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## Building with Kirby Lumber: A Critique of Related-Party Debt Acquisitions

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## BUILDING WITH *KIRBY LUMBER*: A CRITIQUE OF RELATED-PARTY DEBT ACQUISITIONS\*

Mark R. Siegel†

I.	INTRODUCTION .....	2
II.	THE LAW PRIOR TO SECTION 108(e)(4).....	3
III.	SECTION 108(e)(4).....	4
	A. <i>Self-Operative Statute</i> .....	6
	B. <i>Proposed Regulations—Section 1.108-2</i> .....	7
	C. <i>Direct and Indirect Acquisitions</i> .....	7
	D. <i>Proposed Regulations—Exceptions</i> .....	9
	E. <i>Deemed Sale Treatment</i> .....	10
IV.	AMOUNT OF DEBT DISCHARGE INCOME .....	10
V.	CORRELATIVE ADJUSTMENTS .....	12
VI.	EFFECTIVE DATE .....	14
VII.	APPLICATION TO CERTAIN NONRECOGNITION TRANSACTIONS .....	14
VIII.	ANALYSIS OF THE PROPOSED REGULATIONS .....	15
	A. <i>Existing Means to Attack Abuse</i> .....	16
	B. <i>Unintended Indirect Acquisitions</i> .....	17
	C. <i>One Year Retirement Exception</i> .....	18
	D. <i>Measurement of Debt Discharge Income</i> .....	19

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E. <i>Stock for Debt</i> .....	20
IX. CONCLUSION .....	22

## I. INTRODUCTION

While it is a well established principle of income taxation that a mere loan does not result in gross income to the borrower,<sup>1</sup> it is equally true that debt discharge income is realized when the borrower satisfies the loan for less than the amount due.<sup>2</sup> Income from the discharge of indebtedness has been a part of the tax landscape since the United States Supreme Court decided *United States v. Kirby Lumber Co.*<sup>3</sup> in 1931. The result in *Kirby Lumber* is now codified in section 61(a)(12) of the Internal Revenue Code.<sup>4</sup>

As originally enunciated and most typically encountered, debt discharge income arises from a two-party transaction, i.e., a transaction between the debtor and the creditor. After *Kirby Lumber*, debtors could successfully circumvent section 61(a)(12) by having their outstanding debt obligations acquired by a related-party. For example, a subsidiary corporation borrows \$1,000,000 from a lender bank. If the parent corporation, rather than the subsidiary, retires the subsidiary's indebtedness to the lender bank by purchasing it for \$850,000, the subsidiary avoids having to include \$150,000 of debt discharge income in its gross income.

In an effort to prevent borrowers from avoiding debt discharge income through related-party acquisitions, Congress added section 108(e)(4) to the Internal Revenue Code as part of the Bankruptcy Tax Act of 1980.<sup>5</sup> Section 108(e)(4) treats debt acquired by parties related to the debtor as acquired directly by the debtor. On March 21, 1991, the Internal Revenue Service issued proposed regulations under section

1. *Commissioner v. Tufts*, 461 U.S. 300, 307 (1983). The obligation to repay the loan negates any accession to wealth as required under *Commissioner v. Glenshaw Glass Co.*, 348 U.S. 426 (1955).

2. See *United States v. Centennial Savings Bank FSB*, 111 S. Ct. 1512, 1518 (1991).

3. 284 U.S. 1 (1931).

4. I.R.C. § 61(a)(12) (West 1988 & Supp. 1992).

5. Pub. L. No. 96-589, 94 Stat. 3389 (1980).

Section 108(e)(4)(A) provides as follows:

For purposes of determining income of the debtor from discharge of indebtedness, to the extent provided in regulations prescribed by the Secretary, the acquisition of outstanding indebtedness by a person bearing a relationship to the debtor specified in § 267(b) or § 707(b)(1) from a person who does not bear such a relationship to the debtor shall be treated as the acquisition of such indebtedness by the debtor.

I.R.C. § 108(e)(4)(A) (1988).

108(e)(4).<sup>6</sup> The proposed regulations broaden the scope of debt acquisitions covered by section 108(e)(4). As written, the proposed regulations require debt discharge income to be measured by reference to the fair market value of the debt when the outstanding debt is acquired by a person related to the debtor from a person not related to the debtor.

This article first details the history of the law leading to the enactment of section 108(e)(4) and explores the legislative history and cases concerning the statute. Thereafter, the proposed regulations under section 108(e)(4) will be analyzed. The proposed regulations expand the reach of the statute by covering direct and indirect acquisitions of indebtedness; provide for the measurement of the amount of income from the discharge of indebtedness; and create correlative adjustments to address the economic reality that the indebtedness deemed discharged for income tax purposes remains an outstanding liability of the debtor.

## II. THE LAW PRIOR TO SECTION 108(e)(4)

A debtor must recognize gross income when it purchases its own outstanding indebtedness at a discount.<sup>7</sup> In *Briarcliff Inv. Co. v. Commissioner*,<sup>8</sup> the Fifth Circuit treated a majority shareholder's discounted purchase of outstanding corporate debt as a direct purchase by the corporation of its own debt. Consequently, the corporation had gross income equal to the amount of the discount under *Kirby Lumber* principles.<sup>9</sup> The circumstances of the transaction supported the finding of the court that the majority shareholder sold the acquired debt back to the corporation at his cost.

Initially successful litigating related-party debt purchases, the government subsequently encountered a series of defeats. In *Forrester v. Commissioner*,<sup>10</sup> the Tax Court rejected the government's argument that a related-party debt purchase be treated as a debtor's purchase where one spouse purchased outstanding debt of the other spouse. The taxpayer owed money to a corporation in which he was a shareholder. Prior to liquidation the corporation sold the taxpayer's note to his wife at a discounted value. The court noted that the taxpayer had not reduced his

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6. Prop. Treas. Reg. § 1.108-2, 56 Fed. Reg. 12,135 (1991).

7. *Kirby Lumber*, 284 U.S. at 3; I.R.C. § 61(a)(12).

8. 90 F.2d 330 (5th Cir. 1937).

9. *Id.* at 331.

10. 4 T.C. 907, 921 (1945).

liability as a result of the spousal purchase, nor was there any legal inability of the acquiring spouse to pursue remedies for payment.<sup>11</sup> Consequently, the debtor successfully avoided debt discharge income under section 61(a)(12).

