REPORT #608

TAX SECTION

New York State Bar Association

Alternative Minimum Tax Committee
Report on the Application of the Corporate
Alternative Minimum Tax in Bankruptcy Settings

17 March 1989

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TAX REPORT # 608

TAX SECTION

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April 11, 1989

The Honorable Kenneth W. Gideon
Assistant Secretary of the Treasury
for Tax Policy Designate
3120 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Mr. Gideon:

Enclosed is a Report on the Application of the Corporate Alternative Minimum Tax in Bankruptcy Settings. The Report was prepared by the Committee on Alternative Minimum Tax. The principal draftsman was Robert A. Jacobs.

The Report makes the following recommendations in order for the bankruptcy policy of relieving taxpayers in bankruptcy, or that remain insolvent after a debt is forgiven, from tax liability as a result of fore giveness of indebtedness:

(1) the Congress expand its TAMRA amendment so that alternative minimum taxable income ("AMTI") will not reflect cancellation of indebtedness income ("COD income") excluded from gross income under Code 5 108(a), as well as the common law stock-for-debt exception;

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(2) the Internal Revenue Service rule that quasi-reorganization accounting will be respected in computing a corporation's book income;

(3) a regulation or ruling be promulgated holding that COD income excluded from gross income by Code § 108(a) should not be counted so as to both increase ACE in the year of the COD and reduce NOLs available to offset income in subsequent years;

(4) a regulation or ruling be promulgated holding that no COD income is realized in a proceeding where no debt is discharged under the applicable rules of title 11;

(5) a regulation or ruling be promulgated holding that for AMTI purposes, FDIC and FSLIC (i) negotiated cash payments, negative net worth notes, capital loss guarantees, expense guarantees, or any other FDIC and FSLIC assistance payments in the nature of capital contributions do not augment the recipient's book income or earnings and profits, and (ii) annual income subsidies or interest payments & augment the recipient's book income or earnings and profits; and

(6) a regulation or ruling be promulgated holding that for AMT purposes, AMTI does not include BURP items attributable to reversals arising from relief in insolvency proceedings or bankruptcy reorganizations of charges to reserves.

Sincerely yours,

Wm. L. Burke

Enclosure

cc (w/encl):Dana L. Trier, Esq., Tax Legislative
Counsel, Treasury Department

Duplicate letter with enclosure to:

The Honorable Lloyd Bentsen, Chairman, Senate Finance
Committee
cc(w/encl): H. Patrick Oglesby, Esq., Chief Tax
Counsel, Senate Finance Committee

The Honorable Dan Rostenkowski, Chairman, House Ways and Means
Committee
cc(w/encl): Janice May, Esq., Majority Tax Counsel
The Honorable Bill Archer, Ranking Minority Member,
House Ways and Means Committee
cc(w/encl): James Clark, Esq., Minority Tax
Counsel, House Ways and Means Committee
The Honorable Bob Packwood, Ranking Minority Member
Senate Finance Committee
cc(w/encl): Ed Mihalski, Esq., Minority Chief
of Tax, Senate Finance Committee
The Honorable Michael J. Murphy, Acting Commissioner of
Internal Revenue
cc(w/encl): Peter K. Scott, Esq., Acting Chief
Counsel, Internal Revenue Service
The Honorable Ronald A. Pearlman, Chief of Staff, Joint
Committee on Taxation

NEW YORK STATE BAR ASSOCIATION

TAX SECTION REPORT #608

LETTER DATED APRIL 11, 1989 TO KENNETH W. GIDEON, ESQ., ASSISTANT SECRETARY OF THE TREASURY FOR TAX POLICY, AND OTHERS ENCLOSING REPORT ON THE APPLICATION OF THE CORPORATE ALTERNATIVE MINIMUM TAX IN BANKRUPTCY SETTINGS.

The New York State Bar Association Tax Section

Alternative Minimum Tax Committee

Report on the Application of the Corporate

Alternative Minimum Tax in Bankruptcy Settings

NYSBAAMT.10

17 March 198

The Application of the Corporate Alternative Minimum Tax in Bankruptcy Settings*

Two alternative minimum tax ("AMT") concerns pervade corporate debtor insolvency proceedings. They are (i) the possible application of AMT to debt cancellation and (ii) the possible application of AMT to FSLIC or FDIC assistance payments to troubled financial institutions. While TAMRA[1] provides some welcome AMT certainty and relief where debt is cancelled by issuing stock of the debtor, no relief is afforded where debt is cancelled in exchange for property other than stock or extinguished without consideration. In those cases, a "BURP" (a Business UnReported Profits Adjustment) or "ACE" (an adjusted current earnings) tax preference may cause the debtor to incur a substantial AMT and reduce the debtor's AMT net operating losses ("AMTNOLs"). The AMT tax consequences of FSLIC or FDIC assistance to troubled financial institutions remain uncertain. A third concern involves the AMT treatment of accounting reserves.

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* This report was prepared by the Alternative Minimum Tax Committee with the concurrence of the Bankruptcy Committee; its principal drafter is Robert A. Jacobs. Committee members Stuart Goldring, Richard Reichler and Daniel J. Barsky made significant contributions to the report. Helpful contributions were made by William L. Burke, John A. Corry, Harvey P. Dale, Arthur A. Feder, Simon Friedman, Susan J. Halpern, James A. Locke, Hugh T. McCormick, J. Roger Mentz, Donald Schapiro, Michael L. Schler, Eugene L. Vogel, David E. Watts, and Ralph 0. Winger.

1 The Technical and Miscellaneous Revenue Act of 1988(H.R. 4333).

In 1986, Congress substantially extended AMT's application to corporations to serve one overriding objective:

> to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits.... The ability of high-income taxpayers to pay little or no tax undermines respect for the entire tax system and, thus, for the incentive provisions themselves.[2]

Proper application of these principles to insolvent corporate debtors in and out of title 11 proceedings is the subject of this report. As developed below, existing Code provisions may operate to exact an AMT from insolvent corporate taxpayers, an exaction we believe inappropriate. Administrative (and, where necessary, legislative) changes should be fashioned to relieve financially troubled corporations from the AMT.

1. Debt Discharge.

In 1980, when enacting the Bankruptcy Tax Act, Congress knowingly compromised the competing interests that create conflict where tax and bankruptcy principles intersect in bankruptcy proceedings.

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[2] Staff of Joint Comm. on Taxation, 98th Cong., 2d Sess., General Explanation of the Tax Reform Act of 1986(1987) ("Blue Book") at 432-433.

