[177] Indeed, this is the crux of the issue in the CCA transaction. Although the debtor in the CCA clearly has realized COD income, because its assets have been transferred to its creditors, it will feel the tax effect only to the extent that it has NOLs remaining after the sale. This, in fact, was the case in the original Bruno's transaction.[178] Furthermore, if the debtor is a member of a consolidated group, then the COD income will be applied *first* to the tax attributes of the debtor, *and then* to the tax attributes of each member of the consolidated group.[179] Finally, if the transaction in which ownership of the debtor changes hands qualifies as a G Reorganization, then, pursuant to recently enacted regulations, the NOLs and asset bases of the transferor will be reduced in the hands of the acquiring corporation.[180]

Another set of statutory provisions—enacted by the Tax Reform Act of 1986[181]—apply *only if* the transaction qualifies as a tax-free reorganization under section 368 or as a liquidating distribution to which section 332 applies.[182] Generally, "in the case of the acquisition of assets of a corporation by another corporation . . . if the transfer [of assets] is in connection with a reorganization described in" section 368(a)(1)(G), the acquiring corporation shall succeed to the debtor corporation's tax attributes,[183] including NOL carryovers,[184] earnings and profits,[185] capital loss carryovers,[186] and so on.[187] However, the acquiring corporation's actual *use* of the tax attributes is limited

[177] I.R.C. § 108(b) (providing for "reduction of tax attributes"); I.R.C. § 1017 (providing that amounts excluded from gross income under section 108(a) "shall be applied in reduction of the basis of any property held by the taxpayer at the beginning of the taxable year following the taxable year in which the discharge occurs"); S. Rep. No. 96-1035, at 10–11 (1980), *as reprinted in* 1980 U.S.C.C.A.N. 7017, 7025–26 ("[T]he 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.").

[178] *See* Sheppard, *supra* note 12, at 984.

[179] Reg. § 1.1502-21T(b)(2)(iv) (as amended in 2006). These regulations, which followed and mimicked legislation introduced by Senator Rick Santorum, were passed in the wake of media attention devoted to MCI/Worldcom's bankruptcy proceedings. Hart, *supra* note 15, at 194–99.

[180] Treas. Reg. §§ 1.108-7 (as amended in 2004), 1.1017-1(b)(4) (as amended in 2006); *see also* Candace A. Ridgway, *Whose Attributes Are They, Anyway? Recent Guidance on the Effects upon Tax Attributes of Debtors' Reorganizations, Cancellation of Debt, and Related Transactions*, 45 Tax Mgm't Memorandum 165 (2004).

[181] Pub. L. No. 99-514, 100 Stat. 2085 (1986) (codified as amended in scattered sections of Code); 11 Collier on Bankruptcy ¶ 11.04[1] (Alan N. Resnick & Henry J. Sommer eds., 15th ed. rev. 2007) ("The Tax Reform Act of 1986 substantially revised . . . Section 382 . . . .").

[182] I.R.C. § 381(a) (providing that a corporation will succeed to a loss corporation's tax attributes if a transfer is in connection with a reorganization "described in subparagraph (A), (C), (D), (F), or (G) of section 368(a)(1)").

[183] I.R.C. § 381(a).

[184] I.R.C. § 381(c)(1).

[185] I.R.C. § 381(c)(2).

[186] I.R.C. § 381(c)(3).

[187] I.R.C. § 381(c)(4)–(6), (8)–(14), (16)–(19), (22)–(26).

by section 382.

In general, section 382(a) limits the use of any tax attributes by so-called "loss corporations" whose ownership changes hands during a three year testing period, regardless of whether a reorganization under section 368 has occurred or not.[188] The limitation amount is equal to the value of the loss corporation multiplied by the long-term tax-exempt rate.[189] Thus, if ownership of a loss corporation changes hands, the loss corporation will only be able to use NOLs in succeeding years equal to a small fraction of the corporation's own value at the time of the "ownership change."[190] Furthermore, capital contributions made to the loss corporation during the two year period before the date of the "ownership change" will be presumptively treated as "part of a plan . . . to avoid or increase [the section 382] limitation," and will be disregarded.[191] And if the corporation does not continue its historic business enterprise "at all times during the 2-year period beginning on the change date," then the corporation will not be able to use *any* of its previous NOLs.[192]

If the loss corporation has net unrealized built-in gain at the time of the ownership change, however, the "limitation amount" is increased by the recognized built-in gains for the given taxable year.[193] Correspondingly, net unrealized built-in losses and subsequent recognized built-in losses will reduce the "limitation amount."[194] The reduction or increase of the limitation amount by recognized built-in gains (or losses) will only occur, however, if the net unrealized built-in gains (or losses) at the time of the ownership change exceed either 15% of the value of the assets or $10 million.[195]

In bankruptcy, however, the rules change. A debtor corporation in bankruptcy can make an election under section 382(l)(5) that prevents the section

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[188] I.R.C. § 382(a) (limiting the use of "pre-change losses" by an amount determined under subsection (b)); I.R.C. § 382(b) (providing calculations for the limitation amount); I.R.C. § 382(c) (defining "pre-change loss" as NOLs existing at the time of an "ownership change"); I.R.C. § 382(g)(1) (defining "ownership change" as any "owner shift" involving a five-percent shareholder if the "owner shift" causes the percentage of stock owned by one or more five-percent shareholders to have increased by more than 50 percentage points over a three year "testing period," *or* as any "equity structure shift"); I.R.C. § 382(g)(2) (defining "owner shift involving a 5-percent shareholder" as a change in the respective ownership of stock that affects the percentage of stock owned by any five-percent shareholder before or after the change); I.R.C. § 382(g)(3) (defining "equity structure shift" as any reorganization within the meaning of section 368, except for section 368(a)(1)(F)). Thus, any G Reorganization will automatically be subject to the section 382 provisions.

[189] I.R.C. § 382(b)(1).

[190] I.R.C. § 382(e)(1) (providing that the value of the loss corporation shall be computed at the time of the ownership change); P.L.R. 1993-32-004 (Apr. 30, 1993) (providing that a control premium above the trading value of a minority stock on the New York Stock Exchange could be included in the calculations of the section 382 limitation).

[191] I.R.C. § 382(l)(1)(A).

[192] I.R.C. § 382(c).

[193] I.R.C. § 382(h)(1)(A).

[194] I.R.C. § 382(h)(1)(B).

[195] I.R.C. § 382(h)(3)(B).

382 limitation on the use of NOLs from ever applying.[196] Generally, as long as shareholders and historic creditors[197] of the loss corporation control (defined as 50% ownership) of the loss corporation by reason of "being shareholders or creditors immediately before" the ownership change, then the section 382 limitation will not apply.[198] This benefit to debtors, however, comes at a cost. If at any time during the two-year period following the ownership change a second ownership change occurs, then the corporation will not be entitled to *any* of its NOLs.[199] Furthermore, even if no second ownership change occurs, any NOLs which are attributed to interest payments made to creditors who exchange their claims for stock of the reorganized debtor may not be carried forward and are lost to the debtor.[200]

The prospect of losing the NOLs completely forces debtors to make a choice between the NOL limitations and trading restrictions on their stock.[201] Obviously, if no trading restrictions were placed on the debtor's stock, there would be nothing to stop outside speculators from purchasing the stock and either purposefully or inadvertently causing an "ownership change." Thus, the only option is to restrict the stock, which, obviously, will have negative effects on the stock's liquidity and therefore its price. Because of the disadvantages of the "sticks" in this "stick and carrot" approach,[202] debtors are able to

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[196] I.R.C. § 382(l)(5).

[197] Reg. § 1.382-9(d)(1) (as amended in 1994) (defining "qualified creditors" for purposes of section 382(l)(5) as those holding "qualified indebtedness"); Reg. § 1.382-9(d)(2) (as amended in 1994) (defining "qualified indebtedness" as indebtedness held by the same owner for 18 months before filing of the bankruptcy petition or indebtedness arising in the ordinary course of business after the filing of the petition). Such "ordinary course" obligations include "trade debt, tax liabilities, liabilities to employees or former employees, tort liabilities, [and] debt incurred to pay [s]ection 162 expenses." Matthew A. Rosen et al., *A Practical Guide to the Tax Considerations and Consequences of Acquiring Stock and Debt Securities of Financially Troubled Corporations*, 789 PLI/Tax 431, 481–82 (2007).

[198] I.R.C. § 382(l)(5)(A).

[199] I.R.C. § 382(l)(5)(D). Any NOLs previously used by the loss corporation in the time period between the first ownership change and the second ownership change, however, will not be retroactively rescinded. P.L.R. 2007-51-011 (Sept. 7, 2007).

[200] I.R.C. § 382(l)(5)(B); Reg. § 1.382-9(k)(1)(ii) (as amended in 1994).

[201] *See* P.L.R. 2006-05-003 (Oct. 28, 2005) (involving Bankruptcy Court's placement of trading restrictions on the corporation's stock, prohibiting four-percent owners from owning five percent of the corporation's stock).

[202] *See* Robert Willens, *Ruling Favors Firm in Fixing 'Ownership Change' Date at Bankruptcy Confirmation*, 26 TAX MGM'T WKLY. REP. (BNA) 839 (June 18, 2007). Willens states:

> On the one hand, Congress wished to allow these corporations to have an opportunity to rehabilitate themselves and one way to do so was to insure that the NOL of such a corporation could be used . . . against any taxable income it might generate after emerging from bankruptcy. On the other hand, in light of the penalties imposed by § 382(l)(5), it seems clear Congress also wanted to "punish" these taxpayers for their profligacy.

Id.

opt out of section 382(l)(5) treatment.[203]

The effects of ownership changes under section 382 and COD income under 108 do not fulfill the statutory purpose of *effectuating* the reorganization or purchase itself. The reorganization provisions are discussed above and will be mentioned briefly here.

Generally, sales of stock or assets are taxed in the same manner that any other transaction is taxed—amount realized over the basis.[204] Under the reorganization provisions, however, if a corporation—pursuant to a "plan of reorganization"—exchanges its stock,[205] its stock plus boot,[206] or its assets[207] in exchange for stock or securities in another corporation that is "a party to the reorganization," then no gain or loss shall be recognized.[208] Likewise, if it distributes to its shareholders stock or securities (or stock or securities plus boot) of a corporation which it controls immediately before the distribution, "then[,] [again] no gain or loss shall be recognized."[209] Additionally, two points should be made concerning the difference between section 355 and section 354 reorganizations:

1. section 354 applies generally to transactions in which one corporation acquires another corporation;[210] and
2. section 355 applies both to transactions in which a corporation:
   a. "spins off" a subsidiary to its shareholders, where both the distributing and the distributed corporation carry on an active trade or business after the distribution;[211] or
   b. transfers stock or assets from one controlled subsidiary to another controlled subsidiary.

The bottom line is that a G Reorganization can be deemed to occur as long as either the provisions of section 354 or section 355 are met.[212] Thus, a corporation spinning off some of its assets in a subsidiary whose shares it then distributes to its shareholders or security holders may qualify as a section 355

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[203] I.R.C. § 382(l)(6). Additionally, if the debtor chooses not to make a section 382(l)(5) election, then the fair market value of the loss corporation for NOL-limitation purposes (under section 382(b)) is the lesser of the value of the stock of the loss corporation immediately after the ownership change or the value of the loss corporation's pre-change assets, plus any increase in value resulting from surrender or cancellation of creditors' claims in the transaction. I.R.C. § 382(l)(6).

