REPORT 1289

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ADDRESSING PROPOSED TREASURY REGULATION § 1.108-9

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New York State Bar Association Tax Section
Report Addressing Proposed Treasury Regulation § 1.108-9[*]

I. Introduction & Summary of Recommendations

In April 2011, the Treasury Department (the "Treasury") and the Internal Revenue Service (the "Service") issued proposed regulations addressing the exclusion from gross income under section 108(a)[1] (the "Proposed Regulations") of cancellation of indebtedness ("COD") income of an entity that is a grantor trust or that is disregarded as separate from its owner (a "disregarded entity") for U.S. federal income tax ("U.S. tax") purposes.[2] The Proposed Regulations address how the exclusions from gross income for COD income from a discharge of indebtedness of a taxpayer occurring in a Title 11 case (the "Title 11 Exception") or occurring when the taxpayer is insolvent (the "Insolvency Exception") apply when the entity legally liable for the discharged indebtedness is a grantor trust or disregarded entity. The Proposed Regulations provide that in applying these exceptions (i) the term "taxpayer" refers to the owner(s) of the grantor trust or disregarded entity, respectively, (ii) the Title 11 Exception applies only if such owner(s) are under the jurisdiction of the court in a Title 11 case, and (iii) the Insolvency Exception applies only to the extent of the insolvency of such owner(s).[3]

We commend Treasury and the Service for issuing the Proposed Regulations, which, if finalized, would provide guidance that is critical given the increasing prevalence of single

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[*] The principal drafters of this report were Stuart J. Goldring, Linda Z. Swartz, Max A. Goodman, Richard M. Nugent and Eric D. Remijan. Helpful comments were received from Kimberly S. Blanchard, Andrew H. Braiterman, Peter C. Canellos, Michael Farber, Stephen B. Land, William L. McRae, David S. Miller, Deborah L. Paul, Michael L. Schler, David R. Sicular, Eric Sloan and Diana L. Wollman. This report reflects solely the views of the Tax Section of the NYSBA and not those of the NYSBA Executive Committee or the House of Delegates.

[1] Unless otherwise indicated, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury regulations promulgated thereunder.

[2] REG 154159 - 09; 76 Fed. Reg. 20593 (Apr. 11, 2011). The Proposed Regulations define a "grantor trust" as any portion of a trust that is treated under sections 671-678 as being owned by the grantor or another person. Prop. Treas. Reg. § 1.108-9(c)(2).

[3] Prop. Treas. Reg. § 1.108-9(a).

member limited liability companies (each, an "LLC") that are disregarded entities.[4] We generally agree with the approach adopted in the Proposed Regulations and believe that this approach would establish an appropriate framework for applying the Insolvency Exception and the Title 11 Exception to COD income realized in connection with the discharge of a disregarded entity's indebtedness.

However, we also think that final regulations should clarify several aspects of the Proposed Regulations and should address certain additional, related issues in order to implement fully the objectives of the Proposed Regulations and the purpose of the statute. More specifically, we recommend that final regulations:

> (i) clarify that indebtedness of a disregarded entity constitutes indebtedness of the regarded owner under section 108(d)(1);
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> (ii) adopt the principles of Rev. Rul. 92-53, 1992-2 C.B. 48, subject to certain exceptions, to determine how a disregarded entity's indebtedness is taken into account in measuring the regarded owner's insolvency;
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> (iii) treat a disregarded entity's regarded owner as "under the jurisdiction of the court" for purposes of section 108(d)(2) if the bankruptcy court asserts jurisdiction over such owner during the case and discharges (*i.e.*, releases) such owner from any "*bona fide* liability" with respect to the disregarded entity's discharged indebtedness that gives rise to COD income;
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> (iv) limit a "*bona fide* liability" for purposes of clause (iii) immediately above to a discharged obligation for which (i) the regarded owner's liability has been previously established (by contract or otherwise), (ii) the regarded owner is liable for all (or substantially all) of the discharged obligation, and (iii) qualifying for the Title 11 Exception was not a principal purpose of the regarded owner's undertaking such liability;
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> (v) adopt the same approach as the Proposed Regulations for purposes of applying the remaining COD income exclusions in section 108(a); and

[4] We agree with the need for guidance addressing the application of the Insolvency Exception and the Title 11 Exception in the case of a grantor trust that realizes COD income. However, given the current prevalence of LLCs, this report focuses on the application of the Insolvency Exception and the Title 11 Exception to the discharge of a disregarded entity's indebtedness. Nevertheless, unless the context otherwise requires, references to a disregarded entity also refer to a grantor trust.

(vi) permit retroactive application of such final regulations (at least where a taxpayer applies the rules consistently with respect to all of its disregarded entities).[5]

We address each of these recommendations in detail below. This report does not address whether and when debt of a disregarded entity should be treated as recourse or nonrecourse debt for purposes of Treas. Reg. §§ 1.1001-2 and -3 or other U.S. tax purposes.

II. Background

A. Section 108

Generally, COD income is includable in gross income.[6] In the Bankruptcy Tax Act of 1980 (the "1980 Act"), Congress codified several exceptions to the inclusion in gross income of COD income, including the Insolvency Exception and the Title 11 Exception.[7] The Insolvency Exception in section 108(a)(1)(B) excludes from gross income any COD income that would be includable by reason of the discharge of indebtedness of the taxpayer up to the amount by which the taxpayer is insolvent immediately before the discharge. A taxpayer is insolvent to the extent

[5] Additionally, we observe that the Treasury regulations under section 6050P are unclear as to whether an applicable entity must furnish Form 1099-C to the regarded owner or the disregarded entity when the disregarded entity's indebtedness is discharged. In such case, because the applicable entity may not be able to determine whether the obligor is a disregarded entity, we recommend that Treasury and the Service consider modifying the regulations under section 6050P to permit the applicable entity to furnish Form 1099-C to either the disregarded entity or the regarded owner.

[6] Section 61(a)(12); *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931). COD income generally equals the adjusted issue price of the discharged indebtedness over the sum of the cash, the issue price of any debt instrument and the fair market value of any other property delivered in exchange therefor. *See* section 108(e)(10)(A); Treas. Reg. § 1.61-12(c)(2)(ii).

[7] *See* S. Rep. No. 96-1035 (1980); H.R. Rep. No. 96-833 (1980). Prior law also generally contained exceptions to the recognition of COD income in the case of discharged indebtedness if the taxpayer was insolvent or in a bankruptcy proceeding. *See, e.g.*, *Dallas Transfer & Terminal Warehouse Co. v. Comm'r*, 70 F.2d 95 (5th Cir. 1934); *Lakeland Grocery Co. v. Comm'r*, 36 B.T.A. 289 (1937) (applying an insolvency exception); 11 U.S.C. §§ 268, 270, 395, 396, 520, 522 and 679 prior to enactment of Pub. L. No. 95-598, 92 Stat. 2549 (1978) (establishing a bankruptcy exception). For a thorough history of the COD income rules and the exceptions that were available if the taxpayer was insolvent or in a bankruptcy proceeding, see William T. Plumb, Jr., *The Tax Recommendations of the Commission on the Bankruptcy Laws—Reorganizations, Carryovers and the Effects of Debt Reduction*, 29 Tax L. Rev. 228 (1974); James S. Eustice, *Cancellation of Indebtedness and the Federal Income Tax: A Problem of Creeping Confusion*, 14 Tax L. Rev. 225 (1959).