> The rules of the bill concerning income tax treatment of debt discharge in bankruptcy are intended to accommodate bankruptcy policy and tax policy. To preserve the debtor's "fresh start" after bankruptcy, the bill provides that no income is recognized by reason of debt discharge in bankruptcy, so that a debtor coming out of bankruptcy (or an insolvent debtor outside bankruptcy) is not burdened with an immediate tax liability.[3]

If a Chapter 7 liquidating debtor loss corporation ("L") pays $1 million to its creditors to whom it owes $11 million, L realizes no income under Code §61(a)(12) or Code §108.[4] Technically, L's debt is not cancelled; it remains outstanding. A Chapter 7 corporate debtor does not have any of its debt discharged.[5] Because no debt is discharged, there should be no cancellation of debt ("COD") to report for either tax or accounting (book) purposes.[6] Under the same facts in a Chapter 11

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[3] S. Rep. No. 96-1035, 96th Cong., 2d Sess.(1980)("1980 S. Rep."), reprinted at 1980-2 C.B. at 624. Long before the enactment of the Bankruptcy Tax Act the courts provided insolvent debtors with an exception to the general rule of income recognition for their COD. See e.g., Dallas Transfer & Terminal Warehouse Co. v Commissioner. 70 F.2d 95 (5th Cir. 1934) (transfer by insolvent debtor of appreciated property in exchange for debt discharge did not produce cognizable gain). See also. Treas. Reg. § 1.61-12(b)(1).

[4] All Code references are to the Internal Revenue Code of 1986.

[5] See Section 1.3 infra.

[6] From a tax perspective, the described Chapter 7 case arguably could be viewed as a constructive liquidation, producing a constructive debt cancellation. Even though the L debt is not discharged legally, it will never be repaid. Were that nondischarged debt treated as a constructive debt cancellation, creditors who receive 10 cents on the dollar of their debt, would have their recovery further reduced by the "government take" on the 90 cent constructively effected COD of the debtor.

reorganization case, the debt is discharged upon confirmation.[7] That debt discharge produces COD income (even though the income is excluded from gross income under Code §108(a)(2)(A)) and may cause the corporate debtor to incur a substantial alternative minimum tax.

Under generally accepted accounting principles ("GAAP"), book income includes COD income,[8] even if that income is excluded for Federal income tax purposes under Code §108(a). If the COD income included in book income causes the book income to exceed the debtor corporation's taxable income, that COD will trigger a BURP adjustment. That adjustment -- generally equal to 50% of the excess of net book income over AMTI (alternative minimum taxable income) computed without regard to BURP or AMTNOLs[9] -- may further reduce any AMTNOLs[10] and can generate significant

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[7] 11 U.S.C. §1141(d)(1).

[8] See "Early Extinguishment of Debt", A.P.B. Opinion No. 26 (1972). Accounting by Debtors and Creditors for Troubled Debt Restructurings, Statement of Financial Accounting Standards ("FASB") No. 15 (Fin. Accounting Standards Bd. 1977), generally treats as recognized gain the excess of the debt cancelled over the book value of assets transferred. Where debtor stock is issued for debt, the gain is the excess of the debt cancelled over the fair value of the stock. FASB No. 15 does not apply, however, to troubled debt restructurings of debtors involved in bankruptcy proceedings where the debtor generally restates its liabilities under quasi-reorganization accounting. FASB Tech. Bull. 81-6.

[9] AMTNOLs are specially calculated NOLs, available for AMT purposes under Code §56(d).They generally track regular NOLs, accumulating to the extent of AMT losses and reducing to the extent applied to reduce AMTI. Code §382(1)(7) requires Treasury to issue regulations applying Code §382 principles to AMTNOLs under Code §56(d). See PLR 8901055 (10 Jan. 1989) (applying Code §382 to AMTNOLs).

[10] AMTNOLs will first be reduced by the amount of the BURP adjustment they eliminate. Are they then to be further reduced under Code §108 (b) for the COD income? Until Regulations are published, it is uncertain how AMTNOLs will be affected by COD excluded from income under Code §108(a). Assuming the AMT is a separate taxing regime (for this purpose not governed by regular tax principles), the excluded COD that reduces regular NOLs under Code §108(b) may or may not reduce AMTNOLs.

tax liability.[11] Because AMTNOLs may be deducted only to the extent of 90% of L's AMTI, 10% of L's AMTI (consisting of 50% of the excess of book income over AMTI) will be subject to a 20% AMT. Thus, the exacted tax will be 1% of L's COD (assuming no offsetting book-tax differences). In addition, to the immediate tax, L may encounter a second regular income tax if its NOLs, having been reduced by Code §108(b), are insufficient to shelter future L income. The AMT adjustments to prevent omission or duplication mechanism of Reg. §1.56-1T(d)(4) will not avoid this "double dipping".

> Example 1: On March 1, 1989, L emerges from its Chapter 11 proceedings. L pays $1 million cash to its creditors to cancel a $11 million debt. L has $15 million in NOLs and $15 million of AMTNOLs.[12] During 1989, L has no taxable income; its business gains and losses offset each other, and its COD is excluded under the Code §108(a) exception to income inclusion available to Chapter 11 debtors, although its NOLs will be reduced under Code §108(b). L's AMTI before the Code §56(f) BURP adjustment is zero

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[11] Code §56 (f)(1). See generally, Feinberg and Robinson, "The Corporate Alternative Minimum Tax: Working with BURP While Waiting for ACE," 15 J. Corp. Tax 3 (1988).

[12] L's AMTNOL carryovers on January 1, 1987 were equal to its NOL carryovers on that date. Blue Book at 469. In the case of a corporation that had a deferral of add-on minimum tax liability for a year prior to 1987 under Code §56(b) due to certain NOLs, the corporation's AMTNOLs will be reduced by the amount of preference that gave rise to the deferred liability. Id. at 469-70.

(assuming no other adjustments or preferences). L's book income attributable to its debt cancellation is $10 million. Accordingly, L's BURP adjustment will be $5 million [50% of ($10 million COD - 0 AMTI)]. L's AMTI after the BURP adjustment is, therefore, $5 million. After offsetting 90% of its AMTI (i.e., $4.5 million) with its AMTNOLs, L's AMTI will be $500,000, upon which it will pay a $100,000 tax (20% tax rate x $500,000 AMTI), an amount equal to 1% of L's $10 million COD. In addition, L will have $5 million of NOLs available for regular tax purposes ($15 million beginning amount reduced by the $10 million Code §108 reduction), but may have only $500,000 of AMTNOL available, $15 million beginning amount reduced by the $10 million Code §108(b) adjustment and the additional $4.5 million used to offset BURP, if AMTNOLs are adjusted by both the excluded COD income and the utilized AMTNOLs. That result appears questionable. So too does the obverse result (not reducing AMTNOLs by the excluded COD income); NOLs of $5 million and AMTNOLs of $10.5 million.

