REPORT #670

TAX SECTION

New York State Bar Association

Budget Reconciliation Bill

October 17, 1990

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The Honorable Lloyd Bentsen
Chairman, Senate Committee on Finance
703 Hart Senate Office Building
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The Honorable Dan Rostenkowski
Chairman
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1102 Longworth House Office Building
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Dear Messrs. Bentsen and Rostenkowski:

We urge that the Conference Committee reject the provisions in the Budget Reconciliation Bills which would make it far more expensive for troubled corporations to restructure their debt and consequently drive many such corporations into bankruptcy. These provisions (Section 13335 of the House Bill) would: require recognition of cancellation of indebtedness income where old bonds are exchanged for new bonds of equal face amount; and repeal the stock for debt exception for debtors which are insolvent or in bankruptcy and exchange preferred stock for debt.

Although we acknowledge that this area of the law requires study we urge that such a study be directed so that well structured legislation can be considered next year. In particular, this study must take into account the policies underlying the bankruptcy laws. We suspect that many initiatives taken by the Service and the Treasury recently in this area (see Rev. Rul. 90-87, 1990-43 I.R.B. 1; Notice CO-77-89) were taken without considering those policies.

Congress should not take precipitate action at this time which will have disastrous effects on many corporations struggling to avoid bankruptcy and thus make an already threatening economic situation worse. We say this particularly since we think it likely that the major tax effect of this legislation will not be to raise revenue but to allow corporations to accelerate income when it is advantageous for them to do so.

The reasons for our position are:

1. The potential enormous additional tax burdens will discourage debt restructurings and in particular discourage debt-for-debt restructurings without actual bankruptcy filings. Creditors will be less willing to agree to debt restructurings since the tax cost of the restructurings will often seriously reduce the assets, and particularly the liquid assets, of the troubled company. This is likely to force into bankruptcy many companies that might have been restructured outside bankruptcy, and encourage, liquidating rather than reorganizing bankruptcies. This will impose enormous delay and unnecessary legal and other costs upon such transactions, making it less likely that economically viable entities will result from the reorganization process.

2. Inevitably, these provisions will add cases to the already overburdened dockets of the bankruptcy courts.

3. We question whether these amendments are sensible tax policy since the holders of refinanced debt would have a carryover basis for the debt or preferred stock received in exchange* Thus, the investor would not recognize loss although the debtor corporation would have taxable income.

4. We question the estimate of the revenue these provisions will produce since the additional tax cost will make most, of the transactions at which they are aimed uneconomic*

5. Every dollar of tax collected now upon a debt-for-debt restructuring will be offset by a dollar of tax reduction as a result of a deduction for original issue discount over the term of the debt. This provision simply mortgages future tax collections to collect revenue now.

6. In fact, if these provisions are enacted debt-for-debt restructurings are likely to be used by aggressive tax planners to convert expiring tax benefits into future deductions.

7. These tax provisions conflict with the policy of the Bankruptcy Code — to encourage and facilitate the restructuring and survival of troubled businesses. For example, the House Report for the Bankruptcy Reform Act of 1978 stated:

> The purpose of a business reorganization case, unlike a liquidation case, is to restructure a business's finances so that it may continue to operate, provide its employees with jobs, pay its creditors, and produce a return for its stockholders. The premise of a business reorganization is that assets that are used for production in the industry for which they were designed are more valuable than those same assets sold for scrap.... If a business can extend or reduce its debts, it often can be returned to a viable state. It is more economically efficient to reorganize than to liquidate, because it preserves jobs and assets. H. Rep. No. 95-595, 95th Cong., 1st Sess. 220(1977).

8. Finally, we note that these two proposals are just the latest in a number of tax changes made since the adoption of the Bankruptcy Reform Act of 1978 and the Bankruptcy Tax Act of 1980 that have made the survival of troubled companies more difficult and thus have been contrary to the policies of both these Acts.

We urge that a vital part of any study of this area be a consideration of the policies underlying the bankruptcy laws. It cannot be addressed simply as a matter of abstract tax theory.

We therefore urge that Congress and the Treasury undertake a study designed to bring the policies of the tax law into greater harmony with the policies of the bankruptcy law. To this end, the group conducting the study should include United States Bankruptcy Court judges and others experienced in bankruptcy matters. Thus, study is particularly needed now when so many American companies are in financial distress.

We would be glad to lend our assistance to any such study.

Yours very truly,

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Chair

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