its liabilities exceed the fair market value of its assets.[8] The Title 11 Exception in section 108(a)(1)(A) excludes from gross income any COD income that would be includable by reason of the discharge of indebtedness of the taxpayer if the discharge occurs in a Title 11 case. A "Title 11 case" is "a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court."[9] The Title 11 Exception applies regardless of solvency.[10] For purposes of applying all of the rules in section 108, "indebtedness of the taxpayer" or the "taxpayer's indebtedness" means any indebtedness for which the taxpayer is liable or that encumbers property the taxpayer holds.[11]

The legislative history indicates that, in enacting the Insolvency Exception and the Title 11 Exception, Congress sought to preserve a debtor's "fresh start" by allowing a debtor emerging from bankruptcy or an insolvent debtor outside bankruptcy to avoid an immediate income tax liability.[12] However, Congress also exacted a cost by requiring a taxpayer that excludes COD income under either of these exceptions to reduce the taxpayer's tax attributes (*e.g.*, net operating losses and asset tax basis) in the manner provided in section 108(b) and

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[8] Section 108(d)(3). We recently issued a report addressing the treatment of contingent liabilities in measuring insolvency. *See* New York State Bar Ass'n Tax Section ("NYSBA"), *Report on Insolvency Under Section 108: The Treatment of Contingent Liabilities*, reprinted at 2012 TNT 225-17 (Nov. 20, 2012).

[9] Section 108(d)(2).

[10] Insolvency is not an essential prerequisite for filing bankruptcy. *See*, *e.g.*, *In re Marshall*, 403 B.R. 668, 685 (C.D. Cal. 2009) ("As a statutory matter, it is clear that the bankruptcy law does not require that a bankruptcy debtor be insolvent, either in the balance sheet sense (more liabilities than assets) or in the liquidity sense (unable to pay the debtor's debts as they come due), to file a chapter 11 case or proceed to the confirmation of a plan of reorganization."); *In re Cent. Jersey Airport Servs., LLC*, 282 B.R. 176, 180-81 (Bankr. D. N.J. 2002) ("First, a careful reading of 11 U.S.C. § 109 reveals no requirement of insolvency for the filing of a Chapter 11 proceeding. Second, case law, as well, clearly establishes that a debtor need not be insolvent at the time of filing.").

[11] Section 108(d)(1).

[12] *See* S. Rep. No. 96-1035 at 9-10.

Treas. Reg. § 1.108-7.[13] According to the legislative history, Congress essentially intended to exchange a current income tax liability for the deferred income tax liability that the rehabilitated debtor hopefully would incur in the future due to the reduction in tax attributes (*i.e.*, decreased tax shield).[14]

Finally, section 108(d)(6) provides that, if an entity classified as a partnership for U.S. tax purposes realizes COD income upon the discharge of partnership indebtedness, the Insolvency Exception and the Title 11 Exception apply at the partner level. Accordingly, regardless of whether the partnership itself is insolvent or in a Title 11 case, the partner must independently satisfy the insolvency test or be under the jurisdiction of the court in a Title 11 case if the partner is to avoid recognizing its distributive share of the partnership's COD income under one of these exceptions.[15]

B. Disregarded Entity Rules

In 1995, Treasury and the Service announced a reconsideration of their longstanding regulations for determining the classification of unincorporated entities as corporations or partnerships for U.S. tax purposes.[16] In order to simplify then-existing law and reduce the resulting burdens on the government and taxpayers, Treasury and the Service proposed an elective system whereby an unincorporated entity generally could elect its desired tax

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[13] For the application of attribute reduction rules if the debtor is a member of an affiliated group, see Treas. Reg. § 1.1502-28.

[14] *See* S. Rep. No. 96-1035 at 10; H.R. Rep. No. 96-833 at 9.

[15] *See* S. Rep. No. 96-1035 at 22, n. 28 (illustrating application of COD income rules upon a discharge of partnership indebtedness); H.R. Rep. No. 96-833 at 18, n. 28 (same). Congress included this rule for partnerships in the 1980 Act. *See* S. Rep. No. 96-1035 at 21; H.R. Rep. No. 96-833, at 17.

[16] Notice 95-14, 1995-1 C.B. 297.

classification (the so-called "check-the-box rules").[17] In 1997, Treasury and the Service released final regulations adopting the check-the-box rules.[18]

The check-the-box rules generally treat a domestic unincorporated entity with a single owner as a disregarded entity, unless the entity affirmatively elects to be classified as a corporation for U.S. tax purposes.[19] A disregarded entity, in turn, generally is treated for U.S. tax purposes as a branch or division of the disregarded entity's owner.[20] Accordingly, for U.S. tax purposes, a disregarded entity's assets, liabilities and items of income, loss and credit generally constitute assets, liabilities and such items of the disregarded entity's owner.

Since the adoption of the check-the-box rules in 1997, the use of single member LLCs that are disregarded entities has increased tremendously given the tax and commercial benefits.[21] For example, corporate parents frequently utilize disregarded entities to achieve structural subordination with respect to the disregarded entity's indebtedness.

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[17] Section 7701(a)(2) generally defines a "partnership" to include a syndicate, group, pool, joint venture or other unincorporated organization through which any business, financial operation or venture is conducted and which is not a trust, estate or corporation. Section 7701(a)(3), in turn, generally defines a "corporation" to include an association, joint-stock company and insurance company. Under the prior regulations, the key issue for an unincorporated entity was whether it was an "association," in which case it would be taxable as a corporation. The prior regulations generally treated an entity as an association if the entity possessed at least three out of four characteristics that the government believed were common to corporations; if the entity possessed two or fewer of these characteristics, the entity generally was taxable as a partnership. *See* Former Treas. Reg. § 301.7701-2(a)(1)-(2).

[18] *See* Treas. Reg. § 301.7701-1(f).

[19] Treas. Reg. § 301.7701-3(a), (b)(1). The Code also creates disregarded entities by statute, such as a qualified REIT subsidiary (within the meaning of section 856(i)(2)) and a qualified subchapter S subsidiary (within the meaning of section 1361(b)(3)(B)). The Service generally treats the sole owner of a grantor trust as the owner of the trust's assets for U.S. tax purposes. *See*, *e.g.*, Rev. Rul. 85-13, 1985-1 C.B. 184; *see also* sections 671-78 (grantor trust rules).

[20] Treas. Reg. § 301.7701-2(a).

[21] *See* Rodney D. Chrisman, *LLCs Are the New King of the Hill: An Empirical Study of the Number of New LLCs, Corporations, and LPs Formed in the United States Between 2004-2007 and How LLCs Were Taxed for Tax Years 2002-2006*, 15 Fordham J. Corp. Fin. L. 459 (2010).

