Reinvigorating Chapter 11: The Case for Reinstating the Stock-For-Debt Exception in Bankruptcy

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REINVIGORATING CHAPTER 11: 
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STOCK-FOR-DEBT EXCEPTION IN BANKRUPTCY

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I. INTRODUCTION

Most bankruptcy scholars agree that chapter 11 of the Bankruptcy Code is not working well in practice. Some conclude that it should be abolished; others argue for its reform. Yet while these scholars

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3. See, e.g., Adler, supra note 2, at 313; Bowers, Groping and Coping, supra note 2, at 2099-100; Bradley & Rosenzweig, supra note 2, at 1078.

4. See, e.g., Baird, supra note 2, at 128; Korobkin, supra note 2, at 734; LoPucki, supra note 2, at 81; Skeel, supra note 2, at 510; see also Jagdeep S. Bhandari &
vigorously debate such topics as whether chapter 11 only serves to protect corporate managers\(^5\) and whether it provides a lesser return to bondholders than did the old Bankruptcy Act.\(^6\) Congress is quietly and systematically eliminating any hope for the continued viability of chapter 11 through a curious and unlikely mechanism: the Internal Revenue Code.\(^7\) Its latest victim is a small and rather uncomplicated provision (by Code standards) known as the stock-for-debt exception.\(^8\)

Generally, when a creditor discharges indebtedness for less than its face amount, the debtor must include the difference in gross income as income from discharge of indebtedness, or debt discharge income.\(^9\) For example, if a creditor agrees to accept $6,000 in full satisfaction of a $10,000 debt, the debtor would recognize $4,000 of debt discharge income. If, however, the debtor is either insolvent or involved in a chapter 11 bankruptcy proceeding, the debt discharge income realized by the debtor need not be recognized, or included in gross income, at that time.\(^10\) Instead, the debtor must reduce its tax attributes, such as its net operating loss carryovers and its tax credits, by the debt discharge amount, on the theory that it is in a precarious financial position and is unlikely to have the funds available to pay the tax on any debt discharge income currently.\(^11\) The government recoups its lost revenue, however, when the debtor becomes profitable following its reorganization and has no net operating loss carryovers to offset against its taxable income.

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\(^6\) Bradley & Rosenzweig, supra note 2, at 1069-72; LoPucki, supra note 2, at 82-94.

\(^7\) Unless otherwise noted, the term "Code" in this Article refers to the Internal Revenue Code of 1986, as amended.

\(^8\) I.R.C. § 108(e)(10)(B) (repealed 1993). For a complete discussion of the stock-for-debt exception, see infra notes 86-99 and accompanying text.


\(^10\) I.R.C. § 108(a)(1) (1994). For insolvent taxpayers, however, this exception applies only to the extent of the insolvency. I.R.C. § 108(a)(3) (1994); see also infra notes 80-85 and accompanying text.

\(^11\) I.R.C. § 108(b) (1994). Alternatively, the debtor can elect to reduce the basis in its depreciable property by the discharge of indebtedness income and leave its net operating losses intact. I.R.C. § 108(b)(5) (1994). For an in-depth discussion of the tax attribute reduction rules and the depreciable basis election, see infra notes 83-85 and accompanying text.
Prior to its repeal in 1993, there was a broad statutory exception to these debt discharge rules. Originally created at common law,12 the stock-for-debt exception provided that, if a corporation was either insolvent or in bankruptcy and issued stock to its creditors in exchange for their indebtedness, the corporation would not be required to include any discharge of indebtedness resulting from the exchange in gross income, nor would it be forced to reduce its tax attributes by a like amount.13

When Congress codified the stock-for-debt exception in 1980, it justified the exception as furthering the general policy goals of chapter 11 bankruptcy reorganizations, including rehabilitating rather than liquidating financially troubled corporations, preserving countless jobs, and fostering economic growth through increased competition.14 Empirical evidence suggests that the stock-for-debt exception did, in fact, promote these laudable goals of chapter 11. For example, conservative estimates suggest that the stock-for-debt exception was used in eight out of every ten bankruptcy reorganizations prior to its repeal.15 Moreover, without it, a number of large corporations, such as LTV and TWA, would have been forced to liquidate, resulting in the loss of thousands of jobs and devastating the national economy.16

Yet despite the prominent role that the stock-for-debt exception played in successful chapter 11 reorganizations, it was repealed as part of the Omnibus Budget Reconciliation Act of 199317 without any public hearings ever being held.18 Although a senate committee report suggests that the exception was repealed because it distorted “the proper measurement of economic income” and was unduly “complex and cumbersome,” it is clear from the repeal’s location within the Act that the exception was repealed merely to raise revenue for other special interest

12. See, e.g., Comm’r v. Capento Sec. Corp., 140 F.2d 382, 386 (1st Cir. 1946). For a detailed discussion of the common law origins of the stock-for-debt exception, see infra notes 43-65 and accompanying text.

13. I.R.C. § 108(e)(10)(B) (repealed 1993). This rule was subject to exceptions, which are discussed infra notes 92-99 and accompanying text.


15. Peter F. Blackman, Farewell to a Tax Break: Deadline Could Spur Rush of Chapter 11 Filings, N.Y. L.J. Aug. 12, 1993, at 5 (estimate provided by Paul Asofsky, prominent bankruptcy taxation scholar); see also infra notes 220-21 and accompanying text.

16. Id.; see also infra notes 222-24 and accompanying text.


provisions. In fact, when Congress initially proposed the repeal of the exception in 1992, it was estimated to raise $286 million over five years. Yet when the exception was actually repealed less than one year later, it was estimated to raise $622 million over the same time period, an astonishing 218% increase. In yet another procedural irregularity, Congress delayed the effective date of the repeal for almost two years, an unusual act at a time when Congress was often making tax legislation applicable retroactively. One commentator has aptly referred to these congressional attempts to repeal the stock-for-debt exception as a "rancid piece of political pork." It is obvious that the exception's repeal was marked by hasty political maneuvering rather than by considered legislative decision-making.

Even though Congress repealed the stock-for-debt exception in 1993, because of the highly unusual delayed effective date of the repeal, corporations governed by the new law are only now beginning to emerge from bankruptcy. Thus, there is not yet any empirical evidence available to document what impact the repeal of the exception will have on chapter 11 bankruptcy reorganizations.

The stock-for-debt exception was not free from valid criticism before its repeal. Tax scholars had substantially discredited the purported tax policy justifications on which it was based, the substitution of liability theory and the subscription price theory. Yet this Article proposes that another unarticulated but compelling tax policy justification supports the stock-for-debt exception. Based on the open transaction doctrine espoused by the Supreme Court in another context, the Article suggests that, because the stock of an insolvent corporation or one involved in a bankruptcy proceeding cannot be valued with any accuracy, it is impossible to determine the true amount of debt actually discharged in the stock-for-debt exchange or whether, in fact, any debt was discharged at

19. The RIA Complete Analysis of the Revenue Reconciliation Act of 1993 With Code Sections as Amended and Committee Reports 736-37 (1993); see also infra notes 200-01 and accompanying text.
24. See, e.g., Capento Sec., 140 F.2d at 386; see also Comm’r v. Motor Mart Trust, 156 F.2d 122, 126 (1st Cir. 1946); Woodmont Corp. v. Comm’r, 5 T.C.M. 291, 293 (1946). Scholarly criticisms of these theories are outlined in detail infra notes 239-47 and accompanying text.
all until the transaction is closed when the creditor later-sells the stock and establishes its true value.\textsuperscript{25}

Accordingly, this Article proposes that Congress reinstate the stock-for-debt exception for corporations that are insolvent or in bankruptcy, so that they recognize no discharge of indebtedness income and suffer no tax attribute reduction at the time of the stock-for-debt exchange. It also proposes that, based on the open transaction theory, Congress amend the exception to require debtors to reduce their tax attributes at the time that a creditor receiving stock in the exchange sells or otherwise disposes of it, in an amount equal to the excess of the indebtedness cancelled over the selling price of the stock (or its fair market value on the date of the disposition if the creditor disposes of the stock in a transaction that does not constitute a sale). The proposal resolves valuation issues raised by a creditor’s premature sale of the debtor’s stock.\textsuperscript{26} This Article suggests that such a proposal will harmonize the bankruptcy policy of rehabilitating financially distressed corporations with the tax policy of ensuring that true economic income is subject to federal income taxation.\textsuperscript{27}

Parts II and III of this Article will trace the common law evolution of the stock-for-debt exception and its statutory codification in 1980, with particular emphasis on the stated policy justifications for the exception. Part IV will then examine the history of the repeal of the stock-for-debt exception, demonstrating that the repeal was the result of hasty political maneuvering rather than reasoned legislative decision-making. In Part V, the Article will first explore the exception’s critical role in realizing the fundamental rehabilitative goals of chapter 11 bankruptcy and will justify the exception under both bankruptcy and tax theory. It will propose the reinstatement of the stock-for-debt exception for insolvent corporations and those in bankruptcy, and will resolve three tax issues relating to the exception that remained unanswered at the time that the exception was repealed. The Article will conclude that reinstating the stock-for-debt exception will improve the success rate of chapter 11 bankruptcy reorganizations and reduce the devastating economic impact of corporate liquidations.\textsuperscript{28}

\textsuperscript{25} Burnet v. Logan, 283 U.S. 404 (1931); see also infra notes 248-55 and accompanying text.

\textsuperscript{26} Resolution of these vexing valuation issues is addressed infra notes 266-76 and accompanying text.

\textsuperscript{27} This Article suggests that bankruptcy scholars generally fail to consider the tax implications of bankruptcy issues that they examine, while tax scholars are generally unaware of the bankruptcy ramifications of tax issues. Thus, few, if any, articles explore issues at the intersection of these two vast bodies of law. This Article takes the position that this lack of attention to the intersection of bankruptcy and tax law is one factor contributing to the demise of the chapter 11 system.

\textsuperscript{28} For an earlier article suggesting that another amendment to the Internal Revenue Code would produce similar results, see Michelle M. Arnopol, \textit{Why Have Chapter 11 Bankruptcies Failed So Miserably? A Reappraisal of Congressional Attempts}
II. THE COMMON LAW EVOLUTION OF THE STOCK-FOR-DEBT EXCEPTION

Section 61 of the Internal Revenue Code requires a taxpayer to include in gross income, "income from whatever source derived." 29 The Supreme Court has stated that gross income includes any accession to the taxpayer's wealth. 30 When a taxpayer borrows money, the loan proceeds are not considered gross income because the taxpayer acquires a corresponding obligation to repay the borrowed money and, thus, does not have an accession to wealth. 31 If, however, the taxpayer is relieved of the obligation to repay the borrowed funds, then the taxpayer must include the discharged debt in her gross income. 32 This concept, referred to as cancellation of debt ("COD") income, or debt discharge income, was first recognized in the landmark 1931 Supreme Court case of United States v. Kirby Lumber Co. 33 The policy justification for including discharge of indebtedness in gross income enunciated by Justice Holmes in Kirby Lumber was that the taxpayer experienced an increase in its net worth when its assets were freed up as a result of extinguishing its liabilities at a discount. 34 Although Kirby Lumber's theoretical underpinnings have been

30. Comm'r v. Glenshaw Glass Co., 348 U.S. 426, 431 (1955) (stating that gross income includes all "accessions to wealth, clearly realized, and over which the taxpayers have complete dominion").
31. United States v. Rochelle, 384 F.2d 748, 751 (5th Cir. 1967), cert. denied, 390 U.S. 946 (1968) ("A loan does not in itself constitute income to the borrower, because whatever temporary economic benefit he derives from the use of the funds is offset by the corresponding obligation to repay them."); see also Comm'r v. Wilcox, 327 U.S. 404, 408 (1946); Minnis v. Comm'r, 71 T.C. 1049, 1056 (1979); Stayton v. Comm'r, 32 B.T.A. 940, 943 (1935).
33. Id. In Kirby Lumber, Kirby Lumber issued its own bonds for approximately $12 million and received par value on the sale of the bonds. Because of a decline in the value of the bonds later that year, Kirby Lumber repurchased some of the bonds for less than par value, with a price differential of approximately $137,000. The Commissioner sought to tax Kirby Lumber on the $137,000 amount as an accession to Kirby Lumber's gross income for the year. Justice Holmes, writing the opinion for the Court, agreed with the Commissioner, holding that, as a result of the transaction, Kirby Lumber suffered no reduction in its assets and recognized a clear gain. "As a result of its dealings it made available $137,521.30 assets previously offset by the obligation of bonds now extinct... [Kirby Lumber] has realized within the year an accession to income, if we take words in their plain popular meaning, as they should be taken here." Kirby Lumber, 284 U.S. at 3. See also Haden Co. v. Comm'r, 118 F.2d 285, 286 (5th Cir. 1941) ("Assets to the extent of $116,906.54, previously offset by liabilities, were freed from the claims of creditors, and to this extent the petitioner thereby 'realized within the year an accession to income.'")
34. Kirby Lumber, 284 U.S. at 3. Commentators have often referred to this policy justification as the balance sheet approach. Peter C. Canellos, Rethinking the Tax
challenged by tax scholars, this net worth approach is consistent with traditional notions of a comprehensive income tax base, and the concept of including discharges of indebtedness in gross income is now clearly embedded in the income tax system.

In an effort to provide relief from the harsh tax consequences of Kirby Lumber, lower courts soon began creating exceptions to its strict application. The first such exception stated that cancellation of indebtedness was not included as income or gain if the taxpayer was insolvent both before and after the debt discharge. This exception was


35. Boris I. Bittker & Barton H. Thompson, Jr., Income From the Discharge of Indebtedness: The Progeny of United States v. Kirby Lumber Co., 66 CAL. L. REV. 1159 (1978) (arguing that COD income can be justified not under a net worth or freeing of assets approach, but rather under a tax benefit theory: "[B]orrowed funds are excluded from gross income when received because of the assumption that they will be repaid in full . . . [and] a tax adjustment is required when this assumption proves erroneous") (citing to cases discussing the tax benefit theory); see also Theodore P. Seto, The Function of the Discharge of Indebtedness Doctrine: Complete Accounting in the Federal Income Tax System, 51 TAX L. REV. 199, 201-06 (1996) (noting that the Supreme Court has recently adopted both the net worth theory and the tax benefit rationale for COD income in United States v. Centennial Sav. Bank FSB, 499 U.S. 573, 582 (1991)). For a more complete discussion of the impact of Centennial on the policy underlying COD income, see Paul J. Sax, Supreme Court Decides Fundamental Debt Discharge, Loss Realization Issues, 75 J. TAX’N 54, 54-56 (1991).


37. See, e.g., Patricia L. Bryan, Cancellation of Indebtedness by Issuing Stock in Exchange: Challenging the Congressional Solution to Debt-Equity Swaps, 63 TEX. L. REV. 89, 96 (1984) ("Although the Court’s analysis in Kirby Lumber . . . has been criticized by commentators, the correctness of the result has rarely been doubted.") (footnotes omitted).

38. Discharge of indebtedness is indeed one of the most complicated areas of tax law, in part because it is fraught with exceptions. A discussion of all of these exceptions is beyond the scope of this Article. One of the preeminent tax scholars of our day, James Eustice, however, wrote an early article that attempted to grapple with these many exceptions, such as how to define indebtedness, determining when it is discharged, the effect of non-recourse indebtedness as well as debt-for-debt exchanges, and how reductions in the purchase price of an item should be treated. Much of his discussion remains relevant today. See James S. Eustice, Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion, 14 TAX L. REV. 225 (1959). For a more recent discussion of many of these issues, see Jack F. Williams, Rethinking Bankruptcy and Tax Policy, 3 AM. BANKR. INST. L. REV. 153, 155-78 (1995).

39. Dallas Transfer & Terminal Warehouse Co. v. Comm’r, 70 F.2d 95, 96 (5th Cir. 1934); Kramon Dev. Co. v. Comm’r, 3 T.C. 342, 349 (1944). Several prominent tax
premised on the theory that, because the cancellation of past due debts of an insolvent debtor did not have the effect of increasing the debtor’s assets over his remaining liabilities, there was no freeing of assets, as in *Kirby Lumber*; thus the transaction involved no element of gain or profit.\(^4\) This insolvency exception was modified somewhat in cases in which the debtor was insolvent before the discharge of indebtedness, but became solvent as a result of the debt discharge. That line of cases held that cancellation of indebtedness was included in the gross income of the debtor only to the extent that the debtor became solvent as a result of the discharge.\(^4\) The courts reasoned that the cancellation of a taxpayer’s indebtedness had the effect of increasing his assets over his remaining liabilities, creating an accession to the taxpayer’s wealth that was includable in gross income.\(^5\)

The second exception to *Kirby Lumber* created by the lower courts has come to be known as the stock-for-debt exception. The leading case espousing this exception was *Commissioner v. Capento Securities Corp.* \(^4\)

In that case, Capento Securities was organized as a subsidiary of scholars criticize this exception because it is based on *Kirby Lumber’s* freeing of assets approach, rather than being based on a tax benefit theory. See, e.g., Bittker & Thompson, *supra* note 35, at 1182-84.

\(^4\) *Dallas Transfer*, 70 F.2d at 96; *Kramon*, 3 T.C. at 349 (“A reduction in outstanding liabilities which does not make a taxpayer solvent does not result in taxable gain.”). In *Dallas Transfer*, the court explained the theory behind the insolvency exception best when it stated:

Taxable income is not acquired by a transaction which does not result in the taxpayer getting or having anything he did not have before. Gain or profit is essential to the existence of taxable income. A transaction whereby nothing of exchangeable value comes to or is received by a taxpayer does not give rise to or create taxable income.

*Dallas Transfer*, 70 F.2d at 96 (citations omitted). Commentators have argued, however, that the common law insolvency exception was inconsistent with sound tax theory, because loan proceeds usually generate current tax benefits to businesses (such as depreciation deductions derived from property purchased with the borrowed funds); therefore, there is no reason for excluding the discharged indebtedness from the taxpayer’s income. Canellos, *supra* note 34, at 811. But see Part III, *infra*, for a discussion of the statutory codification of the insolvency exception, in which Congress rejected the theory underlying this exception.


\(^4\) *Haden Co.*, 118 F.2d at 286 (holding that assets freed from creditors’ claims and no longer encumbered by liabilities result in taxable income); *Texas Gas*, 3 T.C. at 61-62 (“[W]here an insolvent debtor, by reason of [the cancellation of indebtedness] becomes solvent he realizes taxable gain in the amount of the assets freed from the claims of creditors, i.e., to the extent by which the transaction renders him solvent.”); *Lakeland Grocery Co.*, 36 B.T.A. at 292 (stating that *Kirby Lumber* was applicable to the extent that Lakeland was solvent after the discharge because “the cancellation of [Lakeland’s] debts had the effect of making its assets greater than they were before that transaction occurred”).

\(^4\) 140 F.2d 382 (1st Cir. 1944).
Raytheon Manufacturing for the sole purpose of purchasing $500,000 in bonds that had previously been issued by Raytheon Manufacturing’s other subsidiary, Raytheon Production. The purchase amount of the bonds was $15,160. Had Raytheon Production instead repurchased its own bonds at a discount, it would have had a large taxable gain under Kirby Lumber. The primary issue that the First Circuit faced was whether Raytheon Production realized $450,000 in cancellation of indebtedness income when it subsequently transferred its preferred stock, worth $50,000, and with a par value of $500,000, to Capento Securities in exchange for cancellation of the bonds.

The court held that, while Raytheon Production had discharged its liability on the bonds,

it created a new stock interest which became a balance sheet liability . . . . [T]o substitute a capital stock liability for a bonded indebtedness may have its advantages . . . but it cannot be called a present realization of gain . . . . While the bond loan has been terminated, the amount borrowed is now committed to capital stock liability instead of to the liability of a fixed indebtedness.

In essence, the First Circuit adopted the theory that merely exchanging debt, one form of corporate obligation, for stock, another type of corporate obligation, was not an appropriate time to impose a tax. This theory has come to be known as the “substitution of liability” theory.

The court in Capento Securities espoused a second rationale in support of its holding. Using what has come to be known as the “subscription price theory,” the court held that a corporation does not recognize gain or loss upon the issuance of its own stock, “and this would

44. Although the exchange involved the issuance of 5,000 shares of six percent non-cumulative preferred stock with a par value of $100 per share, the stock was worth only $50,000. The court was unaware of why the valuation discrepancy was present. Id. at 386.

45. While the primary issue in the case was whether Raytheon Production realized cancellation of indebtedness income, the initial aspects of the case dealt with whether Capento Securities could claim that a transfer of the bonds in exchange for Raytheon Production’s preferred stock was a non-recognition transaction. The court held that this was a recapitalization of the corporation and, because it was clearly done to allow Raytheon Production to raise more capital, was not subject to recognition. Id. at 384-85.

46. Id. at 386.


seem to be no less true when the subscription price, instead of being newly paid, is the amount which has already been paid in as the principal of the bond loan."\textsuperscript{49}

Shortly after the First Circuit established the stock-for-debt exception in \textit{Capento Securities}, it reaffirmed the doctrine in \textit{Commissioner v. Motor Mart Trust},\textsuperscript{50} despite the interim enactment of statutory changes to the Bankruptcy Act that threatened to eliminate the stock-for-debt exception.\textsuperscript{51} \textit{Motor Mart Trust} involved a trust taxable as a corporation. Upon the trust’s formation in 1926, it acquired a leasehold interest and issued 5,000 shares of common stock with a value of $500,000 for the interest. Motor Mart Trust erected a building on the land and financed it by the sale of first and second mortgage bonds as well as preferred stock. The building had a yearly depreciation of $47,700. The trust became financially distressed and filed a petition for bankruptcy reorganization in April, 1937. The reorganization plan involved a transfer of preferred and common stock in exchange for the bonds.\textsuperscript{52} All interests of the old shareholders were completely extinguished in the reorganization. This exchange resulted in a significant reduction in Motor Mart Trust’s existing liabilities.