Following *Forrester*, related corporations were also able to avoid debt discharge income. For example, in *Peter Pan Seafoods, Inc. v. United States*,<sup>12</sup> the Ninth Circuit refused to treat the purchase by a sister corporation as a purchase by the debtor corporation. The corporate taxpayer executed two mortgage notes. Several years later, it became apparent the notes could be purchased at a substantial discount. In order to avoid discharge of indebtedness income, a sister corporation (with largely the same shareholders as the taxpayer) was formed to purchase the outstanding mortgage notes that were selling at a discount. Although it recognized the sister corporation was established primarily to avoid debt discharge income, the court found that the sister corporation was not a "conduit, agent, alter ego, tool or instrumentality" of the taxpayer.<sup>13</sup> Therefore, in cases following *Briarcliff*, the government was largely unsuccessful in establishing that a related-party acted on the debtor's behalf in the debt purchase transaction.<sup>14</sup>

### III. SECTION 108(e)(4)

To preclude debtors from avoiding discharge of indebtedness income through a related-party's acquisition of its debt for less than face value from an unrelated creditor, Congress enacted section 108(e)(4) as part of the Bankruptcy Tax Act of 1980.<sup>15</sup>

With respect to section 108(e)(4), the committee reports note that under prior law:

a related party (such as the parent corporation of a debtor) can acquire the taxpayer's debt at a discount and effectively eliminate it as a real liability to outside interests, but the debtor thereby avoids the tax treatment which would apply if the debtor had directly retired the debt by repurchasing it.<sup>16</sup>

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11. *Id.* (explaining that the substance of the transaction amounted to a substitution of creditors).

12. 417 F.2d 670 (9th Cir. 1969).

13. *Id.* at 672-73.

14. Fred T. Witt, Jr. & William H. Lyons, *An Examination of the Tax Consequences of Discharge of Indebtedness*, 10 VA. TAX REV. 1, 88 (1990); James M. Peaslee, *Discharge of Debt Through Its Acquisition by a Person Related to the Debtor—An Analysis of Section 108(e)(4)*, 37 TAX L. REV. 193, 197 n.11 (1982).

15. Pub. L. No. 96-589, 94 Stat. 3389 (1980).

16. H.R. Rep. No. 833, 96th Cong., 2d Sess. 9 (1980); S. Rep. No. 1035, 96th Cong., 2d Sess. 10

Section 108(e)(4) provides that a debtor has discharge of indebtedness income upon the acquisition of its debt at a discount by a person related to the debtor from an unrelated person.<sup>17</sup> Thus, section 108(e)(4) should only apply to treat the debtor as acquiring its own indebtedness in situations where a related-party acquires the outstanding debt from a party unrelated to the debtor.

Because the acquirer of the debtor's outstanding indebtedness must be related to the debtor to trigger the application of section 108(e)(4), it is important to know who is treated as a person related to the debtor. Sections 108(e)(4)(A) and (B) provide that sections 267(b) and 707(b)(1) apply for purposes of determining related-party status. However, the definition of "family" contained in section 267(c)(4) is modified.<sup>18</sup> Therefore the following parties are among those that will be treated as related for section 108(e)(4) purposes:

- (i) the individual debtor and his family which consists of the individual's spouse, children, grandchildren, parents and any spouse of the individual's children or grandchildren;<sup>19</sup>
- (ii) two corporations which are members of the same controlled group of corporations;
- (iii) an individual and a corporation in which the individual owns more than 50% of its stock value;
- (iv) two entities that are treated as a single employer under sections 414(b) or (c);
- (v) a partnership and a partner owning a more than 50% capital or profits interest in the partnership; and
- (vi) two partnerships in which the same persons own more than 50% of the capital or profits interest.

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(1980). A fairly common practice observed by related party acquirers was to contribute the newly acquired debt to the capital of the debtor. Peaslee, *supra* note 14, at 197-98. Prior to the enactment of § 180(e)(6) in the Bankruptcy Tax Act of 1980, the capital contribution did not result in the debtor having debt discharge income. Putoma Corp. v. Commissioner, 66 T.C. 652 (1976), *aff'd*, 601 F.2d 734 (5th Cir. 1979). Under § 108(e)(6), a debtor corporation which receives its debts as a capital contribution is treated as having purchased the debt for an amount of money equal to the contributing shareholder's adjusted basis in the debt. Therefore, the debtor corporation will have to recognize debt discharge income to the extent the principal amount of the debt exceeds the shareholder's adjusted basis.

17. See § 108(e)(4)(A); *supra* note 5.

18. The definition of "family" found in § 267(c)(4) is replaced with the following definition under § 108(e)(4)(B): "the family of an individual consists of the individual's spouse, the individual's children, grandchildren, and parents, and any spouse of the individual's children or grandchildren."

19. As a result, the debtor's brother is not treated as a related person.

### A. *Self-Operative Statute*

By its own unambiguous terms, section 108(e)(4) applies "to the extent provided in regulations prescribed by the Secretary." Despite the broad authority for the government to issue retroactive regulations,<sup>20</sup> the statute itself arguably is inoperative until regulatory guidance is promulgated.<sup>21</sup> Nevertheless, the government's position has been, and continues to be, that section 108(e)(4) is self-executing.<sup>22</sup> In *Traylor v. Commissioner*,<sup>23</sup> a 1990 memorandum opinion predating the issuance of proposed regulations under section 108(e)(4), the Tax Court, without elaboration as to whether section 108(e)(4) was self-operative, applied section 108(e)(4) to a situation involving the purchase of a parent's debt at a discount by the children. In *Traylor*, the taxpayer owed creditors \$3.75 million. In 1981, his children acquired the creditors' claims for \$2.2 million. Under the authority of section 108(e)(4), the court concluded that the debt acquisition caused the taxpayer to realize income from the discharge of indebtedness.<sup>24</sup>

Following its decision in *Traylor*, the Tax Court in *Alexander v. Commissioner*,<sup>25</sup> a court reviewed opinion, had the opportunity to consider whether section 465(b)(3) of the at-risk rules of the Internal Revenue Code was applicable in the absence of prescribed regulations.<sup>26</sup> The court held that section 465(b)(3) did not apply since final regulations had not been issued as mandated by section 465(c)(3)(D).<sup>27</sup> Since section 108(e)(4) uses language virtually identical to that contained in section 465(c)(3)(D),<sup>28</sup> the opinion in *Alexander* raises doubt whether *Traylor* remains the law.

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20. I.R.C. § 7805(b) (1986). See Mitchell Rogovin, *The Four R's: Regulations, Rulings, Reliance and Retroactivity*, 43 TAXES 756, 760-63 (1965).

21. Regulations which implement the statute have only recently been proposed. See *infra* note 29.

22. See Priv. Ltr. Rul. 89-23-021 (Mar. 10, 1989) and Priv. Ltr. Rul. 89-22-080 (Mar. 9, 1989). See also text accompanying *infra* notes 24 and 66.

23. 59 T.C.M. (P.H.) 564 (1990).

24. *Id.* at 573.

25. 95 T.C. 467 (1990).

26. In pertinent part, § 465(c)(3)(D) provides that "subsection (b)(3) shall apply only to the extent provided in regulations prescribed by the Secretary."