C. Proposed Regulations

The restructuring of a disregarded entity's indebtedness presents important issues for the disregarded entity's owner with respect to the proper application of the Insolvency Exception and the Title 11 Exception, and the Proposed Regulations represent an important first step in addressing these issues. The preamble to the Proposed Regulations explains that some taxpayers have argued that (i) the Insolvency Exception is available to the extent a grantor trust or disregarded entity is insolvent, even if its owner(s) are not, and (ii) the Title 11 Exception is available if a grantor trust or disregarded entity is under the jurisdiction of a bankruptcy court, even if the entity's owner(s) are not.[22]

The Proposed Regulations reject these arguments. The Proposed Regulations provide that (i) in applying the Insolvency Exception and the Title 11 Exception to COD income of a grantor trust or a disregarded entity, the term "taxpayer" in section 108(a)(1) and section 108(d)(1) through (3) refers to the owner(s) of the grantor trust or disregarded entity, (ii) grantor trusts and disregarded entities themselves are not owners for this purpose, and the tests for the Insolvency Exception and the Title 11 Exception, therefore, apply at the level of the grantor trust's or disregarded entity's regarded owner(s), and (iii) the owner rules apply at the partner level in the case of a partnership that realizes (and allocates) COD income from a grantor trust or disregarded entity that the partnership owns.[23]

The Proposed Regulations, by their terms, will apply to discharges of indebtedness occurring on or after the date on which final regulations are published in the Federal Register.[24]

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[22] Guidance Under Section 108(a) Concerning the Exception of Section 61(a)(12) Discharge of Indebtedness Income of a Grantor Trust or a Disregarded Entity Reg. § 1.108-9, 76 Fed. Reg. 20593 (Apr. 11, 2011) (hereinafter, the "Preamble").

[23] Prop. Treas. Reg. § 1.108-9(a)-(c).

[24] Prop. Treas. Reg. § 1.108-9(d).

In addition, the Preamble provides that "[n]o inference is intended that the provisions set forth in these proposed regulations are not current law."[25]

III. Who is the "Taxpayer"?

The Preamble explains that some taxpayers take the position that (i) the Insolvency Exception applies to the extent a disregarded entity is insolvent, even if its owner is not, and (ii) for purposes of the Title 11 Exception, a disregarded entity's bankruptcy filing brings the regarded owner under the jurisdiction of the bankruptcy court for purposes of section 108(d)(2), because a portion of the owner's assets and liabilities (as determined for U.S. tax purposes) are under the court's jurisdiction.[26] The Proposed Regulations reject both interpretations.

We agree with the approach adopted by the Proposed Regulations that, in applying the Insolvency Exception and the Title 11 Exception to COD income of a disregarded entity, the term "taxpayer" in section 108(a)(1) and sections 108(d)(1) through (3) refers to the regarded owner of the disregarded entity (subject to section 108(d)(6) if the regarded owner is a partnership). This approach is consistent with the treatment of a disregarded entity under the check-the-box rules as part of the disregarded entity's regarded owner for all income tax purposes pursuant to the check-the-box rules, rather than a separate person.[27] This approach also is consistent with section 108(d)(6)'s treatment of a partner, rather than the partnership, as the relevant taxpayer for purposes of applying the section 108(a) exclusions.

An alternative approach would be to apply the section 108(a) exclusions at the disregarded entity level, which would be consistent with section 108(d)(7)'s application of the exclusions to S corporations (as defined in section 1362), another kind of pass-through entity.

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[25] Preamble, 76 Fed. Reg. at 20594.

[26] *Id.*

[27] *See* Treas. Reg. § 301.7701-2(a) ("if the entity is disregarded, its activities are treated in the same manner as a sole proprietorship, branch, or division of the owner").

However, the purpose of section 108(d)(7) as evidenced by the legislative history does not support this approach. As amended by the Subchapter S Revision Act of 1982, section 108(d)(6) applied to both partnerships and S corporations.[28] In the Deficit Reduction Act of 1984, Congress limited section 108(d)(6) to partnerships and adopted section 108(d)(7) "[i]n order to treat all shareholders in the same manner."[29] Hence, the purpose animating section 108(d)(7) does not apply to disregarded entities.

Additionally, we believe that the discharge of indebtedness of a disregarded entity is more analogous to the discharge of indebtedness of a partnership than to that of an S corporation. Unlike S corporations, which are subject to income taxation under certain provisions of the Code (such as section 1374), disregarded entities are not subject to income taxation.[30] In this regard, disregarded entities are more similar to partnerships than S corporations. In fact, disregarded entities do not even have their own U.S. tax attributes (such as tax bases or holding periods in the assets they hold), while partnerships actually do, highlighting that disregarded entities are less entity-like than partnerships.[31] Therefore, consistent with the congressional distinction between

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[28] *See* Subchapter S Revision Act of 1982, Pub. L. No. 97-354, §3(e), 96 Stat. 1669, 1689 (1982).

[29] H.R. Rep. No. 98-432, Part 2, at 1640 (1984).

[30] A disregarded entity has no income tax liability and the Service cannot even proceed against a disregarded entity to collect the income tax liability of the owner resulting from the activities of the disregarded entity. *See*, *e.g.*, Chief Counsel Adv. 200235023 (Aug. 30, 2002) ("When the single member owner is the taxpayer, the Service may recover the tax liability [resulting from the operations of a single member LLC that is a disregarded entity] from the property and rights to property of the single member owner, but the single member owner under state law has no interest in the assets of the LLC. In short, the Service may not look to the LLC's assets to satisfy the tax liability of the single member owner.").

[31] In the affiliated group filing a consolidated return context, the Insolvency Exception and the Title 11 Exception apply at the member level, rather than to the group as a whole. *See* Treas. Reg. § 1.1502-28(a)(1). Because each member of an affiliated group is, in fact, a separate corporation, it is consistent with section 108(d)(7) and the congressional purpose behind that provision to apply the section 108(a) exceptions at the corporate member level. We also believe that disregarded entities are more similar to partnerships than such consolidated subsidiaries; the members join together for purposes of making certain income tax computations and for purposes of filing a consolidated return, but each remains a separate corporation with its own outstanding stock held by its own shareholders; each consolidated subsidiary is a separate taxpayer from whom the Service may collect income tax, and has its own tax attributes. Another justification that has been articulated for applying the Insolvency Exception and the Title 11 Exception at the regarded owner level is that, because the Service cannot collect any tax

partnerships and S corporations for section 108(a) purposes, we believe the regarded owner of a disregarded entity, like the partners of a partnership, is the relevant taxpayer for purposes of applying the section 108(a) exclusions.

We recognize that applying the Title 11 Exception at the level of the regarded owner may appear inequitable if the owner conducts substantially all of its business operations through the applicable disregarded entity and the owner cannot file for bankruptcy for technical reasons (such as where the owner standing alone is solvent and able to pay its debts as they become due). On balance, we do not think that this concern outweighs the considerations supporting the approach adopted in the Proposed Regulations. Moreover, any attempt to address this concern by creating an exception to the general approach of the Proposed Regulations would necessitate a line-drawing exercise that either would result in an arbitrary cutoff based on the extent of activities or amount of assets held by the regarded owner or would result in a facts-and-circumstances test that would impose undue complexity and would be difficult to administer.

For purposes of the Title 11 Exception, we note that a disregarded entity generally is a separate legal entity for bankruptcy law purposes, and the disregarded entity's owner is not under the jurisdiction of the bankruptcy court solely by virtue of the disregarded entity's bankruptcy filing. We think that this bankruptcy law principle is instructive and is consistent with the approach in the Proposed Regulations that applies the test for the Title 11 Exception at the regarded owner level.[32]

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liability attributable to the discharge of a disregarded entity's indebtedness from the disregarded entity itself, the regarded owner should not be able to take advantage of the disregarded entity's insolvent or bankrupt status in rendering the regarded owner eligible for the Insolvency Exception when the regarded owner is solvent or the Title 11 Exception when the regarded owner is not under the jurisdiction of the bankruptcy court in a Title 11 case, as applicable.

