

American Bankruptcy Institute Law Review

Volume 3 Number 2 Winter 1995

EXAMINING THE IMPACT FROM THE REPEAL OF THE STOCK-FOR-DEBT EXCEPTION

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The Omnibus Budget Reconciliation Act of 1993 (the "1993 Act")¹ repealed the provision under former IRC section 108(e)(10) that allowed a debtor corporation to exchange stock for debt in a title 11 case, or to the extent of the debtor's insolvency, without reducing any positive tax attributes.² It appears, however, that the repeal of the stock-for-debt exception was incorporated into the 1993 Act without the opportunity for public hearings and without the chance for members of Congress to fully understand the economic impact of the repeal.³

An examination of public companies that had a plan of reorganization confirmed during 1988-1992 revealed that the tax savings resulting from the repeal of the stock-for-debt exception for these companies, if the repeal had been effective for all Chapter 11 plans confirmed after January 1, 1988, would represent only a small portion of the increase in tax revenue estimated in the 1993 Act. If the estimate in the 1993 Act is correct, the remainder of the revenue raised from a repeal of the stock-for-debt exception would be from *smaller, mostly nonpublic companies*. If this is the case, the companies being affected would be those *least* able to afford it. Furthermore, the experience of many practitioners is that a majority of the tax benefit is realized by public companies.⁴ This suggests that the estimate used in the Omnibus Budget Reconciliation Act is much greater than what the actual tax savings will be.⁵

Any modification of the stock-for-debt exception should have been made only after an appropriate study of the bankruptcy and restructuring process. The objective of this Article is to examine the impact that the repeal of the stock-for-debt exception will have on tax revenue, and to suggest that the limited amount of revenue that will be generated as a result of the repeal will be offset by losses in revenue due to the loss of jobs and an increase in company liquidations that will occur when companies no longer have this benefit.⁶

I. Background

A. The Stock-for-Debt Exception

Former IRC section 108(e), as amended by the Bankruptcy Tax Act of 1980,⁷ acknowledged the general rule developed by courts that the exchange of stock for debt did not require the recognition of income for the corporation who was relieved of the debt.⁸ In *Capento Securities Corp. v. Commissioner*, the Board of Tax Appeals held that the exchange of preferred stock for debentures did not give rise to cancellation of indebtedness income because the exchange had merely substituted a capital stock liability for a debt liability.⁹ Cases following *Capento* extended the holding of the Board of Tax Appeals to common stock.¹⁰ After the 1940s, the stock-for-debt exception was applied by courts.¹¹

In the Bankruptcy Tax Act of 1980,¹² Congress modified the longstanding stock-for-debt exception by stating that the exception did not apply in *de minimis* cases.¹³ Application of the exception required that: (1) the stock issued was not nominal or token, and (2) the stock issued satisfied the proportionality rule.¹⁴

Two subsequent modifications to the stock-for-debt rules eliminated some of the abuses that had developed and restricted the application of the rules to certain cases. As interest rates increased and the market price of public debt declined in the early 1980s, corporations entered into stock-for-debt swaps with investment bankers.¹⁵ The investment bankers would buy the debt, exchange the debt for stock and sell the stock to the public.¹⁶ The gain on the cancellation of the debt was not taxed and did not result in the reduction of tax attributes.¹⁷ Congress considered this practice to be an abuse of the stock-for-debt rules, and in the Deficit Reduction Act of 1984,¹⁸ repealed the stock-for-debt rules except for debtors in bankruptcy or insolvency (limited to the extent of insolvency).¹⁹ The other major modification was made by the Omnibus Budget Reconciliation Act of 1990.²⁰ This Act provided that the stock-for-debt exception did not apply to the issuance of redeemable preferred stock for debt,²¹ and thus the debtor was prevented from redeeming the stock before the creditor had an opportunity to recover the full amount of the debt.²²

B. Net Operating Loss

Net operating loss is a valuable positive tax attribute to a reorganizing debtor.²³ Without the stock-for-debt exception, the desire to maintain net operating loss carryover becomes an important factor in the operations of a reorganizing debtor. Prior to the repeal of the stock-for-debt exception corporations were able to protect this valuable asset.²⁴ When the Bankruptcy Tax Act of 1980 became effective, IRC section 382 provided that under certain conditions, the use of part or all of the net operating loss carryover could be limited.²⁵ Under the old IRC section 382(a), in order to preserve the net operating loss when there was an internal restructuring, the debtor corporation had to satisfy the business test or avoid a change of ownership.²⁶ To satisfy the business test under subsection (C), the debtor must have continued to carry on substantially the same trade or business that it conducted prior to the change in ownership.²⁷ The determination of whether a corporation satisfied the trade or business test was based on all relevant facts and circumstances, including changes in employees, equipment, products, location, customers and other items.²⁸ While the addition of other business did not affect the business continuity requirement, discontinuance of "more than minor" activities did not constitute carrying on substantially the same business.²⁹ If there was a change in business, section 382(a) required that the corporation avoid a change in ownership or forfeit the net operating loss carryover.³⁰ A change in ownership occurred when the ten largest stockholders at the end of any given year increased their ownership of the debtor corporation's stock by 50 percentage points or more through purchases in that year or the preceding year.³¹

The old IRC section 382(b) also limited the use of the net operating loss carryover in whole, or in part, in the case of a tax-free reorganization, unless the shareholders of the loss corporation owned at least twenty percent of the fair market value of the outstanding stock of the acquiring corporation.³² Legislative history to the 1986 Act indicates that Congress believed that changes in a loss corporation's stock ownership was the best indicator of a potentially abusive transaction.³³ Stated differently, use of the net operating loss should be limited to the income earned by the loss corporation, and the acquiring corporation should not be able to use more of the net operating loss than the loss corporation could have used had there been no change in stock ownership.³⁴ To achieve this objective, Congress provided in the 1986 Act, that if the percentage of stock owned by the shareholders increased by more than fifty percentage points within a three-year period (a "change of ownership"), the use of the acquired loss corporation's net operating loss carryover in each future year is limited to the value of the shareholders' equity multiplied by the long-term tax exempt bond rate.³⁵

The key to the loss reduction rules is the ownership change. Until an ownership change takes place, there is full utilization of losses without a "section 382 limitation," and none of the numerous restrictions and limitations of IRC section 382 apply.³⁶ An ownership change occurs when the percentage of stock of the new loss corporation owned by one or more five percent shareholders has increased by more than fifty percentage points relative to the lowest percentage of stock of the old loss corporation owned by those five percent shareholders at any time during the testing period (generally, three years).³⁷

The determination of whether an ownership change has occurred on a date on which there has been an owner shift (the "testing date") is made by aggregating the increases (and ignoring the decreases) in percentage ownership for each five percent shareholder during the prior three year period.³⁸ The three year period does not begin before the earlier of the first day of the first taxable year from which there is a loss or credit carryforward to the first postchange year or

the taxable year in which the tested transaction occurs.³⁹ All stock owned by persons who own less than five percent of a loss corporation is generally treated as stock owned by a single five percent shareholder.⁴⁰

The ownership change test bears a distinct similarity to old IRC section 382(a) and the definition of "purchase." Under prior law, a determination was made as to whether the ten largest shareholders of the loss corporation increased their ownership interest in the loss corporation by fifty percentage points or more, over the previous two taxable years.⁴¹ However, prior law had two completely different tests, depending on whether there was a taxable purchase (ten largest shareholders and fifty percent change of ownership)⁴² or a tax-free reorganization (twenty percent continuity of shareholder interest).⁴³ New IRC section 382 has one test: an ownership change by five shareholders of more than fifty percentage points over the lowest ownership percentage of such shareholders during the past three years.⁴⁴ Although the statutory framework categorizes an ownership change as either (1) an owner shift involving five percent shareholders,⁴⁵ or (2) an equity structure shift (*i.e.*, a reorganization),⁴⁶ they generally receive the same treatment under section 382.⁴⁷ The 1986 Act contained special provisions for companies in bankruptcy.⁴⁸ Section 382(l)(5)(A) provides that in situations where the creditors and shareholders of the loss corporation own fifty percent or more of the value of the new loss corporation, the net operating loss carryover may survive.⁴⁹ However, the amount of the loss that may be otherwise available will be reduced by:

(i) The interest expense deducted during the three full years prior to the ownership change, plus interest deducted up to the date of the ownership change in the year of the change,⁵⁰ or