We believe it inappropriate to exact an AMT under these circumstances. When enacting the Bankruptcy Tax Act of 1980, Congress recognized the desirability of giving a bankrupt company time to pay the tax associated with COD income. It achieved its purpose through the exclusion and deferral mechanism of Code §§108(a) and (b).[13]

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[13] Code §108 acknowledges that an insolvent debtor does not currently benefit from the discharge of indebtedness, because no assets have been freed for the taxpayer's use by the discharge. Although the debtor may have had an untaxed accession to wealth in the past, it now has an obligation that it is unable to liquidate because of a lack of funds. Code § 108(b) nevertheless applies to postpone the recognition of income in this instance. For example, if A borrows $100, spends it, and then becomes insolvent, it can be argued that as a technical matter A has had the economic benefit of the $100, and thus should be taxed on it at some point. Moreover, when there has been a past accession to wealth there is no theoretical injustice in requiring that the tax be paid out of remaining assets, for if the $100 had been treated as income when consumed, A's assets would have been depleted by the amount of tax paid at that time, and A's assets going into bankruptcy would have been reduced by that amount. However, the policy decision has been made that neither the time of consumption nor the time of discharge (in insolvency) is the proper time for taxation. Instead, Code §108 permits the deferral of avoidance of tax.

The stated purposes of Code §108 are (i) to preserve the debtor's fresh start after bankruptcy, by not recognizing income that would otherwise arise as a result of the debt discharge and thus not burdening the debtor with an immediate tax liability, and (ii) to relieve the creditors of an insolvent debtor of the liability for the tax on "income" that, if collected, would reduce already diminished assets:

> We are sympathetic to the basic policy of bankruptcy and would not want to discourage creditors from forgiving part of a debtor's debts by creating a tax liability that might be collectible before the amounts owing to forgiving debtors. Accordingly, we agree with the position taken in H.R. 5043 that no taxpayer in bankruptcy, and no taxpayer who is insolvent after a debt is forgiven, should incur a tax liability as a result of forgiveness of indebtedness.[14]

There is no "tax benefit rule" in Code §108; i.e., insolvency relief is not denied when borrowed funds have been used for deductible expenditures. It has long been recognized that a taxpayer could use borrowed funds to generate current

[14] Bankruptcy Tax Act of 1980: Hearings Before the Subcommittee on Select Reserve Measures of the House Ways and Means Committee. 96th Cong. 1st Sess. (Sept. 27, 1979) (Statement of Daniel I. Halpern, Deputy Assistant Secretary of the Treasury for Tax Legislation).

deductions, either by using them to pay deductible expenses or by investing them in assets that generate capital losses, and, after becoming insolvent, could be discharged from the liability to pay the indebtedness without recapturing the deducted amounts.[15] When enacting Code §108, Congress could logically have forced prior deductions to be restored to income when the indebtedness was forgiven. Instead, the mechanism devised by Congress in Code §108 to account for deductions that may have been taken by an insolvent debtor through the use of borrowed funds is to require the debtor to reduce its current tax attributes (primarily NOLs).[16] Once tax attributes are used up, the discharge has no further tax consequences. Even a 1% tax exaction (which, in Example 1, amounts to $100,000 that will be borne by creditors who have sustained the bulk of the loss incurred by L) may be so large it will prevent L from effecting a successful reorganization and frustrate the general purpose of the Bankruptcy Tax Act. By contrast, were no AMT exacted from insolvent or bankrupt companies that settle their debts at less than face, the legislative purpose of the AMT, quoted on page 2 of this Report, would not be subverted.

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15 See Rev. Rul. 58-600,1958-2 C.B. 29; Rev. Rul. 67-200, 1967-1 C.B. 15; Bittker, Federal Taxation of Income, Estates and Gifts 6-52 (1981).

16 Congress specifically rejected the inclusion of a tax benefit rule in the pre-1980 version of Code §108. See S. Rep. No. 1622, 83d, Cong. 2d Sess. 186 (1954); H. Rep. No. 2543, 83d Cong., 2d Sess. 22 (1954) (the Conference Report).

TAMRA provides AMT relief to title 11 (or insolvent) debtors that exchange stock (or stock and other property) to extinguish their debts. TAMRA excludes COD from the BURP base of title 11(or insolvent) debtors.[17] Thus, the $100,000 AMT exacted in Example 1 is avoided if L issues L stock, rather than cash or other property, to its creditors. By limiting its AMT relief to stock-for-debt exchanges, it may be inferred that Congress intended that cash-for-debt COD transactions would give rise to AMT, a result we believe is inappropriate and contrary to the principles of all prior legislative action.[18]

> Example 2: On March 1, 1989, L emerges from its Chapter 11 proceedings. L delivers $1 million worth of L stock to its creditors in exchange for their cancelling a $11 million debt. L has $15 million in NOLs and $15 million of AMTNOLs. During 1989, L has no taxable income -- its business gains and losses offset each other. If the stock-for-debt exception to COD income is available, L's NOLs will not be reduced under Code §108(b) (because L's liability to its creditors will not be treated as cancelled, but merely continuing in a different form).[19] L's AMTI before the Code §56 (f)BURP adjustment(assuming no other adjustments or preferences) will be zero. L's book income attributable to its debt cancellation is $10 million. Absent TAMRA's legislative relief, L's BURP adjustment would be $5 million.

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[17] TAMRA §6303 (a), adding Code §56(f)(2)(I), applies solely to stock for debt exchanges effected by debtors in title 11 proceedings and by insolvent debtors. It does not address other cases, e.g., cash for debt cancellations by insolvent debtors or debtors in title 11 proceedings.

[18] See the discussion of the Bankruptcy Tax Act at 2-4, and 7-8, supra and discussion of the 1986 corporate AMT amendments at 2, supra. See Blue Book at 434("there must be reasonable certainty that, whenever a company publicly reports significant earnings, that company will pay some tax for the year").

[19] See Code §108(e)(10), and cases cited in Note 26, infra.

The TAMRA amendment to Code §56(f)(2), which is retroactive to the BURP effective date, furthers the 1980 Bankruptcy Tax Act philosophy of accommodating both tax and bankruptcy policy.

> The proposal provides that the transfer of a corporation's own stock to its creditors in exchange for the corporation's debt in a Title 11 case (or to the extent the corporation is insolvent) does not give rise to adjusted net book income. Thus, a bankrupt or insolvent corporation will not incur a minimum tax liability by reason of transferring its stock to creditors.
>
> * * *
>
> Corporations that restructure their capital by issuing stock to their creditors in a bankruptcy case or to the extent insolvent should not incur a tax liability.[20]

The case for providing or withholding relief from AMT exaction between situations where stock is issued and where stock is not issued is unconvincing. The detrimental effect of a current tax on a corporation emerging from bankruptcy is the same in both situations. For those reasons, we recommend:

> the Congress expand its TAMRA amendment so that AMTI will not reflect COD income excluded under Code §108(a), as well as income excluded from gross income under the common law stock-for-debt exception.