[32] Although a disregarded entity generally is a separate legal entity for bankruptcy law purposes, we note that a branch or division of a corporation generally cannot itself become a debtor in a bankruptcy case. Instead, the operative bankruptcy rules focus on legally recognized entities. *See* 11 U.S.C. § 109 (in general, only a "person" qualified to be a debtor under chapter 7 may be a debtor under chapter 11); *id*. at § 101(41) (defining a "person" generally to include an "individual, partnership, and corporation"); *id*. at

Accordingly, we agree with the approach of the Proposed Regulations to test the application of the Insolvency Exception and the Title 11 Exception at the level of the regarded owner of the applicable disregarded entity.

Given this approach to "who is the taxpayer," we recommend that final regulations clarify that, in determining the "indebtedness of the taxpayer" within the meaning of section 108(d)(1), debt of a disregarded entity constitutes indebtedness of its regarded owner. As stated above, section 108(d)(1) defines "indebtedness of the taxpayer" as any indebtedness for which the taxpayer is liable or subject to which the taxpayer holds property. We recognize that a regarded owner may not be liable for its disregarded entity's indebtedness as a commercial matter. However, because the check-the-box rules treat the regarded owner as directly holding the disregarded entity's assets for U.S. tax purposes, the Treasury regulations properly should view a disregarded entity's indebtedness as debt subject to which the regarded owner holds such assets. Moreover, the regarded owner must include in gross income the COD income from the discharge of that indebtedness, unless one of the section 108(a) exceptions applies. Therefore, in applying those exceptions, the indebtedness should be viewed as indebtedness of the applicable regarded owner. If the indebtedness of the disregarded entity was not treated as the indebtedness of the regarded owner for section 108(a) purposes, then COD income from the discharge of such indebtedness could never be eligible for exclusion from gross income under section 108(a) (because those exceptions will apply only at the regarded owner level). Treating indebtedness of a disregarded entity as indebtedness of the regarded owner for purposes of section 108(d)(1) also

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§ 101(9) (defining a "corporation" generally to include an "unincorporated company or association" or a "business trust"). State law generally determines whether a business entity has the capacity to file as a debtor in a bankruptcy case. *See In re Efoora, Inc.*, 472 B.R. 481 (Bankr. N.D. Ill. 2012).

is consistent with the treatment of partnership indebtedness as indebtedness of the partners pursuant to section 108(d)(6) and Rev. Rul. 2012-14.[33]

IV. Measuring Insolvency

The Proposed Regulations do not address how debt of a disregarded entity should be taken into account in measuring the regarded owner's insolvency. As explained above, the purpose of the Insolvency Exception is to provide an insolvent taxpayer who receives a discharge of its indebtedness with a "fresh start" by removing the concurrent burden of paying taxes attributable to any COD income resulting from the discharge when the taxpayer is unable to pay such taxes due to insolvency. However, to the extent a discharge leaves a taxpayer solvent, the taxpayer generally has the ability to pay tax and generally must do so with respect to the COD income equal to the amount of its solvency.[34] As a general matter, the applicability and mechanics of the Insolvency Exception thus depend upon whether the taxpayer has any net assets that could be used to pay the tax attributable to the COD income.

This understanding of the Insolvency Exception may seem to be at odds with the operation of the Insolvency Exception when debt is satisfied through the issuance of the debtor's equity. For example, when an insolvent corporate debtor cancels all of its existing stock and issues all of its new stock to its creditors in discharge of all of its debt, the discharge leaves the debtor solvent and yet the Insolvency Exception normally would exclude all of the resulting COD income due to sufficient pre-cancellation insolvency. This apparent discrepancy can be

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[33] 2012-24 I.R.B. 1012 ("[A] partnership's discharged excess nonrecourse debt is treated as a liability of the partners for purposes of measuring the partners' insolvency under § 108(d)(3).").

[34] *See* Rev. Rul. 92-53, 1992-2 C.B. 48 (citing S. Rep. No. 96-1035 and H.R. Rep. No. 96-833). The Insolvency Exception does not require the taxpayer to include sufficient COD income to result in a tax liability equal to the amount of the taxpayer's net assets (such that the tax liability leaves the taxpayer with zero net worth). Instead, the exception requires only that the taxpayer include COD income up to the amount of its net assets (such that the taxpayer is left with some net worth despite the resulting tax liability). That way, the taxpayer is given something of a fresh start rather than being left with no net assets and thus on the edge of insolvency.

justified by viewing the equity issuance as equivalent to a distribution by the debtor of its net assets to its creditors. Because such a distribution would not render the debtor solvent and capable of paying taxes on the resulting COD income, an economically equivalent equity issuance is treated in a similar manner (by comparing the COD income to the amount of the prior insolvency rather than by focusing on the existence of post-discharge solvency). All references in the remainder of this Part IV to solvency and net assets should be so understood.

The purpose of the Insolvency Exception as explained above informed the Service's application of the exception to nonrecourse debt in Rev. Rul. 92-53, which sets forth three principles. First, nonrecourse debt always is taken into account in measuring a taxpayer's insolvency to the extent of the fair market value ("FMV") of the property securing such debt. Second, the amount by which a nonrecourse debt exceeds the FMV of the property securing such debt is taken into account in measuring a taxpayer's insolvency to the extent that such excess nonrecourse debt is discharged. Otherwise the discharge could give rise to tax at a time when the taxpayer is unable to pay such tax – a concern that is easiest to see where the taxpayer has no assets other than those securing the nonrecourse debt. Third, excess nonrecourse debt is not taken into account in measuring a taxpayer's insolvency when (or to the extent) it is not discharged.[35] When another debt of the taxpayer is discharged, the excess nonrecourse debt in question has no impact on the taxpayer's ability to pay tax on the resulting COD income attributable to such other debt, because the nonrecourse lender cannot collect any of the excess nonrecourse debt from the taxpayer (it is as though such debt is not a liability at all).

We recommend that final regulations explain how debt of a disregarded entity is properly taken into account in measuring insolvency for purposes of the Insolvency Exception. We

[35] *See* Rev. Rul. 92-53, 1992-2 C.B. 48.

recommend that, when debt is issued by a disregarded entity, final regulations apply the principles of Rev. Rul. 92-53 in measuring insolvency, except to the extent that (i) credit support for such debt is provided by the regarded owner (*e.g.*, pursuant to a guarantee or co-borrowing arrangement), or (ii) the regarded owner is liable (even if secondarily) for such debt under applicable law (*e.g.*, because the disregarded entity is a limited partnership and the general partnership interest is directly held by the regarded owner). This would be consistent with the treatment of the regarded owner as directly holding all of the disregarded entity's assets in applying the Insolvency Exception (that is, in measuring the regarded owner's "solvency").

We want to be clear that our recommended approach to taking debt of a disregarded entity into account in measuring a regarded owner's insolvency for purposes of section 108 is based on the purpose of the Insolvency Exception, rather than a "grand theory" of debt of a disregarded entity that we would recommend should apply for all tax purposes. Thus, our approach should not be read to imply that we view recourse debt of a disregarded entity as nonrecourse debt for U.S. tax purposes (including under Treas. Reg. §§ 1.1001-2 and -3) whenever the regarded owner has not provided credit support for such debt and is not liable for such debt under applicable law.[36]

The discussion below elaborates upon our recommended approach in greater detail with respect to debt of a disregarded entity that is recourse as to all of the disregarded entity's assets.[37]

If the regarded owner has not provided credit support, and is not liable under applicable law, for the disregarded entity's indebtedness, the disregarded entity's recourse liabilities in

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[36] We also recognize that, for *other* tax purposes, whether the regarded entity has other assets may be relevant in determining whether recourse debt of a disregarded entity should be treated as recourse or nonrecourse debt.