The Commissioner initially took the position that Motor Mart Trust had realized no taxable gain upon the exchange of its stock for debt, and the court upheld the Commissioner’s position. The court stated that “[a]t the date of the reorganization the equity of the old shareholders had vanished, and in substance the bondholders were the owners of the company. This situation was merely given formal recognition . . . the bondholders changed their status to that of shareholders in the reorganized company.”\textsuperscript{53}

The difficulty in the case arose because, before the final order approving the plan was entered, Congress enacted several new provisions in the Bankruptcy Act (the predecessor to the Bankruptcy Code) addressing the issue of cancellation of indebtedness income in bankruptcy

\textsuperscript{49} \textit{Capento Securities}, 140 F.2d at 386.
\textsuperscript{50} 156 F.2d 122 (1st Cir. 1946).
\textsuperscript{51} Bankruptcy Act of July 1, 1898, ch. 541, 30 Stat. 544 (1898) (the “Bankruptcy Act”) (amended by the Act of June 22, 1938, ch. 575, §§ 268-70, 52 Stat. 840, 904 (1938) (the “Chandler Act”) and the Act of July 1, 1940, ch. 500, § 270, 54 Stat. 709, 709 (1940)). For a more complete discussion of these provisions, see infra notes 54-59 and accompanying text.
\textsuperscript{52} More specifically, the trust transferred 9,548 shares of preferred stock at fifty dollars per share and 4,774 shares of common stock at five dollars per share in exchange for the first mortgage bonds; 1,410 shares of common stock at five dollars per share in exchange for the second mortgage bonds; and 253 shares of common stock at five dollars per share to cover the compensation of the trustees under the bonds. \textit{Motor Mart Trust}, 156 F.2d at 123.
\textsuperscript{53} \textit{Id.} at 124.
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proceedings. In short, section 268 of the Chandler Act of 1938 declared that no gain or profit would be deemed to have accrued to a corporation modifying or canceling its debt in a reorganization in bankruptcy. Section 270 of the Chandler Act then provided that the basis of the debtor’s property in the bankruptcy reorganization must be reduced by the amount of cancelled debt. As a result of these statutory changes to the Bankruptcy Act, the Commissioner claimed that the basis of Motor Mart Trust’s property should be reduced by its cancelled debt; thus, he disallowed the depreciation deductions taken on the property in 1939 and 1940 and assessed a deficiency.

The First Circuit disagreed with the Commissioner’s position and reversed the assessed deficiencies. The court reasoned that section 270 was enacted to prevent a “double deduction” when debt was forgiven under section 268 that would otherwise have been taxable. The court stated that Motor Mart Trust obtained no tax advantage from section 268, “for upon consummation of the plan of reorganization the taxpayer realized no gain which would otherwise have been taxable under the provisions of the revenue acts.” Citing the Supreme Court’s decision in Claridge Apartments Co. v. Commissioner, the First Circuit stated that, in cases where no benefit accrued from the application of section 268, it would be a penalty as well as a tax deterrent to bankruptcy reorganization to apply section 270 to reduce the basis of the debtor’s property. Thus, the court, reaffirming the stock-for-debt exception previously established in Capento Securities, concluded that there was no cancellation of indebtedness within the meaning of section 270, but rather that the

54. See supra note 51 and accompanying text. For a complete discussion of the statutory codification of cancellation of indebtedness income and its exceptions, see infra notes 66-99 and accompanying text.


57. Motor Mart Trust, 156 F.2d at 126.

58. 323 U.S. 141, 151 (1944). It is interesting to note that the Seventh Circuit had rejected the stock-for-debt exception to Kirby Lumber in its entirety. Claridge Apartments Co. v. Comm’r, 138 F.2d 962, 965-66 (7th Cir. 1943). Although the Supreme Court reversed the Seventh Circuit’s decision, it did so on the ground that section 270 of the Chandler Act could not be applied retroactively to the debtor in Claridge Apartments, without passing directly on the viability of the stock-for-debt exception. Claridge Apartments Co. v. Comm’r, 323 U.S. 141 (1944). The Tax Court subsequently interpreted the Supreme Court’s opinion in Claridge Apartments as adopting the stock-for-debt exception implicitly. See infra notes 60-65 and accompanying text. A leading commentator, however, believes that the Court’s opinion could be read differently. Paul H. Asofsky, Discharge of Indebtedness Income in Bankruptcy After the Bankruptcy Tax Act of 1980, 27 ST. LOUIS U. L.J. 583, 606-07 (1983); see also Canellos, supra note 34, at 813.
exchange of stock of Motor Mart Trust for its debt was for good consideration. "The transaction may be considered a form of payment for the bonds, not cancellation."59

Following the First Circuit’s decision in Motor Mart Trust, the Tax Court decided several cases in rapid succession that firmly established the stock-for-debt exception in the common law. In Tower Building Corp. v. Commissioner,60 the Tax Court held that an exchange of Tower Building’s new stock for its secured and unsecured debt and old stock under a plan of reorganization was not a cancellation of its indebtedness under sections 268 and 270 of the Chandler Act.61 Therefore, the court required no corresponding reduction of Tower Building’s basis in its assets. Similarly, in Woodmont Corp. v. Commissioner,62 the Tax Court held that the cancellation of mortgages in a bankruptcy proceeding in exchange for Woodmont’s preferred and common stock required no adjustment to the basis of the transferred assets because “[t]he obligation owing to those who originally held bonds was continued in another form.”63 Citing Motor Mart Trust and Tower Building Corp., the court found no cancellation or reduction of debt by which the basis of Woodmont’s property should have been adjusted.64 After the Tax Court handed down its decision in Woodmont, the stock-for-debt exception appeared to have become firmly entrenched in the common law, and the exception was subject to little case law dispute after 1946.65

III. STATUTORY CODIFICATION OF KIRBY LUMBER AND THE STOCK-FOR-DEBT EXCEPTION

Until Congress enacted sweeping and comprehensive provisions addressing the taxation of insolvent and bankrupt corporations as part of the Bankruptcy Tax Act of 1980,66 statutory codification of bankruptcy taxation provisions was sporadic and piecemeal. In 1954, more than

59. Motor Mart Trust, 156 F.2d at 127.
60. 6 T.C. 125 (1946).
61. Id. at 134-35.
62. 5 T.C.M. (CCH) 291 (1946).
63. Id. at 293.
64. Id. The Tax Court reached the same result in Potter & Rayfield, Inc. v. Comm’r, 5 T.C.M. (CCH) 119, 122 (1946); Alcazar Hotel, Inc. v. Comm’r, 1 T.C. 872, 879-80 (1943).
65. In 1947, the Internal Revenue Service [the “Service”] finally acquiesced in three of the leading Tax Court cases that had established the stock-for-debt exception. Tower Bldg. Corp. v. Comm’r, 6 T.C. 125, 137 (1946), acq., 1947-1 C.B. 4, Motor Mart Trust v. Comm’r, 4 T.C. 931 (1945), acq., 1947-1 C.B. 3, aff’d, Comm’r v. Motor Mart Trust, 156 F.2d 122 (1st Cir. 1946); Alcazar Hotel, Inc. v. Comm’r, 1 T.C. 872 (1943), acq., 1947-1 C.B. 1.
twenty years after the Supreme Court rendered its landmark decision in *Kirby Lumber*, Congress codified *Kirby Lumber*’s cancellation of indebtedness income doctrine. As discussed earlier, the codification was contained in section 268 of the Chandler Act, which provided that any corporation modifying or canceling its debt in a bankruptcy reorganization would not be required to recognize any gain or profit as a result of its discharge of indebtedness in the bankruptcy proceeding (the “bankruptcy exception”). As quid pro quo for the COD income exception found in section 268, however, section 270 of the Chandler Act provided that the debtor corporation was required to reduce the basis of its property by the amount of debt cancelled or discharged in the bankruptcy reorganization proceeding. Thus, while Congress gave with one hand, it

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69. See supra note 55 and accompanying text.
   
   Except as provided in section 270 of this Act, no income or profit, taxable under any law of the United States or of any State now in force or which may hereafter be enacted, shall, in respect to the adjustment of the indebtedness of a debtor in a proceeding under this chapter, be deemed to have accrued to or to have been realized by a debtor, by a trustee provided for in a plan under this chapter, or by a corporation organized or made use of for effectuating a plan under this chapter by reason of a modification in or cancellation in whole or in part of any of the indebtedness of the debtor in a proceeding under this chapter.

*Id.*


In determining the basis of property for any purposes of any law of the United States or of a State imposing a tax upon income, the basis of the debtor’s property (other than money) or of such property (other than money) as is transferred to any person required to use the debtor’s basis in whole or in part shall be decreased by an amount equal to the amount by which the indebtedness of the debtor, not including accrued interest unpaid and not resulting in a tax benefit on any income tax return, has been canceled or reduced in a proceeding under this chapter.

*Id.* This section was amended in 1940 to provide that the basis reduction to the debtor’s property be capped at the fair market value of the property as of the date on which the court enters an order confirming the debtor’s reorganization plan. Act of July 1, 1940, ch. 500, § 270, 54 Stat. 709, 709 (1940). For a comprehensive discussion of the policies
took away with the other. Although section 268 afforded a debtor corporation relief from immediate recognition of COD income, section 270 exacted a "toll charge" for such relief by requiring the corporation to reduce its asset bases, so that the government would eventually receive the tax benefit of the corporation's discharge of indebtedness in the form of larger gain when the corporation eventually sold its assets with their reduced bases.\footnote{claridge}

In the early 1970s Congress appointed a special commission to review the entire structure of the bankruptcy laws, which dated back to 1898.\footnote{s.j. res. 88, 91st cong. (1970); see also h.r. rep. no. 91-927, at 1 (1970); s. rep. no. 91-240, at 1 (1969).} One of the Commission's consultants was William T. Plumb, Jr., arguably the most influential bankruptcy tax scholar of the twentieth century. Although the Commission's report was quite comprehensive and contained a full chapter addressing topics related to bankruptcy taxation,\footnote{h.r. doc. no. 93-137, pt. 1, at 277 (1973). In fact, Plumb wrote a series of articles in 1974 and 1975 discussing these bankruptcy tax provisions and the policies underlying them. William T. Plumb, Jr., *The Tax Recommendations of the Commission on the Bankruptcy Laws—Tax Procedures*, 88 Harv. L. Rev. 1360 (1975); William T. Plumb, Jr., *The Tax Recommendations of the Commission on the Bankruptcy Laws—Reorganizations, Carryovers and the Effects of Debt Reduction*, 29 Tax L. Rev. 229 (1974); William T. Plumb, Jr., *The Tax Recommendations of the Commission on the Bankruptcy Laws—Priority and Dischargeability of Tax Claims*, 59 Cornell L. Rev. 991 (1974); William T. Plumb, Jr., *The Tax Recommendations of the Commission on Bankruptcy Laws—Income Tax Liabilities of the Estate and the Debtor*, 72 Mich. L. Rev. 935 (1974). One scholar aptly stated that these articles are "a gold mine of legislative history . . . . There is no doubt that the Plumb articles informed every change in the legislative product that developed in the ensuing five years." Asofsky, *supra* note 23, at 13-5.} jurisdictional acrimony between the House Judiciary Committee, responsible for the bankruptcy laws of the United States, and the House Ways and Means Committee, with responsibility for federal taxation matters, threatened to undermine the entire bankruptcy overhaul process.\footnote{asofsky, *supra* note 23, at 13-6.}

The sponsors of the bankruptcy bill responded to this turf war by removing all references in the bill to federal taxation matters. Thus, when Congress enacted a sweeping overhaul of the bankruptcy system in the Bankruptcy Code in 1978,\footnote{bankruptcy reform act of 1978, pub. l. no. 95-598, 92 stat. 2549 (1978).} the bill contained references only to state and local income tax issues. All federal tax matters were introduced in a separate bill,\footnote{h.r. 9973, 95th cong. (1977).} which was given lengthy consideration by the House and Senate committees responsible for both tax and bankruptcy matters. After underlying § 270 of the Chandler Act, see Claridge Apartments Co. v. Comm'r, 323 U.S. 141, 149-52 (1944).
extensive testimony and debate, Congress passed the Bankruptcy Tax Act of 1980 on December 13, 1980.

The Bankruptcy Tax Act attempted to harmonize often conflicting bankruptcy and tax policies in a comprehensive and systematic fashion. To that end, it first codified in the Tax Code the bankruptcy exception enacted over forty years earlier as part of the Chandler Act, and extended it to insolvent taxpayers as well. Thus, section 108(a) of the Code provides that gross income of a taxpayer does not include any amount that otherwise would be discharge of indebtedness income to the taxpayer if the debt discharge occurs either (i) in a title 11 bankruptcy proceeding, or (ii) while the taxpayer is insolvent. The legislative history of the Bankruptcy Tax Act provides that the policy justification for this rule is to "preserve the debtor's 'fresh start' after bankruptcy . . . so that a debtor coming out of bankruptcy (or an insolvent debtor outside bankruptcy) is not burdened with an immediate tax liability."

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78. For an exhaustive history of the debates and hearings leading to the passage of the Bankruptcy Tax Act of 1980, see Asofsky, supra note 23, at 13-4 to 13-14.
80. A taxpayer is entitled to rely on the title 11 exception only if the taxpayer is under the jurisdiction of a bankruptcy court in a case commenced under title 11 of the United States Code, and "the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court." I.R.C. § 108(d)(2) (1994).
(1) In general
Gross income does not include any amount which (but for this subsection) would be includable in gross income by reason of the discharge (in whole or in part) of indebtedness of the taxpayer if -
(A) the discharge occurs in a title 11 case,
(B) the discharge occurs when the taxpayer is insolvent,
(C) the indebtedness discharged is qualified farm indebtedness, or
(D) in the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness.

Id.

If this gross income exclusion applies by reason of the taxpayer's insolvency, section 108(a)(3) provides that the exclusion will only apply to the extent that the taxpayer is insolvent. I.R.C. § 108(a)(3) (1994). Moreover, insolvency is defined in section 108(d)(3) as "the excess of liabilities over the fair market value of assets." The determination of insolvency is made by looking at the taxpayer's assets and liabilities just prior to the debt discharge. I.R.C. § 108(d)(3) (1994).

One issue that continues to perplex the courts is whether contingent liabilities, such as guarantees, should be counted as liabilities for purposes of determining insolvency under I.R.C. § 108(d)(3). In a recent case, Merkel v. Comm'r, 109 T.C. 463, 484 (1997), the Tax Court held that only those liabilities that the taxpayer is likely to be called upon to pay (under a "more probable than not" standard) would affect the determination of insolvency under section 108(d)(3) of the Code. Id. at 484. For a more comprehensive discussion of this issue, see Celia R. Clark, COD Income: New Opportunities for Insolvency Planning After Merkel, 89 J. TAX'N 29 (1998); see also Pratt, supra note 34, at 28.

There is, however, a toll charge exacted from these taxpayers in bankruptcy and insolvent taxpayers, codified in section 108(b) of the Code. This provision modifies section 270 of the Chandler Act by expanding the list of tax attributes affected by the taxpayer's cancellation of indebtedness. Section 108(b) provides that the amount excluded from a taxpayer's gross income by reason of section 108(a) must be applied to reduce the taxpayer's tax attributes in the following order: net operating losses ("NOLs"),\(^8\) general business credits, minimum tax credits, capital loss carryovers, the basis of the taxpayer's property, passive activity loss and credit carryovers, and foreign tax credit carryovers.\(^4\) The Senate

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83. Net operating losses are often the most valuable assets of a financially troubled corporation, because they can shelter its income from federal income taxes when it emerges from bankruptcy. For a more comprehensive discussion of the value of NOLs generally, see Arnopol, supra note 28, at 138-39; see also Valerie E. Burke & Gardner F. Davis, The Forgotten Asset: Net Operating Losses of the Chapter 11 Corporate Debtor, 68 FLA. B.J. 69, 69 (1994).

84. I.R.C. § 108(b) (1994). That section provides in pertinent part:

(b) Reduction of Tax Attributes

(1) In general

The amount excluded from gross income under subparagraph (A), (B), or (C) of subsection (a)(1) shall be applied to reduce the tax attributes of the taxpayer as provided in paragraph (2).

(2) Tax attributes affected; order of reduction

Except as provided in paragraph (5), the reduction referred to in paragraph (1) shall be made in the following tax attributes in the following order:

(A) NOL

Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.

(B) General business credit

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

(C) Minimum Tax Credit

The amount of the minimum tax credit available under section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.

(D) Capital loss carryovers

Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.

(E) Basis reduction

(i) In general

The basis of the property of the taxpayer.

(ii) Cross reference

For provisions for making the reduction described in clause (i), see section 1017.

(F) Passive Activity Loss and Credit Carryovers
Finance Committee explained that the policy underlying these attribute reduction rules was to allow financially distressed debtors to defer

Any passive activity loss or credit carryover of the taxpayer under section 469(b) from the taxable year of the discharge.

(G) Foreign tax credit carryovers
Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 27.

(3) Amount of reduction

(A) In general
Except as provided in subparagraph (B), the reductions described in paragraph (2) shall be one dollar for each dollar excluded by subsection (a).

(B) Credit carryover reduction
The reductions described in subparagraphs (B), (C), and (G) shall be $\frac{1}{3}$ cents for each dollar excluded by subsection (a). The reduction described in subparagraph (F) in any passive activity credit carryover shall be $\frac{1}{3}$ cents for each dollar excluded by subsection (a).

If a taxpayer is required to reduce the basis in her property under section 108(b)(2)(E), the basis reduction is capped at the amount by which the adjusted basis of the taxpayer’s assets exceeds the aggregate amount of her liabilities immediately after the debt discharge. I.R.C. § 1017(b)(2) (1994). For an in-depth examination of these tax attribute reduction rules, including the basis reduction limitation, see Asofsky, supra note 58, at 587-600; see also Bercik, supra note 47, at 206-09.

Alternatively, under section 108(b)(5), a taxpayer can forego reducing her tax attributes in the prescribed order and instead elect to reduce the basis of her depreciable property. I.R.C. § 108(b)(5) (1994). A taxpayer might choose to make such an election when, for example, she plans to use her net operating losses in the near future and preserving the net operating losses would be more beneficial on an after-tax basis than a reduction in the basis of depreciable property, which would have the effect of reducing overall depreciation deductions over an extended period of time. If a taxpayer makes this depreciable property election, the basis limitation of section 1017(b)(2) described in the preceding paragraph does not apply. I.R.C. § 1017(b)(2) (1994) (flush language). For a more extensive discussion of the section 108(b)(5) election, see Thomas J. Carroll et al., Tax Aspects of Bankruptcy 24-26 (1992). In the case of both the basis reduction required by section 108(b)(2)(E) and the alternative depreciable basis election of section 108(b)(5), regulations have recently been promulgated in final form prescribing the order in which the basis of the taxpayer’s assets must be reduced. For example, the regulations provide that, in the case of the section 108(b)(2)(E) basis reduction, the taxpayer must first reduce the basis in his real property held for investment or used in his trade or business, to the extent that such property secured the discharged indebtedness. The basis of similar personal property is next reduced, and so on. Treas. Reg. § 1.1017-1(a) (as amended in 1999). For a more complete discussion of these complicated new regulations, see Harry C. Steinmetz & William Morris, Bankruptcy and Insolvency Tax Developments of 1998: A Look Back, 18 Am. Bankr. Inst. J. 10 (1999).