27. 95 T.C. at 473. The result in *Alexander* has been followed in subsequent Tax Court opinions. See *Martyr v. Commissioner*, 60 T.C.M. (CCH) 1115 (1990). It is interesting to note that in *Alexander* the government, not the taxpayer, asserted that its failure to prescribe the regulation precluded the application of § 465(b)(3).

28. The word "only" which immediately precedes the "to the extent" language contained in § 465(c)(3)(D) is omitted in § 108(e)(4).

### B. *Proposed Regulations—Section 1.108-2*

On March 21, 1991, almost eleven years after its enactment of section 108(e)(4), the government issued proposed regulations under that section.<sup>29</sup> According to the proposed regulations, the acquisition of outstanding indebtedness of the debtor by a person related to the debtor causes the debtor to recognize debt discharge income measured by reference to the fair market value of the indebtedness. The proposed regulations broaden the scope of debt acquisitions covered by section 108(e)(4); address the amount of section 61(a)(12) income to the debtor in a confusing manner; and provide limited exceptions to the application of section 108(e)(4). Additionally, the proposed regulations provide for certain adjustments to reflect the fact that while the debt is constructively discharged with respect to the debtor, the debtor may, in fact, honor the payment terms of its outstanding debt held by the related-party.

### C. *Direct and Indirect Acquisitions*

While section 108(e)(4) applies to related-party debt acquisitions, the section does not specify the point in time the debt acquirer must be related to the debtor. To assist in the determination of whether the parties are related, the proposed regulations provide for both direct and indirect acquisitions of outstanding indebtedness. A direct acquisition occurs if a related-party (or a person who becomes related to the debtor on the date the indebtedness is acquired) acquires the indebtedness from an unrelated party.<sup>30</sup> Therefore, a parent corporation's acquisition of an existing subsidiary's debt from an unrelated third party is a direct acquisition. Further, a direct acquisition results if the parent-subsidiary relationship is newly created through the simultaneous purchase of indebtedness and an ownership interest in the debtor.

Practical application of the proposed regulations becomes confounded in certain circumstances. For example, suppose individual A owns 100% of the stock of corporation X. A loaned money to X several years ago and holds a promissory note from X. Individual B (unrelated to A) purchases all of A's stock of X and also purchases from A the note from X. In this example, B has simultaneously acquired all of the debt and stock which A owned. The question remains, however, whether B acquired the debt from a related or unrelated party since A no longer has an ownership interest in X. This issue could be resolved by focusing on

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29. Prop. Treas. Reg. § 1.108-2, 56 Fed. Reg. 12,135, 12,139 (1991).

30. Prop. Treas. Reg. § 1.108-2(b)(1), 56 Fed. Reg. 12,135, 12,139 (1991).



the debt holder's related-party status immediately before the transaction. The better approach would be to treat A as related to X when analyzing whether B acquired the debt from a party unrelated to the debtor.<sup>31</sup> Thus, section 108(e)(4) should not be applied to this transaction because B acquired the debt from a party related to X.

In addition to covering debt acquisitions by parties related to the debtor at the time of acquisition (or who become related to the debtor simultaneous to the debt acquisition), the proposed regulations extend the rules to indirect acquisitions. The purpose behind indirect acquisitions is to extend section 108(e)(4) to unrelated debt holders who subsequently become related to the debtor. An indirect acquisition results if two conditions are satisfied. First, a holder of outstanding indebtedness must become related to the debtor. Second, the debt must be acquired in anticipation of later becoming related to the debtor.<sup>32</sup> Thus, the proposed regulations do not make section 108(e)(4) automatically applicable on the date the acquirer becomes related to the debtor. The government is no doubt concerned about taxpayers potentially avoiding a direct acquisition by simply timing the transaction in which the debtor and debt acquirer become related to occur after the debt acquisition. However by subjecting indirect acquisitions to section 108(e)(4), the proposed regulations go beyond the scope of the statute and its legislative history.<sup>33</sup>

The proposed regulations describe several situations in which a holder of debt is treated as acquiring the debt in anticipation of becoming related to the debtor. First, if the holder acquired the debt within six months of becoming related to the debtor, it is conclusively established that the debt was acquired in anticipation of becoming related.<sup>34</sup> Second, a holder is treated as having conclusively acquired debt in anticipation of becoming related if, on the date the holder becomes related to the debtor, the debtor's debt comprises more than twenty-five percent of the fair

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31. The inapplicability of § 108(e)(4) seems sound given that the debt is held by a related-party, both immediately before and immediately after the transaction. The result is also consistent with the result that would be obtained if A owned the stock and debt through a separate corporation whose stock was sold to B. The proposed regulations should be clarified to provide that a related party debt holder continues to be treated as related throughout the simultaneous acquisition of debt and stock if, immediately prior to the transaction, the holder was related to the debtor.

32. Prop. Treas. Reg. § 1.108-2(b)(2)(i), 56 Fed. Reg. 12,135, 12,139 (1991).

33. The preamble equates an indirect acquisition to a direct acquisition to justify extending § 108(e)(4) to indirect acquisitions. 56 Fed. Reg. 12,135, 12,136 (1991). However, there is no basis under § 108(e)(4) for treating an indirect acquisition as an acquisition of debt by a party related to the debtor.

34. Prop. Treas. Reg. § 1.108-2(b)(2)(ii)(A), 56 Fed. Reg. 12,135, 12,139 (1991).

market value of the total gross assets of the holder or the holder group.<sup>35</sup> Third, there is a rebuttable presumption that a debt holder who becomes related to the debtor more than six months but less than twenty-four months after acquiring the debt acquired the debt in anticipation of becoming a related-party.<sup>36</sup> Finally, debt will not be treated as acquired in anticipation of becoming a related-party if it is held by the holder for at least twenty-four months before the date the holder becomes a related-party.<sup>37</sup>

For purposes of the six and twenty-four month holding periods, the proposed regulations specify some additional principles. The holder must add to its holding period the period during which the debt was held by a corporation to whose tax attributes the holder succeeds under section 381.<sup>38</sup> Further, both holding periods are suspended during any period in which the debt holder (or any person related to the debt holder) is directly or indirectly protected against risk of loss with respect to the debt in the form of an option, short sale, or any other device or transaction.<sup>39</sup> Moreover, the holding period suspension is evidence that the debt was acquired by the holder in anticipation of becoming related to the debtor.<sup>40</sup>

#### D. Proposed Regulations—Exceptions

The proposed regulations contain two exceptions to the application of section 108(e)(4) to direct and indirect acquisitions. Section 108(e)(4) will not apply to direct or indirect acquisitions of debt with a stated maturity date within one year of the acquisition date, provided the debt is,

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35. Prop. Treas. Reg. § 1.108-2(b)(2)(ii)(B), 56 Fed. Reg. 12,135, 12,139 (1991). Cash, cash items, marketable stocks or securities, short-term indebtedness, options, futures, contracts, notional principal contracts, or similar items (other than the debtor's debt) are not included for purposes of the total gross assets definition. The holder group is comprised of all persons who are related to the holder before the holder becomes related to the debtor provided they are also related to the debtor after the holder becomes related to the debtor. *Id.*

36. Prop. Treas. Reg. § 1.108-2(b)(2)(ii)(C), 56 Fed. Reg. 12,135, 12,139 (1991). To rebut the presumption, the holder may show, for example, that the debt was acquired in the ordinary course of its portfolio investment activities and that the debt acquisition preceded any discussions concerning acquisition transactions between the debtor and the debt holder. *Id.* The holder will be unable to establish that the debt was not acquired in anticipation of becoming related to the debtor merely by showing that the debtor and debt holder failed to discuss the transaction in which they became related.