[37] If the disregarded entity issues traditional nonrecourse debt (*i.e.*, debt secured by a specific asset of the disregarded entity), the application of Rev. Rul. 92-53 is more straightforward.

excess of the gross FMV of the disregarded entity's assets should be taken into account in measuring the regarded owner's insolvency to the extent that such debt is discharged. Otherwise, the discharge of the excess indebtedness would create COD for the regarded owner but would not be taken into account in measuring the regarded owner's insolvency, which would frustrate the purpose of the Insolvency Exception.

The following example, which modifies the facts of Situation 1 of Rev. Rul. 92-53, illustrates this:

> Example 1: Individual A, who is not subject to the jurisdiction of a court in a Title 11 case, owns DRE (a single member LLC treated as a disregarded entity). DRE has $800,000 of assets and $1 million of recourse debt. A has not guaranteed or otherwise provided any credit support for, and is not liable under applicable law for, DRE's debt. A has $100,000 of other assets and $50,000 of recourse debt. DRE's creditor forgives $175,000 of DRE's debt, and A realizes $175,000 of COD income.

A has only $50,000 of net assets after the discharge[38] and therefore might be unable to pay the full tax on $175,000 of COD income.[39] Under the principles of Rev. Rul. 92-53, only $975,000 of DRE's debt should be taken into account in measuring A's insolvency,[40] and the amount of A's insolvency prior to the discharge should be $125,000.[41] Therefore, A should exclude $125,000 of the COD income under the Insolvency Exception and include $50,000 of the COD

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[38] DRE has no net worth following the discharge ($825,000 of DRE's debt post-discharge minus $800,000 of DRE's assets), so A has $50,000 of net assets ($100,000 of A's other assets minus $50,000 of A's other debt).

[39] The extent to which A truly is unable to pay tax on the $175,000 of COD income depends on A's tax rate. Despite this, in promulgating section 108(a)(3), Congress crafted the Insolvency Exception to apply to COD income to the full extent of the taxpayer's insolvency. As discussed above, although Congress could have drafted the rule to require taxpayers to pay their tentative tax liabilities to the extent of their post-discharge solvency, Congress presumably chose not to do so in order to give insolvent taxpayers a fresh start rather than leaving them on the edge of insolvency. Because the Insolvency Exception operates in this manner in the absence of nonrecourse debt or a disregarded entity, the introduction of these elements should not change the basic operation of this rule.

[40] The sum of (i) the amount of DRE's debt equal to the gross FMV of its assets ($800,000) and (ii) the amount of DRE's debt in excess of the gross FMV of its assets that is discharged ($175,000).

[41] ($975,000 of DRE's debt taken into account plus $50,000 of A's other debt) minus ($800,000 of DRE's assets plus $100,000 of A's other assets).

income in gross income. The fact that the COD income is taxable solely to the extent of A's net assets following the discharge is consistent with the purpose of the Insolvency Exception.

When debt of a regarded owner is discharged, and the regarded owner owns an insolvent disregarded entity but has not provided credit support for the disregarded entity's debt and is not liable for such debt under applicable law, the disregarded entity's liabilities in excess of the gross FMV of its assets should not be taken into account in measuring the regarded owner's insolvency. In such circumstances, the extent of the disregarded entity's standalone insolvency does not affect the amount of the regarded owner's net assets that are available to pay tax on the COD income attributable to the discharge of the regarded owner's debt. Therefore, taking the disregarded entity's standalone insolvency into account in measuring the regarded owner's insolvency in such circumstances would be inconsistent with the purpose of the Insolvency Exception.

The following example, which modifies the facts of Situation 2 of Rev. Rul. 92-53, illustrates this:

> Example 2: The facts are the same as Example 1, except that there is no forgiveness of any DRE debt. Rather, A settles his recourse debt for $40,000 of A's other assets and realizes $10,000 of COD income.

A has $60,000 of net assets after the discharge[42] and therefore should be able to pay the full tax on the $10,000 of COD income. Under the principles of Rev. Rul. 92-53, only $800,000 of DRE's debt should be taken into account in measuring A's insolvency (*i.e.*, an amount of DRE's debt equal to the gross FMV of DRE's assets), and A should be treated as solvent prior to the

[42] DRE has no net worth ($1 million of DRE's debt minus $800,000 of DRE's assets), so A has $60,000 of net assets following the discharge ($60,000 of A's other assets minus $0 of A's other debt post-discharge).

discharge.[43] Therefore, A should include all of the COD income in A's gross income. The Insolvency Exception is unnecessary in this situation because the amount of A's net assets following the discharge exceeds the amount of A's COD income, and, in fact, applying the exception in this context would be contrary to its purpose.

When a regarded owner provides credit support for a disregarded entity's debt or is liable for such debt under applicable law, and the disregarded entity is insolvent, the amount of the disregarded entity's debt that exceeds the gross FMV of the disregarded entity's assets should be taken into account in measuring the regarded owner's insolvency to the extent that the regarded owner would be liable to the disregarded entity's creditors at the time of measurement if such creditors were to have sought collection at such time (irrespective of whether debt of the regarded owner or disregarded entity is discharged). In such circumstances, such debt is in form and substance recourse to the regarded owner and thus should be treated in the same manner as any other recourse debt of the regarded owner.

The following example illustrates this:

> Example 3: The facts are the same as Example 2, except that A has guaranteed $500,000 of DRE's debt.

Whether A should be treated as solvent or insolvent depends upon the terms of the guarantee. If DRE's creditors were to seek to collect on DRE's debt, and, under the terms of the guarantee, A would be obligated to pay $200,000 to such creditors (a normal guarantee), then all of DRE's debt should be taken into account in measuring A's insolvency, and the amount of A's insolvency prior to the discharge should be $150,000.[44] Therefore, all of A's COD income

[43] ($800,000 of DRE's assets plus $100,000 of A's other assets) minus ($800,000 of DRE's debt taken into account plus $50,000 of A's other debt).

[44] ($1 million of DRE's debt taken into account plus $50,000 of A's other debt) minus ($800,000 of DRE's assets plus $100,000 of A's other assets).

should be excluded under the Insolvency Exception. In this case, there is no fundamental difference from A's perspective between DRE's debt and A's other debt, and taking all of DRE's debt into account is consistent with the purpose of the Insolvency Exception.

By contrast, if DRE's creditors were to seek to collect on DRE's debt and A's $500,000 guarantee was a "bottom dollar guarantee" such that A had no payment obligation because DRE has more than $500,000 of gross assets, only $800,000 of DRE's debt should be taken into account in measuring A's insolvency, and A should be treated as solvent prior to the discharge (as in Example 2). Therefore, A should include all of the COD income in A's gross income. Because the amount of DRE's debt that exceeds the gross FMV of DRE's assets is not a liability that A is obligated to satisfy, taking such debt into account would be contrary to the purpose of the Insolvency Exception.