(ii) fifty percent of the gain from the discharge of debt that was excepted from gain by the issuance of stock under IRC section 108(e)(10) (prior to repeal).⁵¹

In addition, if there is another change of ownership within the next two years, the balance of the net operating loss that existed prior to the previous change of ownership will be eliminated.⁵² The 1986 Act also added IRC section 382(l)(6) for those companies in title 11 that do not qualify for the IRC section 382(l)(5) exception, or elect not to have section 382(l)(5) apply.⁵³ Under section 382(l)(6), the section 382 limitation (use of the net operating loss each year is limited to the value of the equity of the loss corporation multiplied by the long-term, tax-exempt bond rate) applies, however, the limitation is based on the enhanced value of the corporation after the ownership change.⁵⁴ Section 382(l)(6) has encouraged companies that reorganize to issue large amounts of stock for debt, resulting in a much more favorable balanced capital structure.⁵⁵

C. Repeal of the Stock-for-Debt Exception.

The retention of the stock-for-debt exception was a part of the Bankruptcy Tax Act of 1980,⁵⁶ which was the result of nearly a decade of public hearings and study of the restructuring process.⁵⁷ The repeal of the stock-for-debt exception originally appeared as part of a special interest bill, in which the repeal was proposed as a means of making the bill revenue neutral.⁵⁸ The special interest bill was incorporated into 1992 tax legislation without opportunity for public hearings, and became part of the total budget reduction package as passed by the Senate in late June, 1993.⁵⁹ The tax bill as passed by the Senate contained the repeal and the House version did not.⁶⁰ However, the Joint House and Senate Committee included the repeal, but delayed the effective date to all transactions completed after December 31, 1994.⁶¹ The repeal does not apply to bankruptcy petitions filed before January 1, 1994.⁶²

II. Justification for the Stock-for-Debt Exception

The justifications for resurrecting the stock-for-debt exception are theoretical as well as practical, based on policy implications and economic impact.

A. More Debt Will Be Left In Place

With the repeal of the stock-for-debt exception, restructuring corporations will leave more debt in place.⁶³ One of the major reasons that creditors were willing to take stock in a chapter 11 reorganization was because of the tax benefit derived from the availability of the stock-for-debt exception.⁶⁴ Without the benefits of this exception, both creditors and corporate debtors will be encouraged to leave more debt in place after a restructuring, placing the

prospects for a successful restructuring at a substantially greater risk.⁶⁵ This is especially true for nonpublic companies where the primary reason a creditor is willing to exchange its debt for stock is the ability of the nonpublic debtor to preserve part of the net operating loss.⁶⁶ In other words, the corporation would have a larger portion of debt in its capital structure, a situation that contributed to the bankruptcy in the first place.

The repeal of the stock-for-debt exception eliminated one of the few provisions in the tax laws that encouraged companies to have a financially strong equity structure.⁶⁷ Instead, the repeal serves as an incentive for corporations to have as much debt on their books as possible to utilize the interest deductibility provision.⁶⁸ The elimination of the stock-for-debt exception reduces the tax incentive to issue stock and correspondingly increases the incentive to issue debt in order to receive an interest deduction.⁶⁹ Under the stock-for-debt exception, many companies reorganized in order to have a significant portion of the value of their capital structure in the equity section of the balance sheet.⁷⁰ It is unfortunate that the repeal of the stock-for-debt exception will cause a reversal of this trend.

B. The Potential For Significant Loss of Jobs

Use of the stock-for-debt exception allows troubled companies to amortize debt principal out of pre-tax dollars as opposed to after-tax dollars.⁷¹ A repeal of the stock-for-debt exception, however, causes post-restructuring corporations to pay higher income taxes.⁷² The increased income tax liability could be more than twice the amount of cash available to pay off debt principal during the critical years after completion of the restructuring.⁷³ This is because the post-restructuring corporation would have to pay cash income taxes on its taxable income applied to pay nondeductible loan principal and nondeductible capital expenditures that exceed depreciation.⁷⁴ The resulting increase in risk for secured creditors could lead to a forced liquidation in many circumstances, resulting in a loss of jobs.⁷⁵

In many industries, a liquidation would not result in re-employment of the troubled company's work force in the same industry. To appreciate the magnitude and severity of the problem, one only need look to failed reorganizations in: the furniture industry [Barker Brothers (275 employees),⁷⁶ RB Furniture, Inc. (500 employees)],⁷⁷ the retail industry [Highland Superstores (1,200 employees),⁷⁸ Goldenberg Caplan Pierce, Inc. (200 employees),⁷⁹ Raleighs (300 employees),⁸⁰ and Pay 'N Pak (2,200 employees)],⁸¹ the manufacturing industry [Bayly Corp. (3,000 employees),⁸² El Dorado Motors Corp. (300 employees),⁸³ and Cruden Martin (280 employees)], and the airline industry [Eastern Airlines (18,000 employees),⁸⁴ Florida Express (950 employees),⁸⁵ Wein Airlines (1,070 employees), Frontier Airlines (5,700 employees), Midway Airlines (5,880 employees),⁸⁶ and Braniff Airlines (3,900 employees)],⁸⁷ among others. The large majority of the employees of these firms became displaced workers, forced to seek re-employment in other industries. Thus, repeal of the stock-for-debt exception could force many re-organized companies into complete liquidation, leading to significant loss of jobs.

C. The Economic Burden On Financial Institutions

The repeal of the stock-for-debt exception will cause a significant portion of the economic burden to fall on banks, insurance companies, and other financial institutions. As a result, this burden will in be passed on to their customers or the governmental units responsible for supervision of insolvent institutions. These institutions hold fifty percent or more of the claims that are discharged with stock in many restructuring cases.⁸⁸ The value of both the stock and the debt that they hold after a restructuring will be reduced by the repeal of the stock-for-debt exception.⁸⁹

D. The Effect On Small Businesses

One of the major concerns expressed by the Clinton administration in the area of economic policy has been the plight of small business. Many economic policies have been proposed to help small businesses, and this concern has been part of the Clinton economic policy since the beginning of his campaign.⁹⁰ The repeal of the stock-for-debt exception violates this fundamental concern since the majority of organizations affected would be small, non-public corporations.⁹¹ Retention of the stock-for-debt exception, on the other hand, would have benefited these small businesses by allowing them to avoid the high debt position that lead to financial trouble in the first place.⁹² In addition, a major thrust of the Clinton economic policy has been to shift the tax burden to those most able to afford it.⁹³ The repeal of the stock-for-debt exception, however, removes a tax benefit from those least able to afford it,

companies already in financial difficulty.

E. Companies Will Seek To Preserve Net Operating Loss

The repeal of the stock-for-debt exception reduces the amount of available net operating loss carryforward by the amount of the gain on the discharge of debt.⁹⁴ In response, companies will search for other options that allow their net operating loss to remain in place.⁹⁵ As a result, there will not be a significant change in the amount of the net operating loss carryforward. Thus, the tax benefits that were suggested by the staff of the Joint Committee on Taxation will not be realized unless a major allowance is made for the adoption of other strategies by debtors in chapter 11.

Due to the repeal, the incentive will be for debtors, especially those that issue non-public debt, to issue as much debt as possible in order to reduce the gain from debt discharge, thereby preserving the net operating loss.⁹⁶ For example, if the debtor has the option to (1) issue stock for debt, which would result in a gain, or (2) discharge the difference between the market value of the stock and the tax basis of the debt by the issuance of a very long-term note with a face amount equal to the tax basis of the old debt that has the minimum allowable interest rate under IRC section 1274(d) to avoid the original issue discount (OID) rules, the latter option will be selected because there will not be any reduction in tax attributes.⁹⁷ The corporation has a much better chance to successfully reorganize and emerge from bankruptcy if the first option is selected. However, as is true with tax policy in general, companies are encouraged by the tax law to have as much debt on the books as possible.⁹⁸ This debtor will most likely be unsuccessful in their attempt at reorganization, and will find themselves back in bankruptcy court. Consider the following example (all values in thousands):

Net operating loss carryforward	\$15,000
Total reorganization value of debtor	\$60,000
Prepetition unsecured debt	\$35,000
Prepetition secured debt	\$20,000
Prepetition taxes	\$ 2,500
Postpetition claims, unpaid administrative expenses, postpetition payables, postpetition taxes, etc.	\$ 7,500
Total interest paid on debt last 3+ years that will be canceled with stock	\$ 4,500
Long-term, tax-exempt bond rate	6.5%

Five million dollars of the unsecured debt is held by the bank and insurance company that hold liens on most of the property of the debtor. With the stock-for-debt exception, a plan similar to Plan A presented below might be developed (all values in thousands):

Plan A

	Debt	Cash	Debt Value	Stock Value
Administrative expenses	\$ 7,500	\$ 2,500	\$ 5,000	
Prepetition taxes	\$ 2,500		\$ 2,500	
Secured debt	\$20,000		\$20,000	
Unsecured debt	\$35,000		\$24,000	
Stockholder, management				\$ 6,000

Prior to the repeal of the stock-for-debt exception, there would be no reduction of the \$15 million net operating loss as a result of the cancellation of debt under IRC section 108.