37. Prop. Treas. Reg. § 1.108-2(b)(2)(ii)(C), 56 Fed. Reg. 12,135, 12,139 (1991).

38. Prop. Treas. Reg. § 1.108-2(b)(2)(ii)(E), 56 Fed. Reg. 12,135, 12,139 (1991).

39. Prop. Treas. Reg. § 1.108-2(b)(2)(ii)(D), 56 Fed. Reg. 12,135, 12,139 (1991).

40. *Id.*

in fact, retired by its stated maturity date.<sup>41</sup> A second exception, consistent with prior pronouncements by the government,<sup>42</sup> is applicable to debt acquisitions by securities dealers.<sup>43</sup> As long as the securities dealer acquires the debt in the ordinary course of its business and disposes of it within the usual and customary period for holding debt for sale to customers, section 108(e)(4) will be inapplicable.<sup>44</sup>

#### E. Deemed Sale Treatment

The proposed regulations specify the tax treatment required for the debt holder under an indirect acquisition.<sup>45</sup> The holder is treated as having sold the debt to an unrelated person on the day before the acquisition date for an amount of money equal to the fair market value of the debt on the acquisition date.<sup>46</sup> As a result of the deemed sale treatment, the holder will recognize gain or loss based on the difference between the fair market value of the debt and the holder's adjusted basis in the debt immediately before the indirect acquisition; and the holder will have a new basis in the debt equal to its fair market value on the acquisition date.<sup>47</sup>

### IV. AMOUNT OF DEBT DISCHARGE INCOME

Generally, the amount of debt discharge income under section 61(a)(12) equals the excess of the adjusted issue price of the debt being cancelled over the amount repaid in satisfaction of the debt. For example, if a borrower received \$100 and executed a promissory note for the same amount but subsequently repaid the lender only \$90 in full satisfaction of the debt, the borrower would have \$10 of debt discharge income.

The proposed regulations attempt to quantify the amount of income

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41. Prop. Treas. Reg. § 1.108-2(d)(1), 56 Fed. Reg. 12,135, 12,139 (1991).

42. See Announcement 82-138, 1982-45 I.R.B. 30. The proposed regulations are broader than Announcement 82-138 in that the securities dealer exception also applies to noncorporate securities dealers.

43. Prop. Treas. Reg. § 1.108-2(d)(2), 56 Fed. Reg. 12,135, 12,139 (1991).

44. Prop. Treas. Reg. §§ 1.108-2(d)(2)(A) and (B), 56 Fed. Reg. 12,135, 12,139 (1991). A sale or other transfer by the dealer to a person related to the debtor will fall outside of the securities dealer exception. Prop. Treas. Reg. § 1.108-2(d)(2)(C), 56 Fed. Reg. 12,135, 12,139 (1991).

45. Prop. Treas. Reg. § 1.108-2(b)(3), 56 Fed. Reg. 12,135, 12,139 (1991).

46. The acquisition date for an indirect acquisition is the date the holder becomes related to the debtor. Prop. Treas. Reg. § 1.108-2(c)(1), 56 Fed. Reg. 12,135, 12,139 (1991).

47. Prop. Treas. Reg. § 1.108-2(b)(3), 56 Fed. Reg. 12,135, 12,139 (1991). For example, suppose an unrelated party buys a \$1000 bond of the debtor in January of the current year for \$800 and less than six months later becomes related to the debtor. At the time the debtor and holder become related, the bond has a fair market value of \$875. Under the deemed sale rule, the debtor has \$125 of debt discharge income and the bond holder would recognize a \$75 gain (\$875-\$800) and have a \$875 basis in the bond. The loss disallowance rule in § 1091 does not apply for purposes of the deemed sale provision in Prop. Treas. Reg. § 1.108-2(b)(3).

resulting from related-party debt acquisitions. Section 1.108-2 states that the debtor has income from the discharge of indebtedness (to the extent required by sections 61(a)(12) and 108<sup>48</sup>) measured by reference to the fair market value of the indebtedness on the acquisition date.<sup>49</sup> The point in time for measuring debt discharge income differs for direct and indirect acquisitions. The difference is directly attributable to the acquisition date definitions. The acquisition date for a direct acquisition is the date the debt is acquired by the related-party.<sup>50</sup> In contrast, the acquisition date for indirect acquisitions is the date the unrelated debt holder becomes a person related to the debtor.<sup>51</sup> Does the government intend to depart from the generally accepted measurement computation by the fair market value of indebtedness reference? For example, in a direct acquisition where the related-party acquires the debt entirely for cash, the reference to fair market value of the indebtedness can only apply to the outstanding debt of the debtor. Is the cash amount paid by the related-party to be subtracted from the fair market value of the newly acquired indebtedness to determine the amount of the debtor's discharge income?

Assuming the proposed regulations were not meant to alter the traditional computation, one must inquire as to the true meaning of the fair market value reference in determining the amount of income to the debtor. It appears the reference to fair market value is applicable to situations where the related-party uses its own note as part of the acquisition of the debtor's indebtedness. The preamble to the proposed regulations supports this view. Under section 108(e)(11) if a debtor issues new debt to satisfy its outstanding indebtedness, the outstanding indebtedness is treated as being satisfied with an amount of money equal to the issue price, not the fair market value, of the new debt. The preamble provides that the issue price rule contained in section 108(e)(11) applicable to debt for debt transfers does not apply to new debt issued by the related-party as opposed to the original debtor. As a result, for purposes of section

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48. Under § 108(a), debtors in bankruptcy cases and insolvent debtors may exclude the amount of discharge income. For insolvent debtors not in bankruptcy, the exclusion is limited and may not exceed the amount by which the debtor is insolvent. For purposes of § 108, a debtor is insolvent if liabilities exceed the fair market value of assets as measured immediately before the discharge. § 108(d)(3). The exclusion provided by § 108 does not come without a price however. The taxpayer is required to reduce certain prescribed tax attributes, specifically net operating losses, general business credit carryovers, capital loss carryovers, and basis of assets, by the amount of discharge income. I.R.C. §§ 108(b)(1) and (2). If the amount of discharge income exceeds the amount of tax attributes, the excess is disregarded. S. Rep. No. 1035, 96th Cong., 2d Sess. 2 (1980).