In formulating our recommended approach, we considered an alternative approach of taking into account all recourse debt of a disregarded entity (even if the regarded owner has not provided credit support for such debt and is not liable for such debt under applicable law) where other debt of the regarded owner is discharged. However, we rejected this alternative because it ignores the purpose of the Insolvency Exception. As illustrated by Example 2 above, in such circumstances, the extent of a disregarded entity's standalone insolvency has no bearing on the amount of the regarded owner's net assets that are available to pay tax on the COD income when such other debt is discharged.

We also considered an alternative approach of always excluding the amount of a disregarded entity's debt in excess of the gross FMV of the disregarded entity's assets (if the regarded owner has not provided credit support for such debt and is not liable for such debt under applicable law) where debt of the disregarded entity is discharged. However, this approach creates situations in which the regarded owner cannot avail itself of the Insolvency

Exception even though the regarded owner has no net assets with which to pay tax on the resulting COD income, which is contrary to the purpose of the Insolvency Exception.

The following example illustrates this:

> Example 4: The facts are the same as Example 1, except that A has no other assets and no other debt.

If DRE's insolvency is completely ignored, A is not insolvent, so the Insolvency Exception will not exclude any of A's COD income. However, A has no net assets available to pay the tax attributable to such COD income, which is precisely the situation that the Insolvency Exception seeks to avoid.[45]

V. Clarify the Meaning of "under the jurisdiction of the court" in Section 108(d)(2)

The Title 11 Exception excludes from gross income any COD income if the discharge of the taxpayer's indebtedness:

> occurs . . . in a case under title 11 of the United States Code (relating to bankruptcy), but only if the taxpayer is under the jurisdiction of the court in such case and the discharge of indebtedness is granted by the court or is pursuant to a plan approved by the court.[46]

The Proposed Regulations provide that, in the case of a disregarded entity, the test for applying the Title 11 Exception applies at the level of the disregarded entity's regarded owner.[47]

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[45] Our recommended approach to measuring insolvency is consistent with the views expressed by other commentators. *See, e.g.*, American Bar Ass'n Section of Taxation, *Comments on Guidance Under Section 108(a) Concerning the Exclusion of Section 61(a)(12) Discharge of Indebtedness Income of a Grantor Trust or a Disregarded Entity* (Jan. 17, 2012) (hereinafter, the "ABA Letter").

[46] Section 108(a)(1)(A), (d)(2). As stated above, we recommend that final regulations clarify that, subject to section 108(d)(6), a disregarded entity's indebtedness constitutes indebtedness of the regarded owner for purposes of section 108(a)(1)(A) and section 108(d)(1).

[47] Prop. Treas. Reg. § 1.108-9(a). All references in this Part V to a "regarded owner" are subject to the requirements of section 108(d)(6), *i.e.*, if an entity classified as a partnership for U.S. tax purposes is the owner of a disregarded entity that has filed for bankruptcy, qualification for the Title 11 Exception is tested at the partner level.

As explained in Part III above, we agree with the Proposed Regulations approach to applying the Title 11 Exception at the regarded owner level.[48] Accordingly, if the regarded owner is not under the jurisdiction of the bankruptcy court for purposes of section 108(d)(2), the Title 11 Exception should not apply.

But what is meant by "under the jurisdiction of the court"? Because the meaning of the phrase "under the jurisdiction of the court" is critical to the application of the Title 11 Exception, we recommend that final regulations define this phrase.[49] We believe that the regarded owner of a disregarded entity should, in limited circumstances, qualify for the Title 11 Exception even if the owner is not a debtor in its disregarded entity's bankruptcy case. In this regard, we recommend that final regulations treat a disregarded entity's regarded owner as "under the jurisdiction of the court in [a Title 11] case" for purposes of section 108(d)(2) if (i) the regarded owner itself is a debtor in the applicable Title 11 case or (ii) the bankruptcy court asserts jurisdiction over the regarded owner during the applicable Title 11 case and discharges (*i.e.*, releases) the owner from any *bona fide* liability that such owner has with respect to the disregarded entity's discharged indebtedness that gives rise to COD income.[50] Further, we recommend that final regulations limit a "*bona fide* liability" for the above purposes to a discharged obligation for which (i) the regarded owner's liability has been previously established (by contract or otherwise), (ii) the regarded owner is liable for all (or substantially all) of the discharged obligation, and (iii) qualifying for the Title 11 Exception was not a principal purpose

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[48] The following discussion assumes that (i) the disregarded entity is a debtor in a bankruptcy case, (ii) the bankruptcy court discharges indebtedness of the disregarded entity or the discharge occurs pursuant to a plan approved by the bankruptcy court, (iii) this indebtedness constitutes indebtedness of the regarded owner for purposes of section 108(a)(1)(A) and section 108(d)(1), and (iv) the regarded owner realizes COD income upon the discharge of the indebtedness.

[49] The ABA Letter makes the same recommendation.

[50] Some commentators take a contrary position, contending that the Title 11 Exception only applies to a debtor in a bankruptcy proceeding. *See*, *e.g.*, Collier on Bankruptcy ¶ TX 13.03[1][b][iii] (16th ed. 2013).

of the regarded owner's undertaking such liability. As discussed below, the text of section 108(d)(2), applicable policy and precedent support our recommendation.

First, the plain meaning of section 108(d)(2) requires only that the taxpayer "be under the jurisdiction of" the court, and not that it "be a debtor in a title 11 case," and the Supreme Court has instructed that courts generally should give effect to the plain meaning of statutory text.[51] The words that Congress used here contrast with the wording used in other Code provisions that refer explicitly to debtors in a bankruptcy case.[52] Congress enacted four of these other

[51] *See, e.g., United States v. Ron Pair Enter., Inc.*, 489 U.S. 235, 241 (1989) ("plain meaning of legislation should be conclusive, except in the rare cases in which the literal application of a statute will produce a result demonstrably at odds with the intentions of the drafters"); *Consumer Product Safety Comm'n v. GTE Sylvania, Inc.*, 447 U.S. 102, 108 (1980) (language of the statute must be primary source of any interpretation and, when that language is not ambiguous, it is conclusive "absent a clearly expressed legislative intent to the contrary"); *United States v. American Trucking Assocs. Inc.*, 310 U.S. 534, 543 (1940) ("There is, of course, no more persuasive evidence of the purpose of a statute than the words by which the legislature undertook to give expression to its wishes. Often these words are sufficient in and of themselves to determine the purpose of the legislation. In such cases we have followed their plain meaning. When that meaning has led to absurd or futile results, however, this Court has looked beyond the words to the purpose of the act.").