Finally, it is important to note that if the debtor corporation has none of the tax attributes enumerated in section 108(b)(2) and does not make the depreciable basis election of section 108(b)(5), there are no tax consequences to the debtor’s discharge of indebtedness. It is not included in the debtor’s gross income, nor does it carry over to future years to reduce tax attributes in those years.
including in gross income the income that they realize from discharge of indebtedness, but not to allow them to exclude such amounts from income forever. "[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."\(^5\)

One of the most controversial aspects of the Bankruptcy Tax Act of 1980 was the continued viability of the stock-for-debt exception. Early in the debate, the Treasury Department made clear its position that the common law stock-for-debt exception should be abolished, so that solvent debtors would include in gross income the amount of indebtedness discharged in excess of the indebtedness satisfied with stock, while insolvent and bankrupt debtors would instead be required to reduce their tax attributes by a like amount.\(^6\)

The House of Representatives adopted a somewhat more moderate approach, providing that the stock-for-debt exception would be fully applicable for cases in which the creditor relinquished a security in exchange for the debtor's stock, but would be inapplicable in all other cases.\(^7\) The apparent reasoning underlying this curious position was an

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\(^7\) For purposes of the House's proposed amendment to the stock-for-debt exception, a security was defined as one that both (i) was in registered form or had interest coupons attached, pursuant to section 165(g) of the Code, and (ii) qualified as a security under section 354 of the Code (generally defined by case law as a long-term note, often with a maturity of ten years or more). H.R. REP. No. 96-833, at 2-3, 58 (1980); see also H.R. 5043, 96th Cong. § 2(a) (1979). It is interesting, however, that this was not the House's first position on the stock-for-debt issue. Two years earlier, in 1977, a bill was introduced that would have fully codified the common law stock-for-debt rule, except in cases where the indebtedness itself was deductible when it was created. H.R. 9973, 95th Cong. § 102 (1977). This proposal was attacked by interested parties on the ground that it would serve as an impediment to rehabilitating failing corporations. Changes in Bankruptcy Tax Law: Hearing on H.R. 9973 Before the House Comm. on Ways and Means, 95th Cong. 143-46 (1978) (statement of David A. Berenson on behalf of the American Institute of Certified Public Accountants, Federal Tax Division); Changes in Bankruptcy Tax Law: Hearing on H.R. 9973 Before the House Comm. on Ways and Means, 95th Cong. 120-24 (1978) (statement of John S.
effort to coordinate the tax consequences of debtor corporations with those of their creditors. Thus, if a creditor exchanged a security for stock, the exchange would be a nontaxable reorganization to the creditor, requiring no recognition of gain or loss. In such a situation, the debtor corporation likewise would not be required to recognize gain or loss on the issuance of its stock in exchange for the creditor's security. 88 If, on the other hand, the creditor relinquished indebtedness that was not a security (such as short-term trade debt) in exchange for the debtor's stock, the exchange would be taxable, often generating a deductible loss to the creditor. In this situation, the House reasoned that the stock-for-debt exception should not be available to the debtor corporation, thereby requiring it to recognize gain, in the form of a tax attribute reduction, in a like amount. 89

The bankruptcy and tax community harshly criticized the House's proposal as antithetical to the rehabilitative goals of the legislation and of bankruptcy law generally. They argued that the proposal would discourage reorganizations and encourage liquidations. 90 Finally, witnesses testified that the distinction between securities and short term indebtedness would discriminate against smaller businesses, who would be less able to obtain long-term financing and, thus would be less able to take advantage of the House's narrow stock-for-debt exception. 91

The Senate Finance Committee was apparently influenced by this unified opposition. It rejected the position of the House on the stock-for-debt exception, and instead recommended that the common law rule be retained, except in two limited instances in which the stock issued by the corporation in exchange for its debt was de minimis. 92 The Committee explained the policy rationale for its position as follows:

The Committee believes that by providing for favorable tax treatment if stock is issued to creditors in discharge of debt, the committee bill encourages reorganization, rather than

Pennell, Chairman, American Bar Association, Section of Taxation). For a comprehensive examination of congressional attempts to codify the stock-for-debt exception, see Asofsky, supra note 58, at 602-04, and Bryan, supra note 37, at 101-04.
89. Id. at 14-15.
91. The Bankruptcy Tax Act and Minor Tax Bills: Hearing on H.R. 5043 Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 96th Cong. 53-54 (1979) (statement of David A. Berenson, Chairman, Bankruptcy Task Force, American Institute of Certified Public Accountants); see also id. at 171-72 (statement of John J. Jerome on behalf of the American Bankers Association).
92. For a comprehensive discussion of these de minimis rules, see infra notes 150-77 and accompanying text.
liquidation, of financially distressed companies that have a potential for surviving as operating concerns. However, the committee does not believe that these rules should apply if only a de minimis amount of stock is issued for the outstanding debt, so that the general rules on debt forgiveness cannot thereby be circumvented.\footnote{93}

The Senate's version of the stock-for-debt exception was ultimately adopted as part of the Bankruptcy Tax Act of 1980.\footnote{94} It provided in pertinent part:

For purposes of determining income of the debtor from discharge of indebtedness, the stock for debt exception shall not apply—

(A) to the issuance of nominal or token shares, or

(B) with respect to an unsecured creditor, where the ratio of the value of the stock received by such unsecured creditor to the amount of his indebtedness cancelled or exchanged for stock in the workout is less than 50 percent of a similar ratio computed for all unsecured creditors participating in the workout.\footnote{95}

At its statutory inception, the stock-for-debt exception applied equally to solvent and insolvent corporations.\footnote{96} Only four years later, however, Congress limited the application of the stock-for-debt exception to insolvent debtors and those involved in bankruptcy proceedings.\footnote{97} The stated Congressional purpose behind narrowing the application of the stock-for-debt exception was that it provided solvent corporations a mechanism by which to manipulate the tax laws by engaging in debt-equity swaps in order to improve their balance sheets without being


\footnote{94. Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, § 2, 94 Stat. 3389, 3394 (1980) (codified as amended at I.R.C. § 108(e)(8) (repealed 1993)). Although section 108(e)(8) of the Code was said to be the statutory codification of the stock-for-debt exception, it actually contained only the two de minimis exceptions to the stock-for-debt rule, thereby adopting the rule only by implication.}

\footnote{95. I.R.C. § 108(e)(8) (repealed 1993).}

\footnote{96. This is because the Bankruptcy Tax Act of 1980 merely codified common law, and the case that had first established the stock-for-debt exception, \textit{Capento Securities}, had involved a solvent debtor. The next major stock-for-debt case, \textit{Motor Mart Trust}, however, involved a debtor in bankruptcy. \textit{Capento Sec.}, 140 F.2d at 383-84; see also \textit{Motor Mart Trust}, 156 F.2d at 123.}

forced to realize taxable income. In the legislative history of the Deficit Reduction Act of 1984, the Conference Committee stated that the stock-for-debt exception "allowed a corporation which retired existing indebtedness for stock and then issued new indebtedness with a lower principal amount and a higher interest rate to obtain a larger interest deduction, notwithstanding that total debt payments (principal and interest) may have remained unchanged." Thus, to curtail the burgeoning popularity of these debt-equity swaps, Congress limited the application of the stock-for-debt exception to insolvent and bankrupt companies that were unlikely to manipulate the tax benefits of the exception.

After the passage of the Bankruptcy Tax Act in 1980, the scope of the de minimis limitation remained unclear, and the government did not pass any regulations defining the parameters of the limitation for a full ten years. Moreover, during that time period, questions arose as to whether parent stock could be used to satisfy the stock-for-debt exception. Finally, there was uncertainty regarding the extent to which preferred stock qualified as stock under the exception.

It would be easy to label these issues as irrelevant because the stock-for-debt exception has been repealed and, therefore, is dead letter. Because this Article calls for its reinstatement, however, these issues will resurface and must be resolved as part of the Article's proposal. Accordingly, the status of each issue as of the stock-for-debt exception's repeal in 1993 is discussed separately below.

A. Using Preferred Stock Under the Stock-for-Debt Exception

In the two leading cases establishing the common law stock-for-debt exception, Commissioner v. Capento Securities Corp. and Commissioner v. Motor Mart Trust, the court made no distinction between issuing common or preferred stock to creditors in exchange for their indebtedness. In fact, in Capento Securities, the debtor issued only preferred stock (with a value of $50,000) in exchange for its creditors' claims (with a face value of $500,000), and yet the First Circuit held that the debtor did not realize any taxable gain in the exchange. As a result of these two leading cases, more than forty years elapsed before the

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99. For a comprehensive discussion of debt-equity swaps and congressional attempts to curtail them, see Bryan, supra note 37.

100. 140 F.2d 382 (1st Cir. 1944). For a complete discussion of the Capento Securities case, see supra notes 43-49 and accompanying text.

101. 156 F.2d 122 (1st Cir. 1946). For a more complete discussion of the Motor Mart Trust case, see supra notes 50-59 and accompanying text.

102. Capento Sec., 140 F.2d at 386.
Service first raised the issue of whether preferred stock should qualify as stock for purposes of the stock-for-debt exception.

During this forty-year period, commentators questioned whether preferred stock with a redemption price or liquidation preference that was less than the amount of debt being cancelled in the exchange should qualify as stock under the stock-for-debt exception in full, or instead only to the extent of its redemption price or liquidation preference. In 1988, the Service issued its first ruling on this preferred stock question. In Technical Advice Memorandum 88-37-001, the Service addressed the issue of whether convertible preferred stock issued by a debtor corporation in a chapter 11 bankruptcy proceeding was "nominal or token" within the meaning of section 108(e)(8)(A) of the Code, thus disqualifying it from being considered stock for purposes of the stock-for-debt exception. The value of the preferred stock was approximately ten percent of the face amount of the indebtedness cancelled in exchange for it. Moreover, the preferred stock was redeemable by the debtor corporation five years after it was issued at a set liquidation value. It is unclear whether the redemption price was equal to, or less than, the amount of the indebtedness cancelled in the exchange.

The Service ruled that, although conversion and redemption features could be considered in assessing whether stock was nominal or token under the Code, the preferred stock issued in this exchange was not nominal or token, and therefore qualified in full under the stock-for-debt exception. Relying on the substitution of liability theory first espoused in Capento Securities, the Service ruled that the preferred stock issued in the exchange was not nominal or token because it accounted for a significant part of the consideration used in the exchange. It is unclear from the language of Technical Advice Memorandum 88-37-001 whether the preferred stock's conversion feature was a relevant factor in determining that the stock was not nominal or token and qualified as stock under the stock-for-debt exception.

105. Id.
106. Id. The court stated:
The substitution of liability theory rests on the proposition that the substitution of a capital stock liability for a bonded indebtedness cannot be called a present realization of gain . . . . Because the exchange of liabilities is a mere substitution, the transaction is not closed and gain or loss remains to be measured at the time that the stock issued is extinguished.
107. After issuing Technical Advice Memorandum 88-37-001, the Service refused to issue any private letter rulings on the issue of whether the stock-for-debt exception could be invoked when only preferred stock was issued in the exchange. See, e.g., Priv. Ltr. Rul. 90-19-036 (Feb. 9, 1990); Priv. Ltr. Rul. 90-12-039 (Dec. 22, 1989).
Just two years later, the Service reversed its course on the preferred stock issue. In Revenue Ruling 90-87,\(^{108}\) Z corporation, a debtor in a title 11 bankruptcy case, issued preferred stock with a redemption price and liquidation preference of $300,000 to its creditor, C, in exchange for indebtedness with a face amount of $500,000.\(^{109}\) Again relying upon Capento Securities' substitution of liability theory, the Service ruled that the stock-for-debt exception applied only to the extent of the preferred stock's redemption price and liquidation preference. Accordingly, the debtor corporation, Z, realized $200,000 of discharge of indebtedness income, and was forced to reduce its tax attributes by a like amount.\(^{110}\)

The Service stated that "under the stock-for-debt exception, Z is considered to have substituted a capital stock liability for the indebtedness. Because the redemption price and liquidation preference of the preferred stock are limited, however, the amount of the substitution is limited."\(^{111}\)

One week after the Service established its new ruling position on the preferred stock issue in Revenue Ruling 90-87, Congress announced legislation that took a markedly different approach to the issue. As part of the Omnibus Budget Reconciliation Act of 1990,\(^{112}\) Congress revised section 108 of the Code to exclude "disqualified stock" from the application of the stock-for-debt exception. Disqualified stock was defined as stock that had a stated redemption price and either (1) had a fixed redemption date; (2) was callable by the issuer; or (3) was puttable by the holder of the stock.\(^{113}\) If stock was deemed to be disqualified stock, then it was treated as having satisfied the debt in an amount equal to the fair market value of the stock at the time of issuance.\(^{114}\) According to the Act's legislative history, the provision was designed to prevent the application of the stock-for-debt exception to the issuance of preferred stock that closely resembled debt.\(^{115}\)

The approaches taken to the preferred stock issue in Revenue Ruling 90-87 and the Omnibus Budget Reconciliation Act of 1990 differed.

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109. Id.
110. The $200,000 debt discharge amount represents the difference between the $500,000 indebtedness and the $300,000 redemption price and liquidation preference of the preferred stock issued in the exchange. Id. For a more complete discussion of the tax attribute reduction required by Z's realization of $200,000 of debt discharge income, see supra notes 83-85 and accompanying text.
111. Id. (citing Comm'r v. Capento Sec. Corp., 47 B.T.A. 691 (1942), nonacq., 1943 C.B. 28, aff'd, 140 F.2d 382 (1st Cir. 1944)).
114. Id; see also H.R. CONF. REP. No. 101-964, at 1099 (1990). The amendment also provided that disqualified stock would not be considered stock for purposes of the stock-for-debt exception's de minimis limitation. Id.
dramatically. In the revenue ruling, preferred stock was deemed to satisfy indebtedness to the extent of its redemption or liquidation price. Conversely, under the Act, preferred stock could satisfy indebtedness only to the extent of the stock’s fair market value at the time of issuance. A simple example will help to illustrate the differing tax consequences of these two approaches. Recall that in Revenue Ruling 90-87, Z corporation’s preferred stock had a redemption price and liquidation preference of $300,000 and was exchanged for indebtedness with a face amount of $500,000. Under the ruling, Z corporation was required to reduce its tax attributes by the $200,000 difference between the stock’s redemption price and the face amount of the indebtedness, because that $200,000 represented cancellation of indebtedness income to Z. If the same preferred stock had a fair market value of only $100,000 at the time of issuance, however, Z would have been required under the Act to reduce its tax attributes by the $400,000 difference between the indebtedness cancelled in the exchange and the fair market value of the stock at the time of issuance. Thus, under the Act, Z’s preferred stock was treated just as any other property issued in the exchange. It satisfied indebtedness only to the extent of its fair market value, even though the stock had a clear potential to increase in value to its redemption price.

If the stock-for-debt exception were reinstated, an issue arises as to how preferred stock should be treated under the exception. Should preferred stock be treated as any other type of stock for purposes of the exception, so long as it is not nominal or token, as was the case from the inception of the stock-for-debt exception until three years before its demise? Conversely, should preferred stock be deemed non-stock for purposes of the stock-for-debt exception, as the 1990 Act provided? Or, instead, should the compromise position taken by Revenue Ruling 90-87 be adopted, so that preferred stock qualifies as stock only to the extent of its redemption price or fair market value at the time of issuance? As discussed in greater detail in Part V, the position taken in Revenue Ruling 90-87 best comports with the policy justifications underlying the stock-for-debt exception generally, and should be used as the model for resolving the preferred stock issue.

B. Use of Parent Company Stock in a Stock-For-Debt Transaction

Prior to the repeal of the stock-for-debt exception in 1993, it was unclear whether a subsidiary corporation could satisfy its indebtedness with its parent’s stock and still qualify for the stock-for-debt exception.116

116. Many commentators have debated this issue over the years. See, e.g., Henderson & Goldring, supra note 18, at 112-15; Asofszy, supra note 58, at 609; Blashek, supra note 103, ¶ 102.3; Stefan R. Boshkov, Selected Federal Income Tax Consequences of Restructuring Debt of Failing Corporations After the Revenue Reconciliation Act of 1990, 69 Taxes 214, 224-25 (1991); James D. Bridgeman, Using
To understand the importance of the parent stock issue, consider the following scenario, which occurs while the stock-for-debt exception is still in place. Corporation $S$ is a wholly-owned subsidiary of Corporation $P$, and they file consolidated tax returns. $S$ is facing financial difficulties, and thus files for relief under chapter 11 of the Bankruptcy Code. $S$ would like to offer its creditors a combination of stock and cash in exchange for their indebtedness, using the stock-for-debt exception to avoid any discharge of indebtedness income or tax attribute reduction. If $S$ offers the creditors $P$ stock in the exchange, and parent stock does not qualify for the stock-for-debt exception, $S$ may risk a significant reduction in its tax attributes as a result of any discharge of indebtedness income incurred in the exchange. If, on the other hand, $S$ offers its creditors its own stock in the exchange, the exchange qualifies for the stock-for-debt exception but $S$ risks losing its ability to file consolidated returns with its parent, $P$. Because the Code remained ambiguous on the parent stock issue until the repeal of the stock-for-debt exception, a corporation was thus forced to choose between giving up the flexibility of using parent stock to cancel subsidiary debt or risk incurring substantial discharge of indebtedness income with a corresponding reduction in its tax attributes.

Some corporations attempted to use a 1959 revenue ruling to argue that the stock-for-debt exception could be invoked when parent stock was used to satisfy subsidiary debt. In Revenue Ruling 59-222, an unrelated corporation, wanted to gain control of $M$, a corporation seeking bankruptcy protection under chapter 11's reorganization provisions. In the reorganization, $M$ exchanged its stock for $N$ stock, and then issued the $N$ stock to $A$'s creditors in exchange for their debt. Therefore, $N$'s stock was effectively issued to cancel $M$'s indebtedness.

In its ruling, the Service recharacterized the transaction as a two-step process, in which $M$'s creditors first constructively exchanged their claims

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118. For a discussion of tax attributes reductions, see supra notes 83-85 and accompanying text.
120. Of course, if a corporation were financially solvent (and not in bankruptcy) and parent stock did not qualify for the stock-for-debt exception, the corporation would recognize discharge of indebtedness income rather than suffering a reduction in its tax attributes. See supra notes 80-85 and accompanying text.
122. Id.
for M stock, invoking protection under the stock-for-debt exception.\textsuperscript{123} In the second part of the recharacterized transaction, M's creditors constructively exchanged their M stock for N stock, qualifying as a tax-free reorganization.\textsuperscript{124} Thus, in Revenue Ruling 59-222 the Service appeared to condone the use of parent stock under the common law stock-for-debt exception in effect at the time of the ruling.\textsuperscript{125}

Nearly ten years after Congress codified the stock-for-debt exception in 1980, the Service issued a series of three private letter rulings in which it permitted the exchange of parent stock for subsidiary debt to qualify for the statutory stock-for-debt exception.\textsuperscript{126} In each ruling, the Service explicitly relied on Revenue Ruling 59-222 in reaching its holding.\textsuperscript{127}

\textsuperscript{123} Id. at 81 (citing Tower Bldg Corp. v. Comm'r, 6 T.C. 125 (1946)).
\textsuperscript{124} In the second step of the recharacterized transaction, N obtained control of M in exchange for N's voting stock, thus qualifying as a "B" reorganization under I.R.C. § 368(a)(1)(B) (1994). To justify this constructive treatment, the Service reasoned that the unsecured creditors of a bankrupt or insolvent corporation are, in reality, the equity holders of the corporation. Accordingly, the overall effect of the deemed transaction is the same as that of the actual transaction. For a more extensive explanation of why unsecured creditors should be treated as equity holders in this situation, see the Supreme Court's landmark decision in Helvering v. Alabama Asphaltic Limestone Co., 315 U.S. 179, 183-84 (1942).
\textsuperscript{125} For a discussion of the common law stock-for-debt exception in effect in 1959, see supra notes 43-65 and accompanying text.

Private Letter Ruling 89-33-001 involved a chapter 11 reorganization of a parent and four subsidiaries. Under the reorganization plan, parent stock was directly issued to each subsidiary's creditors. The Service recharacterized the plan as if each creditor had exchanged its debt for stock of the corresponding subsidiary, after which the creditor received parent stock in exchange for the newly received subsidiary stock. Because of this recharacterization, the deemed first step qualified for the stock-for-debt exception and the second step qualified as a tax-free B reorganization. Priv. Ltr. Rul. 89-33-001 (Aug. 22, 1989).

Finally, in Private Letter Ruling 89-14-080, the subsidiary was a savings and loan association that the state regulatory body had put into receivership. Under a plan of reorganization, the debtor subsidiary transferred all of its assets to another subsidiary of the parent corporation in exchange for stock of the parent. The debtor subsidiary then distributed the parent stock to its creditors in satisfaction of its debts. The Service recharacterized the transaction as a deemed first step that qualified for the stock-for-debt exception and a second step that qualified as a triangular "G" reorganization. I.R.C. § 368(a)(1)(G) (1994).

\textsuperscript{127} Priv. Ltr. Rul. 89-33-001 (Aug. 22, 1989) ("Note that the Service would decline to recast any part of the transaction [if] all of the parties were not in bankruptcy and Rev. Rul. 59-222 was not applicable, e.g., if the requirements of section 368(a)(1)(B) were not satisfied."); Priv. Ltr. Rul. 89-14-080 (Apr. 7, 1989) ("Target will not recognize income from the discharge of indebtedness as a result of the constructive exchange of its
These rulings still left many questions unanswered, however, such as whether the second step of the transaction had to qualify as a B reorganization in order to use the stock-for-debt exception, and whether both the parent and subsidiary corporations were required to have filed for bankruptcy protection to invoke the exception. Yet despite these unresolved questions, shortly after the trio of private letter rulings discussed above was announced, the Service refused to issue any further rulings on the parent stock issue until it was directly resolved by regulations.

During the period in which the Service declined to rule on the parent stock issue, debtor corporations could avail themselves of two statutory interpretation arguments to support their contention that parent stock

stock for liabilities discharged in the transaction, to the extent that Target is insolvent at the time of the transaction (section 108(e)(10), Rev. Rul. 59-222, 1959-1 C.B. 80).'); Priv. Ltr. Rul. 88-52-039 (Dec. 30, 1988) ("The transfer of Target common stock in satisfaction of the unsecured debt of Target was a transfer described generally in section 108(e)(10) of the Code . . . . The transfer did not effect a cancellation, reduction, or discharge of indebtedness of Target and did not require any reduction in Target's tax attributes (Rev. Rul. 59-222, 1959-1 C.B. 80).").

128. In Private Letter Ruling 89-33-001, the Service limited its ruling by stating that it would not have recharacterized that transaction if the requirements for a B reorganization had not been met. On the other hand, there is nothing in Revenue Ruling 59-222 to indicate that a B reorganization is a requirement for recharacterization. Furthermore, the two private letter rulings issued by the Service just prior to Private Letter Ruling 89-33-001 do not state that a B reorganization is a requirement for recharacterization. In fact, the transaction in Private Letter Ruling 89-14-080 qualified as a G reorganization, not a B reorganization. Finally, Revenue Ruling 59-222 justifies the deemed first step of the transaction by reasoning that the creditors were actually in control of the company, so they could be treated as having exchanged their claims for stock of the debtor. This rationale has nothing to do with a B reorganization. Therefore, reading a B reorganization requirement into Revenue Ruling 59-222 would be a stretch, and thus one could logically conclude that a B reorganization is not a prerequisite to recharacterization under Revenue Ruling 59-222, despite the language of Private Letter Ruling 89-33-001 to the contrary. See Pollack & Goldring, supra note 116, at 22-23.

129. Private Letter Ruling 89-33-001 states that the Service would not have recharacterized the transaction if the parent and subsidiaries had not been in bankruptcy. Yet a requirement that the parent corporation be in bankruptcy does not emanate from Revenue Ruling 59-222, because the facts there involved an unrelated acquiring corporation rather than a pre-bankruptcy parent. Thus, the ruling was obviously not based on the fact that the parent was in bankruptcy. Furthermore, Private Letter Ruling 89-14-080, issued only months before Private Letter Ruling 89-33-001, involved a parent that was clearly not in bankruptcy. Therefore, the Service's rulings have been inconsistent on this issue. Moreover, under Revenue Ruling 59-222, the subsidiary might not need to be in bankruptcy either. Although the facts of the ruling did include a bankrupt subsidiary, the underlying rationale given by the Service would be equally applicable even if the subsidiary had only been insolvent. Rev. Rul. 59-222, 1959-1 C.B. 80.

should qualify under the exception.  First, section 108(e)(7) of the Code, which addresses a creditor's tax consequences in a stock-for-debt exchange, specifically provides that stock of the debtor's parent corporation should be considered stock of the debtor for purposes of that section. Before the repeal of the stock-for-debt exception, section 108(e)(10) paralleled section 108(e)(7) by outlining the debtor's tax consequences in a stock-for-debt exchange. If parent stock was considered stock of the debtor for purposes of section 108(e)(7), Congress likely intended for it to be considered stock of the debtor for purposes of section 108(e)(10) as well. There is no logical basis for different treatment of parent stock in these two paragraphs of the same Code section, which outlined the tax consequences to two parties in the same exchange.