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[20] Joint Committee on Taxation Staff Description (JCX-15-88) of Amendment Proposing Additional Tax Law Changes and Tax Increases, to HR 4333, Proposed Technical Corrections Act, as Already Amended by House Ways and Means Committee, and Revenue Estimates of Amendment (JCX-16-88), released July 13, 1988 at 26, reprinted in DTR No. 135 (July 14, 1988) at L-21, L-31.

1.1. Quasi-Reorganization Accounting.

L may be able to avoid any BURP adjustment if it accounts for its debt cancellation as a "quasi-reorganization." A detailed discussion of quasi-reorganization and other accounting principles is attached as the Appendix to this report. In an FASB sanctioned quasi-reorganization, COD is accounted for as an addition to the debtor's capital account, and not as an extraordinary income item includable in book income. By eliminating COD from its book income, L can avoid a BURP adjustment and AMT. Generally, book income for AMT purposes means income reported on a taxpayer's "applicable financial statement." The regulations describe the "applicable financial statement"[21] in descending order of priority as: (1) a statement required to be filed with the SEC, (2) a certified audited financial statement, (3) a financial statement provided to a government regulator, and (4) "other financial statements."[22] In particular, a "certified audited financial statement" is a "statement that is used for credit purposes, for reporting to shareholders or for any other substantial non-tax purpose" and is "certified by a Certified Public Accountant."[23]

Because quasi-reorganization accounting complies with GAAP and may be used in the preparation of a certified audited financial statement for accounting purposes, it should, under the

[21] Treas. Reg. §1.56-1T(b)(2).

[22] Treas. Reg. §1.56-1T(c)(1).

[23] Treas. Reg. §1.56-1T(c)(1)(ii).

plain language of Treas. Reg. §56-1T(c)(1)(ii), be available to avoid a BURP tax preference, even though it is an elective accounting method that, until recently, was rarely used. Although a certified financial statement prepared under a quasi-reorganization accounting appears to qualify as an "applicable financial statement" for AMT purposes, to provide needed certainty in this area, we recommend:

> the Internal Revenue Service rule that quasi-reorganization accounting will be respected in computing a corporation's book income.[24]

1.2. Debt Discharge Under ACE.

Beginning in 1990, "ACE", the adjusted current earnings AMTI component, will replace the BURP adjustment.[25] Under ACE, L's AMTI will be increased by 75% of the excess of L's ACE over its AMTI, determined without regard to the ACE adjustment. In calculating ACE, L will include items excluded from gross income in computing its AMTI, if those items are included in the computation of earnings and profits under subchapter C (e.g., tax exempt interest). The impact of this rule on stock-for-debt exchanges and other property for debt exchanges or simple debt forgiveness situations may vary. The Senate Committee Report

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[24] If the Congress excludes Code §108(a) COD income from AMTI, as recommended earlier, this recommendation will become unnecessary.

[25] Code §56(g).

makes clear that earnings and profits will not be generated where the stock-for-debt exception to COD income applies.[26]

> [U]nder the present law adjusted current earnings preference, no adjusted current earnings arise (because there is no income from the discharge of indebtedness and thus no earnings and profits) where a corporation issues stock to its creditors in a Title 11 case (or to the extent the corporation is insolvent and the common law stock for debt exception applies).[27]

To similar effect is the Joint Committee Staff Description, under the heading "Items Requiring Only Report Language." Thus, no ACE adjustment will be required with respect to stock-for-debt exchanges satisfying the stock-for-debt exception.

In addition, where the bankrupt company elects, or is required, to reduce asset basis by the amount of the COD, no ACE adjustment would result. This follows from the application of Code §312(1)(1), which provides that:

> The earnings and profits of a corporation shall not include income from the discharge of indebtedness to the extent of the amount applied to reduce basis under section 1017.

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[26] The stock-for-debt exception to COD income inclusion is a court fashioned rule begun in Capento Securities Corp.v. Commissioner, 47 B.T.A. 691 (1942), aff'd, 140 F.2 382 (1st Cir. 1944); Commissioner v. Motor Mart Trust, 156 F.2d 122 (1st Cir. 1946); and Alcazar Hotel, Inc. v. Commissioner, 1 T.C. 872(1943), acq. 1947-1 C.B. 1 (both holding that the exchange of stock for debt merely represents a continuation of the existing liability in a different form and does not effect a true discharge of the debt); Accord, Rev. Rul. 59¬222, 1959-1 C.B. 80.

[27] Senate Finance Committee Report to Accompany S 2 2 38, "Technical Corrections Act of 1988," S. Rep. No. 44 5, 100th Cong., 2d Sess. 96 (Aug. 3, 1988) (footnote omitted), reprinted in DTR No. 152 (August 8, 1988) at 5-3 4.

A negative implication of Code §312(l)(1), however, is that COD income that is not applied to reduce the asset basis of depreciable property is included in earnings and profits. This is made clear in the legislative history.[28] Similarly, professors Bittker and Eustice note that:

> If the corporate debtor does not elect to exclude cancellation of indebtedness income under sections 108 and 1017 (or, as a result of 1986 amendments, cannot exclude such gain because it is solvent), earnings and profits should be increased by the gain on debt cancellation, unless it qualifies for one of the exceptions to cancellation of indebtedness income.[29]

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[28] See 1980 S. Rep., 1980-2 C.B. at 623 and 642-43. See also IRS Publication 908, "Bankruptcy and Other Debt Cancellation" (Dec. 1988) (where the basis of property is not reduced under Code §312(l), "discharge of indebtedness income, including amounts excluded from income increases the earnings and profits of the corporation....").

Including excluded COD income in earnings and profits does not necessarily follow general earnings and profits principles. Compare Meyer v. Commissioner, 383 F.2d 883 (8th Cir. 1967), rev'g 46 T.C. 65 (1966) (COD realized by the Chapter 11 debt or gave rise to neither income realization nor augmentation of earnings and profits) with Revenue Ruling 75-515, 1975-2 C.B. 117, where the Service disagreed with the Meyer holding, arguing that accretions to wealth, such as nontaxable COD income, increase the corporate earnings and profits available for dividend payments to shareholders. The Congress, in 1980, endorsed the Service's position in the legislative history to Code §312(l)(1)

The difference between the Code §312(l)(1) approach and general earnings and profits principles is further illustrated by Rev. Rul. 76-239,1976-1 C.B. 90, where the Service held that no increase in earnings and profits occurred when a corporation's gain on the sale of its assets was not recognized under the predecessor to Code §337. PLR 8836010(9 Sept. 1988) applies these principles in a case where a corporation elected under Code §56(f)(3)(B)(ii) to treat its current earnings and profits as its net income for AMT book purposes. The corporation liquidated under Old Code §337. Under Rev. Rul. 76-239, the gain realized on the sale of its assets was excluded from its earnings and profits. PLR 8836010 holds that exclusion is equally applicable for AMT purposes; the gain does not increase earnings and profits for purposes of computing the corporation's adjusted net book income for purposes of calculating alternative minimum taxable income.