[52] These include:

> section 56 ("in the case of a debtor in a case under title 11") (enacted in 1990);
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> section 219(b)(5)(C)(iii)(I) ("such employer (or any controlling corporation of such employer) was a debtor in a case under title 11") (enacted in 2006);
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> section 351(e)(2) ("A transfer of property of a debtor pursuant to a plan while the debtor is under the jurisdiction of a court in a title 11 or similar case") (enacted pursuant to the 1980 Act);
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> section 401(a)(33)(A) ("while the employer is a debtor in a case under title 11") (enacted in 1994);
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> section 409A(b)(3)(B)(ii) ("the plan sponsor is a debtor in a case under title 11") (enacted in 2006);
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> section 436(d)(2) ("A defined benefit plan which is a single-employer plan shall provide that, during any period in which the plan sponsor is a debtor in a case under title 11, United States Code, or similar Federal or State law, the plan may not pay any prohibited payment.") (enacted in 2006);
>
> section 1398(a) ("this section shall apply to any case under . . . title 11 of the United States Code in which the debtor is an individual") (enacted pursuant to the 1980 Act);
>
> section 6229(b)(2) ("the person is a debtor in a bankruptcy proceeding under title 11"); section 6229(h) ("If a petition is filed naming a partner as a debtor in a bankruptcy proceeding under title 11 of the United States Code") (enacted in 1997);

provisions as part of the same legislation that enacted the Title 11 Exception. If Congress had intended to limit section 108(d)(2) in the same manner, Congress presumably would have done so explicitly. In discussing the Title 11 Exception, the legislative history generally refers to a debtor in a bankruptcy proceeding only in a very general context and does not address the scope of the term "under the jurisdiction of the court" or distinguish the Title 11 Exception from other Code provisions that apply solely to a debtor in a bankruptcy case. Accordingly, the legislative history is not conclusive on the issue.

Second, our proposed standard — the application of the Title 11 Exception to a regarded owner's *bona fide* liability for a disregarded entity's indebtedness if the bankruptcy court discharges the owner's liability — is consistent with the general purpose of the Title 11 Exception, namely, to align the rehabilitative "fresh start" policy of the Bankruptcy Code with tax policy by allowing the taxpayer to avoid a potential immediate cash tax liability with respect to COD income. Said another way, if the bankruptcy laws are broad enough to discharge liabilities of a disregarded entity's non-debtor regarded owner, it is reasonable to conclude that Congress wanted to create a corresponding relief under the tax laws so the person would not be subjected to a current tax liability. It should be noted that, in general, a bankruptcy proceeding addresses only the discharge of claims asserted against a debtor, and liabilities of non-debtors, regardless of their relationship to the debtor, may not be dischargeable (other than with the consent of the respective parties).[53] Accordingly, we expect that only in limited circumstances

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section 6871(b)(2) ("the debtor, but only if liability for such tax has become res judicata pursuant to a determination in a case under title 11 of the United States Code") (enacted pursuant to the 1980 Act); and

section 7464 ("The trustee of the debtor's estate in any case under title 11 of the United States Code may intervene, on behalf of the debtor's estate, in any proceeding before the Tax Court to which the debtor is a party.") (enacted pursuant to the 1980 Act).

[53] *See generally* Collier on Bankruptcy ¶ 524.05 (16th ed. 2013) (discussing liability of non-debtors for discharged indebtedness).

would a regarded owner that is not itself in bankruptcy qualify for the Title 11 Exception under our proposed standard.

Third, the Tax Court has interpreted the Title 11 Exception in *Gracia v. Commissioner*[54] and its companion cases to extend beyond a debtor in a bankruptcy case.[55] The taxpayers in *Gracia* and the companion cases were general partners in Notchcliff Associates ("Notchcliff"), a general partnership. The general partners had personally guaranteed approximately $21 million of Notchcliff's loans. After Notchcliff filed a voluntary petition under Chapter 11, the court-appointed trustee filed a reorganization plan that proposed that Notchcliff's general partners would contribute to a partnership release fund to be used to resolve claims by Notchcliff and Notchcliff's creditors as against Notchcliff's general partners. The bankruptcy court confirmed the reorganization plan and subsequently approved the contribution agreement. In the accompanying order, the bankruptcy court specifically discharged and released the contributing partners from "the claims or potential claims of all creditors" of Notchcliff and directed that the contributing partners were "subject to the jurisdiction of the Bankruptcy Court."[56] The contributing partners did not report their distributive shares of Notchcliff's COD income, and the Service assessed deficiencies for the unreported COD income.

The Tax Court allowed the contributing partners to exclude their distributive shares of COD income under the Title 11 Exception. The Tax Court explained that the bankruptcy court order specifically discharged the four contributing partners and "explicitly asserted [the court's] jurisdiction over [the four contributing partners] for this purpose[]," and concluded that,

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[54] 87 T.C.M. (CCH) 1423, 2004 Tax Ct. Memo. LEXIS 155 (2004).

[55] *Mirarchi v. Comm'r*, 87 T.C.M. (CCH) 1424, 2004 Tax Ct. Memo. LEXIS 156 (2004); *Price v. Comm'r*, 87 T.C.M. (CCH) 1426, 2004 Tax Ct. Memo. LEXIS 154 (2004); *Estate of Martinez v. Comm'r*, 87 T.C.M. (CCH) 1428, 2004 Tax Ct. Memo. LEXIS 153 (2004).

[56] *Gracia*, 2004 Tax Ct. Memo. LEXIS 155, at *4 (internal quotations omitted).

"[g]iving due regard to the principles of judicial comity, we discern no reason to second-guess the bankruptcy court's assertion of jurisdiction over [the four contributing taxpayers] in the partnership's chapter 11 bankruptcy case."[57]

Fourth, our proposed standard generally should be easily administrable by taxpayers, the Service and, if necessary, the courts. The issues of the bankruptcy court's assertion of jurisdiction over the regarded owner, the owner's prior contractual or other liability for all (or substantially all) of the discharged obligation (a concept that the Service addresses in other areas), and the bankruptcy court's grant of a discharge (*i.e.*, release) to the owner generally should be readily verifiable in court documents. The determination that the owner did not undertake the discharged obligation for a principal purpose of qualifying for the Title 11 Exception would be similar to other "a principal purpose" inquiries that the Code and regulations require the Service and, if necessary, the courts to make.[58] Under our recommended standard, a discharge from solely speculative claims would not qualify a regarded owner for the Title 11 Exception.[59]

In many cases, the regarded owner itself will file for bankruptcy to obtain its own discharge from the bankruptcy court. However, filing for bankruptcy is a very significant

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[57] *Id.* at *6.

[58] By contrast, while we considered a standard in which the test for the Title 11 Exception would apply at the disregarded entity level if the disregarded entity represented a substantial portion of the regarded owner's assets, we questioned whether such a standard would be administrable in practice given the potentially difficult valuation questions that would need to be addressed, and we view these questions as considerably more difficult than the determination as to whether the owner undertook a discharged obligation for a principal purpose of qualifying for the Title 11 Exception.

[59] For example, if a non-debtor regarded owner of a disregarded single member LLC has not provided any credit support for the LLC's indebtedness and the likelihood of a creditor successfully asserting a veil piercing or alter ego challenge to the owner's separate legal existence is speculative (*i.e.*, such liability of the owner has not previously been established), the owner would not qualify for the Title 11 Exception under our recommended standard solely because a consensual Chapter 11 plan for the LLC releases such owner from any theoretical liability with respect to the indebtedness of the LLC. An example in the final regulations should illustrate this limitation.

business decision, and the regarded owner may reasonably conclude that a release by the bankruptcy court as part of the disregarded entity's Title 11 case, if attainable, is sufficient. In those instances, given the language of section 108(d)(2) and the consistency of our proposed standard with the general purpose of the Title 11 Exception, we find no compelling justification to require the regarded owner itself to file for bankruptcy to qualify for the Title 11 Exception.[60]

VI. Address Other Section 108(a) COD Income Exceptions

As stated above, the Proposed Regulations provide that, in applying the Insolvency Exception and the Title 11 Exception, the term "taxpayer" refers to the regarded owner of a disregarded entity. We recommend that final regulations expand upon the Proposed Regulations and provide that "taxpayer" also refers to the regarded owner of a disregarded entity for purposes of the other section 108(a)(1) COD income exclusions.