Under IRC section 382(1)(5), \$5 million of the net operating loss survives, determined as follows (all values in thousands):

Net operating loss		\$15,000
Less:	\$ 4,500	
Interest paid in last 3+ years	\$ <u>5,500</u>	
Fifty percent of the gain on the exchange of stock-for-debt that was not reported due to the stock-for-debt rules [(\$35,000 – \$24,000) x .50]		\$ <u>10,000</u>
Net operating loss available for use		\$ <u>5,000</u>

Under IRC section 382(1)(6), \$1.95 million of the net operating loss would be available for use each year, determined by multiplying the value of the equity of the reorganized company by the long-term, tax exempt bond rate [\$30,000,000 x .065 = \$1,950,000].

With the repeal of the stock-for-debt exception, \$11 million of the net operating loss would be eliminated due to cancellation of debt income on the exchange of stock for debt. Thus, the net operating loss that would be subject to section 382 rules is only \$4 million.

Under IRC section 382(1)(5), none of the net operating loss survives, as shown below (all values in thousands):

Net Operating Loss	\$ 4,000
Less: Interest paid in last 3+ years	(<u>4,500</u>)
Net Operating Loss Available	\$ 0

Under IRC section 382(1)(6), \$4 million of the net operating loss could be used. Thus, if stock is issued for debt, the debtor would elect the IRC section 382(1)(6) option. The annual limitation would be \$1.82 million as shown below (all values in thousands):

Value of reorganized entity prior to repeal	\$30,000
Less: Value of tax benefit of NOL carryforward lost ⁹⁹	\$ <u>2,000</u>
Value of reorganized entity after the repeal	\$28,000
Long-term, tax-exempt bond rate	<u>X .065</u>
Annual limitation	\$ 1,820

Due to the repeal of the stock-for-debt exception, companies, especially those with nonpublic debt, will try to develop a plan that leaves as much debt on the books as possible. ¹⁰⁰ Thus, management may propose a plan that will pay unsecured creditors 100% of the amount of their claim over an extended period of time, with an interest rate that is at least equal to the rate published under 1274(d) in order to avoid the application of the Original Issue Discount rules. ¹⁰¹

As noted above, the \$2 million would be lost due to the repeal if the same plan was adopted and the company elected IRC section 382(1)(6). On the other hand, if the creditors elected to receive debt, the company may be able to preserve all of the net operating loss, and the use each year would not be restricted. ¹⁰² The inability of the company to use \$11 million of the net operating loss and the loss of \$2 million in value will likely encourage the creditors not to accept a plan that involves stock.

A plan similar to Plan B presented below might be proposed by the debtor (all values in thousands):

Plan B

	Debt	Cash	Debt value	Stock value
Administrative expenses	\$ 7,500	\$ 2,500	\$ 5,000	
Prepetition taxes	\$ 2,500		\$ 2,500	
Secured debt	\$20,000		\$20,000	
Unsecured debt	\$35,000		\$25,000 ¹⁰³	
Stockholders, management				\$ 5,000

Note that the unsecured creditor receives value similar to the amount proposed in Plan A. Since the face value of the \$35 million note is equal to the amount of the unsecured debt and the interest rate is within the guidelines of section 1274, there will not be any attribute reduction and all of the net operating loss will be preserved. With this plan, however, the company will most likely either liquidate or be back in the bankruptcy court in a few years.

III. Examination of the Impact of Repeal on Public Firms

A. Results of the Study

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An examination of annual reports of publicly traded firms as reported by The National Automated Accounting Research System ("NAARS") for the period January 1, 1988 to December 31, 1992, and an examination of the list of plans confirmed with assets in excess of \$100 million from the Bankruptcy Yearbook and Almanac¹⁰⁵ for the same period, revealed a total of 142 companies that had a plan of reorganization confirmed during 1988–1992 for which we could obtain financial data.¹⁰⁶ It should be noted that the 142 companies examined represent only publicly traded firms. The remainder of the firms that would be affected by a repeal of the stock–for–debt exception would be smaller, mostly non–public companies. All companies with plans confirmed during 1988–1992 with assets exceeding \$100 million are included in the list, as well as many companies with assets under \$100 million. Exhibit 1, appended at the end of this Article, presents a summary of the total tax savings for the 142 companies due to the stock–for–debt exception. It should be noted that as the economy improves, the number of Chapter 11 petitions that are being filed, especially for larger companies, is beginning to decline.¹⁰⁷ The current sample was taken during a period of time when the number of bankruptcies was abnormally high, and the amount of liabilities associated with those bankruptcies, due to the practice of leveraged buyouts, was relatively large. For each company, the total net operating loss expected to be utilized was estimated for each year during 1989–1993 as if the repeal was effective as of January 1, 1988. Based on these net operating loss figures and an estimated tax rate of 35%, the total tax savings for each company was estimated. Actual net operating loss estimates were obtained from annual reports, disclosure statements, SEC filings, or from communications with either the company or its auditor. The use of the net operating loss carryover was determined by examining subsequent annual reports issued. In situations where subsequent data was not available, estimates were made based on other information, including cash projections in the disclosure statement and from a comparison with other companies of similar size and operating characteristics. The total projected tax savings for each year are presented in Exhibit 1.

Based on the numbers in Exhibit 1, approximately \$100 million in tax savings will result from the repeal of the stock–for–debt exception. This will represent only about 15% of the \$622 million increase in tax revenue estimated in the Budget Reconciliation Act. If it is assumed that the \$622 million value is correct, then the remainder of the revenue raised from the repeal of the stock–for–debt exception will be from smaller, mostly non–public companies. In this case, the companies being affected would be those coming out of reorganization and trying to regain a favorable financial position. These companies are the least able to afford it.

The experience of many practitioners, however, is that a majority of the tax benefit is realized by public companies.¹⁰⁸ This suggests that the estimate used in the Budget Reconciliation Act is much greater than what the actual tax savings will be. Smaller companies that may have taken advantage of the stock-for-debt exception will now issue long-term debt with a face value equal or close to the tax basis of the old debt and will avoid or limit net operating loss reductions.¹⁰⁹

B. Limitations of the study.

It was difficult to assess the tax impact of the repeal of the stock-for-debt exception from the annual reports and disclosure statements. For most companies, the net operating loss before reorganization and the net operating loss after reorganization was able to be determined from the annual reports. Generally, whether the company applied IRC section 382(1)(5) or (1)(6) was also determined. As a general rule, it was assumed that the gain from debt discharge as reported for financial statement purposes was equal to the gain reported for tax purposes. To the extent that there is a difference in these values the estimate of tax savings is incorrect. It was difficult to assess the impact of increases in gains or losses and, as a result, the tax impact of these gains or losses may not be properly determined in all cases.

In situations where the income from debt discharge resulting from the exchange of stock for debt exceeded the amount of the net operating loss carryover, basis and other tax attributes would have been subject to reduction.¹¹⁰ The extent to which basis was reduced is generally not disclosed in the annual report. In some cases that figure was able to be determined through communications with the company or its accountants. In most cases, the tax basis of assets was less than the liabilities after confirmation, resulting in no impact on the estimated revenue. To the extent that basis reduction was overlooked, the tax benefit of the repeal is incorrect. This study only dealt with the impact of net operating loss carryovers. Thus, the extent to which other credits may have impacted the estimated tax was not considered.¹¹¹ For example, the extent to which an investment tax credit carryover would have reduced future tax payments is ignored.¹¹² Once the net operating loss carryovers were used, the assumption was made that any future income was subject to tax. Likewise, the impact of the minimum tax was ignored.¹¹³ As a result, the extent to which a minimum tax liability would have existed in determining the tax impact without the repeal was not taken into account. It was assumed that the company would not change its plan as a result of the repeal of the stock-for-debt exception. Thus, to the extent that a company might have issued debt to reduce the income from debt discharge or avoided a change in ownership because of the repeal is not included in the study.