[29] Bittker & Eustice, Federal Income Taxation of Corporations and Shareholders (5th ed. 1987) at 7-15.

It thus would appear that ACE will include any COD income excluded under Code §108(a) for which no basis reduction was taken.

Where tax attributes (other than asset basis) are reduced under Code §108(b) -- and thus are not available to reduce taxable income in subsequent years -- the imposition of ACE creates a potential double counting of COD -- once for regular tax purposes and once for AMT purposes.

> Example 3: L's Chapter 11 reorganization plan provides for it to pay $1 million cash to its creditors to cancel an $11 million debt. L has $15 million in NOLs and $15 million in AMTNOLs. L excludes its $10 million COD under Code §108(a) and reduces its NOLs by that amount as directed by Code § 108(b).
>
> In its first post-Chapter 11 year, L earns $15 million. Because L's NOLs have been reduced to $5 million, L will pay a tax on $10 million.
>
> If L's COD income is treated as giving rise to ACE, that one item of COD income will produce two taxes:
>
> 1. The ACE AMT in the year of the COD; and
> 2. The regular tax in the year the NOL reduction affects L's regular taxable income.

This “double dipping” should be avoided by an appropriate ACE regulation or ruling that exonerates COD income

excluded by Code §108(a) from ACE augmentations.[30] Thus, we recommend:

> a regulation or ruling be promulgated holding that COD income excluded from gross income by Code §108 (a) should not be counted so as to both increase ACE in the year of the COD and reduce NOLs available to offset income in subsequent years.

1.3. <u>Debt Discharge in Chapter 7 Liquidations</u>.

Up to this point, this report has focused principally on debt cancellations occurring in a Chapter 11 proceeding or in a non-bankruptcy restructuring of an ongoing company. Tax concerns can also arise in liquidating bankruptcies. For creditors of a corporation in a Chapter 7 proceeding, the imposition of a tax attributable to debt cancellation would be particularly surprising and puzzling. In those cases, the assets available for distribution to creditors are generally small in relation to the debt. As a result, as we have already noted, even a 1% tax on COD income can have a significant financial impact. It is difficult to justify requiring a corporation in liquidation, whose only asset is cash, that is distributing all its cash to its creditors, must pay a portion of that cash to satisfy a tax liability generated solely because it cannot pay its creditors in full. This result makes little sense from a bankruptcy or tax policy perspective.

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[30] Cf. Code §382 (1) (5) (C)(ii),as amended by TAMRA §1006(d)(18), which avoids the double counting of interest cancelled in stock-for-debt exchanges qualifying for the bankruptcy exception to the application of Code § 382(a). If the Congress excludes COD income from AMTI, as recommended earlier, this recommendation will become unnecessary.

In Chapter 7 cases, no AMT will be exacted if the technical "no discharge" rule of Chapter 7 is controlling.[31] There having been no debt discharge, there should be no COD income (although it is possible that a court could treat a Chapter 7 distribution as a de facto liquidation and constructive debt satisfaction).

In short, we believe the imposition of the AMT in connection with debt cancellations by an insolvent or bankrupt corporation is contrary to the basic goals of the Bankruptcy Tax Act of 1980 and that corrective action should be taken. We recommend:

> a regulation or ruling be promulgated holding that no COD income is realized in a proceeding where no debt is discharged under the applicable rules of title 11.[32]

4. FDIC and FSLIC Assistance Payments.[33]

Code §597 provides special treatment for troubled banks and savings and loan institutions that receive assistance payments from the Federal Deposit Insurance Corporation ("FDIC") or the Federal Savings and Loan Insurance Corporation ("FSLIC"). Assistance payments come in many forms, the most prevalent being

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[31] 11 U.S.C. §727(a)(I) ("The court shall grant the debtor a discharge, unless...the debtor is not an individual").

[32] If the Congress excludes COD income from AMTI, as recommended earlier, this recommendation will become unnecessary.

[33] The principal drafter of this report represents clients, some of whom have asserted assistance payments are income and others of whom have asserted they are nontaxable contributions to capital. His representation has not included an undertaking to characterize the treatment of those payments for alternative minimum tax purposes.

(i) negotiated cash payments; (ii) negative net worth notes (and interest)interest); (iii) capital loss guarantees; (iv) yield maintenance payments; and (5) guarantees or reimbursements of certain costs relating to the acquired assets.[34] TAMRA applies this provision to payments received before January 1, 1990 (or later if pursuant to an acquisition occurring after the date of TAMRA's enactment and before January 1, 1990). Under Code §597, assistance payments are not included in gross income. As in the case of excluded COD income under Code §108, Code §597 exacts a price for its income exclusion. An amount equal to 50% of the

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[34] The Joint Committee Staff has described these payments in the following terms:

> A negotiated cash payment is a lump sum cash payment negotiated between the FSLIC and the acquirer of a financially troubled thrift institution. A negative net worth note generally is an interest-bearing term note with a face amount equal to the difference of [sic] the time of the acquisition, between the book value of the assets of the financially troubled thrift institution and its liabilities. The note brings the net worth of the troubled thrift institution up to zero. A capital loss guarantee generally is a guarantee by the FSLIC of all or a portion of the stated book value of certain assets acquired from a financially troubled thrift institution. Under such a guarantee, if the guaranteed assets are disposed of for a price less than the guaranteed value, the FSLIC will reimburse the thrift institution for the difference. A yield maintenance payment generally is an amount paid by the FSLIC with respect to certain assets acquired from a financially troubled thrift institution which is intended to supplement the yield on such assets. . . . Guarantees or reimbursements of the cost of certain expenses related to the acquired assets of a financially troubled thrift institution may be made by the FSLIC, either directly or indirectly through the setting of the yield maintenance rate or other aspects of other guarantees.

Joint Committee on Taxation, "Current Tax Rules Relating to Financially Troubled Savings and Loan Associations" (JCS-3-89), February 16, 1989 (hereafter "JCS Pamphlet") at 27-28.

assistance payment is deducted from the troubled financial institution's favorable tax attributes. It is unclear, however, whether any payments excluded from income under Code §597 give rise to BURP (or ACE if the life of Code §597 is extended into years governed by ACE) with the resulting application of the AMT.[35]

Under BURP, the determination depends on whether the assistance payment is treated as a capital contribution or as income for financial accounting purposes; whereas, under ACE, the issue is whether the assistance payment, in the absence of Code §597, would be treated as a capital contribution or income for federal income tax purposes. Assistance payments characterized as income would generate a BURP or ACE adjustment (as the case may be) because book income and earnings and profits probably would be increased.[36] As in the Code §108 debt cancellation area, the imposition of a BURP or ACE adjustment would impose a tax burden where Congress had previously determined none was appropriate. Also, because the troubled financial institution's tax attributes are reduced by 50% of the assistance payments excluded from income under Code §597(a), there is a potential "double dipping".