[204] I.R.C. § 1001(a).

[205] *See* I.R.C. § 354(a)(1).

[206] *See* I.R.C. § 356(a).

[207] *See* I.R.C. § 361(a).

[208] *See* I.R.C. §§ 354(a)(1), 361(a).

[209] I.R.C. § 355(a).

[210] Kwall, *supra* note 35, at 507 ("When a corporate enterprise is transferred in an A, B, C or nondivisive D reorganization, I.R.C. § 354 or § 356 applies to the shareholders of the transferred enterprise.").

[211] *Id.* ("When a divisive D reorganization occurs, I.R.C. § 355 or § 356 applies to the shareholders of the divided enterprise.").

[212] I.R.C. § 368(a)(1)(G).

G Reorganization; and a corporation selling its assets to another corporation for shares (or shares plus boot, pursuant to section 356) of that corporation may qualify as a section 354 G Reorganization.

The upshot of the preceding analysis of Code provisions is as follows. It appears that the most potent criticism of the Bruno's Transaction—if we accept the "short-term-long-term debt distinction" and the "no liquidation" facts found by the Service—is that the reorganization provisions, along with the limitations on COD income and use of NOLs, already provide the sole mechanisms and statutory framework by which transactions between debtor corporations and proprietary interest holders (that is, creditor-shareholders) can occur. The G Reorganization provisions should be exclusive and air tight. Alternative reorganizations-as-sales should therefore not be tolerated. Either a debtor corporation subjects itself to NOL limitations or subjects itself to trading restrictions.[213] Either a debtor realizes actual income or reduces its tax attributes due to the receipt of COD income.[214] And finally, in the CCA, the debtor has *either* separated two trades or businesses and "spun off" the shares of the separate trade or business to its proprietary interest holders (tax-free under section 355) *or* has transferred its assets to a new set of proprietary interest holders for their stock or securities (tax-free under section 354). To treat this transaction otherwise permits a loophole between sections 354 and 355 through which creditor-shareholders in G Reorganization-like transactions will all too readily drive trucks, yachts, planes, bulldozers, forklifts, and innumerable other depreciable assets. Thus, either section 354 or 355 should be interpreted more broadly than they were in the Bruno's sale to close this gap between them.[215]

While not well developed by critics of the CCA, the argument in support of the exclusivity of the G Reorganization provisions appears to be as follows. First, Congress intended the G Reorganization provisions, enacted as part of the Bankruptcy Tax Act of 1980, to give debtors a flexible[216] means to transfer ownership from the current owners (the original residual shareholders) to the future owners (shareholders and creditors) without incurring tax on the transfer.[217] The provisions were meant to benefit both the debtor and its creditor-shareholders because it was believed that such a transfer would implicate only

[213] *See* I.R.C. § 382(a)–(b); *see also* I.R.C. § 382(l)(5).

[214] *See* I.R.C. § 108.

[215] As one treatise has noted, "a 'G' [reorganization] is not elective but definitional in nature—and presumably the I.R.S. is free to recharacterize a taxable two corporation assets acquisition as a tax-free 'G' reorganization or vice versa." 10 Collier, *supra* note 15, ¶ 10.01[2]. Critics would argue that Bruno-like debtors are evading the non-elective G Reorganization provisions and that the Service should drop the hatchet.

[216] *See* Michael J. Kliegman & Anna Turkenich, *Reaching Absolute Zero: Recent Proposed Regulations Focus on Net Value Requirement in Subchapter C,* 46 Tax Mgm't Memorandum 566, 574 (2005) (noting that the legislative history of the G Reorganization provisions encourages a liberal approach to qualification as a G Reorganization).

[217] *See* S. Rep. No. 96-1035, at 35–37 (1980), *as reprinted in* 1980 U.S.C.C.A.N. 7017, 7050–51.

a readjustment of the corporate form.[218] In one sense this argument depends upon the nature of creditors as proprietary interest holders. But in another sense, it follows directly from the statutory framework itself. The COI rules, the COD income provisions, and the NOL limitation clearly provide the framework for a debtor's transfer of assets from itself to its creditors (in other words, from itself to itself). It would make no sense conceptually for a debtor to treat such a transaction as a sale (*i.e.*, selling to itself), rather than characterizing a transaction between itself (original residual shareholders) and its future "self" (creditor-shareholders) as a reorganization.[219]

By analogy, a critic might ask, what would happen if the debtor were *not* in bankruptcy and not insolvent—so that the nonrecognition provisions of section 108 would apply[220]—and the creditors purchased either the stock or the assets of the corporation for a combination of discharged debt and cash?[221] In both an asset and a stock purchase, a step-up in the assets' bases would occur.[222] But also, notably, in both cases, the target corporation would actually realize the gain on the transaction because the section 108 deferral provisions would not apply.[223] If, as is presumably the case, the target corporation is then merged or liquidated into the acquiring corporation, the acquiring corporation would receive a "net value" less than the actual purchase price, whether the transaction occurs in an actual asset sale or a deemed asset sale

[218] *See id.*

[219] Especially given the fact, as shown above, that the G Reorganization provisions are not elective. *See generally supra* text accompanying notes 211–12.

[220] *See* I.R.C. § 108(a)(1)(A)–(B) (excluding discharge of indebtedness from gross income if the discharge occurs in a Title 11 case or if the taxpayer is insolvent).

[221] In the CCA itself, the taxpayers sought to characterize the sale as one of assets for a combination of stock, cash, and notes. C.C.A. 2003-50-016 (Aug. 28, 2003).

[222] *See* I.R.C. § 1012 (defining basis of property to be the cost of the property); I.R.C. § 338 (permitting an election, in the case of a stock purchase of 80% or more of a corporation's stock, to treat the stock purchase as an asset purchase, with a subsequent recognition of gain by the target corporation and step-up in asset basis to the purchasing corporation).

[223] *See* I.R.C. § 1001 (the amount realized over the adjusted basis is gain to the seller); I.R.C. § 338(a)(1)("[T]he target corporation shall be treated as having sold all of its assets at the close of the acquisition date at fair market value.").

under section 338.[224] Why should it matter that the purchase occurs in a Title 11 case between a debtor and its creditors? Especially where there are no special provisions under section 338 or any other provision for the treatment of the transaction in the CCA for the outright sale of assets or stock? In past situations where Congress wished to enable bankruptcy reorganizations, it has done so with specific statutory language. A critic of the CCA would say that it makes a distinction between bankruptcy sales and nonbankruptcy sales that is not warranted by the Code, especially given Congress's intent, discussed in the section that follows, to ensure that a tax is paid on COD income eventually, whether through actual payment or reduction of tax attributes.

Second, as noted above, if the debtor is not liquidating, and is retaining assets in a separate corporate entity, then it must have split multiple trades or businesses.[225] Under section 368(a)(1)(D)—the D Reorganization provisions—if a corporation transfers a part of its assets to another corporation, and after the transfer, its shareholders (either before or after the transaction) are in control of the transferee corporation, then the transaction constitutes a "reorganization" if the provisions of sections 354, 355, or 356 are met.[226] Likewise, if the transaction qualifies for tax-free treatment under sections 355 (solely stock or securities) and section 356 (boot relaxation), and the transaction occurs as part of a plan of reorganization, then the G Reorganization provisions will apply.[227]

Section 355 governs corporate divisions. To determine whether the provisions of section 355 apply in the spin-off context, section 355(b) states that section 355 will apply to a transaction "only if . . . the distributing corporation, and the controlled corporation . . . is engaged immediately after the distribution in the active conduct of a trade or business."[228] The CCA transaction seems clearly to be covered by these provisions, especially if one considers that

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[224] *See* 1 Bittker & Eustice, *supra* note 23, ¶ 10.41[4].

> If Z buys the X stock for $1,000 and makes a § 338 election, X will be deemed to sell the [assets] for [their] value of $1,000. X will pay $200 in tax. If X is then liquidated, Z will receive net value of $800 and again will have lost $200 . . . over the life of the [assets] . . . through tax savings from depreciation on the new $1,000 basis rather than the former $200 basis. The problem with this approach is that the discounted present value of $200 in tax savings . . . is less than the $200 excess paid . . . in the form of a § 338 tax bill. . . .
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> Therefore, Z will want to pay only $800 for the stock, in which event A [X's sole shareholder] will have effectively "paid" the $200 built-in-gains tax of X and . . . will net only $650 after A's own tax of $150, the same as if X had sold the machine for $1,000, paid its $200 tax, and liquidated. . . . Therefore, [the result is] the same as if X had sold its assets to Z in the first place.

Id.

[225] *See supra* notes 34–35.

[226] I.R.C. § 368(a)(1)(D).

[227] I.R.C. § 368(a)(1)(G).

[228] I.R.C. § 355(b).

the G Reorganization provisions take precedence over the other reorganization provisions as long as those provisions apply to the transaction,[229] as well as the fact—stated above—that the G Reorganization provisions are prescriptive, not elective.[230] And, as one authority has noted, the G Reorganization provisions themselves should be interpreted more flexibly than the D Reorganization provisions.[231] Thus, if there is an open question whether the D Reorganization provisions apply—as it appears might be the case in the CCA—then clearly the flexible interpretation of the G Reorganization provisions should sweep the transaction within its governance.[232]

Third, if the CCA transaction is not a divisive D Reorganization, then it can certainly—as elaborated upon in the discussion of the criticisms above[233]—be interpreted as a nondivisive D Reorganization.[234] As discussed briefly above,[235] a nonacquisitive D Reorganization involves the transfer of assets by one corporation to a corporation that it already controls. As one casebook author has noted, "the nondivisive D reorganization has not generally been used as an affirmate planning strategy . . . but instead . . . as a weapon by the government."[236] As also discussed above, the principal evil at which it is directed is the liquidation-reincorporation transaction, in which a corporation's shareholders distribute its assets and earnings in a transaction that qualifies for capital gains treatment under section 332, and then reincorporate the corporate assets in a new corporation, thereby extracting earnings and profits from the corporation at ordinary capital gains rates. Although the usefulness of the nondivisive D Reorganizations has been limited by the repeal of the *General Utilities* doctrine and the change of the definition of

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[229] *See* I.R.C. § 368(a)(3)(C) (providing that a transaction qualifying as a G Reorganization cannot qualify either as another type of reorganization or under sections 332 or 351).

[230] *See supra* notes 34, 211–212 and accompanying text.

[231] Kliegman & Turkenich, *supra* note 216, at 575; *see also* Sheppard, *supra* note 12 ("Congress meant to fit most bankruptcy reorganizations into section 368(a)(1)(D).").

[232] *See also* H.R. Rep. No. 105-148, at 462 (1997); S. Rep. No. 105-33, at 139 (1997) (discussing the purpose of section 355: the enabling of tax-free restructurings among existing shareholders). Given the legislative history, one may ask, "where do the bondholders stand?" If we assume that the bondholders are long-term security holders, then the critic of the CCA would argue that the creditors—who effectively control the debtor—are really just selling to themselves, and that therefore, even if the creditors are arguing that this is a sale and not a section 355 reorganization, in reality, it actually is.