49. Prop. Treas. Reg. § 1.108-2(a), 56 Fed. Reg. 12,135, 12,139 (1991).

50. Prop. Treas. Reg. § 1.108-2(c)(1), 56 Fed. Reg. 12,135, 12,139 (1991). See Prop. Treas. Reg. § 1.108-2(b)(1), 56 Fed. Reg. 12,135, 12,139 (1991).

51. *Id.* See Prop. Treas. Reg. § 1.108-2(b)(2), 56 Fed. Reg. 12,135, 12,139 (1991).

108(e)(4), the measurement of income is by reference to the fair market value of the related-party's debt rather than its issue price under section 108(e)(11).<sup>52</sup>

## V. CORRELATIVE ADJUSTMENTS

When a party related to the debtor acquires the debtor's indebtedness, section 108(e)(4) treats the debt as constructively discharged. Although the debt is discharged for income tax purposes with respect to the debtor, the indebtedness remains outstanding in the hands of the related-party. The legislative history of section 108(e)(4) indicates congressional concern that a related-party would not necessarily demand payment in full from the debtor.<sup>53</sup> Congress also recognized that the acquired debt would remain outstanding. Congress therefore provided for adjustments in the event the debtor repays the debt to the related-party holder.<sup>54</sup>

According to the Senate Finance Committee report, the adjustments treat the entire transaction as if the debtor had originally acquired the debt.<sup>55</sup> The Senate approach is illustrated by an example in which a parent corporation acquires a \$1,000 bond issued by its subsidiary for \$900. Upon the subsidiary's repayment of \$1,000 at maturity of the bond, the parent corporation has \$100 of dividend income.<sup>56</sup>

The proposed regulations, however, do not follow the approach indicated by the legislative history.<sup>57</sup> Instead, and consistent with the reality that the debtor's debt remains outstanding, the proposed regulations

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52. It is unclear why § 108(e)(11) should not apply. Moreover, the approach taken in the regulations is inconsistent with an underlying purpose of § 108(e)(4)— treatment of debt acquisitions by related persons as the equivalent of debt acquisitions by the debtor.

53. Staff of the Joint Committee on Taxation, 96th Cong., 2nd Sess., Description of H.R. 5043, Bankruptcy Tax Act of 1979 (Comm. Print 1979).

54. I.R.C. § 108(e)(4)(A).

55. S. Rep. No. 1035, 96th Cong., 2d Sess. 10, 19-20 n.23 (1980). The House Ways and Means Committee report provides "to the extent the related-party recognizes gain, the Treasury has the authority to and will issue regulations providing that a corresponding deduction will be allowed to the debtor if the debtor subsequently pays the debt to the related party." H.R. Rep. No. 833, 96th Cong., 2d Sess. 16 n.25 (1980).

The approach taken by the Senate, which conflicted with that taken by the House, was ultimately agreed to by both House and Senate committees. Cong. Rec. 516, 489-93, H12, 459-64 (daily ed. Dec. 13, 1980).

56. S. Rep. No. 1035, 96th Cong., 2d Sess. 10, 19-20 n.23 (1980).

57. Tax legislation enacted subsequent to § 108(e)(4) has addressed indebtedness bearing below market rates of interest. See e.g., §§ 483, 1274, and 7872. The government places its reliance on this subsequent legislation to support its departure from the Senate Finance Committee report's suggested approach to correlative adjustments. Prop. Treas. Reg. § 1.108-2, 56 Fed. Reg. 12,135, 12,137 (1991).

treat the debt acquired by the related-party as new debt of the debtor issued on the acquisition date with an issue price equal to its fair market value.<sup>58</sup> As a result of the deemed issuance of debt between the debtor and related-party debt holder, the excess of the stated redemption price at maturity of the new debt over its issue price is original issue discount.<sup>59</sup> Using the prior example from the Senate Finance Committee report, under the proposed regulations the parent corporation would be treated as holding new debt with an issue price of \$900 and a stated redemption price at maturity of \$1,000. Therefore, the \$100 of original issue discount would be deductible by the subsidiary and includible in income by the parent over the remaining term of indebtedness to the extent provided in sections 163(e) and 1272(a) respectively.<sup>60</sup>

The deemed issuance rule continues in force subsequent to the related-party debt holder's disposition of the debt to an unrelated party.<sup>61</sup> Therefore, consistent with sections 163 and 1272, the debtor will continue to deduct and the unrelated holder will include the original issue discount attributable to the deemed issuance.<sup>62</sup>

The deemed issuance rule does not apply if the debtor does not realize income from the debt discharge because either the one year retirement exception or securities dealer exception applies.<sup>63</sup> Should these exceptions be unavailable, the debtor may nevertheless be bankrupt or insolvent and thus able to exclude the discharge income under section

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58. Prop. Treas. Reg. § 1.108-2(e)(1), 56 Fed. Reg. 12,135, 12,137 (1991).

59. *Id.* Original issue discount is a technical tax term meaning unstated interest.

60. Prop. Treas. Reg. § 1.108-2(e)(2), Ex. 1, 56 Fed. Reg. 12,135, 12,140 (1991). One consequence of the deemed issuance rule is the triggering of the high yield discount obligation (HYDO) rules under §§ 163(e)(5) and 163(i). Debt will be a HYDO if the following requirements are met: (i) the debt is issued by a corporation; (ii) the term of the debt exceeds five years; (iii) the debt has a yield to maturity that exceeds the applicable federal rate (AFR) by more than five percentage points; and (iv) the debt has significant original issue discount. § 163(i). Under the deemed issuance rule, the new debt has an issue price equal to fair market value which creates original issue discount. As a result, if the HYDO rules apply to acquired debt that has a maturity date beyond five years after the acquisition date, the original issue discount in excess of five percentage points above the AFR cannot be deducted until paid, original issue discount in excess of six percentage points above the AFR is not deductible. Section 163(e)(5).

61. Prop. Treas. Reg. § 1.108-2(e)(2), Ex. 2, 56 Fed. Reg. 12,135, 12,140 (1991). The preamble also provides that the deemed issuance rule will continue to apply after the related holder ceases to be related to the debtor. 56 Fed. Reg. 12,135, 12,140 (1991).

62. The amount of original issue discount to be included by the unrelated holder is adjusted downward under § 1272 (a)(7). Prop. Treas. Reg. § 1.108-2(e)(2), Ex. 2, 56 Fed. Reg. 12,135, 12,140 (1991). The government is considering adopting a rule that suspends the respective deduction and inclusion of the original issue discount attributable to the deemed issuance until maturity of the debt. This alternate approach is based on the perceived difficulty unrelated holders will have in determining whether the debt was acquired from a party related or unrelated to the debtor. Prop. Treas. Reg. § 1.108-2, 56 Fed. Reg. 12,135, 12,137 (1991).