IV. Implications

Based on the information presented in Exhibit 1, and on an examination of the characteristics of the 142 companies identified, several important implications can be drawn:

1. This study found that over 80% of the corporations with assets in excess of \$100 million issue stock to satisfy debt. Thus, these corporations have substantially improved their prospects for survival by emerging from Chapter 11 with a much better debt-to-equity ratio. A major incentive for banks, insurance companies, trade creditors and other lenders to take stock was the potential value of the net operating loss to the debtor.¹¹⁴ The incentive for the creditor to accept stock will be reduced as a result of the repeal, and corporations could find it much more difficult to emerge from reorganization, and could even be forced into final liquidation.¹¹⁵
2. Most companies that issue stock for debt to preserve net operating losses would still have some net operating loss that would survive even after the repeal of the stock-for-debt rules. Thus, the major tax benefit of the stock-for-debt exception is realized four or more years after the plan is confirmed. For example, in the case of *Lomas Financial Corp. v. Northern Trust Co. (In re Lomas Financial Corp.)*,¹¹⁶ \$1.1 billion of the net operating loss was preserved, yet the repeal of the stock-for-debt rule would not start to be realized until after approximately \$100 million of the net operating loss has been utilized, which might be in the fourth or fifth year. In *In re General Homes Corporation*,¹¹⁷ the disclosure statement indicated that approximately \$50 million of the net operating loss would be carried forward without the stock-for-debt exception. With the stock-for-debt rules, the net operating loss that would survive would be approximately \$86 million. From a sample of 65 companies, 27 companies had net operating loss carryovers in excess of the amount that would be lost as a result of the repeal of the stock-for-debt exception.

3. This study also found that companies experienced losses subsequent to emergence from chapter 11 that resulted in zero tax revenues in the current and subsequent years due to the ability to carryover all of the net operating loss. For example, a sample of 65 companies indicated that 47 experienced loss either in the partial year after the discharge or in the subsequent years within the 1989–1993 period.

4. If 1989–1993 is a representative time period to use, it indicates either that: (1) most of the tax revenues from the repeal of the stock–for–debt exception would be from businesses having less than \$100 million in total assets (that could not be identified in the sample), or, (2) the Joint Tax Committee estimate of \$622 million in tax savings is materially incorrect. The total benefit of the net operating loss during the first five year period beginning January 1, 1989 for the 142 companies that had a plan confirmed during 1988–1992 would be just over \$100 million. Note that we have included in our sample all of the corporations listed by the Bankruptcy Yearbook and Almanac ¹¹⁸ that have assets over \$100 million, as well as several that had asset values of lesser amounts, and all companies listed in the NAARS database for which plans were confirmed during 1988–1992. Thus, out of the \$622 million in additional tax revenue that would be collected over the next five years based on a repeal of the stock–for–debt rules, over \$500 million would be realized by smaller, mostly non–public companies. If companies with assets under \$100 million will not realize this amount of savings, then the \$622 million estimated value of the stock–for–debt repeal was overvalued by Congress.

5. In light of the impact the repeal of the stock–for–debt exception will have on small businesses, California and the West Coast will suffer the most from the repeal. With continued reductions in defense spending and with the closings of military bases, ¹¹⁹ many of the small and medium sized companies will find it even more difficult to reorganize. Since the recovery in California and the other West Coast states has not reached the stage that it has in other parts of the country, ¹²⁰ it seems counterproductive to remove the stock–for–debt exception from the options available to these businesses as they attempt to reorganize. The delay of the effective date of the repeal until January 1, 1995 will be of some benefit, but not enough, since the financial recovery in California was not be completed by the effective date.

6. Neither this study nor the revenue estimates by the Joint Tax Committee, take into consideration the cost, including lost revenue, to federal, state, and local governments as a result of the loss of jobs that will occur when the repeal of the stock–for–debt exception is effective. ¹²¹ Also unconsidered, but extremely important, is the cost to the government as a result of the increases in bank and insurance failures that could occur with this repeal.

Conclusion

The stock–for–debt exception allowed companies to emerge from bankruptcy and reorganization with a much more favorable capital structure. The tax benefits provided an incentive for debtors to take stock, as opposed to a more terminal form of liquidation. The retention of the exception in 1980 was intended to achieve a balance between good tax policy and good bankruptcy policy. Although a repeal of the stock–for–debt exception was previously incorporated into 1992 tax legislation without the opportunity for public hearings or for members of Congress to understand the economic impact of the proposed repeal, ¹²² President Bush vetoed this legislation. ¹²³ The inclusion of the repeal in the Omnibus Budget Reconciliation Act of 1993 was similarly made without any hearings. ¹²⁴

Any modification of the stock–for–debt exception should only have been made after an appropriate study of the bankruptcy and restructuring process. Thus, it is recommended that Congress effectively examine the impact that past changes to the Internal Revenue Code have had on eliminating the abuses, and more carefully determine the true dollar impact resulting from the repeal of the stock–for–debt exception.

EXHIBIT 1

Condensed Summary of the Total Projected Tax Savings for 1989–1993 ¹²⁵

Impact in Year:

Year Plan is Confirmed:	1989	1990	1991	1992	1993	TOTAL

1988	0.00	0.00	0.00	0.00	0.00	\$ 0.00
1989		0.00	0.01	0.02	1.75	\$ 1.78
1990			11.78	11.68	9.89	\$ 33.35
1991				6.22	4.94	\$ 11.16
1992					55.16	\$ 55.16
5 YEAR TOTAL	\$ 0.00	\$ 0.00	\$ 11.79	\$ 17.92	\$ 71.74	\$101.45

FOOTNOTES:

* Professor of Accounting, Pepperdine University. [Back To Text](#)

** Associate Professor of Accounting, Pepperdine University. [Back To Text](#)

¹ [Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312.](#) [Back To Text](#)

² I.R.C. § 108(e)(10) (1988), *repealed by* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, § 13226(a), 107 Stat. 312, 487 (current version at I.R.C. § 108(e)(8) (Supp. V 1993)). The repeal of the stock-for-debt exception is effective for all transactions after December 31, 1994, except for petitions filed in a title 11 case on or before December 31, 1993. *Id.* For a general discussion of the repeal see Edward A. Liva, *The Impact of the 1993 Tax Act on Debt Relief and Workouts*, 12 Am Bankr. Inst. J., Nov. 1993, at 13. [Back To Text](#)

³ See Letter of Herbert L. Camp to Rep. Dan Rostenkowski (D-Ill.), *Cancellation of Indebtedness-Stock-for-Debt Exception*, 59 Tax Notes 573, 573 (1993) (arguing that proposed repeal of exception was neither subject to congressional hearings nor widely discussed). [Back To Text](#)

⁴ See Adam O. Emmerich, Comment, *Hybrid Instruments and the Debt-Equity Distinction in Corporate Taxation*, 52 U. Chi. L. Rev. 118, 142-47 (1985) (analyzing different tax treatment of public companies). [Back To Text](#)

⁵ H.R. Conf. Rep. No. 213, 103d Cong., 1st Sess. 141 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088. [Back To Text](#)

⁶ See Grant Newton & Paul Wertheim, *An Examination of the Effect of the Repeal of the Stock for Debt Exception*, 61 Tax Notes 727 (Nov 8, 1993) (discussing earlier study involving 27 companies). [Back To Text](#)

⁷ [Bankruptcy Tax Act of 1980, Pub. L. No. 96-589, 94 Stat. 3389.](#) [Back To Text](#)

⁸ See, e.g., [Tower Bldg. Corp. v. Commissioner](#), 6 T.C. 125, 135 (1946) (holding that exchange of stock was not cancellation or reduction of indebtedness creating realization of income); [Capento Sec. Corp. v. Commissioner](#), 47 B.T.A. 691 (1942) (holding that reorganization provisions protected issuer from recognizing gain when it discharged debt by issuing stock with fair market value less than face amount of debt), *aff'd*, 140 F.2d 382 (1st Cir. 1944).