[233] *See supra* note 114–115.

[234] *See* James Armour, Inc. v. Commissioner, 43 T.C. 295, 307 (1964) (holding that the sale of all the operating assets of one corporation to a commonly owned sister corporation followed by a liquidation of the selling corporation constituted a Type D reorganization and that an actual exchange of stock was unnecessary because the same shareholders already owned all of the stock of both corporations).

[235] *See supra* note 114–115.

[236] Kwall, *supra* note 35, at 527.

"control" for purposes of D Reorganizations from 80% to 50%,[237] the CCA transaction evades D reorganization treatment at a cost to the public fisc and at apparent odds with the Service's historical treatment of liquidation-reincorporation transactions.

Admittedly, the characterization of the CCA transaction as a nondivisive D Reorganization would require a broad interpretation of "liquidation" and "distribution," as D Reorganizations are subject to the "distribution" requirement of section 354(b).[238] But given the arguments for these recharacterizations of the transaction, critics could easily argue that the Service should revert back to a not so distant past and scrutinize the substance of a transaction rather than its form. In Technical Advice Memorandum 98-41-006 (TAM), for instance, the Service ruled that a transaction that the taxpayer had attempted to treat as a qualified stock purchase under section 338(h)(10) should instead be treated as a G Reorganization.[239] In the TAM, two holding company members controlled by a common corporate parent owned all the shares of an operating company. The holding company members transferred the shares to a new corporation in exchange for all the equity of the new corporation and then distributed that equity to its creditors pursuant to a plan of reorganization in bankruptcy.[240] The companies attempted to make an election under section 338(h)(10) to recognize gain on the transaction, thus achieving a cost basis in the assets of the new corporation. The Service, however, disagreed. It considered treating the transaction as either a B, C, or G Reorganization, eventually treating it as a G Reorganization and denying cost basis treatment.[241] If the TAM represents the Service's current posture toward its willingness to recharacterize transactions, it could spell trouble for the CCA.

Although the Service clearly seems not above recharacterizing transactions it believes to be abusive, there are several reasons why this "loophole" criticism of the CCA is ultimately wrong. First, as mentioned above, the

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[237] *But see* Payne v. Commissioner, 85 T.C.M. (CCH) 1073, 2003 T.C.M. (RIA) ¶ 55,098 (finding that the predecessor corporation, and not the taxpayer shareholder, transferred to successor corporation substantially all assets associated with operation of a business in a transaction which qualified it as a tax-free D reorganization, since the assets were transferred to another corporation controlled by the sole shareholder of both corporations in exchange for stock of transferee corporation, followed by distribution of that stock to the taxpayer shareholder); I.R.S. Non-Docketed Serv. Adv. Rev. 5633, 1997 WL 33324255 (Jan. 28, 1997) (denying a worthless stock deduction after recharacterizing a sale of inventory as a sale of substantially all the assets of a corporation and thus as a nondivisive D Reorganization, because the same shareholder or shareholders owned both the transferor corporation and the transferee corporation, thus fulfilling the distribution requirement of section 354(b)).

[238] *See* I.R.C. § 354(b)(1)(B).

[239] T.A.M. 1998-41-006 (Oct. 9, 1998).

[240] *Id.*

[241] *Id.*; *see also* Sheppard, *supra* note 12, at 987 (discussing the TAM).

C Corporation rules provide predictability[242] to taxpayers to the extent that they are engaging in transactions with a significant nontax motive. Second, the assets retained by the Debtor—assets that it then leases or licenses to NewCo—cannot under the current regulations constitute an "active trade or business." Third, depriving reorganizing debtors of the use of the Bruno's arrangement would disadvantage larger corporations with significant investment in depreciable assets. Fourth, one significant advantage to reorganizing in bankruptcy—the section 382(l)(5) election, which avoids the limitation on the use of post-reorganization NOLs—may not be practically available in larger bankruptcies due to the presence of bond-hoarding vulture funds. Fifth, interpreting the G Reorganization provisions as prescriptive rather than elective, thereby prohibiting the use of the Bruno's arrangement, ignores the Treasury's and Congress's trend toward injecting greater flexibility into the reorganization provisions in recent years.

As to the first reason why the "loophole" criticism is ultimately wrong, there *is* a significant nontax motive for this transaction: reorganization of the debtor,[243] which was contemplated from the beginning of the transaction. As noted above, the comparison of the CCA transaction with contingent installment sales under the business purpose doctrine provides a valid argument that the transaction can be undertaken for valid business reasons.[244] A second useful comparison can be made between the CCA transaction and transactions occurring under another doctrine that the Service has used to recharacterize transactions that fall within the letter—but perhaps not the spirit—of the law: the step transaction doctrine.

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[242] *See, e.g.*, Coyle v. United States, 415 F.2d 488, 490 (4th Cir. 1968) (describing the family attribution rules in Subchapter C as "designed to create predictability for the tax planner and to obviate the necessity of a court's scrutinizing family arrangements to determine whether every family member is in fact a completely independent financial entity"); Reg. § 1.1041-2 (permitting divorcing taxpayers who are shareholders of a corporation to treat the redemption of the departing spouse as a redemption coupled with a denial of section 1014 (permitting nonrecognition on gain from divorce decree), or, alternatively, as a constructive distribution to the continuing shareholder spouse (permitting the departing spouse to invoke section 1014)); *see also* I.R.C. § 302(b)(2)–(3)(providing specific rules on when a distribution will be treated as a sale as opposed to a one-side distribution); I.R.C. § 382 (establishing specific numerical thresholds, the crossing of which trigger limitations on the use of a loss corporation's NOLs); I.R.C. § 368(c) (defining "control" as ownership of 80% of the total combined voting power of all voting stock classes and 80% of the total number of shares of all other classes of stock).

[243] *Cf. In re* CM Holdings, Inc., 254 B.R. 578, 653–54 (Bankr. D. Del. 2000) (holding that interest, paid by debtor on policy loans taken against life insurance policies covering lives of its employees, was incurred as part of sham transaction). In *CM Holdings*, the Bankruptcy Court dealt with a situation in which deductions were generated through transactions entered into for the sole purpose of creating the deductions. *Id.* at 581–82. The court arrives at the essence of a transaction that deserves recharacterization when it states: "'[S]hams in fact' are transactions that never occurred in reality, that is, transactions that have been created on paper but which never took place. 'Shams in substance' are transactions that actually occurred but are devoid of economic substance." *Id.* at 598 (internal citations omitted).

[244] *See* Keyes, *supra* note 146.

In *King Enterprises*—the frequently cited step transaction case—the Service recharacterized a shareholder's sale of stock for a combination of stock and cash pursuant to a purchase agreement between two corporations, followed by a merger of the selling corporation into the purchasing corporation as a reorganization with respect to both transactions.[245] Thus, although it was unclear whether the stock sale was being undertaken as part of a comprehensive reorganization, the Service ruled that the selling shareholder could treat it that way.[246] Although the use of the doctrine in *King Enterprises* favored the debtor, the doctrine has been put to use most often in other contexts—such as in the liquidation-reincorporation context—to reject taxpayer arguments that tax treatment of its transactions should conform to its chosen structure.[247]

In the CCA, by contrast, there is no assertion that the debtor had engaged in a transaction and then sought to re-jigger its calculations once a more advantageous tax ploy made itself available[248] or that it was attempting to accomplish a tax objective through two transactions that it could not accomplish through one. In fact it was doing just the opposite. And as argued above, the CCA does not involve a transaction entered into for the sole purpose of generating losses. While it is true that the COD income is excluded, that is precisely the result contemplated by the statute and later approved by the Supreme Court.[249] Although the statute does not explicitly mandate or sanction the use of a sale to creditors as a means of reorganization, neither does it prohibit it. Admittedly, this argument would fail and has failed in the loss-generation context, but the losses "generated" here are real economic losses that the debtor has chosen to utilize through the use of a sale rather than a section 368 reorganization.

Up to this point the Article has discussed extensively the predictability and precision of rules in the Subchapter C context. The C Corporation Reorganization context is somewhat less predictable and more dependent

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[245] King Enterprises, Inc. v. United States, 418 F.2d 511 (Cl. Ct. 1969).

[246] *Id.* at 519. The court also rejected the test proposed by the Service—the binding commitment test—in which the taxpayer would have had to show that a binding commitment to engage in the merger was intended from the beginning. *Id.* at 517–18. Interestingly, the transaction at issue in the CCA could arguably be seen to qualify for step transaction treatment under even this strict test. As the taxpayer in the CCA argued, the transaction can be seen as a sale of the debtor's assets for a combination of stock, notes, and cash.

[247] *See* Reg. § 1.368-1(a) (as amended in 2007) (requiring that the step transaction doctrine be applied when determining whether a transaction qualifies as a reorganization).

[248] *But see* Sheppard, *supra* note 12 (arguing that Bruno's tactic of arguing for reorganization treatment in the bankruptcy court but for sale treatment to the Service gives the Service ample reason to deny Bruno's the treatment it sought). While Sheppard's argument seems somewhat persuasive, one must remember the storied history of taxpayers arguing one thing to one administration and another thing to a second, a tactic the Supreme Court hasn't shied away from approving in the past. *See* Cottage Sav. Ass'n v. Commissioner, 499 U.S. 554 (1991) (permitting taxpayer to argue for loss treatment of exchanged mortgages to the Service and for nonloss treatment on its corporate balance sheet).

[249] *See* Gitlitz v. Commissioner, 531 U.S. 206 (2001).

upon post hoc judgment than Subchapter C in general,[250] but proposals have been suggested in the past[251] and measures have been implemented in the present to alter the status quo. One such proposal—the recently proposed No Net Value regulations[252]—establishes bright-line rules in the reorganization context, whose application to parts of the CCA transaction would argue for non-tax-free treatment.

For reorganizations under section 368, the new regulations require that there be an "exchange of net value."[253] "Exchange of net value" is then defined according to a set of specific rules.[254] The rules require both a (1) surrender of net value[255] and (2) receipt of net value[256] in both stock and asset reorganizations for the "exchange" requirement to be met. A "surrender" occurs only if the "fair market value of the property transferred by [the target] exceeds the sum of . . . [target] liabilities assumed by the acquiring corporation" plus money and property received by target.[257] A "receipt" occurs only if the "fair market value of the assets of the acquiring corporation exceeds the amount of its liabilities immediately after the exchange."[258]

In proposing these rules, the Treasury and the Service were responding to uncertainties caused by the effect of liabilities in reorganizations and other tax-free transactions involving insolvent parties.[259] As one commentator has noted, prior to the proposed regulations, it was unclear "whether an insolvent corporation could be a party to either a tax-free reorganization or a § 351 transaction."[260] The Treasury and the Service sought to ensure that a transfer or distribution of property in cancellation, redemption, or exchange for stock occurred in the transaction.

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[250] *See* KWALL, *supra* note 35, at 506–07 (discussing the nonstatutory requirements and the business purpose doctrine in the context of corporate reorganizations). *But see* George L. Riggs, Inc. v. Commissioner, 64 T.C. 474 (1975) (discussing elective provisions in subsidiary liquidation context, also a tax-free context like the reorganization provisions).