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[35] To the extent NOLs are reduced under Code §597 (c), is a parallel reduction required for AMTNOL purposes? See discussion at note 10, supra.

[36] If considered income for federal income tax purposes, albeit income excluded under Code §597, the income could be viewed as being similar to tax-exempt interest and, thus, increase earnings and profits of the loss institution. See e.g., Treas. Reg. §1.312-6(b).

Assistance payments characterized as capital contributions, on the other hand, would not increase book income or earnings and profits. Under Code §§118(a) and 362(c)(1), a capital contribution from a nonshareholder is not included in gross income for federal income tax purposes, but requires a basis reduction in assets acquired within 12 months of the contribution or on-hand at the end of the 12-month period.

The federal income tax treatment of assistance payments is uncertain.[37] Unfortunately, there is no established practice

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[37] JCS Pamphlet at 26 describes the law applicable without references to Code §597:

> Prior to [the Economic Recovery Tax Act of 1981], the tax treatment of a payment from the FSLIC to a thrift institution was unclear.

In accompanying Footnote 32, the JSC Pamphlet observed:

> The current administrative approach taken by the Internal Revenue Service (the "IRS") for private ruling purposes is that, absent legislation to the contrary, a payment from the FSLIC to a financially troubled thrift institution is not a contribution to capital and, therefore, is taxable as ordinary income to the recipient thrift institution upon receipt. See LTR 8835057 (June 10, 1988). The IRS has not always taken this position on the issue for private ruling purposes (see LTR 8243025 (July 22,1982)), and it is possible that their [sic] current position could change.

Later in its discussion, relying on the Service's present ruling practice, the JCS Pamphlet asserts at 42:

> Certain FSLIC assistance amounts are treated as income for book purposes and as an increase in earnings and profits, which can result in subjecting a corporation or consolidated group to or increasing a corporation's or consolidated group' s alternative minimum tax liability.

among accountants as to whether assistance payments are to be reported as capital contributions or income for financial accounting purposes.

The case law prior to 1954 uniformly held that true capital contributions to a corporation by nonshareholders did not constitute income to the corporation. See e.g., Edwards v. Cuba Railroad Co., 268 U.S. 628(1925) (Cuban government payment to railroad company held nontaxable contribution to capital) and Holton & Co. v. Commissioner, 10 B.T.A. 1317(1928) (factory contributed by residents to induce business to move to their town is a nontaxable contribution to capital) (Acq.). Cases such as Detroit Edison Co. v. Commissioner, 319 U.S. 98(1943) distinguish compensation payments, which are income, from contributions to capital.[38] To the same effect, see Helverino v. Claiborne - Annapolis Ferry Co., 93 F.2d 875 (4th Cir. 1938) (payments made by state to subsidize private corporation's ferry operations held to be compensation income). Assistance to enable financial institutions to reduce or eliminate their deficits or augment their reserves, is the type of assistance the case law would treat as a capital contribution. Other forms of FDIC or FSLIC assistance, (e.g. interest maintenance subsidies) arguably would not be capital contributions under the case law if they are viewed as compensation payments to the new investors or insurance

[38] In Detroit Edison v. Commissioner, 319 U.S. 98(1943), customer payments made to subsidize the electric company's cost of expanding its facilities were payments made for services.

payments to compensate the financial institution for its losses.

Code §§118 and 362(c) codified these early cases. The 1954 Senate Report to the enacting legislation provides:

> The House and your committee's bill provide that in the case of a corporation, gross income is not to include any contribution to the capital of the taxpayer. This in effect places in the code the court decisions on this subject. It deals with cases where a contribution is made to a corporation by a governmental unit, chamber of commerce, or other association of individuals having no proprietary interest in the corporation. In many such cases because the contributor expects to derive indirect benefits, the contribution cannot be called a gift? yet the anticipated future benefits may also be so intangible as to not warrant treating the contribution as a payment for future services.

S. Rep. No. 1662, 83d Cong. 2d Sess; at 18-19 (1954).

> [T]he rule of this section, that contributions to the capital of a corporation are excluded from income, merely restates the existing law as developed through administration and court decisions. Determination of the basis of property contributed to the capital of a corporation is to be made under section 362. Id. at 160.

The enactment of Code §597 did not alter the characterization of assistance payments. That legislation, while codifying the non-income character of the payment, was intended to relieve the troubled financial institution from reducing the basis of its assets, as is otherwise required under Code

§362(c).[39] For a number of years, the Service regarded these assistance payments as contributions to the capital of the troubled financial institution. Shortly before TAMRA's enactment, at the request of the applying banks, the Service reversed its position and privately ruled that FDIC assistance payments were taxable income, rather than capital contributions by a person other than a shareholder.[40] We understand the Service bases its current ruling policy on a view that the assistance payments are for services to be rendered by the reorganized thrift (presumably permitting FSLIC to avoid paying any insurance claims of depositors)even though the Service includes those payments in the

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[39] "[Legislative history indicates the section [597] was intended as a clarification of existing law and may have been directed as much at avoiding basis reduction under section 362(c) as at clarifying the exclusion from income." Wilkins and Hyde, "NCNB Texas Ruling Breaks New Ground," 40 Tax Notes 1424 (September 26, 1988). See General Explanation of The Economic Recovery Tax Act of 1981 (H.R. 4242; Pub. Law 97-34) at 153 and H. Rep. No. 97-201, 1981-2 C.B. 526 establishing that prior to the 1981 Act, the tax treatment of some FSLIC payments to thrifts was uncertain. JCS Pamphlet at 26. That uncertainty focused on those payments that could be viewed as being for services. See Helverina v. Claiborne - Annapolis Ferrv Co., 93 F.2d 875 (4th Cir. 1938) (payments made by state to subsidize private corporation's ferry operations held to be compensation income). Congress mooted these uncertainties in the enactment of Code §597. See General Explanation of the Economic Recovery Tax Act of 1981 at 153 ("[n]o inference is intended as to the proper treatment of Federal Savings and Loan Insurance Corporation assistance payments under prior law with respect to whether such payments are excluded from income or require a basis reduction").