The second statutory argument that debtor corporations could make to support the use of parent stock under the stock-for-debt exception involves the G reorganization rules. In the Bankruptcy Tax Act of 1980, Congress specifically stated that parent stock qualified as consideration in a triangular G reorganization. This statement implicitly recognizes that parent stock qualifies for the stock-for-debt exception because, without the exception, reorganizations would be nearly impossible due to large amounts of discharge of indebtedness income.

Debtor corporations that attempted to rely on these statutory arguments, however, had to overcome two obstacles. First, the House version of the Bankruptcy Tax Act of 1980, which limited the stock-for-debt exception to certain types of debt, explicitly authorized the use of

131. These arguments, of course, were equally available to debtor corporations before the Service issued its no-ruling position. Because the monetary stakes were quite high, however, most debtors sought a ruling from the Service on the parent stock issue rather than taking a risk that their statutory arguments would not be upheld by a court.


134. But see Bridgeman, supra note 116, at 84-85 (arguing that statutory construction requires section 108(e)(7) to operate independently of section 108(e)(10)). Moreover, section 108(e)(7) is phrased “for purposes of this paragraph.” This has led other commentators to argue that Congress would have used the phrase “for purposes of this section” if it had intended that section 108(e)(7)(C) apply equally to the stock-for-debt exception in section 108(e)(10). Pollack & Goldring, supra note 116, at 20 n.14. On the other hand, these authors acknowledge that the discrepancy may have merely been a drafting error. Id.


137. Henderson & Goldring, supra note 18, at 112; see also Pollack & Goldring, supra note 116, at 20.

138. H.R. 5043, 96th Cong. § 2(a) (1979); see also Subcomm. on Select Revenue Measures of the Comm. on Ways and Means, 96th Cong., Description of H.R. 5043 (Bankruptcy Tax Act of 1979) 5-6 (Joint Comm. Print 1979).
Reinstating the Stock-for-Debt Exception

Unfortunately, the Senate deleted the House provision concerning the stock-for-debt exception and replaced it with what would become section 108(e)(8). Therefore, the language concerning parent stock made it into section 108(e)(7), but not into the stock-for-debt exception. Accordingly, the Service could argue that the Senate considered and rejected the House's statement permitting parent stock to be used under the stock-for-debt exception.

Second, the Omnibus Budget Reconciliation Act of 1990, which provided that "disqualified stock" would not qualify for the stock-for-debt exception, also added the phrase "stock of the debtor" to section 108(e)(10)(B) of the Code, the section which states that the stock-for-debt exception applies only to bankrupt and insolvent debtors. A literal reading of this phrase would suggest that Congress intended by these 1990 amendments to preclude the use of parent stock under the exception. There is, however, no indication in the Act's legislative history that this was the intent of Congress. Thus, the Code remained unclear on the parent stock issue until the repeal of the stock-for-debt exception in 1993.

The Service issued its most recent pronouncement on the parent stock issue two years after the repeal of the stock-for-debt exception in 1993. In Private Letter Ruling 95-16-025, a parent corporation and several of its subsidiaries filed separate petitions for reorganization under chapter 11 of the Bankruptcy Code. The reorganization plans provided that secured creditors, subordinated debenture holders, and unsecured claimants of the subsidiaries would receive a combination of cash, debt, stock warrants, and common stock of the parent corporation in exchange for their claims. The Service ruled that the exchange of parent stock for subsidiary debt would qualify for the stock-for-debt exception.

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139. Id.; see also The Bankruptcy Tax Act and Minor Tax Bills: Hearing on H.R. 5043 Before the Subcomm. on Select Revenue Measures of the House Comm. on Ways and Means, 96th Cong. 22-24 (1979).
141. See, e.g., Pollack & Goldring, supra note 116, at 20.
142. See supra notes 117-19 and accompanying text for discussion of disqualified stock.
143. I.R.C. § 108(e)(10)(B) (repealed 1993), provided that:
(B) Exception for certain stock in title 11 cases and insolvent debtors—
   (i) In general. Subparagraph (A) shall not apply to any transfer of stock of the debtor (other than disqualified stock)—
      (I) by a debtor in a title 11 case, or
      (II) by any other debtor but only to the extent such debtor is insolvent.
144. Henderson & Goldring, supra note 18, at 114-15.
145. The Service had occasion to rule on the parent stock issue because the corporation requesting the ruling fell within the repeal's transition rules, and was thus able to avail itself of the stock-for-debt exception. Priv. Ltr. Rul. 95-16-025 (Apr. 21, 1995).
146. Id.
Moreover, it stated that the exchange would not result in any subsidiary losing its ability to file consolidated tax returns with its parent group.147

Although this ruling appears to indicate that the Service would adopt a more pro-taxpayer approach on the parent stock issue if the stock-for-debt exception were reinstated, as this Article suggests, courts have never had occasion to rule on the issue.148 Moreover, the Service's most recent position is in a private letter ruling, which cannot be used or cited by another taxpayer as precedent.149 Thus, if Congress adopts the position taken in this Article and reinstates the stock-for-debt exception, it must also resolve the parent stock issue. Part V of this Article argues that parent stock should be treated as subsidiary stock for purposes of the stock-for-debt exception to afford subsidiary corporations in financial difficulty more flexibility to negotiate successful reorganizations.

C. The Stock-for-Debt Exception's De Minimis Limitation

When Congress codified the stock-for-debt exception as part of the Bankruptcy Tax Act of 1980, it enacted a two-part de minimis limitation in order to curtail corporations' abuse of the exception.150 This provision, contained in section 108(e)(8) of the Code before its repeal in 1993, stated that the stock-for-debt exception would not apply in two instances: (1) to the "issuance of nominal or token shares,"151 or (2) with respect to unsecured creditors, to the disproportional distribution of shares.152 Each of these concepts will be explored in greater detail below.

1. THE ISSUANCE OF NOMINAL OR TOKEN SHARES

Although the Code did not define what constituted nominal or token stock, and there was no reported judicial interpretation of this phrase, the legislative history of section 108 did provide some meager guidance. Both the Senate and House reports to the Bankruptcy Tax Act of 1980 provided that a facts and circumstances test should be applied to determine whether a debtor corporation was attempting to circumvent the recognition of cancellation of indebtedness income or tax attribute

147. Id. The ruling also provided that stock of the parent corporation issued to creditors in the exchange should be considered stock of each subsidiary for purposes of determining whether such stock was nominal or token under section 108(e)(8) of the Code (prior to its repeal in 1993). For a more complete discussion of the nominal or token stock issue, see infra notes 151-62 and accompanying text.
148. HENDERSON & GOLDRING, supra note 18, at 112.
reduction by issuing a nominal amount of stock to a creditor who has no real equity interest in the corporation.\textsuperscript{153}

It was not until eight years after Congress passed the 1980 Act that the Service first attempted to interpret the nominal or token limitation in Technical Advice Memorandum 88-37-001.\textsuperscript{154} The memorandum involved a debtor corporation in a chapter 11 bankruptcy proceeding that issued cash and voting preferred stock to certain of its unsecured creditors in exchange for their debt. The Service, relying on a facts and circumstances determination as suggested by the legislative history of section 108, ruled that the preferred stock was not nominal or token within the meaning of section 108(e)(8)(A) based on a number of factors. First, the stock issued was worth approximately ten percent of the debt cancelled (after reducing the indebtedness by cash paid in the exchange). Second, the stock comprised fifteen percent of the total consideration received by the unsecured creditors and represented slightly over three percent of the corporation's total voting power. Finally, the Service found that sufficiently adverse economic interests existed between the debtor corporation and the unsecured creditors.\textsuperscript{155}

After an initial ill-fated attempt to clarify the nominal or token limitation in 1990 through regulations met with sharp criticism by tax commentators,\textsuperscript{156} the Service issued proposed regulations on the nominal...
or token issue on November 4, 1992.\textsuperscript{157} These proposed regulations provided that all relevant facts and circumstances should be considered in making the determination whether stock issued in a stock-for-debt exchange was nominal or token. In addition, they stated that this determination should be made separately with respect to common and preferred stock.\textsuperscript{158} Finally, the proposed regulations provided that the nominal or token determination be made on an aggregate basis with respect to all common stock issued for unsecured debt, with a separate determination being made with respect to preferred stock issued for each class of preferred stock in the exchange was to be equal to the lesser of the lowest redemption price or the lowest liquidation preference of the preferred stock for any period after its issuance. The allocated debt, however, was not to be less than the fair market value of the preferred stock nor greater than the total amount of debt to be discharged. The regulation defined preferred stock as that stock with a limited or fixed redemption price or liquidation preference that did not materially participate in the growth of the corporation. The regulation expressly stated that meaningful participation was not established by a right to convert the stock into stock other than preferred stock, or the fact that the redemption price or liquidation preference exceeded the fair market value of the preferred stock.

These proposed regulations were roundly criticized by tax commentators. See, e.g., \textit{HENDERSON \& GOLDRING}, supra note 18, at 120-22 (referring to the December 7, 1990 issuance of the proposed regulations as "Pearl Harbor Day for the stock-for-debt exception," and stating that the proposed regulations "turned the de minimis test on its head. They seemed to convert a negative test that the stock issued not be nominal, token, or de minimis into a positive requirement that it be large, substantial, and significant"); Ross S. Friedman \& P. Anthony Nissley, Revised Stock-for-Debt Rules Take More Favorable Approaches to "Nominal or Token" Tests, 78 J. Tax'n 276, 276 (1993) (applauding the 1992 proposed regulations as a vast improvement over the 1990 proposed regulations, which "placed a heavy emphasis on FMV in determining whether the nominal or token shares rule applies"); see also American Bar Association Section of Taxation, Comments Concerning Proposed Standards for Determining Whether Shares Are "Nominal or Token" Under Section 108(e)(8)(A), 50 Tax Notes 995, 995 (1991) ("The proposed standards should be reconsidered. They deviate substantially from any prior interpretations given to words such as 'nominal' or 'token' in the tax law and are unsupported by evidence of congressional intent in the legislative history or by any general understanding of the meaning of those or similar words.").


\textsuperscript{158} According to the regulations, "[w]ithout separate testing of preferred stock and common stock under section 108(e)(8), the debtor could avoid this limitation merely by issuing a de minimis amount of common stock, in addition to the preferred stock, for the indebtedness." Prop. Treas. Reg. § 1.108-1, 57 Fed. Reg. 52601 (Nov. 4, 1992) (as amended by T.D. 8532, 1994-17 I.R.B. 5). For purposes of the regulations, preferred stock was defined as any stock with a limited redemption price or liquidation preference, other than disqualified stock, that had no right to participate in corporate growth to a meaningful extent at the time of its issuance. \textit{Id.} The regulations then defined common stock as all stock other than disqualified or preferred stock. \textit{Id.} For a discussion of the term "disqualified stock," see supra notes 115-17 and accompanying text.
unsecured debt. On March 17, 1994, the Service issued final regulations on the nominal or token limitation, which adopted the 1992 proposed regulations with only minor changes.

On the same day that it promulgated final regulations on the nominal or token issue, the Service also released a revenue procedure providing a safe harbor for establishing that common stock issued in a stock-for-debt transaction would not be considered nominal or token under section 108(e)(8)(A) of the Code. Under the safe harbor, common stock issued in a title 11 bankruptcy case or an insolvency workout would not be considered nominal or token if the “stock-to-total-stock ratio” were at least fifteen percent.

2. THE DISPROPORTIONALITY LIMITATION

The Bankruptcy Tax Act of 1980, which enacted the nominal or token limitation, also added a disproportionality limitation to the stock-for-debt exception. This limitation applied only to creditors holding unsecured claims, and provided that the stock-for-debt exception would not apply with respect to any given unsecured creditor if the ratio of the value of the stock received by the creditor to the amount of the creditor’s unsecured debt to be cancelled or exchanged for stock was less than fifty percent of a similar ratio computed for all unsecured creditors participating in the workout.

When the Service promulgated proposed regulations in 1990 addressing the nominal or token limitation, it failed to provide any guidance on the disproportionality limitation. Upon reissuing these

159. This aggregate approach to the nominal or token determination is a significant departure from the Service’s position in the 1990 proposed regulations, which took a creditor-by-creditor approach to the determination.


162. Id. The stock-to-total-stock ratio is defined as “the ratio of (i) the value of common stock issued for unsecured indebtedness in the title 11 case or insolvency workout to (ii) the value of all stock of the corporation outstanding after the title 11 case or insolvency workout (including preferred stock and disqualified stock).” Id. The effective date of the revenue procedure is generally May 17, 1994. Id.


164. I.R.C. § 108(e)(8)(B) (repealed 1993). The legislative history of the Bankruptcy Tax Act of 1980 defined the term workout to include a title 11 bankruptcy case, a receivership, foreclosure, or similar proceeding, either in federal or state court, or any other transaction in which the indebtedness of the corporation is restructured in an effort to relieve its financial difficulties. S. REP. No. 96-1035, at 17 n.20 (1980), reprinted in 1980 U.S.C.C.A.N. 7017, 7032.

proposed regulations in 1992, however, the Service finally addressed the disproportionality limitation in some detail. \textsuperscript{166} Specifically, the regulations provided that the disproportionality test of section 108(e)(8)(B) was to be applied separately with respect to common and preferred stock issued in the exchange on an indebtedness-by-indebtedness basis. \textsuperscript{167} Under this test, the stock-for-debt exception would not apply to unsecured debt discharged for stock in a title 11 case or an insolvency workout if the "individual stock ratio" did not equal at least one-half of the "group stock ratio." \textsuperscript{168} With respect to common stock, the individual stock ratio was defined in the regulations as the value of common stock issued for a specific unsecured debt divided by the amount of unsecured debt allocated to that common stock. \textsuperscript{169} Similarly, the group stock ratio for common stock was defined as the aggregate value of all common stock issued for unsecured indebtedness over the aggregate amount of unsecured indebtedness allocated to all common stock. \textsuperscript{170} If the individual common stock ratio was less than one-half of the group common stock ratio, then the indebtedness being evaluated would not qualify for the stock-for-debt exception. \textsuperscript{171} Like common stock, preferred

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  \item[167.] The regulations provide that an indebtedness-by-indebtedness approach is used rather than a creditor-by-creditor approach so as to simplify the application of the disproportionality limitation by not requiring the debtor corporation to identify each creditor holding indebtedness. Prop. Treas. Reg. § 1.108-1, 57 Fed. Reg. 52601 (Nov. 4, 1992) (as amended by T. D. 8532, 1994-17 I.R.B. 5).
  \item[168.] Id.
  \item[169.] Under the regulations, the amount of unsecured debt allocated to the common stock equaled the adjusted issue price of the indebtedness for which the common stock was issued, less other consideration transferred in exchange for the indebtedness. Id. For purposes of this calculation, consideration was defined to include money, the issue price of the new indebtedness, the amount of indebtedness allocated to preferred stock under the regulation, and the value of other property, including any disqualified stock. Id.
  \item[170.] Id. For purposes of this calculation, the amount of unsecured indebtedness allocated to all common stock was equal to the adjusted issue price of all unsecured indebtedness exchanged for stock or cancelled in the bankruptcy proceeding or insolvency workout, less other consideration transferred in exchange for indebtedness. Id. The definition of consideration for purposes of the group common stock ratio was the same as the definition of consideration for the individual common stock ratio. Id.
  \item[171.] The following example serves to illustrate the application of the proportionality test under the regulations:

  \begin{itemize}
  \item[(A)] X Corporation has three outstanding debts, each is an unsecured indebtedness of X with a $100,000 adjusted issue price. In a title 11 case, the first indebtedness is exchanged for $50,000 cash and $20,000 of common stock, the second indebtedness is exchanged for $10,000 cash, and the third indebtedness is exchanged for $5,000 common stock. The individual common stock ratio for the first indebtedness is 40 percent, which is determined by comparing the value of the common stock issued for the indebtedness ($20,000) to the amount of unsecured indebtedness allocated to that stock
\end{itemize}
\end{footnotesize}
stock was separately tested for disproportionality using similar ratios. Under the regulations, the individual preferred stock ratio was defined as the value of the preferred stock issued in exchange for an unsecured debt over the amount of unsecured indebtedness allocated to the preferred stock. The group preferred stock ratio was similarly defined in the regulations as the aggregate value of all preferred stock issued for unsecured indebtedness over the aggregate amount of unsecured indebtedness allocated to the preferred stock. If the individual preferred stock ratio with respect to an unsecured indebtedness was not equal to at least one-half of the group preferred stock ratio, then, under the disproportionality test, the stock-for-debt exception would not apply with respect to that indebtedness.

($100,000 adjusted issue price less $50,000 cash received). The individual common stock ratio for the second indebtedness is 0 percent because no stock is received in exchange for the indebtedness. The individual common stock ratio for the third indebtedness is 5 percent, which is determined by comparing the value of the common stock issued for the indebtedness ($5,000) to the amount of unsecured indebtedness allocated to that stock ($100,000).

(B) The group common stock ratio is 10.4 percent, which is determined by comparing the value of all of the common stock issued for unsecured indebtedness in the title II case ($25,000) to the amount of unsecured indebtedness allocated to the stock ($300,000 aggregate adjusted issue price of all indebtedness exchanged for stock or cancelled in the title II case less $60,000 cash received). Accordingly, section 108(e)(8)(B) is satisfied only with respect to the common stock issued for the first indebtedness. The stock-for-debt exception does not apply to the second or third indebtedness.


172. Id. The amount of unsecured debt allocated to the preferred stock was defined in the regulations as equal to the lesser of the stock’s lowest redemption price or its lowest liquidation preference, determined at the time of issuance. Id. This amount, however, could not be less than the fair market value of the preferred stock nor greater than the adjusted issue price of the unsecured indebtedness. Id.

173. Just as with the individual preferred stock ratio, the aggregate amount of unsecured indebtedness allocated to the preferred stock was defined in the regulations as the lowest redemption price for all preferred stock or such stock’s lowest liquidation preference, again determined at the time of issuance. Id.

174. Two additional points deserve clarification at this juncture. First, disqualified stock, defined supra notes 115-17 and accompanying text, does not qualify as stock for purposes of the stock-for-debt exception; therefore, it is treated merely as other consideration issued in exchange for indebtedness and does not otherwise enter into the common or preferred stock ratios. Id. Second, the regulations specifically address the issue of undersecured indebtedness. The regulations provide that undersecured debt is to be considered two separate debts: (1) a secured indebtedness with an adjusted issue price equal to the value of the property securing that indebtedness; and (2) an unsecured indebtedness with an adjusted issue price equal to the remainder of the debt. Id. Accordingly, the undersecured portion of a secured indebtedness will be included in the common or preferred stock ratios outlined above.
These proposed regulations were finalized in 1994 with only minor changes.\textsuperscript{175} A critical issue that the Service failed to address in the final regulations, however, and for which the disproportionality limitation has been roundly criticized, is that the limitation does not take into account that unsecured creditors often have differing levels of contractual priority.\textsuperscript{176} In fact, two noted tax scholars have taken their criticisms one step further, suggesting that the disproportionality limitation "simply does not make a lot of sense."\textsuperscript{177} Part V of this Article will address whether the nominal or token limitation and the disproportionality test should be retained if the stock-for-debt exception is reinstated, as the Article suggests.


Although a number of limitations were placed on the availability of the stock-for-debt exception following its statutory codification in 1980,\textsuperscript{178} Congress did not attempt to repeal the exception until 1992.\textsuperscript{179} The suggestion for repeal arose in a most unusual way. On July 23, 1992, Representative Guy Vander Jagt, a member of the House Ways and Means Committee, introduced in Congress House Bill 5674,\textsuperscript{180} dealing with the tax treatment of certain cargo containers.\textsuperscript{181} The primary purpose of the bill was to extend a number of favorable tax benefits to intermodal

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\item \textsuperscript{175} Treas. Reg. § 1.108-1 (as amended by T.D. 8532, 1994-1 C.B. 21). The Service incorporated into the final regulations commentators' suggestions that (1) the final regulations should clarify that, for purposes of the disproportionality test, the adjusted issue price of stock should include any indebtedness that is discharged in the title 11 case or insolvency workout, including accrued but unpaid stated interest; and (2) in determining whether certain stock is preferred stock for purposes of the disproportionality regulations, "preferred stock that is convertible into common stock should be considered participating stock if the conversion right represents, in substance, a meaningful right to participate in corporate growth." T. D. 8532, 1994-1 C.B. 22.
\item \textsuperscript{176} Blashek, supra note 103, at 1-18.
\item \textsuperscript{177} Henderson & Goldring, supra note 18, at 128 (suggesting that "[t]he regulation seems the best one can do with an imperfectly conceived statute").
\item \textsuperscript{179} H.R. 5674, 102d Cong. § 203 (1992).
\item \textsuperscript{181} H.R. 5674, 102d Cong., Title I (1992).
\end{itemize}
cargo containers. In order to finance the tax benefits being proposed, the bill sought to repeal the stock-for-debt exception. As Representative McGrath explained, “[t]o raise offsetting revenue for these changes, the bill would repeal the rule that gives special treatment to exchanges of stock for debt in bankrupt and insolvent corporations.”

At the time of the introduction of House Bill 5674 in July of 1992, the repeal of the stock-for-debt exception was predicted to increase revenues by $286 million over a five-year period.