While Congress did not expressly codify the stock-for-debt exception in the Bankruptcy Tax Act of 1980, Congress did acknowledge that it intended to preserve the existing common law rule. 1A Collier on Bankruptcy ¶ 15.03(2)(a) (Lawrence P. King ed., 15th ed. 1995). [Back To Text](#)

⁹ [Capento](#), 47 B.T.A. at 695. The court stated that:

[I]t is hard to see that gain was in fact realized. The corporation had a liability of \$500,000 on the bonds having presumably borrowed that amount. While it discharged that liability, it created a new stock interest which became a balance sheet liability called capital stock. This is plainly different from the discharge of indebtedness by the payment of money in a less amount than the indebtedness, as in *Kirby Lumber Co. v. United States*. . . . Even though the shares issued are . . . worth only \$50,000, the amount whereby the par value exceeds the present value is not a gain, for it is the par value which measures the capital stock liability.

Id.Back To Text

¹⁰ See Motor Mart Trust v. Commissioner, 4 T.C. 931, 937 (1945) (holding that exchange of debt for common shares was not realization of taxable income), aff'd, 156 F.2d 122 (1st Cir. 1946); Alcazar Hotel, Inc. v. Commissioner, 1 T.C. 872, 879–80 (1943) (stating that substitution of common stock for mortgage note did not affect cancellation or reduction of indebtedness); Claridge Apartments Co. v. Commissioner, 1 T.C. 163, 173–74 (1942) (holding that substitution of common stock for bonds was not cancellation or reduction of indebtedness which would cause gain realization), modified, 138 F.2d 962 (7th Cir. 1943), rev'd, 323 U.S. 141 (1944).

While there is some question as to whether the Supreme Court implicitly affirmed the stock–for–debt exception in its reversal of the Seventh Circuit decision in *Claridge*, the Tax Courts have read it as doing so. 1A Collier on Bankruptcy, supra note 8, ¶ 15.02. For a further discussion of *Claridge*, see Paul H. Asofsky, *Discharge of Indebtedness Income in Bankruptcy After the Bankruptcy Tax Act of 1980*, 27 St. Louis U. L.J. 583, 605–07 (1983).Back To Text

¹¹ See Scott Paper Co. v. Commissioner, 74 T.C. 137, 162–66 (1980) (discussing treatment of interest on debentures convertible into common stock); Ades v. Commissioner, 38 T.C. 501, 510 (1962) (citing Capento for principle that conversion of bonds for stock does not result in recognizable gain or loss to corporation) (citation omitted), aff'd, 316 F.2d 734 (2d Cir. 1963).Back To Text

¹² Pub. L. No. 96–589, 94 Stat. 3389.Back To Text

¹³ Id. § 2, 94 Stat. at 3394. This limitation was codified at I.R.C. § 108(e)(8). Prior to the repeal under the 1993 Act, § 108(e) stated:

(8) 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—

(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.

I.R.C. § 108(e)(8) (1988 & Supp. IV 1992).Back To Text

¹⁴ I.R.C. § 108(e)(8).Back To Text

¹⁵ See Patricia L. Bryan, *Cancellation of Indebtedness by Issuing Stock in Exchange: Challenging the Congressional Solution to Debt–Equity Swaps*, 63 Tex. L. Rev. 89, 90 (1984) (discussing Wall Street's use of "debt–equity swap" to cure high interest rates and diminished earnings).

For additional information on the popularity of the stock–for–debt exception with investment bankers, see Hershman, *Making Money in Stock–Bond Swaps*, Dun's Bus. Month, Nov. 1981, at 66; Anders, *Corporations Find Help for Balance Sheets: Swaps Costly Debt for Low–Yielding Stock*, Wall St. J., June 30, 1982, at 25; Sloan & Spragins, *It's a Super Deal*, Forbes, Dec. 7, 1981, at 39.Back To Text

¹⁶ Bryan, supra note 15, at 93 (explaining mechanics of swap transactions).Back To Text

¹⁷ Id. at 90 (stating that corporations retired discounted debt in exchange for stock while not recognizing taxable gain).Back To Text

¹⁸ Pub. L. No. 98–369, 98 Stat. 494 (codified as amended in scattered sections of IRC).Back To Text

¹⁹ Id. § 59 at 576 (codified at I.R.C. § 108(e)(10) (1988)). Prior to the repeal, I.R.C. § 108(e)(10) stated:

(10) 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.

(B) Exception for title 11 cases and insolvent debtors

Subparagraph (A) shall not apply in the case of a debtor in a title 11 case or to the extent the debtor is insolvent.

Id. Back To Text

²⁰ Pub. L. No. 101–508, 104 Stat. 1388. Back To Text

²¹ Id. § 11325 at 1388–466 (codified at § 108(e)(10)(B) (1988 & Supp. IV 1993)). For additional information see H.R. Conf. Rep. No. 964, 101st Cong., 2d Sess. (1990). Back To Text

²² Omnibus Budget Reconciliation Act of 1990, § 11325, 104 Stat. at 1388–466. Back To Text

²³ See James Gadsden & Christopher H. Smith, Bankruptcy Reform Act: The Bankruptcy Reform Act of 1994, 112 Banking L.J. 212, 226 (1995) (stating "net operating loss . . . [is] an important asset to create value in many bankruptcy cases and an incentive for reorganization"); Katherine Pratt, Shifting Biases: Troubled Company Debt Restructuring After the 1993 Tax Act, 68 Am. Bankr. L.J. 23, 25 (1994) ("The NOLs are a valuable asset because they can shelter the corporations income following the restructuring, and thus reduces the tax that the corporation must pay in the years following the restructuring."). Back To Text

²⁴ Under the stock–for–debt exception, not only did the debtor not have to recognize any cancellation of debt income, they did not have to decrease any positive tax attributes in the corresponding amount. Pratt, supra note 23, at 25. Back To Text

²⁵ See Internal Revenue Code of 1954, Pub. L. No. 83–591, § 382, 68A Stat. 3, 129–31 (codified as amended at I.R.C. § 382 (1988)). For a historical accounting of the § 382 operating loss limitation see Daniel L. Simmons, Net Operating Losses and Section 382: Searching for a Limitation on Loss Carryovers, 63 Tul. L. Rev. 1045 (1989). Back To Text

²⁶ See Internal Revenue Code of 1954, § 382(a)(1)(A)–(C), 68A Stat. at 129 (indicating that limitation applies only when corporation suffers change of ownership and change of business); S.F.H., Inc. v. Commissioner, 444 F.2d 139, 141 (3d Cir.) (stating that corporation which has substantial change of ownership may utilize net operating loss carryovers only if trade or business remains substantially similar), cert. denied, 404 U.S. 913 (1971). Back To Text

²⁷ See Six Seam Co. v. United States, 524 F.2d 347, 354 (6th Cir. 1975) (holding continuity of business requirement not satisfied when corporation suspended active operations and redeemed stock and sold it at nominal price); S.F.H., 444 F.2d at 142 (holding that corporation which terminated furniture rental sales two years before ownership change had not continued substantially same trade or business); Exel Corp. v. United States, 451 F.2d 80, 83–84 (8th Cir. 1971) ("The statute in plain and unambiguous language requires that the corporation continue a trade or business substantially the same as that conducted before the change in ownership."). But see Glover Packing Co. v. United States, 328 F.2d 342, 348 (Ct. Cl. 1964) (stating that temporary break does not destroy required continuity). Back To Text

²⁸ Treas. Reg. § 1.382(a)–1(h)(5) (amended 1991) discusses the various factors that are to be considered in determining whether there is a continuation of the same business enterprise. These factors are to be considered in light of the general objective of IRC § 382(a). Id.; *see, e.g., Coast Quality Constr. Corp. v. United States*, 463 F.2d 503, 511–12 (5th Cir. 1972) (holding that corporation continued real estate development business after examination of several factors including operations, employees, location and product).[Back To Text](#)

²⁹ *See* Treas. Reg. § 1.382(a)–1(h)(7) (amended 1991) ("A corporation has not continued to carry on a trade or business . . . if the corporation discontinues more than a minor portion of its business."); *see also Coast Quality*, 463 F.2d at 512 (stating that sale of 44% of corporation's land assets was not "more than minor" portion of business since corporation continued to acquire new land); United States v. Federated Dep't Stores, Inc. (In re Federated Dep't Stores, Inc.), 170 B.R. 331, 346 (S.D. Ohio 1994) (stating that reduction in size of business not necessarily discontinuance of "more than minor" portion of total activity).[Back To Text](#)

³⁰ *See Commissioner v. Barclay Jewellery, Inc.*, 367 F.2d 193, 196 (1st Cir. 1966). The court stated:

We do not think it was either unreasonable, or an inadvertence, that the statute requires both that the nature of the business not be changed and that operations continue despite the change in ownership. On the contrary, the general purpose of this type of deduction dictates both of these requirements.