63. Prop. Treas. Reg. § 1.108-2(e)(1), 56 Fed. Reg. 12,135, 12,140 (1991).

108(a),<sup>64</sup> however the deemed issuance rule remains applicable.<sup>65</sup>

## VI. EFFECTIVE DATE

The proposed regulations apply to direct and indirect acquisitions on or after March 21, 1991.<sup>66</sup> While the proposed regulations apply prospectively,<sup>67</sup> the same regulations provide that section 108(e)(4) is effective for transactions made after December 31, 1980.<sup>68</sup> The proposed regulations purport to confirm the government's questionable position in view of *Alexander* that section 108(e)(4) is self-operative.<sup>69</sup>

## VII. APPLICATION TO CERTAIN NONRECOGNITION TRANSACTIONS

In issuing the proposed regulations, the government announced its intention to issue further regulations to address and preclude the avoidance of debt discharge income in certain nonrecognition transactions where the debtor acquires its own indebtedness from a creditor (or a creditor assumes the debtor's debt to the creditor).<sup>70</sup> The additional regulations were to be effective for transactions on or after March 21, 1991.

However the government modified its position in Notice 91-15.<sup>71</sup> The March 21, 1991 effective date is intended to apply to nonrecognition transactions on or after March 21, 1991 only if the following two conditions are met:

- (i) the creditor (or its predecessor) must have acquired the debt or become related to the debtor in a transaction occurring prior to the nonrecognition transaction and that would have been a direct or indirect acquisition if the transaction had occurred on or after March 21, 1991; and
- (ii) the debtor did not report debt discharge income as a result of the creditor's (or predecessor's) acquisition of the debt or becoming related

64. See *supra* note 48.

65. Under Prop. Treas. Reg. § 1.108-2(e)(1), the deemed issuance rule applies whether or not the income is excludable under § 108(a).

66. Prop. Treas. Reg. § 1.108-2(f), 56 Fed. Reg. 12,135, 12,140 (1991).

67. *Id.* The government did not choose to make the regulations retroactively effective despite its broad authority under § 7805.

68. Prop. Treas. Reg. § 1.108-2(f), 56 Fed. Reg. 12,135, 12,140 (1991). See *supra* notes 20-27 and accompanying text.

69. It remains unclear why the government continues to assert that § 108(e)(4) is self-enabling despite the plain language of the statute. The government's successful argument in *Alexander v. Commissioner*, 95 T.C. 467 (1990), was that similar language in § 465(c)(3)(D) prevented § 465(b)(3) from being operative.

70. Prop. Treas. Reg. § 1-108-2, 56 Fed. Reg. 12,135, 12,138 (1991). Specifically included are transactions under §§ 332, 351, 368, 721 and 731.

71. Notice 91-15, 1991-1 C.B. 319.

to the debtor.<sup>72</sup>

### VIII. ANALYSIS OF THE PROPOSED REGULATIONS

The legislative history of section 108(e)(4) expresses concern that debtors were successfully avoiding debt discharge income through the use of a related-party acquisition.<sup>73</sup> Nevertheless, such concern was premised upon the control relationship existing between the debt acquirer and the debtor. The lone example in the legislative history covers a parent corporation purchasing at a discount the debt of a subsidiary. The parent/subsidiary example further illustrates that Congress was concerned with debtors and debt acquirers already related and not with unrelated parties who subsequently become related.<sup>74</sup> It follows that the proposed regulations broaden the scope of the statute beyond its terms and its legislative history.

Including indirect acquisitions within the scope of section 108(e)(4) is a controversial aspect of the proposed regulations. Many bona fide transactions which violate neither the spirit nor the letter of the statute may fall within the purview of the overbroad regulations. Suppose, for example, a party unrelated to the debtor seeks a prudent investment. It acquires an outstanding debt of a publicly traded debtor not intending to become related to the debtor; but within six months the debt acquirer acquires stock in the debtor (who fought the takeover) through a successful hostile takeover. After the completion of the debt and stock acquisitions, the third party is now a creditor and owner of the debtor. These transactions trigger an indirect acquisition and may result in debt discharge income to the debtor because an indirect acquisition is treated as though the debtor acquired its own debt. The rationale in this example for the debtor to have income is not as compelling as the parent/subsidiary example found in the legislative history. In the present scenario, the creditor controls the debtor not vice versa. Also, the stock acquisition was precipitated by the sole action of the creditor rather than through the concerted effort of both parties. Moreover, given the debtor's passive role vis-a-vis the debt acquirer, it certainly cannot be claimed that the creditor will fail to insist on timely payment of the debt.<sup>75</sup>

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72. *Id.*

73. § 108(e)(4) is intended to reverse the result in *Peter Pan Seafoods, Inc. v. United States*, 417 F.2d 670 (9th Cir. 1969).

74. In *Peter Pan*, the debt acquirer was already related to the debtor at the time of debt acquisition. 417 F.2d at 672 (9th Cir. 1969).

75. Even if one assumes that the creditor-shareholder will now be more lenient towards the



The rationale for imposing debt discharge income on indirect acquisitions further breaks down when considered in light of the following example. Suppose the example above is modified by having the debtor acquire the stock of the debt acquirer within six months of the debt acquisition. Here, the debtor now controls the party holding its debt obligation. In this situation, the debtor possesses the ability to both control the debt holder and forgive the debt.

In these two examples, the stock acquisition occurred after the debt acquisition, and at the time the debt was acquired, the acquirer was unrelated to the debtor. The similarity between the examples ceases upon examination of the relationship between the debtor and debt acquirer after the stock transaction. In the first example, the now related-party debt holder is the shareholder of the debtor. In the second example, the related-party debt holder is a controlled subsidiary of the debtor. Despite this difference, the proposed regulations indiscriminately treat both transactions as indirect acquisitions. Yet it is only the latter example that should be characterized as an indirect purchase of debt by the debtor triggering debt discharge income.<sup>76</sup> The former example should not give rise to debt discharge income as it is not so much an indirect purchase by the debtor but rather a direct purchase by the debt acquirer.

As drafted, the indirect acquisition rules contained in the proposed regulations can operate improperly to bring transactions that should not give rise to debt discharge income within the purview of section 108(e)(4). There is little persuasive argument against the governmental concern about an acquisitive transaction between the debtor and the entity holding its debt. However, the appropriate question is whether the transaction in which the holder becomes related to the debtor constitutes an acquisition of the debt by the debtor itself. It should be remembered that in enacting section 108(e)(4) Congress was concerned with related-parties assisting in the avoidance of section 61(a)(12) and not simply with debt being held by a related-party.