All of the reasons given in Part III above in support of the approach reflected in the Proposed Regulations apply equally to the other section 108(a)(1) COD income exclusions, including the fact that our proposed treatment of disregarded entities is consistent with section 108's application of the COD income exclusions at the partner level.[61] Additional supporting arguments for taking the same approach with respect to each of the other three exclusions follow.

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[60] We note that one could assert a literal interpretation of the term "under the jurisdiction of the court," in which case the Title 11 Exception generally would apply whenever the owner takes even the slightest action to subject itself to the bankruptcy court's jurisdiction, *e.g.*, files a proof of interest. However, this interpretation is overly broad and would delink the Title 11 Exception from the above-described policy underlying its enactment. In addition, this interpretation, if adopted in the partnership context as well, would effectively eviscerate the limitation imposed by section 108(d)(6) on a partner's ability to avail itself of the Title 11 Exception upon the discharge of partnership debt.

[61] *See* ABA Report.

A. Qualified Farm Indebtedness

Section 108(a)(1)(C) provides an exclusion for COD income attributable to the discharge of "qualified farm indebtedness" (the "QFI Exclusion").[62] Section 108(g)(2) provides that indebtedness of a taxpayer constitutes "qualified farm indebtedness" if (i) such indebtedness was incurred directly in connection with the operation by the taxpayer of the trade or business of farming and (ii) 50 percent or more of the aggregate gross receipts of the taxpayer for the three tax years preceding the tax year of the discharge is attributable to the trade or business of farming (the "50% Requirement"). Congress believed that the 50% Requirement was necessary to evidence that the relevant taxpayer engaged in the trade or business of farming.[63] Applying the QFI Exclusion (including the 50% Requirement) at the disregarded entity level could undermine the congressional desire to withhold the benefits of the QFI Exclusion from taxpayers that are not primarily farmers, because such an interpretation would exclude the regarded owner's non-farming receipts in measuring qualification for the exception.[64]

B. Qualified Real Property Business Indebtedness

Section 108(a)(1)(D) provides an exclusion for COD income attributable to the discharge of "qualified real property business indebtedness" in the case of a taxpayer other than a C corporation.[65] Testing this exclusion at the level of a disregarded entity that holds real

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[62] The amount of such exclusion cannot exceed the sum of the adjusted tax attributes of the taxpayer and the aggregated adjusted bases of qualified property held by the taxpayer as of the beginning of the tax year following the tax year of the discharge. Section 108(g)(3)(A).

[63] *See* S. Rep. No. 99-313 (1986), at 272 ("Under the provision, individuals are treated as engaged in the trade or business of farming if at least 50 percent of their average annual gross receipts during the three taxable years preceding the year in which the discharge of indebtedness occurs was derived from the trade or business of farming.").

[64] By contrast, if the QFI Exclusion is applied at the regarded owner level, any gross receipts generated by a disregarded entity presumably would be taken into account in determining whether the regarded owner satisfies the 50% Requirement. So taxpayers who are not primarily farmers should not be able to avail themselves of the QFI Exclusion by having a disregarded entity earn their non-farming receipts.

[65] *See* section 108(c)(2) (providing limitations on the amount of COD income excludable under section 108(a)(1)(D)).

property used in a trade or business could undermine the prohibition against C corporations utilizing this exclusion if a C corporation is the regarded owner because the C corporation effectively would reap the benefits of the exclusion. This result appears contrary to the statute's intent.

C. Qualified Principal Residence Indebtedness

Section 108(a)(1)(E) provides an exclusion for COD income attributable to the discharge of "qualified principal residence indebtedness" occurring before January 1, 2014 (the "Principal Residence Exclusion").[66] Section 108(h)(2) defines "qualified principal residence indebtedness" as certain indebtedness with respect to the taxpayer's "principal residence" (as defined in section 121).[67] Section 121(a) excludes from gross income a certain amount of gain from the sale or exchange of property if, during the five-year period ending on the date of the sale or exchange, the taxpayer has owned and used such property as the taxpayer's principal residence for periods aggregating two or more years. If a disregarded entity owns a residence, the Treasury regulations under section 121 treat the regarded owner as the property owner for purposes of establishing whether the regarded owner satisfies the two-year ownership requirement.[68] By implication, this means that a residence owned through a disregarded entity can qualify as a taxpayer's primary residence under section 121. Similarly, we believe that ownership of a principal residence through a disregarded entity should not per se disqualify the regarded owner from applying the Principal Residence Exclusion.

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[66] The amount of such exclusion cannot exceed $2 million. Section 108(h)(2).

[67] Section 108(h)(5).

[68] Treas. Reg. § 1.121-1(c)(3)(ii).

VII. Allow Taxpayers to Apply Final Regulations Retroactively

As noted above, the Proposed Regulations, by their terms, will apply to discharges of indebtedness occurring on or after the date on which final regulations are published in the Federal Register.[69] Treasury and the Service finalized the check-the-box rules over sixteen years ago, and the use of disregarded entities has been widespread for many years. In our practices, we frequently encounter bankruptcy cases that involve the restructuring of a disregarded entity's indebtedness. Accordingly, we believe the need is acute for definitive guidance on the application of the Insolvency Exception and the Title 11 Exception in the case of the discharge of a disregarded entity's indebtedness.

The Preamble makes it abundantly clear that Treasury and the Service reject on statutory grounds (and without the need for regulations) any argument that the Insolvency Exception or the Title 11 Exception is tested at the level of the disregarded entity. The Preamble thereby discourages taxpayers from taking either position. However, neither the Preamble nor the Proposed Regulations provide comfort to taxpayers that intend to take positions consistent with the Proposed Regulations.[70] Permitting retroactive application of final regulations — at least where a taxpayer applies the rules consistently with respect to all of its disregarded entities — with respect to discharges of indebtedness that precede the effective date of the final regulations would be appropriate here because taxpayers with disregarded entities should not be prevented from utilizing these exceptions until the final regulations become effective (or face the risk that on audit the Service argues that these exceptions do not apply at the level of the regarded owner).[71] Retroactive application of final regulations allows similarly situated taxpayers to be

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[69] Prop. Treas. Reg. § 1.108-9(d).

[70] *See* ABA Letter, at 10-11.

[71] In this regard, we understand that, in the absence of final or temporary regulations currently in force addressing a particular matter, Chief Counsel attorneys at the Service ordinarily should not take a position

treated alike and gives certainty to taxpayers who are willing to apply the Proposed Regulations. By requiring consistent treatment, the possibility of taxpayer gamesmanship should be effectively eliminated.[72] We thus recommend that final regulations explicitly permit taxpayers to apply their provisions retroactively.

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in litigation or advice that conflicts with proposed regulations and is adverse to taxpayers. *See* Chief Counsel Notice CC-2003-014 (May 8, 2003).

[72] There is precedent for providing in final regulations that previously proposed regulations may be applied retroactively, even when the proposed regulations did not so provide. *Compare* Treas. Reg. § 1.338-11(d)(7) (permitting retroactive application of the proposed rules) *with* Prop. Treas. Reg. § 1.338-11(h), 67 Fed. Reg. 10640, 10645 (Mar. 8, 2002) (providing that the rules would be applicable only after the filing of final regulations).