[Id.](#)[Back To Text](#)

³¹ *See Internal Revenue Code of 1954, Pub. L. No. 83–591, § 382(a)(1)(A)–(B)*, 68A Stat. 3, 129; *see also* Treas. Reg. § 1.382(a)–1(d)(1) (amended 1991) (stating that aggregate increase may occur at one time or over several transactions during two–year period).[Back To Text](#)

³² Internal Revenue Code of 1954, § 382(b), 68A Stat. at 130. The IRC calculated the amount of the reduction by multiplying the percent of the fair market value of the outstanding stock of the acquiring corporation owned by the stockholders of the loss corporation (as the result of owning stock of the loss corporation) by five and subtracting this amount from 100%. Id. § 382(c).

Under the Tax Reform Act of 1976 (the "1976 Act"), § 382(b), which never became effective due to the continuous postponement of the effective date, increased the minimum continuing of ownership requirement from 20% to 40%. Tax Reform Act of 1976, Pub. L. No. 94–455, § 806(e), 90 Stat. 1520, 1599–605, *repealed by Tax Reform Act of 1986, Pub. L. No. 99–514, § 621*, 100 Stat. 2085, 2266. If the stockholders owned less than 40% but more than 20%, the Code reduced the loss carryover by 3.5% for each percentage point less than 40. Id. If the stockholders owned less than 20%, § 382(b) reduced the loss carryover by 1.5% for each percentage point less than 20%. Id.

The 1976 Act would have reduced the net operating after a requisite change in ownership regardless of whether there was a change in business. Id. *See Simmons, supra note 25, at 1066–67* (stating that Congress eliminated continuity of business requirement to shift focus to changes of ownership). The changes to IRC § 382(b) would have significantly reduced the extent to which large corporations could acquire a small loss corporation and obtain the benefit of the net operating loss. *See Daniel Q. Posin, Three Strikes Are We Out? Transfers of Loss Carryovers After the 1986 Act*, 7 Va. Tax Rev. 697, 720 (1988) (noting that 1976 rules plugged several gaps and tightened stock ownership standards for ascertaining whether loss carryovers should be reduced).[Back To Text](#)

³³ S. Rep. No. 313, 99th Cong., 2d Sess. 232 (1986) (indicating that several options were reviewed, but change of ownership remains best indicator).[Back To Text](#)

³⁴ *See* H.R. Conf. Rep. No. 841, 99th Cong., 2d Sess. 188 (1986), *reprinted in* 1986 U.S.C.C.A.N. 4076, 4276 (stating that "[t]he use of a rate lower than the long–term Federal rate is necessary to ensure that the value of NOL carryforwards to the buying corporation is not more than their value to the loss corporation"). [Back To Text](#)

³⁵ Tax Reform Act of 1986, Pub. L. No. 99–514, § 621, 100 Stat. 2085, 2254–56 (codified at I.R.C. § 382(a)–(g) (1988)).[Back To Text](#)

³⁶ I.R.C. § 382 (1988 & Supp. V 1993).[Back To Text](#)

³⁷ [Id. § 382\(g\)\(1\), \(i\)\(1\) \(1988\).Back To Text](#)

³⁸ *See* Treas. Reg. § 1.382-2T(c)(1) (1987) (stating that five percent shareholders whose ownership interest either decreased or remained unchanged are disregarded for determining whether ownership change has occurred). [Back To Text](#)

³⁹ I.R.C. § 382(i)(3) (1988).[Back To Text](#)

⁴⁰ [Id. § 382\(g\)\(4\)\(A\).Back To Text](#)

⁴¹ [Id. § 382\(a\)\(1\) \(1982\) \(amended 1988\).Back To Text](#)

⁴² [Id.Back To Text](#)

⁴³ [Id. § 382\(b\)\(1\) \(1982\) \(amended 1988\) \(requiring reduction in allowable net operating loss unless twenty percent or more of new corporation's stock retained by owners of loss corporation\).Back To Text](#)

⁴⁴ I.R.C. § 382(g)(1) (1988).[Back To Text](#)

⁴⁵ [Id. § 382\(g\)\(2\).Back To Text](#)

⁴⁶ [Id. § 382\(g\)\(3\).Back To Text](#)

⁴⁷ *See id. § 382(g)(1)*. This section states that there is an ownership change if, immediately after either any owner shift involving a five percent shareholder *or* any equity structure shift, the percentage of stock owned by such shareholders has increased by more than fifty percentage points over the lowest percentage of stock owned by those shareholders during the test period. [Id.Back To Text](#)

⁴⁸ *See Tax Reform Act of 1986, Pub. L. No. 99-514, § 621, 100 Stat. 2085, 2263* (codified at I.R.C. § 382(l)(5)(A) (1988)).[Back To Text](#)

⁴⁹ I.R.C. § 382(l)(5)(A). The section provides that:

Subsection (a) shall not apply to any ownership change if—

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

(ii) the shareholders and creditors of the old loss corporation . . . own . . . stock of the new loss corporation . . . which meets the requirements of section 1504(a)(2) (determined by substituting "50 percent" for "80 percent" each place it appears).

[Id.Back To Text](#)

⁵⁰ I.R.C. § 382(l)(5)(B) (1988 & Supp. V 1993) provides that:

Reduction for interest payments to creditors becoming shareholders.—In any case to which subparagraph (A) applies, the pre-change losses and excess credits (within the meaning of section 383(a)(2)) which may be carried to a post-change year shall be computed as if no deduction was allowable under this chapter for the interest paid or accrued by the old loss corporation on indebtedness which was converted into stock pursuant to title 11 or similar case during—

(i) any taxable year ending during the 3-year period preceding the taxable year in which the ownership change occurs, and

(ii) the period of the taxable year in which the ownership change occurs on or before the change date

Id.Back To Text

⁵¹ I.R.C. § 382(l)(5)(C) (1988) (repealed by Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66, 107 Stat. 312). Prior to the repeal, this section stated:

(C) Reduction of tax attributes where discharge of indebtedness

(i) In General

In any case to which subparagraph (A) applies, 50 percent of the amount which, but for the application of section 108(e)(10)(B), would have been applied to reduce tax attributes under section 108(b) shall be so applied.

(ii) Clarification with subparagraph (B)

In applying clause (i), there shall not be taken into account any indebtedness for interest described in subparagraph (B).

Id.Back To Text

⁵² I.R.C. § 382(l)(5)(D) (1988) (providing that § 382 limitation is zero if another ownership change occurs within two years). Back To Text

⁵³ Tax Reform Act of 1986, Pub. L. No. 99-514, § 621, 100 Stat. 2085, 2265-65 (codified at I.R.C. § 382(l)(6) (1988 & Supp. V 1993)). I.R.C. § 382(l)(6) provides:

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

Id.Back To Text

⁵⁴ Id.Back To Text

⁵⁵ See Jacob Mertens, Jr., Value of Old Loss Corporations, Merten's Law of Federal Income Taxation § 29.80 (1994). "[T]he Proposed Regulations generally treat all increases in the value of the loss corporation resulting from a bankruptcy reorganization as attributable to the conversion of debt into stock." Id.Back To Text

⁵⁶ Pub. L. No. 96-589, 94 Stat. 3389. See S. Rep. No. 1035, 96th Cong., 2d Sess. 11 (1980), *reprinted in* 1980 U.S.C.C.A.N. 7017, 7026 (stating that committee bill generally does not change present rule developed by courts when stock issued to discharge debt). The committee stated that it "believes that by providing for favorable tax treatment if stock is issued to creditors in discharge of debt, the committee bill encourages reorganization, rather than liquidation, of financially distressed companies that have a potential for surviving as operating concerns." Id.; see also Terrel F. Transtrum, The Bankruptcy Tax Act of 1980: A Framework for Analysis, 21 Idaho L. Rev. 599, 621 n.115 (1985) ("The Bankruptcy Tax Act of 1980 does not change the developed judicial law in this area, it merely codifies it.") (citations omitted). Back To Text

⁵⁷ See 1A Collier on Bankruptcy, *supra* note 8, ¶ 8.02. The Commission on the Bankruptcy Laws of the United States was established by Congress in 1970 to study the existing law regarding the tax aspects of bankruptcy and to recommend needed legislation. *Id.* The report of the Commission is in two parts and is located in H.R. Doc. No. 137, 93d Congress, 1st Sess. (1973), *reprinted in* App. 2 Collier on Bankruptcy, *supra* note 8, part I. [Id. Back To Text](#)