As part of a political compromise, House Bill 5674 became part of a larger bill being considered by the House, the Revenue Act of 1992. As part of the same political bargain, no hearings were held on the bill, nor was there any debate by the House Ways and Means Committee. The Revenue Act of 1992 passed the House of Representatives on July 2, 1992, and was referred to the Senate Finance Committee on July 21, 1992 for consideration. Although the Committee initially refused to vote favorably on the Vander Jagt proposal, the Senate conferees eventually accepted the repeal of the stock-for-debt exception in exchange

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184. 138 CONG. REC. H7162 (daily ed. Aug. 3, 1992) (statement of Rep. McGrath). It should be noted that the bill’s sponsor, Representative Vander Jagt, did not admit that the primary purpose of the exception’s repeal was to finance the favorable tax benefits provided to intermodal cargo containers. Instead, he said that the stock-for-debt exception was not grounded in sound tax policy . . . . [B]y using the stock-for-debt exception, an eligible corporation can retire its debts while preserving its net operating losses as a tax shelter to use against future income—an advantage not available to other taxpayers. That result goes beyond what is necessary to give bankrupt and insolvent corporations a fresh start, and is plainly unfair to other taxpayers not eligible to use the special rule. Therefore, the stock-for-debt exception should be repealed.


for their own special interest provisions.190 When House Bill 11 went to
President Bush for his signature, he vetoed the legislation for reasons
unrelated to the repeal of the stock-for-debt exception.191

Although one critic had already referred to the proposed repeal of the
stock-for-debt exception as "a rancid piece of political pork" that would
"occupy a special place in the hall of shame,"192 the push to repeal the
exception was renewed less than a year later as part of Senate Bill 1134,
the Omnibus Budget Reconciliation Act of 1993.193 Like its 1992
predecessor, the bill repealed the stock-for-debt exception in its entirety,
forcing any debtor corporation, whether in bankruptcy or insolvent, to
treat the transfer of its stock in satisfaction of its indebtedness as if it had
transferred money equal to the fair market value of the stock so
transferred.194 Unlike the 1992 proposal, however, the Senate Bill allowed
a corporation in bankruptcy or an insolvent corporation to reduce its tax
attributes by the amount of its discharge-of-indebtedness income rather
than including it in gross income in the year of the discharge.195

Because the House and Senate were unable to concur with respect to
certain aspects of the budget reconciliation bill, the bill was sent to
conference committee on July 14, 1993.196 On August 4, 1993, the

190. 138 Cong. Rec. S17707 (daily ed. Oct. 8, 1992); see also Asofsky, supra
note 23, at 13-32.

Status of House Bills, [1991-1992], 2 Cong. Index (CCH) ¶ 35,001, ¶ 35,003 (Nov. 5,
1992); see also Asofsky, supra note 23, at 13-32 to 13-33.


193. S. 1134, 103d Cong. § 8226(a) (1993).

U.S.C.C.A.N. 1088, 1309. Procedurally, the bill first repealed section 108(e)(8)
(providing generally that the stock-for-debt exception did not apply to the issuance of
nominal or token shares) and section 108(e)(10) (providing that only insolvent debtors and
those in bankruptcy could avail themselves of the exception and that disqualified stock
could not be used to invoke protection under the exception). It then replaced section
108(e)(8) with a new provision, which stated:

(8) Indebtedness satisfied by corporation’s stock.

For purposes of determining income of a debtor from discharge of
indebtedness, if a debtor corporation transfers stock to a creditor in
satisfaction of its indebtedness, such corporation shall be treated as having
satisfied the indebtedness with an amount of money equal to the fair market
value of the stock.

S. 1134, 103d Cong. § 8226(a) (1993); see also Omnibus Budget Reconciliation Act of

195. Staff of Joint Comm. on Taxation, 103d Cong., Comparison of
Revenue Provisions of H.R. 2264 (Omnibus Budget Reconciliation Act of 1993) as
Passed by the House and the Senate 40 (Joint Comm. Print 1993); see also Omnibus
(1993); S. 1134, 103d Cong. § 8226(b) (1993); 139 Cong. Rec. S8037 (daily ed. June 24,
1993).

196. Senate Bill 1134 was first introduced on June 22, 1993. After amendments
to the bill had been adopted by voice vote in the Senate on June 24, 1993, the bill was
conference committee released its report, which indicated that the Senate’s proposal to repeal the stock-for-debt exception was accepted by the committee\textsuperscript{197} without any hearings ever being held regarding the exception’s repeal.\textsuperscript{198} The Conference Committee Report was adopted by the House and Senate on August 5 and 6, 1993, respectively, and the Omnibus Budget Reconciliation Act of 1993 was signed by the President on August 10, 1993.\textsuperscript{199}

The Senate Finance Committee’s report provided the following reasons for the repeal of the stock-for-debt exception:

The committee believes that the present-law stock-for-debt exception distorts the proper measurement of economic income. In addition, because the stock-for-debt exception results in the forgiveness of tax related to COD income without a corresponding reduction in tax attributes, a corporation emerging from bankruptcy may enjoy a significant tax advantage not enjoyed by either a comparable solvent firm that restructures its debt outside bankruptcy or a start-up company. Finally, the ancillary rules surrounding the eligibility for, and the mechanics of, the stock-for-debt exception are complex and cumbersome.\textsuperscript{200}

Yet despite the fact that the committee reports failed to acknowledge that one of the principal purposes of the repeal of the stock-for-debt exception was to raise revenue to support other tax reduction measures, within the


\textsuperscript{198} HENDERSON & GOLDRING, supra note 18, at 105; see also Friedrich, supra note 185, at 95; Williams, supra note 38, at 170.

\textsuperscript{199} Status of House Bills, [1993-1994], 2 CONG. INDEX (CCH) ¶ 35,001, ¶ 35,034 (Dec. 9, 1994); see also Remarks on Signing the Omnibus Budget Reconciliation Act of 1993, 2 PUB. PAPERS 1355 (Aug. 10, 1993).

Act it is clear that this is the case because the repeal is located in the revenue raising provisions of the Conference Report.\textsuperscript{201}

One of the most disconcerting aspects of the exception’s repeal was the estimate of the revenue to be derived from it. Recall that when Representative Vander Jagt attempted to repeal the stock-for-debt exception in 1992, the estimate of the revenue to be derived from the repeal was $286 million.\textsuperscript{202} When the exception was repealed in 1993, however, it was estimated to raise over $622 million in revenue.\textsuperscript{203} Thus, the estimated revenue to be raised by the repeal had increased by 218% in less than one year, which, as one critic stated, illustrates “the Wizard of Oz character of all our Congressional revenue estimates.”\textsuperscript{204}

The effective date of the exception’s repeal illustrates yet another bizarre procedural action taken by the conference committee on this issue. Although the Senate had proposed that the repeal should apply to stock transfers occurring after June 17, 1993,\textsuperscript{205} the conference committee amended the provision’s effective date significantly, so that the repeal applies to stock transferred after December 31, 1994.\textsuperscript{206} Commentators have opined that the repeal’s prospective effective date suggests that the committee was very reluctant to repeal the exception at all.\textsuperscript{207}

\begin{footnotesize}
\begin{enumerate}
\item H.R. Conf. Rep. No. 103-213, at 517, 619 (1993), reprinted in 1993 U.S.C.C.A.N. 1088, 1206, 1308; see also Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312, 418 (1993); Staff of Joint Comm. on Taxation, 103d Cong., Summary of the Revenue Provisions of the Omnibus Budget Reconciliation Act of 1993 (H.R. 2264) V, 18 (Joint Comm. Print 1993); Wayne I. Danson & David R. Kuney, Preserving Tax Attributes in Bankruptcy, Legal Times, Mar. 21, 1994, at 30 (“Members of the congressional staff who worked on this measure indicate that little analysis was done on the effect that the repeal would have on corporate reorganizations and that the legislation was seen as a pure revenue issue.”).
\item See supra note 185 and accompanying text.
\item S. 1134, 103d Cong. § 8226(a)(3) (1993).
\item Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13226(a)(3), 107 Stat. 312, 487-88 (1993). The effective date also contained an important exception: the repeal of the stock-for-debt exception does not apply to transfers of stock in satisfaction of indebtedness made in a title 11 or similar case if the case was filed on or before December 31, 1993. Id. § 13226(a)(3)(B).
\item Friedrich, supra note 185, at 95 (“In effect, taxpayers are given over four months to file in bankruptcy and avoid the repeal of the stock-for-debt exception. Given the well-known proclivity of Congress to backdate legislation, this lead time is especially
V. REINSTATING THE STOCK-FOR-DEBT EXCEPTION IN CHAPTER 11 BANKRUPTCY PROCEEDINGS

The repeal of the stock-for-debt exception in 1993 can be attacked on both procedural and substantive grounds. Procedurally, the repeal was undertaken without any congressional hearings on its economic and policy consequences. It is clear that the sole purpose behind the repeal was to raise revenue to offset specifically targeted tax benefits. Moreover, the estimates of revenue to be derived from the repeal of the exception were highly suspect, having risen in less than six months from $286 million over five years to $622 million over the same time period. Finally, the repeal’s delayed effective date was quite irregular.

Substantively, bankruptcy experts have predicted that the repeal will encourage insolvent and bankrupt corporations to issue debt rather than stock to their creditors, thereby decreasing the value of the reorganized company. Moreover, commentators have argued that lenders will seek liquidation, rather than reorganization, of financially troubled corporations, thereby defeating the bankruptcy policy of rehabilitating rather than liquidating such corporations. These procedural and substantive concerns suggest that the repeal of the stock-for-debt exception might have been hasty political maneuvering rather than a considered change in bankruptcy and tax policy.

I wonder if it does not reflect recognition somewhere that this legislation is ill-considered and disruptive.” (footnotes omitted).

208. Association of the Bar of the City of New York, Cancellation of Indebtedness—Stock-for-Debt Exception, 59 TAX NOTES 573, 573-74 (1993); see also supra notes 196-98 and accompanying text.

209. For a more in-depth discussion of the revenue-raising aspect of the repeal, see supra notes 184-85, 201 and accompanying text.

210. See, e.g., 6 WILLIAM L. NORTON, JR., NORTON BANKRUPTCY LAW & PRACTICE 2d § 127:13 (1994) (“In reality, the savings over the next five years are very small, if any. Using the Chapter 11 reorganization plans that were confirmed in 1991 as representative of the tax savings that the government would receive, the actual savings would be less than one third of the $622 million estimate.”); see also supra notes 202-04 and accompanying text.

211. See supra notes 205-07 and accompanying text.

212. See, e.g., Robert F. Reilly, Impact of the 1993 Tax Act on Bankruptcy and Valuation Analysis, 3 AM. BANKR. INST. J. 10, 10, 19 (1994); see also infra notes 229-31 and accompanying text.

213. See, e.g., Reed W. Easton, Repeal of Stock-for-Debt Exception Discourages Fresh Starts, 22 TAX’N FOR LAW. 229, 234 (1994); James Gadsden & Christopher H. Smith, The Bankruptcy Reform Act of 1994, 112 BANKING L.J. 212, 226 (1995); see also infra notes 231-33 and accompanying text.

214. See infra notes 217-19 and accompanying text.

215. Several bankruptcy taxation scholars have criticized the Revenue Reconciliation Act of 1993, which repealed the stock-for-debt exception, as an example of how tax legislation has changed from a policy debate over the proper measurement of taxable income to a battle over political influence. Friedrich, supra note 185, at 92 (“The
Indeed, there are strong policy justifications for the continued viability of the stock-for-debt exception, from both a bankruptcy and tax perspective. This section of the Article explores the bankruptcy and tax theories underlying the exception, and proposes that the exception be reinstated, but modified so that it better comports with current tax policy. The section also provides solutions to three unresolved tax issues affecting the exception's application: the preferred stock issue, the use of parent stock, and the exception's de minimis limitations. It proposes statutory language that Congress can adopt to implement this proposal. Finally, the section addresses potential criticisms that might be raised in opposition to the proposal. It concludes that reinstating the stock-for-debt exception is a critical step toward reinvigorating the chapter 11 bankruptcy system and encouraging the rehabilitation of financially troubled corporations.

A. Harmonizing Bankruptcy and Tax Policy

Legal scholarship in the field of debtor-creditor relations tends to focus exclusively on the bankruptcy aspects of a vexing legal issue. Very few scholars have attempted to harmonize the often conflicting bankruptcy policies and tax policies underlying these issues. Similarly, the congressional committees devoted to addressing tax issues—the House Ways and Means Committee and the Senate Finance Committee—have often been criticized for passing bankruptcy tax measures as part of an overall tax reform bill without consulting or coordinating with their committee counterparts devoted to bankruptcy issues, the House and Senate Judiciary Committees. Thus, neither academic literature nor recent legislation has explored the intersection of these two vast bodies of law. Reinstating and revising the stock-for-debt exception is one small step toward harmonizing bankruptcy and tax policy. Yet before such a proposal can be made, it is necessary to ascertain the bankruptcy and tax policies underlying the stock-for-debt exception prior to its repeal in 1993 and how these policies were in conflict.

loss of this debate about the elusive right answer and its replacement with political posturing and dealing, where political might makes right, is what I view as the disintegration of tax policy.”); CCH Roundtable, supra note 203, at 542 (stating that the repeal of the stock-for-debt exception without any hearings being held is “a textbook example of how dysfunctional our tax legislative process has become!”) (comments of Gordon D. Henderson).

216. See, e.g., Letter from Representative Jack Brooks, Chairman, House Judiciary Committee, to Representative Dan Rostenkowski, Chairman, House Committee on Ways and Means 2 (July 15, 1993) (on file with author) (“I believe it is desirable for the overall economic policy that changes in the tax law not come at the expense of longstanding bankruptcy policy and not threaten this nation’s job base.”); see also Steven J. Csontos, et al., Roundtable: Congress’s Role in Bankruptcy Tax Policy, 3 AM. BANKR. INST. L. REV. 257, 292-93 (1995); Robert A. Jacobs, The Bankruptcy Court’s Emergence as Tax Dispute Arbiter of Choice, 45 TAX L. 971, 1029 (1992).
1. BANKRUPTCY POLICIES UNDERLYING CHAPTER 11 AND THE STOCK-FOR-DEBT EXCEPTION

When Congress created chapter 11 as part of the Bankruptcy Act of 1978, it stated that the primary goal behind chapter 11 was to allow financially troubled corporations to reorganize and to continue operating as going concerns, rather than to liquidate and sell their assets for scrap.\(^\text{217}\)

One commentator aptly called the public policy favoring reorganization of insolvent businesses rather than liquidation of them as “the single greatest achievement of our bankruptcy system in the 20th century...”\(^\text{218}\)

In the legislative history of the 1978 Act, the Senate committee report explained the policy justifications underlying reorganization rather than liquidation of financially troubled corporations. The Senate report emphasized that:

The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business’s finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap. . . . If the business can extend or reduce its debts, it often can be returned to a viable state. It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets.\(^\text{219}\)

\(^\text{217}\) S. REP. NO. 95-989, at 220 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 6179. Of course, a number of thoughtful articles have recently been written addressing exclusively the issue of the purpose of the chapter 11 bankruptcy system. See, e.g., Kevin A. Kordana & Eric A. Posner, A Positive Theory of Chapter 11, 74 N.Y.U. L. REV. 161 (1999); Elizabeth Warren, Bankruptcy Policymaking in an Imperfect World, 92 MICH. L. REV. 336 (1993). While this body of scholarship makes it clear that the purposes underlying chapter 11 might not be as simple as Congress suggested in the legislative history of the Bankruptcy Reform Act of 1978, it is not the goal of this Article to rehash the chapter 11 debate. This Article accepts as one of its premises that chapter 11 was designed primarily to encourage the rehabilitation rather than liquidation of financially troubled corporations, and that this is a laudable goal that should be encouraged.

\(^\text{218}\) Patrick A. Murphy, My Top 10 Secured Creditor Cases of the 20th Century, 35 BANKR. CT. DECISIONS WKLY. NEWS & COMMENT, Feb. 15, 2000, at 1.

\(^\text{219}\) S. REP. NO. 95-989, at 220 (1978), reprinted in 1978 U.S.C.C.A.N. 5787, 6179; see also Corwin, supra note 204, at 19 (“The underlying logic of Chapter 11 is that, where feasible, business reorganization is preferable to liquidation as a means of saving jobs and maintaining the value of capital assets, to the overall benefit of the U.S. economy.”); Mikel M. Rollyson, Restore Stock-For-Debt, 16 NAT’L L.J., June 6, 1994, at A19 (“Allowing distressed companies to continue to operate under court supervision while reorganizing and negotiating with creditors (1) saved jobs; (2) promoted competition by keeping businesses alive; and (3) stemmed the negative economic ‘fallout’ of a company failure.”).
When the stock-for-debt exception was codified in 1980, Congress justified the exception from a policy perspective as "facilitating corporate restructuring by permitting debtors to rehabilitate their businesses by offering equity to creditors without adverse tax consequences, and thus furthering the general policy to permit financially troubled companies to be rehabilitated rather than liquidated."\(^2\)\(^2\) \(^2\)\(^2\) Empirical evidence suggests that the stock-for-debt exception did, in fact, promote chapter 11 rehabilitations by preserving jobs, spurring economic growth, and fostering competition. For example, experts have estimated that approximately eighty percent of all corporate restructurings relied on the stock-for-debt exception before it was repealed in 1993.\(^2\)\(^2\)\(^1\) Moreover, the stock-for-debt exception has played a prominent role in the reorganizations of a number of mega-chapter 11 bankruptcies, such as Continental Airlines, Macy's, America West Airlines, Federated Department Stores (including Bloomingdale's), LTV, and Southland Corporation (including 7-11 stores).\(^2\)\(^2\)\(^2\) In fact, without the stock-for-debt exception, a number of corporations would have been unable to restructure their debt, which would have had a devastating impact on the national economy. "K.C. Caldava, chief financial officer of LTV Corp., the steel company that operated under bankruptcy protection for seven years, said the company would have been 'devastated and unable to reorganize without the stock-for-debt provision . . . . If LTV had been unable to reorganize, he says, the medical and pension payments of more than 100,000 retirees would have been eliminated and 17,000 jobs"

\(^2\)\(^2\)\(^2\)\(^2\) Association of the Bar of the City of New York, supra note 208, at 574; see also S. Rep. No. 96-1035, at 11 (1980), reprinted in 1980 U.S.C.C.A.N. 7017, 7026 ("The committee believes that providing for favorable tax treatment if stock is issued to creditors in discharge of debt, the committee bill encourages reorganization, rather than liquidation, of financially distressed companies that have a potential for surviving as operating concerns."); 140 Cong. Rec. S14465 (daily ed. Oct. 6, 1994) (statement of Sen. Hatch) ("If creditors agree to the [stock-for-debt] exchange, they invest in the reorganized company's future, reduce the company's debt and preserve the jobs of the company's employees.").

\(^2\)\(^2\) See, e.g., Blackman, supra note 15, at 5 (estimate provided by Paul Asofsky, prominent bankruptcy taxation scholar); Rollyson, supra note 219, at A20.

\(^2\)\(^2\) See, e.g., Blackman, supra note 15, at 5 ("[The stock-for-debt exception] has figured importantly in such mega-reorganizations as Continental Airlines, Federated Department Stores, Ames Department Stores and Southland Corporation."); Rollyson, supra note 219, at A20 ("Approximately 80 percent of recent corporate restructurings, including those of major employers such as LTV, Continental Airlines, Southland Corp. (7-11 stores) and Federated Department Stores, have benefitted from the stock-for-debt exception."); see also Kathleen M. Berry, Executive Update: Taxes, INVESTOR'S BUS. DAILY, Aug. 17, 1993, at 4 ("The stock-for-debt exception was crucial to the recent reorganization plans of a slew of large companies, including Zale Corp., LTV Corp., Trans World Airlines Inc., Continental Airlines Holdings Inc., and Federated Department Stores Inc.").
lost."

Similarly, bankruptcy attorneys for Macy's and America West Airlines stated that the companies might have been forced to liquidate had the stock-for-debt exception not been in existence at the time of the companies' reorganizations.

The stock-for-debt exception was believed by many to be so critical to an effective chapter 11 reorganization that an unusual alliance formed to lobby for its reinstatement after it was repealed in 1993. On November 30, 1993, the Ad Hoc Alliance To Preserve Stock-for-Debt Provisions of the Tax Code, a group comprised of large banks (including Citibank, Bank of America, Chemical Bank, and Morgan Guaranty Trust); labor unions (including the United Steelworkers of America, the Teamsters Union, and the United Auto Workers); major accounting firms (including Arthur Andersen, Ernst & Young, and KPMG Peat Marwick); and lawyers (representing both debtors and creditors) sent a memorandum to the House and Senate Judiciary Committees asking that the stock-for-debt exception be reinstated. The Alliance argued that repeal of the exception would endanger debtors' fresh start policy and would make it less likely that debtor corporations would be able to reorganize effectively. The Alliance also argued that the large revenue estimates predicted from the stock-for-debt exception's repeal would not likely be borne out in reality, because adverse effects, such as longer and more expensive reorganization proceedings, a greater number of liquidations, and a significant loss of jobs—costs not considered in the revenue estimates—would likely offset any increased revenue generated by the exception's repeal. The sheer strength of the Alliance provides strong evidence that the stock-for-debt exception did, in fact, promote chapter 11's goals of reorganizing rather than liquidating financially troubled corporations, preserving jobs, promoting competition, and fostering economic growth.