[251] *See* STAFF OF S. COMM. ON FINANCE, 99TH CONG., FINAL REPORT OF THE SUBCHAPTER C REVISIONS ACT OF 1985 (Comm. Print 1985) (noting the flaws in Subchapter C relating to the definition of "reorganization," continuity of interest requirements, and proposing a new definition—"qualified acquisition"—meant to provide more simplicity and predictability to the reorganization provisions).

[252] Prop. Reg. § 1.368-1, 70 Fed. Reg. 11,903, 11,905 (2005).

[253] Prop. Reg. § 1.368-1(b)(1), 70 Fed. Reg. 11,903, 11,905 (2005).

[254] Prop. Reg. § 1.368-1(f), 70 Fed. Reg. 11,903, 11,905 (2005).

[255] Prop. Reg. § 1.368-1(f)(2)(i), 70 Fed. Reg. 11,903, 11,905 (2005); Prop. Reg. § 1.368-1(f)(3)(i), 70 Fed. Reg. 11,903, 11,905 (2005).

[256] Prop. Reg. § 1.368-1(f)(2)(ii), 70 Fed. Reg. 11,903, 11,905 (2005); Prop. Reg. § 1.368-1(f)(3)(ii), 70 Fed. Reg. 11,903, 11,905 (2005).

[257] Prop. Reg. § 1.368-1, 70 Fed. Reg. 11,903, 11,905 (2005).

[258] *Id.* In breaking with its goal to provide consistency and certainty, the proposed regulations "provide no specific guidance on determining the amount of a liability" but indicate that the Service and Treasury are currently contemplating how this might be done. *Id.*

[259] *See id.* at 11,903.

[260] Kliegman & Turkenich, *supra* note 216, at 566 (discussing the history of tax-free reorganizations and other transactions in the context of distributions by insolvent corporations).

In some ways, the CCA Bruno's transaction resembles a transaction that would on its own fail the "net value" requirement. As noted in the CCA, the debtor transfers assets—subject to liabilities—for a combination of cash and assumption of liabilities. In one portion of the transaction, the exchange of COD income for a fractional interest in the Debtor's assets is a one-to-one transaction, ensuring that in this step of the transaction no net value is exchanged. And assuming that the debtor's liabilities are large enough,[261] the rest of the transaction would fail to trigger the no net value requirement as well. While it will by no means be a foregone conclusion that the Service would apply the No Net Value regulations to CCA-like transactions in every instance, it does demonstrate that, as a prerequisite to affording tax-free treatment to a transaction, the Service will expect a surrender of net value to offset the liabilities assumed by the acquirer. In sum, this militates toward treating the CCA transaction as taxable to the debtor. In other words, the CCA more closely resembles the "sale" to which the Service sought to give "sale treatment" under the No Net Value regulations than it resembles a "reorganization" which the Service excepts from taxation.

As to the second reason why the "loophole" criticism is ultimately wrong, one prong of this criticism of the CCA transaction presupposes that if the debtor is not liquidating under section 354(b)(2)(B), it must instead have split two or multiple trades or businesses under section 355.[262] It bears mentioning that the original Bruno's creditor-sale preserved assets of the debtor worth $25 million that it then leased or licensed to the creditors.[263] While "leasing-licensing" may, upon an extremely tortured and exaggerated reading of the term, constitute a "trade or business," this is doubtful. It is doubtful even that—were the "leasing-licensing trade or business" a sole proprietorship—its owner would be allowed to take deductions against ordinary income for losses in running its "trade or business" due to the limit on passive activity losses in section 269.[264] This is precisely how the Service views the term "trade or business" as well.[265]

In general, a distribution of stock or securities of a controlled corporation—in the CCA transaction, the stock and securities of NewCo, to which the Debtor has transferred its assets[266]—will qualify as tax-free under section 355 only if both NewCo and the Debtor are "engaged in the active conduct

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[261] Which—given that a principal attraction of the transaction is for the debtor to take COD income onto its balance sheet, which it is not required to immediately recognize, and given the fact that creditors rarely receive their claims in full in a bankruptcy reorganization—appears to be the case.

[262] *See* Kwall, *supra* note 35, at 507.

[263] Second Amended Joint Plan of Reorganization Under Chapter 11 of the Bankruptcy Code as Modified December 10, 1999, at 17–19, *In re* PWS Holding Corp., No. 98-212 (SLR) (Bankr. D. Del. Dec. 10, 1999).

[264] *See* I.R.C. § 269 (cabining losses from a passive activity to gains from that passive activity).

[265] *See* I.R.C. § 355(b).

[266] *See supra* note 18.

of a trade or business immediately after the distribution."[267] The regulations define "trade or business" as a "specific group of activities . . . carried on . . . for the purpose of earning income or profit, and the activities included in such group include every operation that forms a part of, or step in, the process of earning income or profit."[268] Furthermore, for the "trade or business" to be considered "active," the corporation itself must perform activities involving "substantial management and operational functions."[269] It is therefore questionable how "leasing and licensing property to a sibling corporation" can constitute an "active trade or business." This becomes especially clear upon contemplation of concrete fact patterns provided in the regulations. The Service specifically excludes "leasing" from the definition, unless significant services are performed by the owner with respect to the leasing.[270] If critics of the CCA cannot claim that "leasing" constitutes a "trade or business," there is not much that remains of the CCA criticism. Although the debtor must be careful that its activities with regard to the leasing do not rise to the level of "operation and management"[271] given the reluctance of the Treasury and Service to find "leasing" to constitute a "trade or business,"[272] it appears that the "liquidation" argument—addressed and rejected above as overly depen-

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[267] Reg. § 1.355-3(a)(1) (as amended in 1989). Additionally, the corporation must not have acquired either an active trade or business during the five-year period preceding the transaction, although expansions of an existing trade or business followed by a spin-off of the expanded branch into a subsidiary corporation will satisfy the section 355 requirements. Reg. § 1.355-3(b)(3) (as amended in 1989).

[268] Reg. § 1.355-3(b)(2)(ii) (as amended in 1989).

[269] Reg. § 1.355-3(b)(2)(iii) (as amended in 1989).

[270] Reg. § 1.355-3(b)(2)(iv)(B) (as amended in 1989).

[271] *See* Reg. § 1.355-3(c), Ex. (12) (as amended in 1989) (subsidiary—to which corporation contributes a building in return for subsidiary stock that it distributes to its shareholder—which will "manage the building, negotiate leases, seek new tenants, and repair and maintain the building" satisfies the "active conduct of trade or business" requirement of section 355(b)); Rev. Rul. 2007-42, 2007-28 I.R.B. 44 (finding an "active trade or business" where an LLC provided trash collection, ground maintenance, electrical and plumbing repair, insect control; the LLC also advertised for new tenants, verified information contained in lease applications, negotiated leases, handled tenant complaints, prepared eviction notices and warnings for delinquent tenants, collected rent, and paid all expenses, including gas, water, sewage, electricity and insurance for the office buildings); *see also* Rev. Rul. 2002-49, 2002-32 I.R.B. 288; Rev. Rul. 1992-17, 1992-12 I.R.B. 5.

[272] *See* Rules and Regulations: Comments On, and Changes to Proposed Regulations, T.D. 8238, 1989-8 I.R.B. 5.

> Treasury and the Internal Revenue Service recognize that the separation of owner-occupied real estate may satisfy the active business requirements, but they also recognize that such a separation presents significant tax avoidance opportunities. Accordingly, the final regulations revise § 1.355-3(b)(2)(iv)(B) of the proposed regulations to provide that the separation of owner-occupied real estate will be subject to careful scrutiny under the active business requirements.

Id.

dent on a vague notion of "business purpose"[273]—is the argument to which CCA critics must resort.[274]

Further, such broad interpretation of "trade or business" in section 355 could have unintended consequences and would defeat the purpose of providing tax-free treatment to spin-offs. Given a broad interpretation, corporate shareholders of solvent corporations could validly argue for nonrecognition treatment of shares spun-off to them following a corporate division that they could then sell to an acquirer with little or no tax consequences, aside from the nonrecognition treatment of the shares. Of course, the Service could always rely on the argument that such a transaction constitutes a device to extract earnings and profits from the corporation[275] or lacks business purpose.[276] But on the other hand, establishing such a rule in the "device" context would backfire on the Service in the CCA context,[277] where the sub-dividing corporation engages in no or minimal management activity with respect to the subdivided assets. The more prudent approach would be to allow the CCA transaction while policing more abusive uses of section 355 to separate a group of assets that do not legitimately constitute a "trade or business" but which nevertheless seek tax-free treatment under section 355.

As to the third reason why the "loophole" criticism is ultimately wrong, denying taxable treatment to the CCA ignores a principal tax goal—neu-

[273] *See* I.R.C. § 269.

[274] This becomes especially apparent upon consideration of the types of activities that the Service contemplates as constituting an "active trade or business." *See, e.g.*, Reg. § 1.355-3(c), Ex. (9) (as amended in 1989) (separation of manufacturing activities from research department activities constitutes the separation of two trades or businesses); Reg. § 1.355-3(c), Ex. (6) (as amended in 1989) (separation of assets of a suburban retail store from the assets of a downtown retail store constitutes the separation of two trades or businesses). A recent Private Letter Ruling demonstrates business purposes that the Service will accept in qualifying a transaction under section 355—"business purposes" that could not possibly be present in a mere separation of $25 million worth of lease assets in a subsidiary corporation. *See* P.L.R. 2008-11-012 (Mar. 14, 2008) (finding the following business purposes permissible and thus qualifying the transaction under section 355:

> (i) permit[ting] the creation of effective management incentives tied to the relevant company's performance and increasing the ability to attract and retain personnel; (ii) creating opportunities to effectively develop and finance expansion plans; (iii) increasing the market value of the companies; (iv) allowing each company to separately pursue the business strategies that best suit its long-term interest; and (v) creating separate companies that have different financial characteristics, which may appeal to different investor bases).

[275] *See* I.R.C. § 355(a)(1)(B); Gregory v. Helvering, 293 U.S. 465 (1935).

[276] *See* Rev. Rul. 2003-75, 2003-2 C.B. 79 (finding that distribution of stock of a controlled corporation to resolve a capital allocation problem between the distributing and the controlled corporations does in fact satisfy the business purpose requirement under Reg. § 1.355-2(b) (as amended in 1992)); *see also* Reg. § 1.355-2(b)(1) (as amended in 1992).