⁵⁸ See Charles E. McLure, Jr., The Budget Process and Tax Simplification/Complication, 45 Tax L. Rev. 25, 38–39 (1989). The Treasury Department established "revenue neutrality" as a guiding principle for tax reform. *Id.* This idea was a fundamental part of the 1986 Act, with the purpose of matching all revenue losses with provisions to restore the lost revenue. [Id. Back To Text](#)

⁵⁹ Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103–66, 107 Stat. 312. [Back To Text](#)

⁶⁰ See H.R. Conf. Rep. 213, 103d Cong., 1st Sess., 619 (1993), *reprinted in* 1993 U.S.C.C.A.N. 1088, 1308–310. [Back To Text](#)

⁶¹ Omnibus Budget Reconciliation Act of 1993, § 13226(a)(3)(A), 107 Stat. at 488. [Back To Text](#)

⁶² *Id.* § 13226(a)(3)(B) at 488. [Back To Text](#)

⁶³ See Pratt, *supra* note 23, at 25 (stating that repeal of stock–for–debt exception will encourage debtor corporations to issue more debt in restructurings). This "new bias" favoring debt–for–debt exchanges will encourage debtor corporations to issue debt to recover the loss of net operating loss carryover. [Id. Back To Text](#)

⁶⁴ See Reed W. Easton, Repeal of Stock–For–Debt Exception Discourages Fresh Starts, 22 Tax'n For Law. 229, 233 (1994) (stating that "[u]nder prior law, creditors were willing to take stock in Title 11 cases and other workouts because favorable tax attributes could be preserved due to the stock–for–debt exception."). Prior to the repeal of the exception, the attributes would offset future taxable income, making it more likely that the creditor might recover most or all of the original debt through stock ownership. *Id.* Under current law, however, it is less beneficial for creditors to take stock in a rehabilitating bankruptcy or workout. [Id. Back To Text](#)

⁶⁵ See *id.* at 233–34 (discussing negative consequences of repeal on creditors and reorganizing businesses). [Back To Text](#)

⁶⁶ See Patrick G. Dunleavy, *Time to Revisit Chapter 11 Stock for Debt Exception*, *Acct. Today*, May 8, 1995, at 12. [Back To Text](#)

⁶⁷ See Jack F. Williams, Rethinking Bankruptcy and Tax Policy, 3 Am. Bankr. Inst. L. Rev. 153, 175 (1995) (stating that supporters argue exception treats equity more favorably than debt at time when more equity and less debt is beneficial to insolvents and Chapter 11 debtors); see also American Institute of Certified Public Accountants, Press Release, *Stock–For–Debt Exception to Cancellation of Indebtedness Income*, 2 (July 20, 1993).

The stock–for–debt exception served a valuable purpose in debtor rehabilitation. "To the extent that a debtor can persuade creditors to take stock instead of cash as part of a plan, the debtor is better able to maintain adequate cash flow to finance operations and capital expenditures, and to secure credit." Mark A. Frankel, Federal Taxation of Corporate Reorganizations, 66 Am. Bankr. L.J. 55, 70 (1992) (citations omitted). [Back To Text](#)

⁶⁸ See Pratt, *supra* note 23, at 51 (stating that debt–for–debt exchange will replace stock–for–debt bias). [Back To Text](#)

⁶⁹ See Pinney L. Allen, *Tax Aspects of Workouts and Reorganizations*, C995 ALI–ABA 353, 368 (1995). "In light of the repeal of the formerly–available stock for debt exception, form will be especially important to maintain; it is essential that no stock be received." *Id.*; see also Pratt, *supra* note 23, at 31. The author states that:

Following repeal of the stock for debt exception, debt discharge reduces NOLs regardless of whether the debt is discharged for new stock, debt, or cash. However, debt exchanges create new interest deductions that

(subject to certain limitations) can shelter post-restructuring income in a manner similar to the lost NOL's, so that the tax rules will encourage debt for debt exchanges.

Id. Back To Text

⁷⁰ See Gadsden & Smith, supra note 23, at 226. "[I]t has been possible to preserve much of a taxpayer's NOLs in bankruptcy reorganizations through the 'stock for debt exception,' which did not require income recognition where debt was exchanged for stock of the reorganized company." Id. Without the ability to take advantage of NOL's in a reorganization, creditors may push for liquidation to maximize their return with the lowest amount of risk. Id. Back To Text

⁷¹ See, e.g., Joseph M. Ford, One-Bank Holding Companies for Community Banks, 14 Tex. Tech. L. Rev. 739, 740-41 (1983) (stating that the ability of one-bank holding company to retire bank stock acquisition indebtedness with "pre-tax" dollars remains important aid to individual ownership of banks). Back To Text

⁷² See Easton, supra note 62, at 234. After the repeal of the stock-for-debt exception, a reorganizing corporation loses the benefits of their net operating loss carryover which has to be reduced to offset the cancellation of debt income. Id. This decrease in net operating loss carryover results in increased taxes as the income loses the protection of these positive tax attributes. Id. Back To Text

⁷³ Id. Back To Text

⁷⁴ The corporation is forced to pay cash for taxes on profit earned as a result of the loss of the net operating loss carryover. Back To Text

⁷⁵ See Gadsden & Smith, supra note 23, at 226 ("The absence of the possibility to take advantage of NOLs in a reorganization may lead creditors to prefer liquidation of the debtor's business as the means of maximizing the creditors' return at the least risk."). Back To Text

⁷⁶ Carla Lazzareschi, *Furniture Retailers in Trouble Recession: Barker Bros. Files for Bankruptcy. RB May File this Week. Both Are Victims of an Industry Slump That's Lasted Four Years*, L.A. Times, Nov. 5, 1991 at, D1. Back To Text

⁷⁷ Carla Lazzareschi, *RB Furniture Forced to File for Bankruptcy Protection * Retailing: Tired of Waiting, Creditors Push the Largest Locally Based Chain into Chapter 11*, L.A. Times, Nov. 16, 1991, at D1. Back To Text

⁷⁸ H. Lee Murphy, *Auction Gives Bidder Shot at Highland Sites*, Crain's Chi. Bus., Oct. 19, 1992, at 9. Back To Text

⁷⁹ *Goldenbergs Files Chapter 11 Petition*, Daily News Rec., Oct. 3, 1989, at 15. Back To Text

⁸⁰ Robert Sharoff, *HSSA Group Slates 89 Store Closings: Five Chains to be Totally Liquidated*, Daily News Rec., Sep. 28, 1992, at 4. Back To Text

⁸¹ Irene Svete, *Pay'N Pak Liquidation Plan to Get Started Immediately*, Valley Daily News (Kent Wash.), June 28, 1992. Back To Text

⁸² *Bayly Files Under Chapter 11*, Wall St. J., Dec. 17, 1990, at A4. Back To Text

⁸³ Lee Ann Groene, *El Dorado Motor Alters Bankruptcy Plan to Chapter 7*, Wichita Bus. J., Jan. 22, 1990, §1. Back To Text

⁸⁴ *The Eastern Chronology*, L.A. Times, Jan. 19, 1991, at D10. Back To Text

⁸⁵ Robert E. Dallos, *Global Air Market Gets Mean With a Handful of Carriers Dominating the Domestic Scene, U.S. Airlines Scramble for a Bigger Share of International Travel*, L.A. Times, March 10, 1991, at D1.[Back To Text](#)

⁸⁶ Robert E. Dallos, *Midway Airlines Seeks Chapter 11 Shield*, L.A. Times, Mar. 27, 1991, at D2.[Back To Text](#)

⁸⁷ Martha M. Hamilton, *Braniff Ends Passenger Air Flights; Most of Remaining Workers Face Layoff*, Wash. Post, Nov. 8, 1989, at B1.[Back To Text](#)

⁸⁸ For a general discussion on the impact of the repeal of the stock-for-debt exception on financial institutions see Report Prepared by the Association of Insolvency Accountants for a Congressional Staff Briefing (March 1, 1993). This document is on file with the authors.[Back To Text](#)

⁸⁹ See Gerald Buccino et al., *American Bankruptcy Institute Roundtable Bankruptcy Reform '94*, 13 Am. Bankr. Inst. J. 20A, 20C (Mar. 1994) (suggesting that repeal of stock-for-debt exception will reduce reorganization values available to creditors in general).[Back To Text](#)