A number of other experts have predicted that, without the stock-for-debt exception, creditors will be less likely to accept a debtor corporation's stock in exchange for their indebtedness, insisting on new

223. Berry, supra note 222, at 4.
225. Memorandum from the Ad Hoc Alliance To Preserve Stock-for-Debt Provisions of the Tax Code to the House and Senate Judiciary 10 (Nov. 30, 1993) (on file with author); see also Blackman, supra note 15, at 5; Tom Pratt, Group Opens Drive To Restore Stock-for-Debt Tax Provision; Rare Alliance Includes Both Bankers and Unions, INVESTMENT DEALER'S DIG., Dec. 20, 1993, at 14.
226. Ad Hoc Alliance to Preserve Stock-for-Debt Provisions of the Tax Code, supra note 225, at 1, 10.
227. Id. (attachments); see also Pratt, supra note 225, at 31.
228. See, e.g., Rollyson, supra note 219, at A20 ("The diversity of business and professional interests joined to support restoration of the stock-for-debt exception attests to the broad economic benefits it provides.").
debt instead. This increased use of debt in corporate reorganizations will reduce the attractiveness of debtor corporations’ balance sheets, and will ultimately lead to a significant increase in corporate liquidations rather than restructurings. A dramatic rise in corporate liquidations will have a devastating impact on the economy because it will result in lost jobs and less economic competition in the marketplace. Moreover, even successful corporate reorganizations will take longer and be more costly, thereby depleting valuable resources of a financially troubled corporation. Experts have also predicted that the repeal of the stock-for-debt exception would have a negative impact on the economy as a whole, because debtor corporations unable to reorganize successfully and forced into liquidation might create a domino effect, whereby their suppliers and lending banks might be forced into bankruptcy as well.

The extent to which experts’ dire predictions about the effects of the repeal will materialize in practice may be impossible to ascertain. Official statistics on chapter 11 bankruptcies are woefully inadequate. For example, statistics are not maintained on the overall success rate of chapter 11; thus, no comparison can be made of the viability of chapter 11 reorganizations before and after the repeal of the stock-for-debt exception. Additionally, the official statistics that are maintained by the Administrative Office of the United States Courts on the number and

229. 140 CONG. REC. S14465 (daily ed. Oct. 6, 1994) (statement of Sen. Hatch); David K. Andres, *Business Provisions of RRA ’93: Higher Rates But Some Benefits*, 22 *TAX’N FOR LAW* 196, 198-99 (1994); Easton, supra note 213, at 233-34; Olson, supra note 224, at 1; see also Rollyson, supra note 219, at A20. But see Lee A. Sheppard, *Congress Tries to Work Out the Workout Rules*, TAX NOTES, Aug. 10, 1992, at 697 (claiming that the argument that repealing the exception creates a bias against equity is a non sequitur because creditors are already the true owners of an insolvent company).


231. See, e.g., Gadsden & Smith, supra note 213, at 226; Newton & Wertheim, supra note 187, at 365-67; see also Bloomberg Business News, *Repeal of Tax Benefit Might Curb Chapter 11s*, ATLANTA J. & CONST., July 6, 1993, at E3; Chadwell, supra note 224, at 3; Olson, supra note 224, at 1.

232. 140 CONG. REC. S14465 (daily ed. Oct. 6, 1994) (statement of Sen. Hatch); CCH Roundtable, supra note 203, at 542; see also Berry, supra note 222, at 4; Rollyson, supra note 219, at A20.

233. CCH Roundtable, supra note 203, at 542; see also Letter from Representative Jack Brooks to Representative Dan Rostenkowski, supra note 216, at 1.


235. See, e.g., Blackman, supra note 15, at 5; Corwin, supra note 204, at 19.

nature (individual versus business) of chapter 11 cases are riddled with errors. Finally, because of the repeal’s delayed effective date, corporations governed by the new law are just beginning to emerge from bankruptcy.

2. COMPETING TAX POLICIES

It is relatively clear that the stock-for-debt exception promoted the three policy goals underlying chapter 11 bankruptcy: favoring reorganization over liquidation, preserving jobs, and fostering economic growth through increased competition. Far less clear, however, is whether the stock-for-debt exception also promoted sound tax policy.

Perhaps the strongest policy underlying the federal income tax system is ensuring that true economic income is subject to taxation. Prior to its repeal, did the stock-for-debt exception further the policy of taxing true income? As discussed earlier, courts have espoused two alternative policy justifications in support of the stock-for-debt exception since its common law inception in 1944: the substitution of liability theory and the subscription price theory. Under the substitution of liability theory, the debtor corporation merely substitutes one liability, equity, for another liability, debt, and thus does not free up any assets, as the debtor did in Kirby Lumber. Accordingly, substituting one liability for another does not trigger any present realization of gain.

Commentators have long criticized Capento Securities and its progeny for failing to recognize the fundamental distinctions between debt and equity. First, debt represents an unconditional liability of the corporation that must be repaid even if the corporation recognizes no profits. Conversely, stock is not an unconditional liability of the corporation; shareholders will recoup their capital contributions on


238. HOUSE COMM. ON WAYS AND MEANS, 101ST CONG., OVERVIEW OF THE FEDERAL TAX SYSTEM 35-36 (1990) (recognizing that the present tax system often, however, departs from this principle by recognizing broad exceptions); see also Seto, supra note 35, at 213.

239. Comm'r v. Capento Sec. Corp., 140 F.2d 382, 386 (1st Cir. 1946); see also Comm'r v. Motor Mart Trust, 156 F.2d 122, 127 (1st Cir. 1946). For a more complete discussion of Capento Securities and Motor Mart Trust, see supra notes 43-59 and accompanying text.

240. Capento Sec., 140 F.2d at 386; see also supra notes 46-47 and accompanying text.

241. Id.

242. See, e.g., Sheppard, supra note 229, at 696 ("Indeed, tax lawyers now acknowledge that the Capento court might have been a bit confused about the differing natures of debt, which is money that must be repaid, and equity, which is money placed at the risk of the business.").
dissolution only if the corporation has assets remaining after paying its creditors. Second, there is a fundamental tax distinction between debt and equity. A corporation can deduct interest paid to creditors on their debt; conversely, it is not entitled to deduct dividends paid to shareholders with respect to their stock. Critics have suggested that the substitution of liability theory fails to recognize this critical tax distinction.

The alternative theory underlying the judicially created stock-for-debt exception is the subscription price theory, which posits that creditors are merely purchasing the debtor corporation's stock with their debt (hence, the face amount of the debt is the subscription price paid for the stock). Because a corporation is not required to recognize gain or loss on the issuance of its stock under section 1032 of the Code, this sale of stock is not taxable to the debtor corporation. Under the courts' view, any difference between the face amount of the indebtedness and the value of the stock received is merely a premium paid for the stock. This theory has been challenged on the grounds that it fails to comport with economic reality.

Only pre-existing creditors, and not new shareholders, would have to "pay" that subscription premium for the debtor's stock, because of their status as creditors. Most creditors would indeed be surprised to learn that money they have advanced to a corporation in a nonconvertible loan transaction was a "prepaid subscription price for stock to be issued at an undetermined time in the future."

243. Asofsky, supra note 23, at 13-77 ("[T]he substitution of liability theory is problematic because a capital stock credit does not represent a fixed obligation as does a debt."); Bridgeman, supra note 116, at 82 ("[C]haracterizing the stock issued to creditors as a continuing 'liability' of the debtor is, at best, analytically suspect . . . ."); Sherck, supra note 48, at 895 ("That this [substitution of liability] rationale is not entirely satisfactory is an understatement . . . . A shift from status as a creditor to that of a preferred, to say nothing of a common, stockholder thus effects a real and substantial change in the relationship between the corporation and its former debtholder, and effects an immediate increase in corporate net worth.").

244. Association of the Bar of the City of New York, supra note 208, at 574 ("For tax purposes, a critical difference between stock and debt is that payments of interest on corporate debt are deductible against the debtor's income, whereas dividend payments to shareholders are not. The substitution of liability theory does not recognize that crucial distinction, and fails to provide for a recapture of the benefits of previously claimed interest deductions by the corporate debtor."); Zachary & Greenwald, supra note 47, at 146 ("[T]he substitution of liability theory, while clearly acknowledging that the form of the liability has changed, ignores the usually significant tax distinction between debt and equity.").

245. Capento Sec., 140 F.2d at 386; see also I.R.C. § 1032 (1994); Eustice, supra note 38, at 240.

246. For a complete discussion of the subscription price theory, see Bryan, supra note 37, at 107-10.

247. Kenneth J. Kies, Taking a Fresh Look at the Stock-for-Debt Exception, 56 Tax Notes 1619, 1622 (1992) (quoting Zachary & Greenwald, supra note 47, at 147...
Reinstating the Stock-for-Debt Exception

The criticisms of these theoretical underpinnings of the stock-for-debt exception are generally well founded. In fact, courts stopped using the subscription price theory to justify the exception shortly after the First Circuit decided *Capento Securities* in 1944. Does it follow, then, that *Capento Securities* was wrongly decided, and thus there is no theoretical tax construct supporting the stock-for-debt exception?

It is the position of this Article that the courts in *Capento Securities* and its progeny reached the right result, but for the wrong reasons. Although not articulated by the courts, there is a third, and far more compelling, tax policy justification for the stock-for-debt exception. It is premised on a theory first espoused by the Supreme Court in 1931 in a different context: the open transaction doctrine. In *Burnet v. Logan*, the taxpayer sold her stock in an iron company, the sales price being contingent on the amount of iron ore produced in a particular iron mine over a period of years. In the past, the amount of iron ore produced by the mine varied dramatically. The Supreme Court rejected the Service’s argument that the taxpayer could estimate the sales price at the time of the sale, and thus should be taxed on the full gain immediately. Instead, it held the transaction open until the taxpayer actually received the iron ore profits each year. Thus, in its most basic form, the open transaction doctrine adopts a wait-and-see approach, wherein the tax consequences of a transaction remain open until a subsequent event occurs, which closes the transaction and allows the taxpayer to determine more accurately the amount of income or loss to be recognized.

Although courts have traditionally used the open transaction doctrine primarily for the sale of property, its theoretical underpinnings have a far broader reach. For example, while it is a well-settled principle of finance that established securities markets generally value publicly traded

("[T]he subscription price theory can be attacked on the ground that the creditors, in advancing money to the corporation in the first instance, took a debt obligation and did not bargain to become equity owners.")

There are, however, scholars who argue that the subscription price theory is a sound basis for the stock-for-debt exception because at the time of the exchange, the creditors are, in fact, the true owners of the company. Therefore, formalizing their true equity position in an inappropriate time to impose an income tax. *See, e.g.*, Bercik, * supra* note 47, at 210-11 (relying on Helvering v. Alabama Asphalitic Limestone Co., 315 U.S. 179 (1942) and Rev. Rul. 59-222, 1959-1 C.B. 80); *see also* Sherck, * supra* note 48, at 896 ("The 'formalization' of [creditors'] equity position by the actual exchange of debt for stock thus would not require recognition of gain to the debtor.").


249. *Burnet*, 283 U.S. at 412-13. The Court also allowed the taxpayer to recoup her full basis in the stock before recognizing any gain. *Id.*

250. Wootton, * supra* note 248, at 726. Moreover, courts have relied on the doctrine less frequently in recent years. *Id.* at 725.
stocks accurately,\textsuperscript{251} it is equally clear that the same securities markets are incapable of accurately valuing the stock of a financially distressed corporation, particularly one involved in a chapter 11 bankruptcy proceeding.\textsuperscript{252} Accordingly, in the absence of the stock-for-debt exception, when a bankrupt or insolvent corporation exchanges its stock for its creditors' indebtedness, it will realize discharge of indebtedness.

\textsuperscript{251} Eugene F. Fama, \textit{Efficient Capital Markets: II}, 46 J. Fin. 1575, 1607 (1991) ("[O]n average stock prices adjust quickly to information about investment decisions, dividend changes, changes in capital structure, and corporate-control transactions."); Christopher P. Saari, Comment, \textit{The Efficient Capital Market Hypothesis}, Economic Theory and the Regulation of the Securities Industry, 29 Stan. L. Rev. 1031 passim (1977). "A market in which prices always fully reflect available information is an 'efficient' market . . . . The empirical evidence overwhelmingly supports the hypothesis that modern American capital markets are efficient, and few economists deny the validity of this view." Id. at 1031; see also Michael C. Jensen, \textit{Takeovers: Their Causes and Consequences}, 2 J. Econ. Persp. 21, 26 (1988) ("Although the evidence is not literally 100 percent in support of the efficient market hypothesis, no proposition in any of the sciences is better documented."); Lynn A. Stout, \textit{Are Takeover Premiums Really Premiums? Market Price, Fair Value, and Corporate Law}, 99 Yale L.J. 1235, 1240-41 (1990). \textit{Cf.} \textit{Financial Accounting Standards Bd., Tentative Conclusions on Objectives of Financial Statements of Business Enterprises} 39 (1976) (recognizing that there are three forms of market efficiency: the "weak" form, which states that the market accurately reflects historical information on market prices; the "semi-strong" form, which provides that stock prices fully reflect public information regarding companies, including their financial statements; and the "strong" form, which suggests that market prices reflect all information, including inside information. The author concludes that empirical evidence generally confirms that United States markets are efficient under the weak and semi-strong forms of market efficiency, but that the strong form of market efficiency "is not generally supported by the limited available evidence."); \textit{JAMES H. LORIE ET AL., THE STOCK MARKET: THEORIES AND EVIDENCE} 73 (2d ed. 1985) ("The evidence has become so persuasive that it is fair to conclude that the semi-strong form of market efficiency is now an accepted working assumption in financial economics research."). There are, however, those who disagree about the efficiency of established securities markets. \textit{See, e.g.}, Henry T.C. Hu, \textit{Risk, Time, and Fiduciary Principles in Corporate Investment}, 38 UCLA L. Rev. 277, 342 (1990) ("The stock market is not 100% efficient in the sense that share price mirrors fundamental economic value.").

\textsuperscript{252} Mark J. Roe, \textit{Bankruptcy and Debt: A New Model for Corporate Reorganizations}, 83 Colum. L. Rev. 527 passim (1983). "The values assigned in reorganization are believed often to have been inaccurate when compared to long-run market values." Id. at 562 n.124. \textit{See also} Citibank, N.A. v. Baer, 651 F.2d 1341, 1347-48 (10th Cir. 1980):

The actual value of stock depends on a number of different factors, including the future earning potential of the company as perceived by outside investors. With a newly reorganized company coming from the throes of bankruptcy, the actual market value of a share of stock may be considerably less than the pro-rata portion of the going-concern value of the company represented by that stock.

\textit{Id.}; \textit{In re} Equity Funding Corp. of Am., 416 F. Supp. 132, 145 (C.D. Cal. 1975) (stating that, because of the uncertainties associated with corporations emerging from bankruptcy proceedings, including initial selling pressure, the stock of such a company could trade at less than its reorganization value in the near term); Lawrence A. Weiss, \textit{Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims}, 27 J. Fin. Econ. 285, 289 (1990).
income equal to the excess of the debt cancelled over the highly depressed value of the stock issued in the exchange, and will be required to reduce its tax attributes, such as net operating loss carryovers, by a like amount.\textsuperscript{253} If, however, the open transaction doctrine governs the exchange, the debtor corporation could postpone its realization of debt discharge income and corresponding tax attribute reduction until the creditor sold its stock, establishing an accurate valuation of the stock for purposes of calculating the debtor's debt discharge amount.\textsuperscript{254} Thus, using the open transaction doctrine as the tax policy justification for the stock-for-debt exception would have the effect of converting the exception from an exclusionary provision, where potential debt discharge income is never taxed, to a mere deferral provision, where debt discharge income is measured and taxed when the creditor subsequently sells or redeems its stock, thereby closing the open transaction.\textsuperscript{255} This theoretical underpinning for the exception can ultimately be justified from a tax perspective because it satisfies one of the first principles of income taxation: taxing true economic income.

\textbf{B. Reinstating the Stock-for-Debt Exception: A Modest Proposal}

Reinstating the stock-for-debt exception will not resolve all of the ills plaguing the chapter 11 bankruptcy system. However, reinstating the exception, which was, after all, repealed for purely political reasons without any hearings or debate, will improve the ability of many corporations to reorganize successfully and will bring the chapter 11 system one step closer to achieving its goals of preserving jobs, promoting competition, fostering economic growth, and rehabilitating troubled businesses.

Congress should reinstate the stock-for-debt exception only for insolvent corporations and those involved in title 11 bankruptcy proceedings. To reinstate the exception for solvent corporations not in bankruptcy would fail to recognize fundamental distinctions between solvent corporations, on the one hand, and insolvent and bankrupt corporations, on the other. First, the amount of debt discharge income

\textsuperscript{253} For a more detailed discussion of discharge of indebtedness income and corresponding tax attribute reduction, see \textit{supra} notes 67-85 and accompanying text.

\textsuperscript{254} Considering how logical it is to apply the open transaction doctrine to exchanges of stock-for-debt, it is surprising that scholars have not seriously debated it before. For a brief discussion of the open transaction doctrine in this context nearly ten years ago, see Bercik, \textit{supra} note 47, at 214-16; Sherck, \textit{supra} note 48, at 896-98.

\textsuperscript{255} One commentator has argued that the open transaction doctrine cannot be used in such an instance because it would run afoul of I.R.C. § 1032 (1994), which provides generally that retiring stock for less than its issue price does not result in taxable income to the corporation. Sherck, \textit{supra} note 48, at 896. This argument is flawed, however, because under current law (after the repeal of the stock-for-debt exception), even the mere issuance of stock by a debtor corporation results in discharge of indebtedness income, also contravening the fundamental principles of section 1032 of the Code.
realized by a solvent corporation can be easily ascertained because the value of its stock issued in the exchange can be readily valued.\textsuperscript{256} Conversely, accurately establishing the value of stock issued by an insolvent or bankrupt corporation in a stock-for-debt exchange is nearly impossible; thus the amount of the corporation's debt discharge income would be highly speculative.\textsuperscript{257} Moreover, solvent corporations have the funds available to satisfy a tax liability based on their debt discharge income, while insolvent and bankrupt corporations usually do not. Finally, past experience indicates that solvent corporations will use the stock-for-debt exception for tax avoidance schemes,\textsuperscript{258} while there is little risk that their insolvent or bankrupt counterparts will do the same.

Yet reinstating the stock-for-debt exception is merely the starting point. To be sure, reinstating the exception furthers bankruptcy policy, but what of tax policy? The judicially established tax theories underlying the stock-for-debt exception, the substitution of liability theory and the subscription price theory, have been thoroughly discredited by scholars over the years.\textsuperscript{259} The only remaining theory that can justify the stock-for-debt exception from a tax policy perspective is the open transaction doctrine discussed in this Article.\textsuperscript{260} Recall that the open transaction doctrine, which basically adopts a wait-and-see approach, is premised on the assumption that the tax consequences of certain transactions cannot be determined with reasonable accuracy until subsequent events occur that close those transactions. Under this proposal, an insolvent corporation or one involved in a bankruptcy proceeding can invoke the stock-for-debt exception to avoid cancellation of indebtedness income at the time of the stock-for-debt exchange. When a creditor that has received stock in exchange for its indebtedness subsequently sells or otherwise disposes of the stock, however, the open transaction doctrine dictates that the transaction will close and the debtor will then realize debt discharge income equal to the difference between the selling price of the stock and the face amount of the indebtedness that had been exchanged for that stock.\textsuperscript{261} This debt discharge income will reduce the debtor corporation's

\textsuperscript{256} See supra note 251 and accompanying text.
\textsuperscript{257} For a more complete discussion of the problems inherent in valuing such stock, see supra notes 252-54 and accompanying text.
\textsuperscript{258} See supra notes 97-99 and accompanying text for an in-depth examination of the tax avoidance schemes concocted with the stock-for-debt exception in the early 1980s.
\textsuperscript{259} For a thorough examination of these theories and the attacks that have been waged against them, see supra notes 242-47 and accompanying text.
\textsuperscript{260} See supra notes 248-55 and accompanying text.
\textsuperscript{261} This selling price should be unreduced by costs or other commissions that the creditor incurs to sell the stock. This will insure parallel treatment of stock-for-debt exchanges and exchanges in which a creditor receives other property in partial satisfaction of its indebtedness. In the latter case, the debtor corporation's income from discharge of indebtedness is calculated by subtracting the fair market value of the property, unreduced by any selling costs incurred by the creditor, from the face amount of indebtedness discharged in the exchange. I.R.C. § 108(b) (1994).
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The following example will illustrate the application of this proposal. Assume that $D$, a financially troubled corporation under the jurisdiction of a bankruptcy court in a chapter 11 reorganization proceeding, has two creditors, each with a $200,000 debt outstanding. As part of its reorganization plan approved by the bankruptcy court, $D$ pays each creditor $25,000 cash and issues 10,000 shares of stock to each of them (the 20,000 shares represent half of the shares of $D$ outstanding). The stock has a fair market value of $4 per share at the time of the transaction. The creditors agree to cancel their debt as part of the exchange.

Because $D$ is involved in a chapter 11 bankruptcy proceeding, it can avail itself of the stock-for-debt exception, as long as the stock that it has issued to its creditors is not nominal or token. As discussed in Part V, stock issued in a stock-for-debt exchange will not be considered nominal or token under the proposal if it represents more than ten percent of the total stock of the debtor corporation outstanding after the exchange. The stock issued to $D$'s creditors far exceeds this threshold, representing fifty percent of $D$'s outstanding stock after the exchange. Thus, $D$'s exchange qualifies for the stock-for-debt exception, and it will recognize no debt discharge income at the time of the transaction.

Further assume that $D$'s first creditor sells its stock three years later for $140,000. Inasmuch as the creditor's original indebtedness was $200,000, and it received $25,000 cash in the exchange, only $175,000 of the indebtedness was cancelled in exchange for stock. Because the original stock-for-debt transaction closes as a result of the creditor's sale or disposition of its stock, $D$ will realize $35,000 of debt discharge income.

A creditor can, of course, dispose of the debtor corporation's stock without selling it. For example, if the creditor makes a gift of the stock, there has been a disposition without a sale or exchange. In such a case, the debtor's debt discharge income should be calculated by making the selling price equal to the fair market value of the stock on the date of the gift. Similarly, if a parent corporation liquidates one of its subsidiaries into itself (generally on a tax-free basis pursuant to I.R.C. § 332 (1994)), after receiving the subsidiary's stock in a stock-for-debt exchange, the liquidation will constitute a disposition of the stock, even though no sale has occurred. As in the gift situation, the fair market value of the subsidiary's stock on the date of the liquidation will be the deemed selling price for purposes of calculating the subsidiary's discharge of indebtedness amount.