[277] *See* David M. Schizer, *Sticks and Snakes: Derivatives and Curtailing Aggressive Tax Planning*, 73 S. Cal. L. Rev. 1339, 1341 (2000) (quoting Martin Ginsburg's statement that "[e]very stick crafted to beat on the head of a taxpayer will, sooner or later, metamorphose into a large green snake and bite the Commissioner on the hind part").

trality.[278] Debtors with significantly depreciated assets—on which they have taken depreciation deductions—that have a fair market value far in excess of the basis (but which nonetheless still have *some* basis that would be threatened by realization of COD income) stand to derive little benefit from use of a G Reorganization. Debtors with significant net unrealized built-in losses, on the other hand, do. A critic of the CCA could, of course, easily argue that a debtor who has taken depreciation deductions on its assets that now have a fair market value substantially in excess of their bases has benefited in the past from depreciation deductions and should not therefore argue "unfairness" due to its lack of choice.[279] However, the counterargument is that corporations in certain industries are simply more prone to "build in" gains than those in other industries. For example, in 2004, depreciable assets constituted more than 88% of the total assets held by corporations involved in "Transportation and Warehousing" (a category which includes air, rail, water, pipeline, truck, and other transportation), an industry whose constituents have spent a considerable amount of time during the past two decades in bankruptcy court.[280] In contrast, the depreciable assets of "Finance and Insurance" corporations—another sector that has in recent times undergone a substantial economic downturn—constituted less than two percent of the total assets held by such corporations.[281] However, stating that the transportation industry has benefited in the past from substantial depreciation deductions and should therefore not benefit from the use of the CCA's taxable resale, merely begs the question. Specifically, such a statement ignores the fact that a G Reorganization may be useless only for corporations in *that particular industry*—unlike corporations in other industries—while the CCA transaction would be quite useful. It thus creates inter-industry inequality. Finance and insurance corporations, on the other hand, have no need for a device that avoids saddling their creditors with low-basis assets because the success or failure of their emergence from bankruptcy never really depended on depreciable assets in the first place. It *would* therefore be "unfair" to permit the latter industry the benefit of a tax-free G Reorganization while denying the former industry the benefit of the Bruno's transaction, because doing so would confer a comparative advantage upon one by depriving the other of perhaps the sole realistic tax-related means of reorganization.

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[278] *See* William A. Klein et al., Federal Income Taxation 3 (14th ed. 2006) (noting that "income tax has . . . had a substantial effect on the allocation of resources in [the] economy" and noting the argument over "[w]hether [tax incentives for particular activities] is good or bad policy").

[279] *Cf. infra* text accompanying note 311 (presenting criticism of the CCA that *someone* should be taxed on the income).

[280] *See* Statistics of Income Division and Other Areas of the Internal Revenue Serv., Internal Revenue Serv., U.S. Dep't of the Treasury, SOI Tax Statistics-Corporation Source Book: Wholesale Trade to Information, *available at* http://www.irs.gov/taxstats/article/0,,id=165687,00.html.

[281] *See id.*

This unfairness has the potential to create inter-industry discrimination in the context of bankruptcy reorganization and, correspondingly, to distort investors and entrepreneurs' choices with respect to the industries in which they choose to invest their resources. In the past, when Congress has confronted instances of inter-industry distortion, it has responded. In the 1986 Tax Reform Act, for instance, Congress noted the distortions caused by the then-extant deduction framework for depreciable assets and effectuated a comprehensive re-working of it. As described by the Treasury in its Report to the President:

> [The] ACRS . . . base[s] depreciation allowances on historic costs rather than current replacement costs, and thus . . . the present value of depreciation deductions [are] tied to the rate of inflation. . . . [O]verstating depreciation and thus understating income creates an artificial incentive for one form of investment over another, discriminates among companies within an industry, and encourages nonproductive, tax-motivated investment activity.[282]

As the Treasury Report noted, the Accelerated Cost Recovery System (ACRS) framework in existence at the time benefited industries with heavy investment in certain depreciable assets.

> ACRS disproportionately benefits capital-intensive industries and methods of production. Income from sectors of the economy without significant investment in depreciable property typically face higher effective tax rates. . . . ACRS favors existing businesses over new, start-up businesses, and tax paying businesses over those with tax losses. . . . [P]otential unavailability of ACRS benefits may in turn lead to tax-motivated acquisitions or combinations that permit the benefits to be used fully in the year incurred.[283]

The fact that some capital-intensive industries derived benefits from the ACRS framework at that time—the distortions of which Congress addressed but did not fully counteract due to resistance from the Senate Finance

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[282] Office of the Sec'y, Dep't of the Treasury, Tax Reform for Fairness, Simplicity, and Economic Growth: The Treasury Department Report to the President, Vol. 2, 154–55 (1984).

[283] *Id.* at 156; *see also* The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity 135, 137 (1985) (discussing the non-neutrality of ACRS investment incentives which taxed machinery and equipment at substantially lower effective rates than "rates on structures for all rates of inflation").

> The tax code guides the allocation of capital, overriding private market forces and the individually expressed consumer preferences they represent. Paradoxically, these distortions do not reflect stated government policy to favor particular assets or industries. As a result, ACRS operates as an undeclared government industrial policy which largely escapes public scrutiny and systematic review.

Id.

Committee in the Tax Reform Act[284]—and that *some* but not all continue to do so, is no reason to continue swinging the pendulum back against capital-intensive industries. If anything, Congress's and the Treasury's experience with distortion avoidance should indicate that neutrality should be preserved whenever possible. This is precisely what the CCA transaction permits.

The Bankruptcy Code provisions rest on the notion that debtors should be given time to restructure their operations and receive a "fresh start" upon emergence from bankruptcy.[285] Rescinding the CCA because of this "loophole concern" would limit that fresh start opportunity for those debtors whose capital structure make the G Reorganization provisions less advantageous than for other debtors. And since it is largely the creditors who take the helm upon sale of the debtor's assets, it is they who would receive the greatest punishment, in the form of low-basis high-value assets against which COD income has been applied. The "start" received by the corporation under such circumstances would be anything but "fresh."[286]

As to the fourth reason why the "loophole" criticism is ultimately wrong, the criticisms regarding the debtor's ability to make a section 382(l)(5) election—thereby avoiding the limitation on the use of NOLs in a section 368 reorganization—ignore the practical availability of that election. A debtor can avoid the NOL use limitation imposed upon an "ownership change" in

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[284] *See* Daniel L. Simmons, *The Tax Reform Act of 1986: An Overview*, 1987 BYU L. Rev. 151, 199–200.

> The 1986 Act increases the rate of recovery for personal property with class lives of ten years or less to 200% declining balance. The acceleration of recovery is reduced for some property because the 1986 Act adds a seven year and a twenty year class to the pre-1986 three, five, ten and fifteen year classes applicable to personal property. The seven year class will require longer recovery periods for property formerly in the five year class. The twenty year class extends recovery periods for property formerly in the fifteen year class.
>
> Recovery periods for real property are lengthened substantially. Capital invested in residential rental property is recoverable over 27.5 years instead of the 19-year recovery available before 1987. Nonresidential real property is moved to a 31.5-year class. In addition, the recovery rate for real property in the 27.5-and 31.5-year classes is limited to the straight line method.

Id. at 199.

[285] *See* Douglas G. Baird, Thomas H. Jackson & Barry E. Adler, Cases, Problems, and Materials on Bankruptcy 23–28 (3d ed. 2001).

[286] This becomes especially relevant when one considers the fact that debtors rarely use the tax incentive of bankruptcy as the principal reason for filing. *See* Carl M. Jenks, *Filing for Bankruptcy: A Starter Kit for Corporate Tax Advisors (Part I)*, 44 Tax Mgm't Memorandum 183 (2003) ("[T]he dollar value of the [tax] benefits of filing may be quite small in the overall decision-making scheme and thus will rarely be decisive."). If abuse of the bankruptcy process is the evil that repeal of the CCA would attempt to counteract, it seems that repeal would be somewhat of an excessive measure. Its chief effect would be to disadvantage debtors who have no financial choice other than to declare bankruptcy, and whose "fresh start" would be impeded by the non-availability of a tax advantage that had been present in past bankruptcies in their industry and is not needed in other industries.

section 382(a) by ensuring that the "ownership change" results in creditors and shareholders owning 50% or more of the reorganized corporation.[287] As noted above however, although short-term creditors may certainly count toward meeting the 50% threshold, creditors who have held their debt for less than 18 months before the bankruptcy filing cannot.[288] Although the debtor may, under regulations promulgated in 1994, treat the "indebtedness as having always been owned by" a beneficial owner "if the beneficial owner is not" a five percent shareholder immediately after the ownership change, this rule does not apply to debt owned by persons whose participation in the reorganization plan puts the debtor on notice that the person or persons have not owned the debt for the required period.[289] This creates an obvious problem for larger publicly traded corporations, many of whose debt obligations may trade like stock on open exchanges.[290] If, for whatever reason, the debtor was unable to restrict or impede the trading of these obligations in the 18 months prior to the bankruptcy filing, the ability to use its NOLs—one of the more essential and useful attributes of a debtor emerging from bankruptcy[291]—will be substantially impeded.

The danger of this occurring is greater than might otherwise be expected. There is money to be made from investing in distressed assets, securities, and companies, and plenty of investors to take advantage of it.[292] Especially in the wake of a massive credit freeze in August 2007, the resultant stock market crash in October 2008, and the impending recessionary gloom that has taken hold of the market, investors sought to purchase corporate debt and other distressed assets on the cheap.[293] And historic debtholders and shareholders

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[287] *See* I.R.C. § 382(l)(5)(A)(ii).

[288] I.R.C. § 382(l)(5)(E)(i). Additionally, creditors whose debt obligations "arose in the ordinary course of the trade or business of the old loss corporation" may also count toward meeting the 50% threshold, even if the debt arose less than 18 months before the filing of the bankruptcy. I.R.C. § 382(l)(5)(E)(ii). Such "ordinary course" obligations include trade debt, "tax liabilities, liabilities to employees or former employees, tort liabilities, [and] debt incurred to pay [s]ection 162 expenses." Rosen et al., *supra* note 197, at 481–82.

[289] Reg. § 1.382-9(d)(3)(i) (as amended in 1994).

[290] Robert F. Bruner & Joseph R. Perella, Applied Mergers and Acquisitions, 314 (2004) (describing debt obligations that behave like equity when a firm's asset values are low).

[291] *See* Scarberry et al., *supra* note 131, at 736–38.

[292] *See* Craig Karmin, *Vulture Funds Start Circling Credit Markets: Move on Distressed Debt Could Signal Recovery Might Be Long, Slow*, Wall St. J., Aug. 31, 2007, at C1 (describing the launch of a "giant distressed-debt fund aimed at seizing on the [2007-2008 credit] turmoil").

[293] *See* Mara der Hovanesian, *Swooping Down on Subprime: There's a Banquet of Troubled Investments to Pick From, but Valuation is Still Tricky*, Bus. Wk., Sept. 10, 2007, at 33 ("Investors are flocking to funds that specialize in distressed debt; they raised $23.7 billion in the first half of [2007], vs. $19 billion in all of 2006 . . . ."); *see also id.* ("[P]rices on speculative corporate loans are getting slashed.").

are more than willing to oblige them[294] and have every incentive to do so.[295]

The specter of vulture funds swooping down to feast on the distressed debt of a fallen corporation can create havoc in bankruptcy. Professor Frederick Tung's article in the 1996 Northwestern Law Review on "claims trading" in Chapter 11 describes the phenomenon superbly:

> The creditor that enters a case by purchasing claims typically differs from the selling claimant in important ways. The purchasing creditor is usually a professional bankruptcy investor; the selling claimant usually is not. Unlike most other creditors, the bankruptcy investor typically had no interaction or relationship with the debtor prior to its entry into the case, and it typically does not contemplate long-term involvement with the reorganized debtor once the case is over. . . .
>
> The bankruptcy investor's very entry into the case sets it apart from other creditors. . . . [G]iven its fine appreciation for the time value of money, the investor knows that the longer the process takes, the greater a recovery it must secure in order to make the investment worthwhile. Far from expanding the common ground for agreement on plan treatment, then, the introduction of this new money perspective into plan negotiations may have a ratcheting effect. . . .
>
> The bankruptcy investor will generally purchase claims strategically, in order to maximize its leverage in plan negotiation. . . . The elaborate plan bargaining framework suggests that by purchasing strategically, the bankruptcy investor can acquire not merely a seat at the negotiation table, but a good seat. . . .
>
> The professional bankruptcy investor's sophistication means a more formidable presence in negotiation generally, with respect to both the plan and the other collective decisions of the community. . . .
>
> . . . .
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> Unlike trade and bank creditors, which had relationships with the debtor prebankruptcy and which will likely continue to do business with the reorganized debtor postconfirmation, the bankruptcy investor often retains no interest in the reorganized debtor's long-term viability. . . . The bankruptcy investor will often negotiate for plan consideration in the form of publicly tradeable securities, or some other debt instrument for which an active private market exists and which can be "flipped" close to confirmation. In this

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[294] *See* Matthew Goldstein, *Vultures to the Rescue: A New Market Gives Holders of Distressed Hedge Funds a Quick Escape*, Bus. Wk., Apr. 9, 2007, at 78–79 (describing vulture funds that bought up shares of hedge funds in bankruptcy as having "creat[ed] a necessary secondary market for investors who prefer to cash out their losses sooner rather than hope for a recovery down the road.").