⁹⁰ See David Wessel, *Proposed Capital-Gains Tax Break For Investors in Small Firms Has Critics Calculating Costs*, Wall St. J., May 17, 1993, at A18 (discussing Clinton's campaign commitment to tax incentives for small businesses).[Back To Text](#)

⁹¹ See Newton & Wertheim, *supra* note 6, at 730. In an earlier study, the authors stated that if the estimated revenue from 1993 Act is correct, then the majority of \$622 million estimated as increased revenue from the repeal of the exception, must ultimately come from small, non-public corporations.[Id.](#)[Back To Text](#)

⁹² See *supra*, notes 63-70 and accompanying footnotes.[Back To Text](#)

⁹³ See Robert J. Caldwell, *Clinton Offers More of the Same, Tax and Spend*, San Diego Union & Trib., Feb. 14, 1993, at G1 (describing increase in top tax rate for those making in excess of \$200,000).[Back To Text](#)

⁹⁴ See I.R.C. § 108(a), (b) (1988 & Supp. V 1993). Without the stock-for-debt exception, any unrecognized gross income under § 108(a) corresponds to a reduction in positive tax attributes under § 108(b), beginning with net operating loss. *Id.* See generally Committee on Corporate Tax; Rudolph R. Ramelli, Committee Chair, *Corporate Tax*, 47 Tax Law. 1123, 1124 (1994) (explaining that any amounts excluded under §108(a) must reduce important tax attributes of corporation, including net operating loss carryover).[Back To Text](#)

⁹⁵ See *Easton*, *supra* note 64, at 232. "Under the new law, a bankrupt or insolvent corporation can still avoid recognition of all or a portion of the COD income from the transfer by reducing its tax attributes." *Id.*[Back To Text](#)

⁹⁶ See *Pratt*, *supra* note 23, at 31 (discussing new corporate strategy of transferring debt to preserve positive tax attributes).[Back To Text](#)

⁹⁷ See *Frankel*, *supra* note 67, at 69 (describing the treatment of publicly traded debt under I.R.C. § 108(e)(11) prior to repeal of stock-for-debt exception) (citing H.R. Rep. No. 881, 101st Cong., 2d Sess., 355 (1990), reprinted in 1990 U.S.C.C.A.N. 2017, 2357).[Back To Text](#)

⁹⁸ See I.R.C. § 108(a)(1)(B) (1988 & Supp. V 1993) (providing that gross income does not include amount of discharged debt if discharge occurs while debtor is insolvent); *F.W. Sickles Co. v. United States*, 31 F. Supp. 654, 656 (Ct. Cl. 1940) (noting that insolvent taxpayer had no income generated from discharge of indebtedness); see also *Pratt*, *supra* note 23, at 31.[Back To Text](#)

⁹⁹ The value was determined by discounting the tax benefit (at a tax rate of 35%) of the net operating loss carryforward that is lost due to the repeal of the stock-for-debt exception. A 14% discount rate was used. A higher discount rate would give an even lower present value.[Back To Text](#)

¹⁰⁰ See generally Pratt, supra note 23 (discussing new corporate strategy of maintaining debt for preservation of positive tax attributes).[Back To Text](#)

¹⁰¹ See I.R.C. § 1272 (1988) (including original issue discount in income); Id. § 1273 (1988) (providing for determination of amount of original issue discount); Id. § 1274(d) (1988) (providing for determination of applicable federal rate for debt instruments); see also 1A Collier on Bankruptcy, supra note 8, ¶ 16.03 (discussing tax consequences of a debt exchange and application of Original Issue Discount rules). Original Issue Discount can arise if the stated redemption price at maturity of the new debt instrument is greater than its fair market value (on publicly traded debt), or if both the old and new debt are not publicly traded if the new instrument does not provide for "adequate stated interest," or, in the case of all debt instruments, if the debt instrument provides interest payments that do not constitute payments of "qualified stated interest." Id. ¶ 16.03 at 16–27.[Back To Text](#)

¹⁰² See supra part I.B. and accompanying footnotes.[Back To Text](#)

¹⁰³ For example, a loan with a face amount of \$35 million and a stated interest rate of 9% would have a market value of \$25 million at a market interest rate of approximately 15%.[Back To Text](#)

¹⁰⁴ The following discussion contains original research that is on file with the authors.[Back To Text](#)

¹⁰⁵ Bankruptcy Yearbook and Almanac (Christopher M. McHugh ed., 1993).[Back To Text](#)

¹⁰⁶ Over 200 firms were identified. More than 60 firms were eliminated from the data because they were liquidated, filed under another name already listed, issued no public data, or were acquired by another entity and it was impossible to determine if any of the net operating loss survived.[Back To Text](#)

¹⁰⁷ See, e.g., Rebecca Kuzins, *Bankruptcies, defaults, foreclosures all tail off*, Business Journal – Sacramento, Jan. 30, 1995, § 1 (noting an 8% decrease in filings in Sacramento, CA); Paul W. Wilke, *Bankruptcy Filings Running Below Record Pace of 1992*, Delaware Business Review, Sept. 20, 1993, § 1 (noting a 9% decrease in Delaware).[Back To Text](#)

¹⁰⁸ See Emmerich, *supra* note 4, at 142–47. [Back To Text](#)

¹⁰⁹ See Pratt, supra note 23, at 38 (discussing tax rules which affect debtor corporation restructuring decisions).[Back To Text](#)

¹¹⁰ See I.R.C. § 108(a), (b) (1988 & Supp. V 1993) (forgiving cancellation of debt income, but listing priority of positive tax attributes to offset gains in income).[Back To Text](#)

¹¹¹ See, e.g., id. § 38 (1988 & Supp. V 1993) (establishing general business credit); id. § 53 (1988 & Supp. V 1993) (establishing minimum tax credit).[Back To Text](#)

¹¹² Id. § 46 (1988 & Supp. V 1993) (indicating amount of investment tax credit).[Back To Text](#)

¹¹³ Id. § 53 (1988 & Supp. V 1993).[Back To Text](#)

¹¹⁴ See Pratt, supra note 23, at 24–25 (stating that net operating losses can be used to offset income corporation makes in postrestructuring period). Net operating loss carryover is a valuable asset because corporations can shelter their future income, thus reducing the taxes the corporation must pay. Id.[Back To Text](#)

¹¹⁵ Id. at 52–54 (discussing various policy arguments calling for re-instatement of stock-for-debt exception).[Back To Text](#)

¹¹⁶ 117 B.R. 64 (Bankr. S.D.N.Y. 1990).[Back To Text](#)

¹¹⁷ [134 B.R. 853 \(Bankr. S.D. Tex. 1991\).Back To Text](#)

¹¹⁸ [Bankruptcy Yearbook and Almanac, supra note 105.Back To Text](#)

¹¹⁹ See, eg., Marc Lacey, *House Rejects Last Attempt To Block Closure of Bases*, L.A. Times, Sept. 9, 1995, at A21; John M. Broder, *Closing Bases Will Hurt State, Clinton Told Conference*, L.A. Times, June 28, 1995, at A3.[Back To Text](#)

¹²⁰ See, eg., Patrick Lee and Don Lee, *Consumers Downbeat About State's Future*, L.A. Times, Sept. 19, 1995, at D1; Robert A. Rosenblatt, *Upswing in Jobs Adds Momentum to State Recovery*, L.A. Times, Sept. 2, 1995, at A1; Nathan Brostrom, *There's Opportunity in Ashes of Those Closed Military Bases*, L.A. Times, July 16, 1995, at D2; Lawrence M. O'Rourke, *Congress Begins Debating Clinton Budget Proposal*, Sacramento Bee, March 18, 1993, at A13.[Back To Text](#)

¹²¹ See [supra part II.B.](#) and accompanying footnotes.[Back To Text](#)

¹²² See Letter of Herbert L. Camp, *supra* note 3, at 573.[Back To Text](#)

¹²³ The stock-for-debt exception was originally part of the Revenue Act of 1992. The bill was passed by both the house and the senate, but was vetoed by President Bush on November 11, 1992.[Back To Text](#)

¹²⁴ See Letter of Herbert L. Camp, *supra* note 3, at 573.[Back To Text](#)

¹²⁵ These amounts represent the total tax savings, in millions, that would have resulted had the repeal been in effect for plans confirmed after January 1, 1988.[Back To Text](#)