[40] See PLR 8821085 (3 Mar. 1988);PLR 8835057(21 Oct. 1988); reversing the Service's earlier position in PLR 8243025(22 July 1982); See also PLR 8223022 (5 Mar. 1982); PLR 8646010 (21 July 1986). Also, the Service has privately ruled that FSLIC assistance payments augment earnings and profits of savings and loan associations. See PLR 8912043(27 Dec. 1988); PLR 8850051 (21 Sept. 1988).

income of the troubled thrift before its acquisition by the reorganized thrift. We believe capital-type assistance payments (such as negotiated cash payments, negative net worth notes, capital loss guarantees, and expense guarantees or reimbursements) are distinguishable from income-type assistance payments (such as income maintenance subsidies or interest payments). To effect the proper tax treatment of assistance payments for AMT purposes, we recommend:

> a regulation or ruling be promulgated holding that for AMT purposes, FSLIC and FDIC (i) negotiated cash payments, negative net worth notes, capital loss guarantees, expense guarantees, or any other FDIC and FSLIC assistance payments in the nature of capital contributions do not augment the recipient's book income or earnings and profits, and (ii) annual income subsidies or interest payments do augment the recipient’s book income or earnings and profits.

5. Treatment of Accounting Reserves

A serious problem under BURP that has an especially adverse impact on the troubled company results from the treatment under generally accepted accounting principles of reserves established to anticipate future expenditures. Reserves for those purposes are often established for anticipated losses from discontinued operations or losses from the anticipated sale of assets.

Typically, the contemplated losses are deductible in a subsequent year when they are realized, even though the loss is credited against the prior period reserve for book purposes. In those cases, book income will exceed taxable income in the later period. For example, if a $100 million reserve is established

for a plant closing in 1986 and the plant is closed in 1987 at an actual loss of $100 million, the 1987 loss will be charged to the reserve for book purposes, but will be deductible for income tax purposes in 1987, thereby resulting in a difference between book and taxable income in 1987.

If a reserved future expense (for example, deferred compensation) is relieved in a bankruptcy reorganization or is settled for less than the amount previously reserved, for book purposes, income is credited to the extent the prior liability is reduced. That income crediting (in a year when a deduction is taken for regular tax purposes) can give rise to a book-tax preference item, even though no tax benefit was realized when the reserve was established. This anomaly should be corrected. We recommend:

> a regulation or ruling be promulgated, holding that for AMT purpose's, AMTI does not include BURP items attributable to reversals arising from relief in insolvency proceedings or bankruptcy reorganizations of previously expensed charges to reserves.

Alternative Minimum Tax in Bankruptcy Settings, Accounting Aspects

Quasi-Reorganization Accounting

The accounting literature provides no specific guidance for financial reporting by entities operating under Chapter 11. Currently, the Task Force on Accounting by Entities in Bankruptcy of the Accounting Standards Division of the American Institute of Certified Public Accountants is addressing this issue.

The authoritative literature covering these subjects includes Accounting Research Bulletins (ARB) issued by the Committee on Accounting Procedure of the AICPA, Opinions issued by the Accounting Principles Board (APB, the successor to the Committee on Accounting Procedure) and Statements of the Financial Accounting Standards Board (FASB), the current accounting principles standard setting body.

Debt Extinguishment

Generally, outside of a "troubled debt restructuring", debt is extinguished under one of the following circumstances:[1]

[1] FASB No. 76, Extinguishment of Debt, November 1983

1. The debtor pays the creditor and is relieved of all obligations with respect to the debt. This includes the debtor's reacquisition of its outstanding debt securities in the public securities markets, regardless of whether the securities are cancelled or held as treasury bonds.

2. The debtor is legally released from being the primary obligor under the debt, either judicially or by the creditor, and it is probable that the debtor will not be required to make future payments with respect to that debt under any guarantees.
3. The debt or irrevocably places cash or other assets in a trust to be used solely for satisfying scheduled payments of both interest and principal of a specific obligation and the possibility that the debtor will be required to make future payments with respect to that debt is remote. In this circumstance, debt is extinguished even through the debtor is not legally released from being the primary obligor under the debt obligation (in-substance defeasance).

The accounting treatment for the described debt extinguishments is generally the same, regardless of how the extinguishment is achieved (i.e. whether by payment in cash, stock, other assets, legal release or in-substance defeasance). The accounting treatment required is provided for in APB Opinion

No. 26 (Early Extinguishment of Debt, October 1972) which states in part, that

> the difference between the reacquisition price and the net carrying amount of the extinguished debt shall be recognized currently in income of the period of extinguishment as a loss or gain and identified as a separate item. Gains and losses shall not be amortized to future periods.

Classification of losses and gains resulting from debt extinguishments is addressed in FASB No. 4, Reporting Gains and Losses from Extinguishment of Debt, March 1975, as follows:

> Gains and losses from extinguishment[s] of debt that are included in the determination of net income shall be aggregated and, if material, classified as an extraordinary item, net of related income tax effect.

When debt is extinguished with the transfer of assets other than cash or by the issuance of stock any resultant loss or gain is determined by measuring the difference (if any) between the carrying amount of the debt extinguished and the fair market value of the assets transferred or stock issued.

Troubled Debt Restructurings

FASB No. 15, Accounting by Debtors and Creditors for Troubled Debt Restructurings, June 1977, describes the accounting for a “troubled debt restructuring,” which occurs “when a

creditor (for economic or legal reasons) grants a concession to the debtor that it would not have otherwise considered." Only restructurings that involve a concession by a creditor are subject to the "troubled debt restructuring" rules of FASB No. 15. The concession may be pursuant to an agreement between the debtor and a creditor or a mandated court order.

A "troubled debt restructuring" may include, but is not necessarily limited to, one or more of the following:

1. Transfer from the debtor to the creditor of receivables from third parties, real estate, or other assets to satisfy fully or partially a debt (including a transfer resulting from foreclosure or repossession)

2. Issuance or other granting of any equity interest to the creditor by the debtor to satisfy fully or partially a debt unless the equity interest is granted pursuant to existing terms for converting the debt into an equity interest.

3. Modification of terms of a debt, such as one or a combination of:

   3.1 Reduction (absolute or contingent) of the stated interest rate for the remaining original life of the debt

   3.2 Extension of the maturity date or dates at a stated interest rate lower than the current market rate for new debt with similar risk

   3.3 Reduction (absolute or contingent) of the face amount or maturity amount of the debt as stated in the instrument or other agreement

   3.4 Reduction (absolute or contingent) of accrued interest.

When the entire debt is extinguished by transferring assets or granting an equity interest pursuant to a "troubled

debt restructuring” the accounting treatment for the extinguishment is the same as under the general rules for debt extinguishment (a gain is recognized to the extent that there is a difference between the fair market value of the assets transferred or stock issued in satisfaction of the original debt and the carrying value of the original debt). Classification of the resultant gain is also the same as for general debt extinguishment, that is, as an extraordinary item (if material).