[295] *See* Manmohan Singh, *Recovery Rates from Distressed Debt—Empirical Evidence from Chapter 11 Filings, International Litigation, and Recent Sovereign Debt Restructurings* 6 (Int'l Monetary Fund, Working Paper No. 03/161, 2003) (reporting that debt default rates in 2001 on high-yield corporate debt reached 13% with another 22% in distress, with aggregate prices of the defaulted debt reaching an all time low of 21 cents to the dollar).

> situation, rehabilitating the debtor company only matters to the extent it affects pricing of the bankruptcy investor's postconfirmation securities. The terms of the securities are critical; the reorganization itself merely serves as a marketing tool.
>
> The bankruptcy investor's short-term, quick exit perspective may have adverse consequences for the debtor and other creditors. With its sophistication and its purchased leverage, the bankruptcy investor usually exerts significant influence over the terms of reorganization.[296]

As Professor Tung also notes in his article, the tax consequences of vulture funds' purchases of long-held bank and other debt can further work to the detriment of the debtor.[297] Specifically, the trading of historic debt—known in common parlance as the debt of "old and cold" creditors[298]—can deprive the debtor of the ability to make a section 382(l)(5) election. As Professor Tung notes, the trading of corporate debt—an ever present phenomenon for larger corporations, as noted above—may "endanger the value of the NOLs to the reorganized debtor."[299]

Thus, simply positing that the Code has provided a statutory means for NOL preservation that debtors can and should take advantage of and that that framework should serve as the sole means for NOL preservation ignores the fact that, in many circumstances, this means of NOL preservation is never even available to the reorganized debtor.[300]

Finally, as to the fifth reason why the "loophole" criticism is ultimately wrong, the comparison of the CCA transaction to a section 338 deemed asset sale or to an outright asset sale in the above criticisms[301] is also without merit, as the Service has in the past few years demonstrated a willingness to afford corporate taxpayers greater flexibility in their planning choices. In Revenue Ruling 2001-46, the Service ruled that the acquisition by the acquiring corporation's subsidiary of the target corporation's stock—the qualified stock

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[296] Frederick Tung, *Confirmation and Claims Trading*, 90 Nw. U. L. Rev. 1684, 1726–29 (1996) (internal citations omitted).

[297] *See generally id.* at 1704.

[298] *See* Rosen et al., *supra* note 197, at 480–81.

[299] Tung, *supra* note 296, at 1743 n.282.

[300] *See also* I.R.C. § 382(g)(4)(D) (deeming that an "ownership change" has occurred and thereby triggering the NOL limitations if a debtor's stock is treated as becoming worthless by a 50% shareholder if such shareholder still owns the debtor's stock at the close of the taxable year); T.D. 9386, 2008-16 I.R.B. 788 (clarifying in final regulations that losses from abandoned securities are treated as losses from worthless securities under section 165(g)). In addition to the potential for 50% shareholders taking worthless stock deductions, there is the fear—related to claims trading—that an active market will develop for the purchase of stock of the reorganized debtor "when issued." In such a market, the purchaser agrees prior to the emergence of the debtor from bankruptcy to buy stock to be received by the seller. The general rule is that if a creditor has a binding obligation to sell its stock through such a "when issued" market, it cannot count toward the 50% threshold for the debtor's use of the section 382(l)(5) election. *See* Hart, *supra* note 15, at 165–67.

[301] *See supra* note 224.

purchase—followed by a merger of the target into the acquirer, would be treated as a statutory reorganization under the step transaction doctrine.[302] Taxpayers responded to this by pointing out that acquisitions of subsidiaries by their corporate parents under section 338(h)(10)—which allows a corporate parent to treat a stock purchase of a subsidiary as an asset purchase *without* recognizing gain or loss on the stock itself[303]—would be endangered by such a substance-over-form rule.[304] The Treasury and the Service responded by issuing regulations stating that "the step transaction doctrine [would] not apply . . . [to] a § 338(h)(10) election . . . in a multi-step transaction (even when the multi-step transaction otherwise would qualify as a reorganization) if the step, standing alone, is a 'qualified stock purchase.'"[305] The regulations demonstrate, if nothing else, a desire on the part of the Service to afford taxpayers leeway and flexibility to structure their transactions in conformance with the rules governing C Corporations.

Although, as one casebook author has noted, "the law of corporate reorganization rests on a judgment that claimants against a distressed firm can realize greater value through a recapitalization than through a liquidation or a sale of the going concern to a third party,"[306] this does not militate toward reading the reorganization provisions as exclusive for reorganizing debtors. Interpreting this anti-sale rationale in a way that treats transactions between debtors and creditors as exclusively within the province of the section 368 reorganization provisions would defeat the same purpose of that very rationale.

C. *Someone Should Be Taxed on the COD Income; Section 108 Permits the Debtor to Avoid Taxation on COD Income but Requires a Corresponding Reduction in the Debtor's Asset Basis; Because the Debtor Gets Rid of the Assets in the Transaction, This Is Tax Avoidance, Plain and Simple*

The CCA transaction depends upon a critical component of the section 108 nonrecognition of COD income rules: any COD income realized in a taxable year in which a corporation is in a Title 11 case or insolvent does not reduce the debtor's tax attributes until the following taxable year.[307] According to the Senate Report accompanying the Bankruptcy Tax Act of 1980, Congress structured section 108 in this way principally to "avoid interaction between basis reduction and reduction of other attributes."[308] The practical effect is

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[302] Rev. Rul. 2001-46, 2001-2 C.B. 321.

[303] I.R.C. § 338(h)(10); 1 Bittker & Eustice, *supra* note 23, ¶ 10.42[6][a] (noting the difference between a section 338(g) and a 338(h)(10) election, due to the nonrecognition of gain or loss on the stock sale).

[304] Rev. Rul. 2001-46, 2001-2 C.B. 321; *see also* Rothman et al., *supra* note 83, at A-25 to A-26.

[305] *See* T.D. 9071, 2003-2 C.B. 560 (2003).

[306] Bratton, *supra* note 90, at 347.

[307] This fact is discussed at *supra* note 176.

[308] S. Rep. No. 96-1035, at 14 (1980), *as reprinted in* 1980 U.S.C.C.A.N. 7017, 7029.

that a debtor who has received COD income in one year can sell high basis assets during that year, thereby avoiding reduction of the bases of those assets in the following taxable year. For CCA purposes, since the debtor in a Bruno's transaction sells its assets to its creditors in the year of receipt of COD income, it likewise avoids reduction of the assets' bases.

The principal criticism to this transaction is that Congress structured section 108 merely to *defer* and not *avoid* taxation on COD income. Realizing that debtors in bankruptcy require time to restructure their operations and bring themselves to a status of operability that enables them to fulfill their tax obligations, Congress permitted *deferral* of the COD income, with the intention to collect the tax owed.[309] Thus, "[a]s a price for the exclusion of COD income, amounts excluded from income under section 108 are applied to reduce certain statutorily prescribed tax attributes of the debtor," which has the "effect of deferring the taxation of any COD income arising from the reduction or cancellation of debt."[310]

The gist of the argument is that *someone* should be taxable on the COD income, as that is precisely what Congress—despite its inclusion of a planning opportunity in section 108 by virtue of the year after rule—intended. The Service and the Treasury have certainly been sympathetic to that argument. In 2003 they issued temporary regulations stating that acquiring corporations in a tax-free G Reorganization must, under section 108, reduce any tax attributes that were carried over to it by operation of section 381.[311] Thus, any acquirer—even creditors exchanging their debt for stock interests—that acquires the debtor's operations in a tax-free reorganization will acquire assets subject to a reduced assets basis if the debtor realizes any COD income, even though the statute explicitly states that attribute reduction shall not occur in the year of discharge.

The Service and Treasury provided themselves further ammunition to shoot down reorganizing debtors' assets bases by proposing regulations in 2003 (and finalizing them in 2005[312]) that extended attribute reduction from the debtor to corporations, which, together with the debtor, constitute a "consolidated

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[309] S. Rep. No. 96-1035, at 10–11 (1980), *as reprinted in* 1980 U.S.C.C.A.N. 7017, 7029.

[310] Zarlenga, *supra* note 130, at 797.

[311] *See* Temp. Reg. §§ 1.108-7T(c), 1.1017-1T(b)(4) (2003). The Service and Treasury finalized these regulations in May 2004. One commentator has argued that the regulations were promulgated under somewhat questionable authority. *See* Ridgway, *supra* note 180, at 168 (arguing that the regulations relied on a portion of the legislative history describing that transaction to which the Service ultimately subjected tax attribute reduction that was then later deleted from the Senate Finance Committee Report).

[312] *See* T.D. 9192, 2005-1 C.B. 866.

group."[313] The regulations[314] provide a set of look-through rules that enable the Service to get at corporations seeking to shelter tax attributes that their fellow consolidated group members may hold,[315] presumably in an effort to accomplish the Congressional mandate of *deferring* but not *avoiding* taxation. In a rather cryptic, but perhaps telling, passage of the final regulations, the Service and Treasury stated: "The preamble to the first temporary regulations stated that the IRS and Treasury Department are considering adopting rules under section 1502 (and possibly other Code sections) to address the effect of transitory transactions and other transactions designed to avoid the application of the rules concerning attribute reduction."[316]

Although the Service ultimately decided that the step transaction and other doctrines were more than sufficient to account for any potential abuses of the attribution rules,[317] the Service's actions demonstrate that the Service is cognizant of the potential for creative tax planning that avoids the effect of the attribute reduction rules in a way contrary to the Congressional mandate of deferral. The consequent possibility of the Service reconsidering the Bruno's transaction on this basis therefore remains high.

There are several reasons why both Congress and the Service should continue to permit this transaction, and why the section 108-based arguments do not work. First, Congress has remedied abuses in other bankruptcy-tax scenarios in the G Reorganization context through implementation of vari-

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[313] *See* T.D. 9117, 2004-1 C.B. 721; T.D. 9098, 2003-2 C.B. 1248; T.D. 9089, 2003-2 C.B. 906.