#### A. *Existing Means to Attack Abuse*

The government presently has sufficient weapons—the step transaction doctrine and the substance over form doctrine—to combat the

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debtor, any benevolence springs from its discretion, not that of the debtor. Moreover, the elements underlying the decision to acquire the debt in the first instance should not metaphysically disappear simply because the debt acquirer subsequently becomes related to the debtor.

76. Under general principles of tax law, such as the substance over form and step transaction doctrines, it appears that § 61(a)(12) would be applicable without the need for § 108(e)(4).

abuses the indirect acquisitions rules appear to target.<sup>77</sup> In Rev. Rul. 91-47,<sup>78</sup> the government applied the substance over form doctrine to impose debt discharge income in an indirect acquisition transaction. In the ruling, a corporation had outstanding debt which was held by persons unrelated to the corporation. The debt was issued at par for \$500,000 and the fair market value was \$350,000. A second individual also unrelated to the corporation learned that the corporation wanted to reduce the amount of its outstanding debt. The corporation and the unrelated party discussed the unrelated party's formation of a new corporation to purchase the outstanding debt and subsequent sale of the new corporation's stock to the corporation. The parties anticipated that structuring the transaction in the planned manner would avoid the debt discharge income that would otherwise result if the debt were acquired directly or through a related-party. Based on this knowledge, the unrelated party formed and funded the new corporation which purchased for \$70,000 a portion of the corporation's debt with an issue price of \$100,000. Shortly after the debt had been acquired, the corporation acquired all of the new corporation's stock for \$70,000.

The government ruled that there is debt discharge income where an unrelated person with the primary purpose of enabling the corporation to avoid debt discharge income forms or uses a corporation to acquire the debtor's debt and then sells the stock of the corporation to the debtor. Therefore the corporation had \$30,000 of debt discharge income. Since the substance of a transaction, rather than its form, should control its tax treatment, the government reasoned that sections 61(a)(12) and 108(e)(4) would be circumvented if the form of the transaction in which the new corporation acquired the debt before the debtor corporation and the new corporation became related were respected. Moreover, the government disregarded the steps taken to avoid related-party status, i.e., the formation of the new corporation.

#### B. *Unintended Indirect Acquisitions*

The proposed regulations conclusively establish that debt is acquired in anticipation of the acquirer becoming related to the debtor if the acquirer acquired the debt less than six months before the date the acquirer becomes related to the debtor. The "anticipation" requirement

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77. The government recently used these weapons in Rev. Rul. 91-47, discussed in the text accompanying note 78 *infra*, to subject a transaction to § 108(e)(4).

78. Rev. Rul. 91-47, 1991-2 C.B. 16.

may be met even in the absence of subjective intent, or control over the transaction. Suppose corporation X acquires a \$1,000 bond issued by corporation Z for \$900 on the open market in August. X and Z are unrelated. In October individual A, a corporate raider, acquires more than 50% of the stock of X. In December, individual B, A's son-in-law, acquires more than 50% of the stock of Z. By virtue of the familial relationship between A and B and the time frame in which their respective ownership interests in X and Z were acquired, Z has debt discharge income. The proposed regulations cause this harsh result even in the complete absence of facts indicating either X or Z intended or anticipated becoming related to each other.

The harshness of the indirect acquisition rules is not limited to the prior example. An indirect acquisition may be attributable to market value fluctuations. Suppose corporation C acquires bonds of corporation D on April 1, 1991 at a discount. C is unrelated to D. Immediately following the bond purchase, the assets of C consist of \$100,000 in D bonds and \$300,000 in real estate. If C becomes related to D on April 1, 1993 and on that date the value of the bonds has not changed but the real estate has declined in value, the bonds will represent more than 25% of the assets of C. D will recognize debt discharge income because the bonds acquired by C are treated as acquired in anticipation of becoming related to D.

### C. *One Year Retirement Exception*

As stated in the preamble, the proffered rationale for the one year retirement exception is that the debtor would, within a short period of time, have to report debt discharge income and then make a corresponding correlative adjustment.<sup>79</sup> For the one year exception to apply, the debt must have a stated maturity date within one year of the acquisition date, and the debt must, in fact, be retired on or before the maturity date.<sup>80</sup> As currently drafted, the one year retirement exception will not be available if the remaining period of time to maturity is more than one year after the acquisition date.<sup>81</sup> The expressed goal of the exception, avoidance of reporting income and subsequent correlative adjustment during a short time period, is not furthered by linking the exception only to debt that will mature within one year after the acquisition date. For

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79. 56 Fed. Reg. 12,135, 12,137 (1991).

80. Prop. Treas. Reg. § 1.108-2(d)(1), 56 Fed. Reg. 12,135, 12,139 (1991).

81. *Id.*

example, suppose a related-party acquires debt which is not scheduled to mature for another two years. If the debtor prepays the debt within a year after its acquisition, income inclusion and correlative adjustments will be necessitated within a short period. Consequently, the goal of the exception can be better achieved by allowing indebtedness, irrespective of its stated maturity date, to qualify for the exception if it is, in fact, retired on or before the date which is one year after the acquisition date.

The one year retirement exception could operate as a potential tax planning opportunity. As illustrated by the following example, the requirement for the one year retirement exception that the debt, in fact, be paid on or before maturity permits a related-party holder to control the tax year in which the debtor will have to report the income. C, who is unrelated to D, acquires in March 1992, a five year bond of D having a \$1,000 face value and a January 1993 maturity date. In June 1992, C acquires all of the stock of D. At the time of the stock acquisition, the bond has a fair market value of \$700. D will not recognize debt discharge income in 1992 under the one year exception, provided the bond is paid by January 1993. However, since C controls D, C may cause D to default on the bond and thus require that D report the income in 1992.

Finally, in keeping with the compliance rationale upon which the one year retirement exception is grounded, an additional exception should be added to the proposed regulations making them inapplicable to debt acquisitions below a specific de minimis amount.<sup>82</sup>

#### D. *Measurement of Debt Discharge Income*

A debtor may have debt discharge income under the indirect acquisition rules even though the unrelated debt acquirer did not purchase the debt at a discount. This can happen as a result of the definition of the acquisition date for indirect acquisitions. For indirect acquisitions, the acquisition date is the date the unrelated debt holder becomes related to the debtor rather than the date the debt was first acquired.<sup>83</sup> Suppose corporation Z has a \$1,000 bond trading at \$1,000 which is acquired by corporation A, unrelated to Z, for \$1,000 cash. Within six months, A and Z are involved in a transaction in which they become related-parties. At the time of the transaction, A's bonds are trading at \$700. Despite the fact that A paid the face amount for the bond, Z will have \$300 of

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82. For an example, see § 1272(a)(2)(E), which excepts debt less than \$10,000 from the original issue discount rules of § 1272.

83. Prop. Treas. Reg. § 1.108-2(c)(1), 56 Fed. Reg. 12,135, 12,139 (1991).

debt discharge income since the bond was trading at a discount when A became related to Z.