Troubled debt restructurings involving modification of terms or a combination of a modification of terms and a partial settlement by transferring assets or granting an equity interest, on the other hand, are accounted for differently than under the general rules. In the case of modifications, the carrying amount of the original debt is not changed at the time of restructuring (and, accordingly, no gain is recognized), unless total future cash payments specified by the restructured terms is less than the carrying amount of the original debt. If the total future cash payments (principal and interest) specified by the restructured terms are less than the carrying amount of the original debt an extraordinary gain is recognized to the extent of the difference and interest no longer accrues. Contingent cash payments should be included in the total future cash payments for purposes of any gain calculation. If the total future cash payments (principal and interest) specified by the restructured terms are more than the carrying amount of the original debt the company shall account for the charges prospectively, as interest

expense, and as previously indicated not adjust the carrying amount of the original debt.

For restructurings involving combinations of the above referred to types, the partial settlement portion involving a transfer of assets or granting an equity interest, the assets or equity is accounted for using fair values. Any difference between the fair value of the assets transferred and their carrying amount is recognized as a gain or loss on the transfer of assets. The balance of the debt that is modified is accounted for as described above for modifications.

Accounting for debt extinguished in a “troubled debt restructuring” is applicable to companies either in or out of bankruptcy unless (per FASB No. 15 and reiterated in FASB Technical Bulletin 81-6) the extinguishment occurs in connection with a general restatement of the debtor's liabilities pursuant to a quasi-reorganization, corporate readjustment or, general restatement of liabilities in connection with a bankruptcy proceeding.

Quasi-Reorganization

A quasi-reorganization is an elective procedure, designed to present a “fresh start” for companies with large losses and a significant accumulated deficit. The procedure involves a readjustment of the carrying amounts of a company's assets, liabilities, capital stock and related surplus.

The authoritative literature addressing the subject of quasi-reorganizations is Accounting Research Bulletin Number 43, chapter 7, Section A - Quasi-Reorganization or Corporate Readjustment (ARB No. 43, Chapter 7).

Written in 1953, ARB No. 43, chapter 7 is actually an amplification of Rule 2 of the American Institute of Accountants (predecessor to the AICPA) which was issued in 1934.[2] Rule 2 basically states that upon reorganization a reorganized company would be relieved of charges that would ordinarily have been made against income if the company had not been reorganized. In addition, the same results could be accomplished without a formal

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[2] It should be noted that the Accounting Standards Executive Committee of the AICPA has approved the issuance, subject to final approval by the Chairman, of an issues paper for submission to the FASB on the subject of quasi-reorganizations. The issues paper is not authoritative and does not contain conclusions. However, it does contain an in depth discussion of the issues. At this time it is not known if the FASB will add the subject to its agenda. The issues paper discusses two types of quasi-reorganizations.

- reclassification of a deficit in reported retained earnings, and
- reclassification (as noted above) plus restatement of the carrying amounts of assets and liabilities.

We understand the SEC staff believes the first accounting procedure defined as a quasi-reorganization-reclassification of deficit only is inappropriate and will challenge readjustments without a simultaneous restatement of asset values. We also understand the SEC does not believe it appropriate to record a net write up of assets in a quasi-reorganization.

reorganization. ARB, No. 43, chapter 7 defined these readjustments as quasi-reorganizations.

ARB No. 43, chapter 7 makes it clear that quasi-reorganizations are not mandatory, but rather permissible. If a company makes an election to adopt a quasi-reorganization the company should obtain the formal consent of its stockholders and should present a readjusted balance sheet as of the date of readjustment. No income or loss results from the quasi-reorganization adjustments.

The deficit in retained earnings would be eliminated and, from that point forward, income or loss of the company would be determined from the date of readjustment. After readjustment, the company's accounting should be substantially similar to that appropriate for a new company[3].

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[3] Accounting Series Release (ASR) No. 25, May 1941, defines the conditions that are necessary to effect a quasi-reorganization. The conditions identified in the ASR are as follows:

(1) Earned surplus, as of the date selected, is exhausted;

(2) Upon consummation of the quasi-reorganization, no deficit exists in any surplus account;

(3) The entire procedure is made known to all persons entitled to vote on matters of general corporate policy and the appropriate consents to the particular transactions are obtained in advance in accordance with the applicable law and charter provisions;

(4) The procedure accomplishes, with respect to the accounts, substantially what might be accomplished in a reorganization by legal proceedings—namely, the restatement of assets in terms of present conditions as well as appropriate modifications of capital and capital surplus, in order to obviate so far as possible the necessity of future reorganizations of like nature.

FASB No. 15 states in paragraph 10 (in part) that its provisions should be applied to troubled debt restructurings consummated under reorganization, arrangement or other provisions of the Federal Bankruptcy Act. However, a footnote to that paragraph reads:

> This statement does not apply, however, if under provisions of those Federal statutes, or in a quasi-reorganization or corporate readjustment (ARB No. 43, chapter 7, Section A, "Quasi-Reorganization or Corporate Readjustment...") with which a troubled debt restructuring coincides, the debtor restates its liabilities generally."

Based upon the foregoing, some accounting firms have taken the position that the provisions of FASB No. 15 do not apply to accounting for troubled debt restructurings when coincidental with an overall quasi-reorganization or corporate readjustment of the type described in ARB No. 43, Chapter 7 and a general restatement of the debtor's liabilities. Accordingly, no income or loss results in the foregoing circumstances and the net resulting adjustment is recorded directly in the equity accounts. Moreover, the adoption by a company of quasi-reorganization accounting, although elective, constitutes the application of generally accepted accounting principles and therefore the book earnings as so reported are those to be used in determining if there is a BURP preference.

SEC Quasi Accounting Pronouncements

The SEC sanctions quasi-reorganization accounting where the following conditions are satisfied:

(1) earned surplus, as of the date selected, is exhausted;

(2) upon consummation of the quasi-reorganization, no deficit exists in any surplus account;

(3) the entire procedure is made known to all persons entitled to vote on matters of general corporate policy and the appropriate consents to the particular transactions are obtained in advance in accordance with the applicable law and charter provisions; and

(4) the procedure accomplishes, with respect to the accounts, substantially what might be accomplished in a reorganization by legal proceedings -- namely, the restatement of assets in terms of present conditions as well as appropriate modifications of capital and capital surplus, in order to obviate as far as possible the necessity of future reorganizations of like nature.[4]

[4] ASR 25, SEC Financial Reporting Release #1, 1987 SEC Rules and Regulations, Prentice-Hall Information Services. Although this Financial Reporting Release, by its terms, is effective for changes through December 1, 1986, it outlines the specific technical steps necessary to effect a quasi-reorganization accounting and is generally believed to be applicable currently. See also "Quasi-Reorganization or Corporate Readjustment," A.R.B. 43, Chapter 7A.