262. For a comprehensive examination of tax attribute reduction under I.R.C. § 108(b) (1994), as well as the alternative election to reduce the debtor's basis in its depreciable property pursuant to I.R.C. § 1017(b) (1994), see supra notes 83-85 and accompanying text.

263. This stock valuation appears to be exceedingly low, however, because the liquidation value of $D$'s assets alone should give the stock a value in excess of $6 per share.

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income, and thus will reduce its tax attributes by that amount.\textsuperscript{264} If \(D\)'s second creditor sells its \(D\) stock the following year for $250,000, \(D\) will realize no discharge of indebtedness income at the time of the sale, because under the open transaction doctrine's wait-and-see approach, the value of \(D\)'s stock "grew into" the indebtedness cancelled in the exchange, thus resulting in no discharge of indebtedness income.\textsuperscript{265}

One potential problem with the proposal is that it would allow creditors to control the debtor corporation's tax consequences.\textsuperscript{266} If creditors sell their stock shortly after they receive it in a stock-for-debt exchange, the value of the stock is still likely to be depressed because of the bankruptcy proceeding or insolvency workout.\textsuperscript{267} This premature sale could cause the debtor corporation to realize an artificially high level of debt discharge income.

But why would creditors agree to accept stock in the exchange and then sell it so quickly? The fact is that most creditors have two distinct incentives to do so. First, federal banking regulations require that certain banks dispose of all stock received in exchange for their indebtedness within two years after receiving it.\textsuperscript{268} Thus, bank creditors have strong incentives to dispose of their stock quickly to satisfy the two-year holding period rule.\textsuperscript{269}

The second reason that creditors might prematurely sell stock that they receive in a stock-for-debt exchange is to trigger favorable tax consequences for themselves. If, for example, a creditor holds long-term indebtedness, and then exchanges that indebtedness for the debtor

\textsuperscript{264} This $35,000 figure represents the difference between the $175,000 debt cancelled in exchange for stock, and the $140,000 value of the stock determined at the time of the creditor's sale.

\textsuperscript{265} Conversely, under current law, \(D\) would realize $270,000 of debt discharge income at the time of the original exchanges of stock for debt, and would be required to reduce its tax attributes by that amount. This figure represents the $400,000 of debt cancelled in the exchange, less the $50,000 of cash issued to the creditors plus the $80,000 fair market value of the stock (20,000 shares at $4 per share).

\textsuperscript{266} Bercik, supra note 47, at 215 ("[A problem] created by the open transaction doctrine is that the debtor corporation's future recognition of COD income is not within its control . . . . The corporation would be at the mercy of its creditors.").

\textsuperscript{267} See supra notes 251-52 and accompanying text.

\textsuperscript{268} 12 U.S.C.A. § 1843(c)(2) (West 1989 & Supp. 1999) ("[S]hares acquired by a bank holding company or any of its subsidiaries in satisfaction of a debt previously contracted in good faith . . . . shall be disposed of within a period of two years from the date on which they were acquired . . . . "). The Board of Governors of the Federal Reserve System can extend the initial two-year holding period for up to a ten-year period after the bank initially acquires the stock if the extension(s) "would not be detrimental to the public interest." \textit{Id}. After the initial five year period, either the bank has attempted in good faith to sell the stock or such a sale "would have been detrimental to the company." \textit{Id}. For the definition of a bank holding company, see 12 U.S.C.A. § 1841(a) (West 1989 & Supp. 1999).

\textsuperscript{269} \textsc{Subcomm. on Select Revenue Measures of the Comm. on Ways and Means, 96th Cong., Written Comments on Certain Aspects of H.R. 5043, Bankruptcy Tax Act of 1979,} at 30 (Comm. Print 1980).
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corporation’s stock, the creditor will not be entitled to recognize any loss on the exchange270 because the exchange qualifies as a tax-free recapitalization.271 Thus, the creditor would have the incentive to sell the debtor’s stock quickly to be entitled to deduct its loss (unless the creditor was relatively confident that the debtor’s stock would appreciate significantly in value).272 Thus, favorable tax consequences often encourage creditors to dispose of their stock received in a stock-for-debt exchange prematurely.

Although creditors have both regulatory and tax incentives to sell the stock that they receive from a financially troubled corporation quickly, a premature disposition of the stock will not allow for a proper measurement of the debtor corporation’s discharge of indebtedness income because market forces will not yet have had the opportunity to value the debtor’s stock accurately. Accordingly, the debtor corporation’s discharge of indebtedness income should not be determined until the first sale of each block of stock occurring more than two years after the

270. There would be a realized loss if the face amount of the debt exceeded the fair market value of the stock received, a likely occurrence in the case of an insolvent debtor corporation or one involved in a bankruptcy reorganization. I.R.C. § 1001 (1994).
271. I.R.C. §§ 354(a)(1) (1994), 368(a)(1)(E) (1994). The transaction will qualify as a tax-free recapitalization only if the indebtedness cancelled in the exchange qualifies as a security. I.R.C. § 354(a)(2)(A)(i) (1994). Although the Code does not define the term security for these purposes, case law and pronouncements by the Service have generally filled in the gaps. For example, indebtedness with an original maturity date greater than five years is usually deemed a security. Rev. Rul. 59-98, 1959-1 C.B. 76. Conversely, debts with a maturity date of five years or less usually do not constitute securities. Neville Coke and Chem. Co. v. Comm'r, 148 F.2d 599 (3d Cir.), cert. denied, 326 U.S. 726, 726-27 (1945). Thus, short-term creditors of the debtor, such as its trade creditors, will not fall within these reorganization rules, and their exchange of stock for debt will be a taxable transaction, allowing them to recognize a loss at the time of the exchange. I.R.C. § 1001 (1994).

272. At the time of the sale, the creditor would generally recognize a loss equal to the difference between the amount realized on the stock sale, less the adjusted basis (often the face amount) of the debt cancelled in the stock-for-debt exchange. I.R.C. § 1001 (1994). If, however, the creditor had previously taken a bad debt deduction under I.R.C. § 166 (1994), that deduction would reduce the creditor’s adjusted basis in its debt, and the sale could produce a gain rather than a loss. The gain would be recaptured as ordinary income to the extent that the previous bad debt deductions were ordinary losses rather than capital losses. I.R.C. § 108(e)(7) (1994). In such a case, the creditor would have less incentive to dispose of its stock received in the exchange prematurely because the transaction would produce a gain rather than a loss. For a more comprehensive discussion of the tax treatment to a creditor in a stock-for-debt exchange, see Asofskey, supra note 58, at 626-33; Mary Kate Wold, A Comprehensive Tax Guide for Corporate Workouts, 456 PRACTICING L. INST. 1087, 1149-57 (1999); see also 15 MYRON M. SHIFFELD ET AL., COLLIER ON BANKRUPTCY ch. TX7 (Lawrence P. King ed., 15th ed. 1999).
original stock-for-debt exchange. Thus, creditors that receive stock in exchange for their indebtedness will merely be required to notify the debtor corporation of any sale or disposition of that stock. If the sale or disposition occurs more than two years after the original exchange, the debtor can calculate its debt discharge income and corresponding tax attribute reduction with respect to the selling creditor at the time. If, however, the sale or disposition occurs within two years of the original stock-for-debt exchange, the purchaser will be subject to the same reporting requirements as the original creditor, and the debtor corporation will compute its debt discharge amount following the purchaser’s sale or other disposition.

As outlined above, the stock-for-debt exception that existed before its repeal in 1993 furthered sound bankruptcy policy at the cost of tax policy. By expanding the scope of the open transaction doctrine to the field of bankruptcy taxation, and coupling it with the two-year limitation described in this section, this proposal is the first to envision a stock-for-debt exception that promotes both sound bankruptcy and tax policy.

273. One possible solution to the premature sale problem is to lock up the stock for a period of time, such as two years, so that creditors are prohibited from selling their stock during that period. See, e.g., Bercik, supra note 47, at 215-16. The problems with this approach are twofold. First, creditors do, in fact, have valid business and economic reasons for selling the debtor’s stock early. Thus, a stock lock-up would violate notions of tax efficiency by encouraging actions to be taken solely for tax purposes rather than for valid economic reasons. For a more complete discussion of the concept of tax efficiency, see infra notes 305-12 and accompanying text. Second, under a stock lock-up, creditors are not actually prohibited from selling their stock; instead, they are liable for the debtor’s adverse tax consequences if they do. If the creditor is in financial difficulty, the debtor’s lawsuit might represent merely a pyrrhic victory because the debtor is unable to collect on its judgment from the creditor. For these reasons, this Article rejects the suggestion of a stock lock-up.

274. The notification must include the date of the sale or disposition, the selling price, if relevant, and the name, address, and social security number or taxpayer’s identification number of the purchasers or recipients of the stock.

275. For an explanation of how this calculation is made, see supra notes 261-65 and accompanying text.

276. Of course, if the purchaser’s sale or other disposition occurs within the two-year period as well, the debtor will not compute its debt discharge income and tax attribute reduction until the conclusion of the first sale after such two-year period.

277. This proposal is not complete until it addresses one final, highly technical, aspect of the stock-for-debt exception. Before its amendment in 1993, section 382(f)(5) of the Code provided that, if a corporation experienced an ownership change while involved in a title 11 bankruptcy proceeding or similar case, and following the ownership change, former creditors and shareholders held at least fifty percent of the corporation’s stock by vote and value, the corporation was required to reduce its net operating loss carryovers by, among other reductions, half of the debt discharge income protected by the stock-for-debt exception. I.R.C. § 382(f)(5) (1994). For the definition of an ownership change under section 382, see infra note 286 and accompanying text; see also Arnopol, supra note 28, at 168-72. Under this proposal, the debtor corporation will ultimately recognize all debt discharge income by way of tax attribute reduction at the time that the creditors or subsequent purchasers sell or dispose of their stock received in the exchange.
1. UNRESOLVED TAX ISSUES

A proposal calling for the reinstatement of the stock-for-debt exception is not complete unless it addresses the three unresolved issues regarding the exception's practical application. First, should preferred stock qualify as stock for purposes of the exception, and, if so, to what extent? Second, should a subsidiary be allowed to issue stock of its parent corporation in exchange for its own indebtedness under the stock-for-debt exception? Finally, should any limitations be set on the minimum amount of stock that a debtor corporation must issue in order to qualify for the exception? The three subsections below resolve these difficult tax issues.

Accordingly, to require that the corporation also reduce its net operating loss carryovers by half of its debt discharge income protected by the stock-for-debt exception would result in "double dipping" by the government. Therefore, this Article suggests that no amendment be made to section 382(f)(5) if this proposal is adopted.

This proposal would also be incomplete if it did not address an alternative proposal to relieve the harsh tax consequences resulting from the repeal of the stock-for-debt exception. The National Bankruptcy Review Commission, which was established by Congress as part of the Bankruptcy Reform Act of 1994, appointed a Special Task Force to consider tax recommendations to be included in the Commission's final report to Congress. The Task Force prepared a special report addressing a number of bankruptcy taxation issues, one of which involved the repeal of the stock-for-debt exception. The Task Force first recognized that the repeal of the exception would result in the liquidation rather than reorganization of financially distressed companies, which was inconsistent with the general bankruptcy policy of encouraging rehabilitation. PAUL H. ASOFSKY & ROBERT E. MCKENZIE, REPORT OF THE ABA TAX SECTION TASK FORCE ON THE TAX RECOMMENDATIONS OF THE NATIONAL BANKRUPTCY REVIEW COMMISSION 204 (1997) (on file with author). The report recommended that, in order to remedy this policy distortion, Congress should amend section 108 of the Code to allow a corporation in bankruptcy to make a "fresh start" election. The ultimate effect of this election would be to allow the debtor corporation to use a larger percentage of its net operating losses each year following its bankruptcy reorganization than would be permitted under present law. Id. at 205 ("[The debtor would be] entitled to a 'fresh start net operating loss carryforward' which will be equal to 5 times [the debtor's] annual limit under Section 382, as determined using equity value as set forth in Section 382(f)(6) and accompanying regulations.") (emphasis added).

While the Task Force's proposal should be commended for recognizing the tax inequities resulting from the repeal of the stock-for-debt exception, it is a wholly inadequate remedy for these inequities because the proposal is premised on ascertaining the value of the corporation immediately after bankruptcy. As discussed supra note 252 and accompanying text, the value of a corporation emerging from bankruptcy reorganization cannot be adequately ascertained. Thus, it is contended that the Task Force's proposal, if implemented, would not have a reasonable likelihood of success in practice.
a. The Preferred Stock Issue

Recall that, prior to the repeal of the stock-for-debt exception in 1993, the Code provided that certain types of preferred stock with a stated redemption price would be treated as "disqualified stock," and thus could not be used by a financially troubled corporation to satisfy the stock-for-debt exception. This congressional position on the preferred stock issue was in direct conflict with the Service's own ruling position on the issue, which allowed preferred stock to qualify for the exception, but only to the extent of the stock's redemption price or liquidation preference.

If Congress reinstates the stock-for-debt exception, it should adopt the Service's ruling position and permit preferred stock to qualify for the stock-for-debt exception to the extent of the greater of its stated redemption price or its liquidation preference. This solution best comports with the policy justification underlying the exception, the open transaction theory.

Under the open transaction theory, even if preferred stock issued by a troubled corporation in exchange for its indebtedness has a fair market value far below the debt being cancelled in the exchange, the stock nevertheless has a potential to increase in value in the creditor's hands. As the value of the preferred stock rises, the amount of indebtedness actually cancelled without the receipt of consideration decreases. Thus, it is possible that by the time that the creditor sells the preferred stock, the debtor corporation will have suffered no discharge of indebtedness income, because the preferred stock will have grown into the value of the cancelled debt. Therefore, this Article's paradigm provides that preferred stock should qualify as stock for purposes of determining a bankrupt or insolvent corporation's discharge of indebtedness income under the stock-for-debt exception.

Still, there are limitations on the extent to which preferred stock can increase in value. Its value will never exceed the greater of its stated redemption price or its liquidation preference. Accordingly, based on the open transaction doctrine, the excess of the cancelled debt over the greater of the preferred stock's redemption price or liquidation preference should constitute discharge of indebtedness income to the debtor.

278. Disqualified stock was defined as preferred stock with a stated redemption price that either was subject to a "put" at the option of the holder of the stock, a "call" at the option of its issuer, or had a fixed redemption date. I.R.C. § 108(e)(10)(B)(ii) (repealed 1993). For a more complete discussion of disqualified stock, see supra notes 113-15 and accompanying text.


280. If stock is denoted as preferred stock but has neither a stated redemption price nor a liquidation preference, then under this proposal it will be treated as common stock for purposes of the stock-for-debt exception.

281. See, e.g., HENDERSON & GOLDRING, supra note 18, at 105.
corporation at the time of the exchange, and the corporation should be required to reduce its tax attributes by a like amount.\textsuperscript{282}

A simple example should illustrate the intended application of this general preferred stock rule and its limitation. Assume that \(B\) is a corporation that has filed for bankruptcy under chapter 11 of the Bankruptcy Code. As part of its plan of reorganization, \(B\) issues preferred stock with a current fair market value of \$40,000 and a redemption price and liquidation preference of \$150,000 in exchange for a creditor’s unsecured debt of \$200,000. The creditor receives no other property in exchange for its debt. Under the proposal outlined in this Article, \(B\) will realize \$50,000 of discharge of indebtedness income at the time of the exchange,\textsuperscript{283} and will reduce its tax attributes by that amount. \(B\) will not realize any other income at the time of the exchange, but may realize further discharge of indebtedness income at the time that the creditor sells the preferred stock, equal to the difference between the selling price of the preferred stock and the \$150,000 of debt cancelled in exchange for the stock.\textsuperscript{284}

\textit{b. The Use of Parent Stock}

If the stock-for-debt exception is reinstated, a subsidiary corporation that is insolvent or in a title 11 bankruptcy proceeding should be entitled to use its parent’s stock to satisfy its own indebtedness for three reasons. First, a creditor would be more likely to accept the stock of a parent corporation that is not insolvent or involved in a bankruptcy proceeding. Such parent stock is obviously more attractive because it can be more readily traded and clearly has a better chance of yielding a return equal to or greater than the cancelled debt.\textsuperscript{285} The lure of parent stock might also allow subsidiaries to negotiate debt cancellation that otherwise would not occur, thereby encouraging reorganization over liquidation.

In addition, and perhaps more importantly, issuing parent stock allows the parent and subsidiary to retain two tax advantages that are

\begin{itemize}
\item \textsuperscript{282} For a detailed discussion of discharge of indebtedness income and corresponding tax attribute reduction, see \textit{supra} notes 66-85 and accompanying text. If both preferred and common stock are issued to a creditor in exchange for its indebtedness, however, and neither the preferred nor the common stock is de minimis, then the preferred stock will be deemed to satisfy indebtedness to the extent of the greater of its redemption price or liquidation preference, and the common stock will be deemed to satisfy the remaining indebtedness. Accordingly, the debtor corporation would realize no discharge of indebtedness income at the time of the stock-for-debt exchange. For a discussion of this proposal’s de minimis limitations, see \textit{infra} notes 292-98 and accompanying text.
\item \textsuperscript{283} This \$50,000 figure is equal to the \$200,000 debt cancelled less the greater of the preferred stock’s redemption price or liquidation preference (both are equal in this case) of \$150,000.
\item \textsuperscript{284} For a more complete explanation of how this calculation is made, see \textit{supra} notes 261-65 and accompanying text.
\item \textsuperscript{285} Bridgeman, \textit{supra} note \textsuperscript{116}, at 81.
\end{itemize}
crucial to a successful reorganization: preservation of the subsidiary's net operating loss carryovers and the ability of the parent and subsidiary to file consolidated tax returns. A subsidiary can lose the immediate use of its net operating losses by issuing more than fifty percent of its common stock to creditors (called an "ownership change").286 It can lose the privilege of filing consolidated returns with its parent corporation if it issues more than twenty percent of its stock to creditors.287 It is very likely that a bankrupt or insolvent subsidiary would be required to issue more than twenty percent of its stock in order to satisfy the claims of creditors, thereby deconsolidating the parent and subsidiary.288 Moreover, oftentimes the subsidiary must issue over fifty percent of its stock to satisfy creditors' claims, thus limiting the ability of the parent corporation to use the subsidiary's net operating losses to offset its own income.

On the other hand, a parent corporation with more valuable stock can issue less stock and thereby avoid an ownership change, deconsolidation, or both. Unfortunately, if the stock-for-debt exception is reinstated without clarifying the parent stock issue, there is a risk that a court might hold that parent stock does not qualify as stock of the debtor for purposes of the stock-for-debt exception. In that case, the subsidiary corporation would realize discharge of indebtedness income and would be forced to reduce one of its most valuable tax attributes, net operating losses, by the amount of its cancellation of indebtedness income. Thus, one of the primary advantages of using parent stock (retaining the subsidiary's net operating losses by issuing less stock and avoiding an ownership change) would be lost.289

Finally, treating parent stock as stock of the debtor for purposes of the stock-for-debt exception would allow for parallel tax treatment of debtor corporations and creditors under the Code. As discussed previously, section 108(e)(7), which outlines the creditor's tax consequences in a stock-for-debt exchange, provides that stock of the

286. If a corporation issues more than fifty percent of its stock to creditors, an ownership change will be triggered pursuant to I.R.C. § 382(g) (1994). After an ownership change occurs, the new owners' subsequent use of the corporation's existing net operating losses will be significantly restricted. I.R.C. § 382(a), (b)(1) (1994). But see I.R.C. § 382(f)(5)-(6) (1994). For a comprehensive discussion of the Code's net operating loss limitations following an ownership change, see Arnopol, supra note 28, at 164-73.

287. I.R.C. §§ 1501, 1504 (1994); see also Treas. Reg. § 1.1502-1(a) (as amended in 1999). A deconsolidation of the parent and subsidiary could also result in other adverse tax consequences, such as triggering deferred intercompany gain under Treas. Reg. §1.1502-13 (as amended in 1999); see also Boshkov, supra note 116, at 224; Bridgeman, supra note 116, at 81-82. For a comprehensive list of adverse tax consequences resulting from the termination of a consolidated group, see Fred W. Peel, Jr. et al., Consolidated Tax Returns § 23.01 (3d ed. 1984).


289. For a discussion of how discharge of indebtedness income is triggered, causing a reduction of the debtor corporation's net operating losses and other tax attributes, see supra notes 66-85 and accompanying text.
Reinstating the Stock-for-Debt Exception

debtor’s parent should be treated as stock of the debtor for purposes of that section.\textsuperscript{290} As a matter of statutory interpretation, stock as a debtor’s parent corporation should similarly be treated as stock of the debtor for purposes of determining the debtor’s tax consequences in the same exchange.\textsuperscript{291}

c. De Minimis Limitations

Allowing an insolvent corporation or one in bankruptcy to avail itself of the stock-for-debt exception when it has issued no real equity interest to its creditors would elevate form over substance. Accordingly, a financially troubled corporation should not be able to use the stock-for-debt exception if it issues only a de minimis amount of stock to its creditors in exchange for their indebtedness. The parameters of the de minimis limitation under this proposal are explored below.

Recall that, under the law in existence at the time of the exception’s repeal, a debtor corporation had to meet two tests in order to satisfy the Code’s de minimis limitation. First, the stock issued to the corporation’s creditors in exchange for their debt could not be nominal or token.\textsuperscript{292} Second, the amount of stock issued to an unsecured creditor could not be disproportionately low in relation to the amount of stock issued to all unsecured creditors.\textsuperscript{293} In each case, the value of the stock issued to creditors was critical in determining whether the nominal or token and disproportionality tests were met.\textsuperscript{294}

One of the fundamental principles upon which this Article is based is that it is impossible to value the stock of a bankrupt or insolvent

\textsuperscript{290} I.R.C. § 108(e)(7)(C) (1994). For a more complete discussion of this provision, see supra note 132 and accompanying text.