[314] Reg. § 1.1502-28(a)(2), -28(a)(3), -28(a)(4). Tax attributes are reduced as following: (1) tax attributes attributed to the debtor member pursuant to the principles of Reg. § 1.1502-21(b)(2)(iv) and tax attributes attributable to the debtor that arose in a separate return year for which the debtor is a member of a separate return limitation year subgroup; (2) attributes of subsidiaries of the debtor member to the extent of any basis reduction in such subsidiary's stock (the "look through" rule); (3) remaining consolidated tax attributes of the consolidated group on a pro rata basis, by year of generation. *See also* 11 COLLIER, *supra* note 181, ¶ 11.08[3][c].

[315] *See* T.D. 9192, 2005-1 C.B. 866.

> [T]hese final regulations provide that, if the taxable year of a member during which such member realizes excluded COD income ends prior to the last day of the consolidated return year and, on the first day of the taxable year of such member that follows the taxable year during which such member realizes excluded COD income, such member has a successor member, the successor member is treated as if it had realized the excluded COD income. Accordingly, all attributes of the successor member listed in section 108(b)(2) (including attributes that were attributable to the successor member prior to the date such member became a successor member) are subject to reduction prior to the attributes attributable to other members of the group.

Id.

[316] *Id.*

[317] *Id.*

ous Code sections,[318] either directly through statute or indirectly through pressure on the Service and tacit approval of its actions. However, Congress directed no attention whatsoever to the taxable sale. This assertion has two corollaries. The first is that because Congress has limited the attractiveness of G Reorganizations—through attribute reduction, NOL limitation, and so on—the availability of the G Reorganization for debtors in bankruptcy has declined, making the taxable Bruno's sale an ever attractive alternative.[319] A decision by either Congress or the Service to prohibit the Bruno's transaction would be extremely detrimental for debtors and hardly in conformance with the "fresh start" principle upon which much of bankruptcy law is centered.[320] This is especially relevant in light of Congress's enactment in 2005 of the Bankruptcy Abuse Prevention and Consumer Protection Act of

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[318] The Congressional acts limiting the usefulness of G Reorganizations include: (1) repeal of the stock-for-debt exception, (2) NOL use limitations in section 382, (3) the Congress-induced consolidated group attribute reduction regulations, and (4) tacit approval of the adoption of the rules reducing tax attributes in the hands of the acquirer in G Reorganizations. In 1993, Congress repealed the so-called "stock for debt exception," a judicial doctrine that granted nonrecognition treatment to COD income, the underlying debt for which had been satisfied through the issuance of stock in the reorganized debtor. *See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13226, 107 Stat. 312, 487 (1993). The judicial exception had been based on the theory that an exchange of stock for debt constitutes a continuation of the creditor's investment in the corporation in the same basic economic form. Capento Sec. Corp. v. Commissioner, 47 B.T.A. 691, 695 (1942), *aff'd*, 140 F.2d 382 (1st Cir. 1994). The capital contribution of a debt liability to the corporation that issued the debt normally does not constitute a realization event. As noted above, Congress passed amendments to the Code in 1980 limiting the stock-for-debt exception to insolvent corporations, before completely doing away with the exception in 1993. *See* 1 Bittker & Eustice, *supra* note 23, ¶ 3.12[3] (discussing corporation's recognition of COD income if stock is worth less than the face amount of the debt exchanged). The limitations imposed on the use of loss corporation NOLs in section 382 are discussed in Subpart B of Part III. *See supra* notes 188–92 and accompanying text. Additionally, as discussed above, Senator Rick Santorum's pressure on the Service in the wake of the WorldCom/MCI bankruptcy caused the Service to implement regulations reducing the tax attributes of subsidiaries as well as debtors. *See supra* note 179. The effect of those regulations is discussed above. *See supra* notes 179–80 and accompanying text. Finally, despite an apparent contradiction between the Service's regulations reducing tax attributes in the hands of an acquirer of the debtor corporation and the explicit statutory text, Congress has done nothing to alter the rule. *See generally supra* note 180.

[319] *See* Robert Willens, *Delta Airlines and U.S. Airways—A G Reorganization Is Proposed*, 2007 Tax Notes Today 15–63, (Jan. 23, 2007) [hereinafter Willens, *Delta Airlines*] ("Inheriting the acquired corporation's NOLs might not be all that attractive. The debtor in those cases will experience significant debt forgiveness and the resultant cancellation of indebtedness income . . . will give rise to attribute reduction . . . ."); *see also* Ridgway, *supra* note 180, at 169 ("The promulgation of the [G Reorganization tax attribute pass-through] regulations will likely focus the attention of debtors . . . on . . . the taxable sale of assets to creditors.").

[320] The original idea animating the Bankruptcy Code—even if it may be subject to abuse in certain situations—was that "the [debtor's] discharge [in bankruptcy] was granted by creditors as part of a fundamental bargain: You deliver your nonexempt assets, distribute them to your creditors, and you'll get a discharge, a fresh start." Ralph Brubaker & Kenneth N. Klee, *Resolved: The 1978 Bankruptcy Code Has Been a Success*, 12 Am. Bankr. Inst. L. Rev. 273, 291 (2004).

2005,[321] which placed several restrictions on debtors' ability to reorganize in bankruptcy. Rescinding Bruno's would itself be contrary to Congress's intent, as derived from its statements in the Senate Report accompanying the Bankruptcy Tax Act of 1980.[322]

The second corollary is that, by negative implication, Congress has implicitly approved the Bruno's sale by not forbidding it.[323] Indeed, by failing to give it any attention whatsoever in the nine years since it was first used in the Bruno's bankruptcy—while all along continuing restrictions on debtors in other Code sections—Congress has indicated its tacit approval of the transaction. The Service's incursion into tax attribute reduction arena—detailed in the previous Part—was itself done under questionable authority.[324] There is no reason for the Service to continue to clamp down on debtors in bankruptcy in this important area.

An additional reason why the section 108-based arguments are inadequate to justify restricting the Bruno's transaction have been discussed above. Generally, repealing the Bruno's sale will undoubtedly result in inter-industry distortion and fairness issues. Certain debtors with certain depreciable assets whose reorganization needs can be better met through a Bruno's sale than through a G Reorganization stand to suffer, while debtors in those industries for which a tax-free G Reorganization would prove to be most beneficial (due to the relative absence of depreciable assets) will stand to gain by comparison.

Finally, the Supreme Court in *Gitlitz v. Commissioner* gave its seal of approval to the one-year rule in section 108,[325] a ruling that—although overruled by Congress with respect to the flow-through of an S Corporation's

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[321] *See* Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), Pub. L. No. 109-8, 119 Stat. 23 (2005).

[322] *See* S. Rep. No. 96-1035, at 9–11 (1980), *as reprinted in* 1980 U.S.C.C.A.N. 7017, 7024–26 (discussing the "preserve[ation] [of] the debtor's 'fresh start' and the flexibility that the Act sought to provide the debtor the chance to structure its reorganization "in a manner most favorable to the debtor's tax situation").

[323] By analogy, in the statutory interpretation context, courts will often assume that where Congress includes certain things, they mean to exclude other dissimilar things from that mandate. *See, e.g.*, William N. Eskridge, Jr. & Philip P. Frickey, *Forward: Law as Equilibrium*, 108 Harv. L. Rev. 26, 67 n.184 (1994) ("The Court frequently relies on arguments by negative implication (*expressio unius* types of argumentation)." (citing O'Melveny & Myers v. FDIC, 512 U.S. 79, 85–87 (1994) (Scalia, J.); Posters 'N' Things, Ltd. v. United States, 511 U.S. 513, 518–20 (1994) (Blackmun, J.); Custis v. United States, 511 U.S. 485, 490–93 (1994) (Rehnquist, C.J.); City of Chicago v. Envtl. Def. Fund, 511 U.S. 328, 335–37 (1994) (Scalia, J.); Cent. Bank v. First Interstate Bank, 511 U.S. 164, 176–82 (1994) (Kennedy, J.); Dep't of Revenue v. ACF Indus., 510 U.S. 332, 341–45 (1994) (Kennedy, J.))).

[324] *See* Ridgway, *supra* note 180, at 168; *see also supra* notes 180, 311.

[325] 531 U.S. 206 (2001).

COD income to its shareholders[326]—has otherwise remained untouched by Congress. Thus, absent a congressional authorization to rule otherwise, it would seem that the Service must continue to respect the one-year rule in section 108.[327]

IV. Underlying the Three Above-Stated Criticisms Is the Fact That the Service Must Do Something Quickly Before the Problem Gets Out of Hand and Debtors Begin to Rely on It Extensively[328]

A sense of urgency underlies the decision as to the course—inaction versus repeal—the Service will eventually take toward the CCA transaction. As noted above, use of the Bruno's structure has been made more attractive by Congress's and the Service's restriction of some of the more attractive features of G Reorganizations.[329] It is clear that utilization of the Bruno's sale is on the minds of bankruptcy planners any time a reorganization of a corporation in bankruptcy is contemplated.[330] This is especially true in today's economic environment, where corporate bankruptcy filings and failures in general are on the rise.[331] The economic climate thus highlights and emphasizes a pressing issue for the Service: how awkward might it be for the Service to wait until the recessionary turmoil is in full swing—after countless debtors have taken advantage of the Bruno's sale—to reverse course on its CCA ruling, thereby subjecting similarly situated corporate debtors to dissimilar treatment?

Clearly there is little if any legal impediment to the Service switching position midstream. The sole bit of judicial precedent that might prevent such discriminatory treatment arose in the 1960s and has been largely limited to

[326]The shareholders in *Gitlitz* had included COD income in their income—despite its being excluded from the corporation's income—which increased the basis in their stock, allowing them to take deductions for the corporation's losses that they would have been unable to take otherwise. *Id.* at 209. Because the losses had already been "passed through" to the shareholders, there was no tax that the COD income could have acted upon. *Id.* at 218. The Supreme Court approved the shareholders' actions, but Congress overruled the Court with respect to the pass-through of the COD income. Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, § 402, 116 Stat. 21, 40.

[327]*But see* Ridgway, *supra* note 180, at 165 (arguing that the regulations reducing tax attributes in the hands of an acquiring corporation are contrary to the holding in *Gitlitz*).

[328]Taxpayers are prohibited by statute from citing Chief Counsel Advice memoranda as precedent. *See* I.R.C. § 6110(k)(3). Whether actual reliance on the Service's pronouncements occurs, however, is a different matter.

[329]*See supra* note 318; *see also* Willens, *Delta Airlines*, *supra* note 319 (noting the availability of a taxable sale in U.S. Airway's proposed purchase of Delta Airlines).

[330]*See* Hart, *supra* note 15, at 179–88 (discussing various planning strategies for debtors in bankruptcy, among them, the Bruno's structure).