The debt discharge measurement problems under the proposed regulations are not limited to indirect acquisitions. The regulations, as proposed, measure the amount of the debtor's income by reference to the fair market value of the indebtedness. For example, a related-party may enter into an arm's length contract with an unrelated debt holder to purchase the debt for cash. While it may be that the cash contract price represents fair market value, events subsequent to the contract date but prior to the closing date may alter the fair market value of the debt on the acquisition date. Thus, a debtor in this situation may incur debt discharge income despite the fact that the original cash outlay represented fair market value at the time of the transaction.

#### E. *Stock for Debt*

A judicially created exception to the recognition of debt discharge income known as the stock for debt exception exists for debtor corporations that transfer stock to a creditor in satisfaction of indebtedness.<sup>84</sup> As historically applied, if a corporation issued its own stock to a creditor for outstanding debt, there would not be any debt discharge income even though the value of the stock was less than the amount of the debt.

Beginning in 1980, Congress began limiting the scope of the stock for debt exception. As part of the Bankruptcy Tax Act of 1980,<sup>85</sup> section 108(e)(8) was enacted to make the exception inapplicable to the debtor corporation's issuance of nominal or token shares.<sup>86</sup> The exception was further restricted by section 108(e)(10), enacted by the Tax Reform Act of 1984.<sup>87</sup> Under section 108(e)(10), only debtors who are insolvent or bankrupt are eligible for the stock for debt exception.<sup>88</sup> Solvent debtor corporations outside of bankruptcy that issue stock in exchange for their outstanding debt are treated as having satisfied the debt for an amount of money equal to the fair market value of the stock issued.<sup>89</sup> Therefore

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84. *Capento Sec. Corp. v. Commissioner*, 47 B.T.A. 691, *aff'd*, 140 F.2d 382 (1st Cir. 1944).

85. Pub. L. No. 96-589, 94 Stat. 3389 (1980) (codified as amended in scattered sections of 26 U.S.C.A. (West 1988 & Supp. 1992)).

86. I.R.C. § 108(e)(8)(A).

87. Pub. L. No. 98-369, 98 Stat. 598 (1984).

88. I.R.C. § 108(e)(10)(B).

89. I.R.C. § 108(e)(10)(A). Proposed regulations under § 108(e)(8)(A), Prop. Treas. Reg. 1.108-1, 55 Fed. Reg. 50,568 (1990), were issued on December 7, 1990, and provide rules for determining whether stock issued in exchange for debt is nominal or token.

Section 108(e)(8)(B) adds a second rule under § 108(e)(8) and provides that the stock for debt exception does not apply

these debtor corporations have debt discharge income measured by the excess of the amount of the indebtedness over the fair market value of the stock issued.

In 1990, Congress withdrew "disqualified stock" from the scope of the exception.<sup>90</sup> Disqualified stock is stock that has a stated redemption price and that either has a fixed redemption date, is callable by the issuer, or putable by the holder.<sup>91</sup> By carving out disqualified stock, Congress has made the stock for debt exception unavailable for bankrupt and insolvent debtor corporations that issue certain preferred stock resembling debt.<sup>92</sup>

The proposed regulations under section 108(e)(4) are silent regarding the applicability of the stock for debt exception to related-party debt acquisitions. For instance, the availability of the exception comes into play in situations where the related-party acquires the debtor's indebtedness in exchange for stock rather than for cash or debt. Suppose corporation B, a wholly-owned subsidiary of corporation A, is insolvent. A acquires a \$1,000 bond of B from an unrelated holder for \$800 of A stock. If the stock for debt exception applies to exchanges of parent corporation stock for subsidiary corporation debt, B will not have to recognize the \$200 of debt discharge income under section 108(e)(4). This approach adheres to the rationale embodied in section 108(e)(4) that the debtor and related-party be treated as a single unit for debt discharge income purposes.<sup>93</sup>

While it is suggested that the stock for debt exception be made applicable to section 108(e)(4), it should be noted that neither section 108(e)(4) nor its legislative history mentions treating the parent stock as

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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.

90. See I.R.C. § 108(e)(10)(B)(ii), which was added, and I.R.C. § 108(e)(8) (West Supp. 1990), which was amended by the Revenue Reconciliation Act of 1990. Pub. L. No. 101-508, 104 Stat. 1388 (1990).

91. I.R.C. § 108(e)(10)(B)(ii) (1980).

92. See S. Rep. No. 3209, 101st Cong., 2d Sess. 177 (1990); H.R. Rep. No. 5835, 101st Cong., 2d Sess. 106 (1990). In addition, § 108(e)(8) provides that disqualified stock is not treated as stock for purposes of §§ 108(e)(8)(A) and (B). See *supra* note 85.

93. See *Peaslee*, *supra* note 14, at 212-13.

subsidiary stock for purposes of the exception. This silence is not necessarily fatal given the status of existing caselaw<sup>94</sup> and rulings<sup>95</sup> which have not limited the exception to the issuance of stock of the debtor.<sup>96</sup>

### IX. CONCLUSION

The proposed regulations greatly broaden the scope of debt acquisitions which trigger section 108(e)(4) and thereby complicate the transactional environment in which the statute operates. The regulations extend section 108(e)(4) to debt acquisitions by parties related to the debtor as well as by unrelated purchasers who subsequently become related to the debtor. The administrative authority to promulgate regulations should not be exercised to make tax law. The likely effect of the regulations will be to curtail acquisitions and prompt taxpayers to seek relief from any discharge of indebtedness income through the commencement of bankruptcy proceedings. As a matter of tax policy, such a result is ill conceived at best. The substance over form and step transaction doctrines are well established in the tax law and are available to combat transactions perceived to be abusive without the need to resort to a regulatory expansion of the statute.

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94. *E.g.*, *Alcazar Hotel, Inc. v. Commissioner*, 1 T.C. 872 (1943), *acq.*, 1947-1 C.B. 1; *Claridge Apartments Co. v. Commissioner*, 1 T.C. 163 (1942), *rev'd* 323 U.S. 141 (1944), *acq.* (to the Tax Court decision), 1947-1 C.B. 2.

95. *E.g.*, Rev. Rul. 59-222, 1959-1 C.B. 80.

96. Suppose the above example were modified so that the subsidiary, corporation B, acquires its own bond with stock of the parent, corporation A, that B previously acquired through a § 351 transaction. Because the acquisition of the bond is by B rather than a related-party, it appears that § 108(e)(4) should not apply; however, it is unresolved whether the stock for debt exception is available for bankrupt or insolvent subsidiaries that satisfy their debt with parent stock. For a more detailed discussion of this issue, see Martin D. Pollack & Stuart J. Goldring, *Can Cancellation of Indebtedness Income Be Avoided with Parent Stock*, 2 CORP. TAX 18 (1990), and Witt and Lyons, *supra* note 14, at 102-103.