\textsuperscript{291} It is a well-settled principle of statutory construction that an identical word or phrase appearing in several locations of the same statute or section thereof should be defined and interpreted consistently throughout the statute or section. WILLIAM N. ESKRIDGE, JR. ET AL., LEGISLATION AND STATUTORY INTERPRETATION 264-65 (2000) (quoting Justice Kennedy’s majority opinion in Gustafson v. Alloyd Co., 513 U.S. 561, 569 (1995)).

\textsuperscript{292} For an in-depth discussion of the nominal or token limitation, see supra notes 151-62 and accompanying text.

\textsuperscript{293} See supra notes 163-77 and accompanying text for a complete discussion of the disproportionality limitation.

\textsuperscript{294} For example, under Revenue Procedure 94-26, 1994-1 C.B. 612, stock would not be considered nominal or token if the value of common stock issued in exchange for unsecured indebtedness was at least fifteen percent of the value of all stock outstanding after the bankruptcy proceeding or insolvency workout. See supra notes 161-62 and accompanying text. Similarly, under Technical Advice Memorandum 88-37-001 (May 10, 1988), the Service ruled that the value of preferred stock issued in exchange for indebtedness was not nominal or token because the value was approximately ten percent of the face amount of debt cancelled in the exchange. For a more complete discussion of this ruling, see supra notes 154-55 and accompanying text; see also Sherck, supra note 48, at 902.
corporation accurately. Therefore, any test that focuses on the value of the debtor corporation's stock in determining whether it is de minimis is, in the end, futile.

Accordingly, under this proposal, stock issued in a stock-for-debt exchange will not be deemed nominal or token if those creditors participating in the exchange receive stock representing at least ten percent of the total amount of stock outstanding after the exchange occurs. This nominal or token test will apply both to exchanges of stock for debt in a title 11 bankruptcy proceeding, as well as to stock-for-debt exchanges occurring as part of an informal insolvency workout.

Finally, this Article proposes that the disproportionality test not be reinstated as part of the proposal. As one commentator aptly noted, the disproportionality test encouraged classes of unsecured creditors with differing priorities to alter the mix of stock and other consideration to be paid to each class in order to satisfy the disproportionality test. He concluded that "the policy aim of efficiency in the income tax system is thus frustrated. Complicated and heated negotiations between different classes of creditors to preserve favorable tax consequences to the debtor under the stock-for-debt exception also can be counterproductive and delay a bankruptcy reorganization." Therefore, because the disproportionality test would encourage tax inefficiency, and inasmuch as the nominal or token test set forth above satisfies the concern that debtors will avail themselves of the stock-for-debt exception without giving creditors a real equity interest in the enterprise, the proposal eliminates the disproportionality test as part of the Code's de minimis limitation.

2. PROPOSED STATUTORY LANGUAGE

If the proposal outlined in this Article is adopted, Congress will be required to amend section 108 of the Code substantially. The amendments should address the tax treatment of exchanges of stock for debt generally, the application of the stock-for-debt exception in the case of insolvent corporations and those involved in title 11 bankruptcy proceedings, limitations on the application of the exception, and the treatment of both preferred and parent stock under the exception. The remainder of this section proposes precise statutory language that can be adopted by Congress in implementing this proposal, providing cross-

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295. See supra notes 251-52 and accompanying text.
296. A debtor with two or more classes of stock outstanding presents special problems. Because preferred and common stock often have different values, the proposal suggests that the ten percent test be applied separately with respect to each class of stock outstanding.
298. Id. at 1626.
reinstating the stock-for-debt exception references in footnotes to the sections of the article that explore each issue in greater detail.

paragraph 108(e)(8) shall be repealed in its entirety, and replaced with the following:

(8) Indebtedness satisfied by corporation’s stock.

(A) In general. For purposes of determining income of a debtor from discharge of indebtedness, if a debtor corporation transfers stock to a creditor in satisfaction of its indebtedness, such corporation shall be treated as having satisfied the indebtedness with an amount of money equal to the fair market value of the stock.299

(B) The stock-for-debt exception for certain stock in title 11 cases and insolvent debtors.

(i) In general. Subparagraph (A) shall not apply to any transfer of stock of the debtor—

(I) by a debtor in a title 11 case, or

(II) by any other debtor, but only to the extent that such debtor is insolvent.300

(ii) Stock-for-debt exception not to apply in de minimis cases. For purposes of determining income of the debtor from discharge of indebtedness, the stock-for-debt exception shall not apply to the issuance of nominal or token shares.301

(iii) Nominal or token shares defined. For purposes of clause (ii), the term “nominal or token shares” means stock, issued in exchange for indebtedness in a title 11 proceeding or insolvency workout, which

299. This subparagraph establishes the general rule for solvent corporations not in bankruptcy that stock is treated the same as any other asset transferred by the corporation for purposes of calculating its income from discharge of indebtedness. For a discussion of why the stock-for-debt exception is inapplicable to solvent debtors not in bankruptcy, see supra notes 256-58 and accompanying text.

300. This clause sets forth the stock-for-debt exception generally, providing that it applies only if the debtor corporation is insolvent or in bankruptcy. For a more complete explanation of the bankruptcy and tax policies underlying the stock-for-debt exception, see supra notes 217-55 and accompanying text.

301. See supra notes 292-98 and accompanying text for a discussion of this de minimis limitation and its application to the stock-for-debt exception.
represents less than 10 percent of the amount of all stock outstanding at the conclusion of the title 11 proceeding or insolvency workout. Such determination shall be made on a class-by-class basis.\(^{302}\)

(iv) Use of preferred stock. Stock with a stated redemption price or liquidation preference shall be treated as stock for purposes of clause (ii) only to the extent of the greater of —

(I) its stated redemption price, or

(II) its liquidation preference.\(^{303}\)

(C) Stock of parent corporation. For purposes of this paragraph, stock of a corporation in control (within the meaning of section 368(c)) of the debtor corporation shall be treated as stock of the debtor corporation.\(^{304}\)

(D) Limitation on stock-for-debt exception.

(i) In general. In the case of an exchange to which clause (i) of paragraph (B) applies, the debtor corporation shall be required to reduce its tax attributes pursuant to subsection (b), on the date on which a creditor that has received stock of the debtor in exchange for its indebtedness sells or otherwise disposes of such stock, by the excess of:

(I) the amount of such creditor's indebtedness cancelled in the exchange, over

(II) the selling price of such stock, or, if such stock was disposed of other than by sale, the fair market value of the stock on the date of such disposition.

\(^{302}\) For a detailed explanation of this ten percent safe harbor, see \textit{supra} note 296 and accompanying text.

\(^{303}\) For a discussion of the treatment of preferred stock under this Article's proposal, see \textit{supra} notes 278-84 and accompanying text.

\(^{304}\) This subparagraph mirrors the language of I.R.C. § 108(e)(7) (1994), which outlines the creditor's tax consequences in a stock-for-debt exchange, by providing that stock of a debtor's parent corporation will be considered stock of the debtor for purposes of the stock-for-debt exception. For a comprehensive discussion of the parent stock issue and how it is resolved under this proposal, see \textit{supra} notes 285-91 and accompanying text.
Reinstating the Stock-for-Debt Exception

(ii) Two-year rule. If a creditor described in paragraph (D) sells or otherwise disposes of the stock of the debtor corporation received in a stock-for-debt exchange within the two-year period beginning on the date of such exchange, the tax attribute reduction described in clause (i) above shall not occur until the first sale or other disposition of such stock following the expiration of such two-year period.

C. Responding to Anticipated Criticisms of the Proposal

Critics of the stock-for-debt exception might attempt to attack the proposal set forth in this Article on two alternative grounds. First, they might argue that reinstating the exception will encourage financially distressed corporations to file for bankruptcy relief rather than attempting to restructure their debt through a less costly informal workout, thereby violating traditional notions of tax efficiency. Second, they might criticize the proposal on the grounds that it violates the fundamental tax principle of horizontal equity and adds unnecessary complexity to the Code. As discussed more fully below, these criticisms are without merit.

1. EFFICIENCY CONCERNS: THE PROPOSAL WOULD ENCOURAGE BANKRUPTCY OVER INFORMAL WORKOUTS

A leading bankruptcy scholar, Kenneth Kies, was one of the principal proponents of repealing the stock-for-debt exception in the early 1990s. In an influential article, Kies argued that the stock-for-debt exception violated one of the basic principles of tax policy: tax efficiency. According to Kies’s definition of efficiency, the income tax system should minimize the extent to which taxpayers attempt to alter their economic behavior in order to avoid incurring an income tax liability.305 "The principle of efficiency implies that the best tax is one which interferes as little as possible with individuals' choices regarding their economic activity."306 Thus, a criticism that will likely be waged against this Article's proposal to reinstate the stock-for-debt exception is that the proposal violates traditional notions of tax efficiency by encouraging financially troubled corporations to restructure their debt in bankruptcy, rather than through an informal workout, in order to avail themselves of the exception.307

305. Kies, supra note 247, at 1625.
306. Id. at 1623 (quoting HOUSE COMM. ON WAYS & MEANS, 101ST CONG., OVERVIEW OF THE FEDERAL TAX SYSTEM 35 (1990)).
307. Kies, supra note 247, at 1625:
This argument is without merit for two reasons. First, the stock-for-debt exception would be available both to corporations in bankruptcy (whether solvent or insolvent) and to insolvent corporations that restructure their debt outside bankruptcy through an informal workout. Thus, it would be only solvent debtors who choose an informal workout over bankruptcy that could not avail themselves of the stock-for-debt exception.

Second, the criticism that corporations will improperly choose bankruptcy over an informal workout solely because of the stock-for-debt exception is premised on the assumption that informal workouts are somehow superior to bankruptcy proceedings in all instances—an assumption that is simply untrue. Consider, for example, the following excerpt from the Senate Judiciary Committee’s report on the Bankruptcy Reform Act of 1978, which outlines some of the non-tax advantages of bankruptcy over an informal workout:

The out-of-court procedure . . . is quick and inexpensive. However, it requires near universal agreement of the business’s creditors, and is limited in the relief it can provide for an overextended business. When an out-of-court arrangement is inadequate to rehabilitate a business, the bankruptcy laws provide an alternative. An arrangement or reorganization accomplished under the Bankruptcy Act binds nonconsenting creditors, and permits more substantial restructuring of a debtor’s finances than does an out-of-court work-out.\(^{308}\)

In addition, the bankruptcy court has nationwide jurisdiction over all creditors, thus alleviating the need to locate and obtain jurisdiction over each creditor separately. Bankruptcy also enhances the debtor corporation’s ability to obtain new loans from lenders because post-petition lenders are accorded special priority status under the Bankruptcy Code.\(^{309}\) Finally, a debtor in bankruptcy can reject certain executory contracts and is afforded the protection of the automatic stay, which freezes all collection actions pending against the debtor.\(^{310}\) These non-tax
advantages of bankruptcy over an informal workout make it an attractive alternative even in the absence of the stock-for-debt exception.\textsuperscript{311}

Because the bankruptcy system offers a number of benefits unavailable outside of bankruptcy, Mr. Kies may be correct that financially distressed corporations might elect to file a chapter 11 reorganization petition rather than attempting an informal workout, but not because of the availability of the stock-for-debt exception, which would apply equally to insolvent debtors in informal workouts. If Congress wants to alter the dichotomy favoring bankruptcy proceedings over insolvency workouts, the entire bankruptcy system should be examined, not just piecemeal tax provisions.\textsuperscript{312}

2. HORIZONTAL EQUITY AND SIMPLICITY CONCERNS

In addition to their efficiency concerns, opponents of the stock-for-debt exception have argued vociferously that it violated two other fundamental goals of tax policy: horizontal equity and simplicity.\textsuperscript{313} It is true that a well-established principle of tax law states that for a tax system to be equitable, it must at a minimum achieve horizontal equity.\textsuperscript{314} Horizontal equity is satisfied if taxpayers in equal positions are treated equally.\textsuperscript{315} Of course, defining when taxpayers are in equal positions is often difficult. For example, two single taxpayers earning identical amounts will have different tax burdens if one taxpayer owns a home while the other rents a home. This is so because Congress has decided to encourage home ownership by allowing deductions for interest paid on a home mortgage, while not allowing a deduction for rent paid on a

\begin{footnotesize}
\textsuperscript{311} Rollyson, supra note 219, at A20.

\textsuperscript{312} There are those who favor abolishing the entire chapter 11 system because it is not economically efficient, allowing weak corporations to survive and undermining the notion that the marketplace will "weed out" the weakest players. This Article is premised on the assumption that chapter 11 is necessary to preserve jobs and promote competition, thereby ultimately strengthening the overall economy. A debate over the efficacy of the entire chapter 11 system is beyond the scope of this Article.

\textsuperscript{313} See, e.g., Kies, supra note 247, at 1623.

\textsuperscript{314} U.S. TREASURY DEP'T, TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH, THE TREASURY DEPARTMENT REPORT TO THE PRESIDENT 14 (1984) [hereinafter 1984 TREASURY REPORT] ("A tax that places significantly different burdens on taxpayers in similar economic circumstances is not fair."); Richard A. Musgrave, ET, OT and SBT, 6 J. PUB. ECON. 3, 4-5 (1976), reprinted in RICHARD A. MUSGRAVE, PUBLIC FINANCE IN A DEMOCRATIC SOCIETY 260, 260-61 (1986); see also Stuart Rosow, The Treasury's Tax Reform Proposals: Not a "Fair" Tax, 3 YALE L. & POL'Y REV. 58, 61 (1984). Of course, an equitable tax system must also achieve vertical equity, in which taxpayers having differing income levels "pay differing proportions of their income in tax." Id.; see also MUSGRAVE, supra, at 261. The current system's progressive tax rate structure is said to achieve vertical equity, although not all scholars have accepted this conclusion. See, e.g., Rosow, supra, at 62.

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principal residence. Thus, taxpayers with identical income levels are not equally situated if there is a valid policy justification for treating the two taxpayers differently by, for example, allowing expenses of only one taxpayer to be deducted against income.

Thus, if Congress seriously considers this proposal, critics of the stock-for-debt exception will surely attack the proposal as inconsistent with notions of horizontal equity. "The exception causes taxpayers to be treated differently, merely because of their status as bankrupt or insolvent debtors. The exception, therefore, creates an uneven playing field . . ." These critics will argue that the stock-for-debt exception gives taxpayers a "head start" rather than a "fresh start."

The response to this criticism is obvious. Financially troubled corporations that are insolvent or involved in chapter 11 bankruptcy proceedings are not in an equal position with financially solvent corporations for two reasons. First, bankrupt and insolvent corporations are financially unable to pay any tax due on cancellation of indebtedness income, while solvent corporations are financially able to do so. Second, and more importantly, the stock of a solvent corporation not in bankruptcy can be valued with reasonable accuracy, often on an established securities exchange. Thus, the amount of its discharge of indebtedness income can be easily determined at the time of the stock-for-debt exchange. Conversely, the stock of an insolvent corporation or one in bankruptcy cannot be valued accurately. It is therefore impossible to calculate the amount of its discharge of indebtedness income at the time of the exchange.

316. I.R.C. § 163(h)(3) (West 1988 & Supp. 1998). One could certainly argue that there is no valid policy justification for encouraging home ownership over home rental, but that is beyond the scope of this Article.

317. Much of this paragraph, including the definition of horizontal equity, was taken from Michelle Arnopol Cecil, Toward Adding Further Complexity to the Internal Revenue Code: A New Paradigm for the Deductibility of Capital Losses, 1999 U. ILL. L. REV. 1083, 1128-29.

318. Kenneth J. Kies, Repeal the Stock-For-Debt Exception, AM. BANKR. INST. J., July-Aug. 1993, at 18, 41; see also Williams, supra note 38, at 174 ("The stock-for-debt exception violates the horizontal equity principle because it allows insolvent and title 11 taxpayers to preserve their tax attributes while it prevents solvent taxpayers from doing the same."). It is interesting to note that, in another article, Kies also attacked the exception as a violation of horizontal equity, defining the term as follows: "taxpayers with similar incomes should pay similar amounts of tax." Kies, supra note 247, at 1623. This is not, however, the widely accepted definition of horizontal equity.

319. Kies, supra note 318, at 42. One commentator responded that the "head start" argument was a "shibboleth," and the terms "head start" and "fresh start" were merely "anodynes for the pains of reasoning." Asofsky, supra note 23, at 13-78 (quoting Judge Learned Hand in Comm'r v. Sansome, 60 F.2d 931, 933 (2d Cir.), cert. denied, 287 U.S. 667 (1932)).


321. For a more comprehensive discussion of these stock valuation issues, see supra note 251 and accompanying text.

322. See supra note 252 and accompanying text.
of the exchange. Thus, waiting until creditors that receive stock in the exchange sell or dispose of their stock before determining the debtor’s discharge of indebtedness income does not violate notions of horizontal equity; it does, however promote fundamental fairness.  

Opponents of reinstating the exception are also likely to criticize it for violating another goal of tax policy: simplicity. “The stock-for-debt exception, along with debt restructurings in general, presents difficult and complex implementation issues . . . . The repeal of the stock-for-debt exception clearly would lessen some of that complexity.” It is conceded that the proposal outlined herein will not simplify the Internal Revenue Code. A mere glance at the multi-page proposed statutory language bears witness to the added complexity that this proposal will create. Yet complexity is inevitable because human circumstances and financial transactions take so many forms. 

The desire to simplify the Code is not a new idea. Thomas Adams once stated that he would “vote for simplicity and inequality, selecting many simple taxes at light rates rather than more equitable but more complex taxes at heavier rates.” Yet however old the desire for tax simplification might be, attempts at broad scale simplification of the Code have failed miserably. For example, one of the three principal goals of the Tax Reform Act of 1986 was to create a simpler tax system. The Tax Reform Act of 1986 did not, however, achieve the simplification that its drafters had so desired. Several explanations for this failure have been offered. One of the most persuasive arguments, and one that echoes Adams’s dilemma, is that attempting to satisfy the dual goals of the equitable distribution of tax burdens and the need for achieving certainty in determining one’s tax liability necessarily leads to complexity.

323. It should be noted that the current Code already treats insolvent and bankrupt corporations differently than solvent corporations for tax purposes. While the latter must recognize discharge of indebtedness income currently, the former are entitled to forego income recognition and instead reduce their tax attributes by a like amount. See supra notes 67-85 and accompanying text. Yet no critics have argued that this difference in tax treatment violates horizontal equity. Williams, supra note 38, at 174.

324. Kies, supra note 247, at 1626.

325. Much of the discussion that follows on the complexity issue is taken from Cecil, supra note 317, at 1137-38.


327. S. REP. NO. 99-313, pt 2, at 3-4 (1986), reprinted in 1986-3 C.B. 3-4; see also 1984 TREASURY REPORT, supra note 314, at 15:

An important goal of the Treasury Department study of fundamental tax reform is simplification. During June of 1984, the Treasury Department held hearings on fundamental tax reform in seven U.S. cities. One of the themes repeated most frequently by citizens appearing at those hearings was the need for simplification of the income tax.

Id.

“Complexity is a bi-product of a tax regime’s reconciliation of the lofty aspiration to distribute tax burdens equitably and the mundane requirement that the tax be susceptible to administration and compliance.” 329 It is simply impossible to achieve simplification in a complex society. 330

Moreover, empirical data suggest that “complication of a tax regime is correlated with the amount of tax revenue that the regime raises.” 331 Thus, the federal income tax system, which raises and often redistributes significant revenue each year, is likely to be more complex simply because the stakes are so high. 332 In addition, the specific needs demanded by special interest groups and lawmakers’ drafting competence (or incompetence) also add to the complexity of the Code. 333

In the final analysis, complexity is inevitable in a politically-based tax system that often succumbs to interest group pressure. 334 More importantly, complexity may even be desirable because it promotes the dual goals of equity and certainty. 335 Until the goals of raising revenue and implementing public policy are divorced from the Code—an unlikely occurrence—the Code will retain its complexity in all its grandeur.

VI. CONCLUSION

Bankruptcy scholars and policymakers cannot continue to ignore the myriad tax issues that plague the chapter 11 bankruptcy system. Congress has consistently undermined the rehabilitative goals of chapter 11 by enacting ill-considered tax legislation without understanding its bankruptcy policy implications. The repeal of the stock-for-debt

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329. Paul, supra note 328, at 155.
331. Paul, supra note 328, at 173.
332. Bittker, supra note 330, at 2 (“When such a tax [the income tax] is imposed on tens of millions of taxpayers at rates yielding tens of billions of dollars, only an incorrigible optimist could expect the kind of simplicity that can be achieved with a poll tax... Income taxation entails a high level of irreducible complexity.”).
333. Paul, supra note 328, at 176-77:
[S]ince tax simplicity is not an ideal that is likely to develop its own independent constituency, complicated, intractable, and incoherent legislation is likely to ensue, according to the public choice view, as self-promoting politicians pander to the special interests by sprinkling loopholes throughout the federal income tax without any regard for the costs imposed on the rest of society.
Id.
334. McCaffery, supra note 330, at 1304-07; Paul, supra note 328, at 164.
335. Paul, supra note 328, at 163. But see McCaffery, supra note 330, at 1268, 1284-87 (arguing that complexity often fails to promote equity).
exception remains a glaring example of this growing trend away from responsible congressional decision-making.

Reinstating the stock-for-debt exception for insolvent corporations and those involved in bankruptcy proceedings and strengthening it to better comport with current tax policy will not solve all of the problems inherent in the chapter 11 system. It will, however, bring Congress one step closer to harmonizing bankruptcy and tax policy, and will move chapter 11 one step closer to realizing its important goals of rehabilitating financially distressed corporations, preserving jobs, and fostering economic growth.