[331]*See, e.g.*, Vikas Bajaj, *One Ill Compounds Another, Hammering the Economy*, N.Y. Times, Mar. 14, 2008, at C1 (discussing the dollar's fall, decline of major United States stock indexes, and talk of a possible recession); Sandra M. Jones, *Struggles Grow for Retailers: Economy's Slide Sends More Stores into Bankruptcy*, Chi. Trib., Apr. 12, 2008, at 1; Sandra M. Jones, *Wickes Plans to Liquidate Assets: Sales Could Start This Weekend*, Chi. Trib., Feb. 27, 2008, at 1 (discussing the bankruptcy proceedings of furniture retailers).

its facts since then. In *IBM v. United States*, the Court of Claims held that the refusal of the Service to make a taxability ruling only prospectively effective, which would have equalized treatment that had been given to a competitor of the taxpayer, was contrary to the inherent requirements of then-section 7805(b), which gave the Service discretionary authority to make taxability rulings merely prospectively effective.[332] Although the court explicitly refused to depart from the established rule that taxpayers are not to rely on private Service rulings pertaining to other taxpayers, it was clear from the opinion that an anti-discrimination principle drove the decision.[333]

Later courts demonstrated mixed reactions to the *IBM* decision, with some limiting it to situations in which the Service issues a retroactive ruling that could disadvantage a taxpayer with respect to its competitors, whereas others expanded it to embrace all or most situations in which discriminatory treatment is at issue.[334] The Service, on the other hand, has been decidedly hostile

[332] Int'l Bus. Machs. v. United States *(IBM)*, 343 F.2d 914, 923–24 (Cl. Ct. 1965).

[333] *See id.* at 924–25.

> We need not, and do not, depart from that settled principle since we do not decide this case on the ground that IBM had a right to invoke or rely upon Remington's private ruling of April 1955. We rest on the wholly different basis that IBM, having taken the pains to ask promptly for its own ruling, was entitled to have the Service's ruling, in response to that request, controlled by the standard of equality and fairness incorporated in Section 7805(b).

Id.

[334] *See, e.g.*, Computer Scis. Corp. v. United States, 50 Fed. Cl. 388, 393, 398 (Fed. Cl. 2001) (finding that the Service may abuse its discretion by treating similarly situated taxpayers differently); Anderson, Clayton & Co. v. United States, 562 F.2d 972, 981 (5th Cir. 1977) (describing the factual situations in which courts should find an abuse of discretion: (1) "when retroactivity would work a change in settled law" or policy relied on by the taxpayer and implicitly approved by Congress; (2) when retroactivity would lead to a result in a particular case that would be unduly harsh; and (3) when retroactivity would lead to inequality of treatment between similarly situated taxpayers); Sirbo Holdings, Inc. v. Commissioner, 476 F.2d 981, 987 (2d Cir. 1973) ("[T]he Commissioner has a duty of consistency toward similarly situated taxpayers; he cannot properly concede capital gains treatment in one case and, without adequate explanation, dispute it in another having seemingly identical facts which is pending at the same time."); La Crosse Country Club v. United States, No. 69-C-259, 1972 WL 3211, at *6 (W.D. Wis. Oct. 16, 1972) (ruling that where the taxpayer is unable to show that a competitor is benefiting to his detriment from an advantageous tax ruling upon which the taxpayer is not allowed to rely, the ruling against the taxpayer may have retroactive effect); Schering-Plough Corp. v. United States, No. 05-2575 (KSH), 2007 WL 4264542, at *1, 8 (D.N.J. Dec. 3, 2007) (rejecting *Computer Sciences Corp.* and rejecting taxpayer's argument—based on *IBM*—that the Service's recharacterization of their sales of notional principal contracts as "loans" or "constructive dividends," which allegedly subjected them to dissimilar treatment as compared with similarly situated taxpayers, was therefore an abuse of discretion).

towards it.[335]

In the CCA context, therefore, it would seem that the Service *might*—in the context of a Private Letter Ruling or similar ruling with regard to a single taxpayer—be limited in some way from repealing the CCA if its repeal would thereby benefit a competitor of the taxpayer seeking the ruling. But there is obviously no issue whatsoever—other than a vague notion of fairness among debtors in the impending wave of recession and foreclosure-related bankruptcies—that the Service could prospectively rescind the CCA in a Revenue Ruling or set of Proposed Regulations.

Yet, regardless of whether the Service could *legally* rescind the CCA, there may exist certain *practical* and *political* difficulties that would prevent it from doing so. Some argue that even in the context of Revenue Rulings and other prospective pronouncements, the Service should give due consideration to reliance issues that have or might have arisen from taxpayer reliance on past pronouncements.[336] Other commentators have shown that, especially in the area of depreciation policy, the political headwinds can blow strongly toward a preservation of the status quo[337] or even toward a lessening of restrictions on politically-favored debtors— foremost in the context of residential foreclosures.[338] While upon first impression, comparison of corporate debtors

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[335] *See* I.R.S. Non-Docketed Serv. Adv. Rev. 20042903F, 2004 WL 1613616 (July 16, 2004).

> The application of *Int'l Bus. Machs. Corp. v. United States*, 343 F2d. [sic] 914 (Ct. Cl. [sic] 1965) . . . is strictly limited to cases in which: (1) Two or more taxpayers in direct economic competition have each applied for a ruling and only one has received a favorable ruling; and (2) The taxpayer denied the favorable ruling is arguing that the Commissioner abused his discretion under I.R.C. § 7805(b)(8) by failing to apply a new legal position only prospectively.

Id.

[336] *See* Edward A. Morse, *Reflections on the Rule of Law and "Clear Reflection of Income": What Constrains Discretion*, 8 Cornell J.L. & Pub. Pol'y 445, 490–91 (1999) (arguing that certain modifications of Revenue Rulings, "[d]espite notice of unreliability," create difficulties "from a Rule of Law perspective" because they tend to "erod[e] . . . taxpayer confidence in, and respect for, a tax system that permits the government to change positions after inducing reliance" and that, therefore, such reliance should be considered in the issuance of such rulings).

[337] *See* Jeff Strnad, *Tax Depreciation and Risk*, 52 SMU L. Rev. 547, 610 n.198 (1999) (demonstrating the political pressures to which depreciation policy is subject through a discussion of Congress' 1988 withdrawal from the Service of the "power to set useful lives that it had delegated to Treasury in the Tax Reform Act of 1986" and arguing that such withdrawal "was prompted by industries who feared that Treasury studies of their depreciable assets would result in decelerated depreciation").

[338] *See* Mortgage Forgiveness Debt Relief Act of 2007, Pub. L. No. 110-142, 121 Stat. 1803 (2007) ("amend[ing] the Internal Revenue Code of 1986 to exclude discharges of indebtedness on principal residences from gross income"); H.R. 1876, 110th Cong. (2007) (bill "to amend the Internal Revenue Code of 1986 to exclude from gross income of individual taxpayers discharges of indebtedness attributable to certain forgiven residential mortgage obligations"); H.R. 3506, 110th Cong. (2007) (bill "to amend the Internal Revenue Code of 1986 to exclude from gross income certain amounts of cancellation of indebtedness income on account of a foreclosure on the mortgage secured by the principal residence of the taxpayer").

with foreclosed residential homeowners may not generate the same suspicion among the electorate of politicians improperly sympathizing with a taxpayer's plight, one must consider that the greater the impact of an impending recession. The greater the pressure upon the corporate giants of the American economy to consider restructuring in bankruptcy,[339] the greater the impact upon the thousands of blue collar American workers employed by those corporate giants, whose jobs may be more imperiled by a bankruptcy hindered by the unavailability of certain favorable tax advantages. Rescinding the CCA in such a recessionary-driven and heated economic climate may turn out to be politically unpalatable and therefore impossible for the Service to accomplish. Thus, if its ultimate intention is to limit the availability of taxable sales of debtors' operations in bankruptcy, it would be best advised to act immediately, before the groundwork for arguments of discriminatory unfairness solidifies.

V. Conclusion

While criticisms of the Service's treatment of the Bruno's transaction in the CCA appear strong and sound upon first impression, several counter-arguments—as this Article has shown—counsel against any reversal of this position. First, Congress has explicitly expressed its intent that short-term creditors be treated differently than long-term creditors for purposes of the reorganization provisions. Although inaction on the part of Congress ordinarily should not be interpreted as approval, Congress has been considerably more than merely silent with respect to the treatment of nonsecurity holders for purposes of the reorganization provisions.[340]

Second, despite the criticisms' appeals to "business purpose" and "economic effect," there may in many instances be a real business purpose to retaining the Debtor's corporate existence and not distributing its assets to the creditor-shareholders. And even assuming that no contractual restrictions prohibit the debtor from structuring the transaction as a tax-free—rather than taxable—reorganization, the "business purpose" and "economic effect" doctrines, as illustrated above, were surely not meant to apply to the CCA transaction. The CCA transaction, while it saves taxes to debtors with certain tax characteristics, does not have as its principal purpose the avoidance of taxes. It is merely an alternative means to the same end that a tax-free reorganization

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[339] *See* David Welch, *Could Chrysler Go Bankrupt?*, Bus. Week, July 2, 2007, *available at* http://www.businessweek.com/autos/content/jul2007/bw2007072_365252.htm.

> Standard & Poor's ratings essentially say that Chrysler could be a recession away from bankruptcy. S&P analyst Gregg Lemos-Stein said that if the U.S. car market were to weaken further—with sales dropping from this year's pace of 16.3 million vehicles to 15.5 million vehicles next year—Chrysler could be in default by 2010.

Id.; David Reilly & Serena Ng, *GM is on Pace to Amass $32 Billion, a Big Fat Cushion to Stay Afloat On*, Wall St. J., Apr. 21, 2006, at C1 (discussing fears of a possible bankruptcy filing for General Motors that were averted in 2006).

[340] *See supra* note 63.

would provide.

Third, even if there really is not a "business purpose" in some isolated instances, the C Corporation laws and regulations are meant to be predictive, useful, and bright-line. Adopting such an ambiguous definition of "liquidation" and "security holder" contrary to the wishes of Congress only muddies the waters much more than they have already been muddied.

Fourth, Congress has restricted debtor reorganizations through (1) repeal of stock-for-debt, (2) trading restrictions in section 382, and (3) application of the section 108 NOL use limitation to consolidated groups. But, as noted above, Congress has not done so here. Thus, by negative implication, Congress presumably did not mean to.

Fifth, Congress had a good reason *not* to restrict the transaction at issue in the CCA, because of (1) the Bankruptcy Code's "fresh start" principle, and (2) avoiding anti-industry distortion. Neutrality is a principal goal of the federal income tax system. A reversal of course on the CCA would be tantamount to a reversal of course on the issue of neutrality.

Sixth, both Congress and the Treasury have taken steps that seem to be in explicit contradiction to the criticisms of the CCA, for example: (1) preservation of the short-term-long-term distinction; (2) realistic interpretations of "active trade or business"; (3) enactment of the Net Value regulations, which *deny* tax-free treatment to transactions structured very much like the CCA; (4) emphasizing the purpose of section 351(d) (securing a bad debt deduction for short-term creditors); and (5) enactment of section 351(e)(2), which explicitly prohibits application of section 351 to corporate contributions, where the stock received in exchange for the contribution is used to discharge indebtedness.

Seventh, the true justification for treating the transaction as nontaxable is the fact that the creditors—by virtue of being creditors of a debtor that is restructuring—have a potential proprietary interest in the corporation given that their claims may be paid out in stock of the reorganized debtor. The reality, however, is that vulture funds more often than not purchase this "proprietary" interest.

Thus, for both technical reasons relating to proper interpretation of the Code as well as for broader justifications of fairness and neutrality, the Service should maintain its current position on the Bruno's transaction and retain the holding of the CCA.