

## FOREWORD TO CLASS 1

Welcome to Bankruptcy Tax. This class is somewhat unique. In other tax courses you take, you will be looking at all or a specialized piece of the Internal Revenue Code and Regulations. You won't have to look outside the tax system for tax rules, and rarely look elsewhere for policies underlying those rules. This class is different. In the area of Bankruptcy Tax, we have two systems – the tax system and the bankruptcy system. Both are creatures of federal law, but they operate in separate legal spheres. The authorization for a federal bankruptcy system is found in Article I, Section 8, Clause 4 of the Constitution, and finds its legislative expression in Title 11 of the United States Code (the Bankruptcy Code). The federal income tax is authorized by the Sixteenth Amendment, and its substance is found in Title 26 of the United States Code (the Internal Revenue Code). Although both Codes were enacted in the same legislative process, the provisions of the Bankruptcy Code were vetted and marked up by the Judiciary Committees of the House and Senate, whereas the tax laws came through the House Ways and Means Committee and Senate Finance Committee.

Each system and the code regulating it has its own economic goals. Among the goals of the bankruptcy system is to give a distressed debtor a discharge of excessive debt and a fresh start. On the creditor side, the Bankruptcy Code seeks to prevent a race to the courthouse and assure an equitable distribution of the debtor's assets by imposing a stay of proceedings against the debtor and requiring a proof of claim to be filed by each creditor in the bankruptcy court, where it will be resolved in a manner prescribed by the Bankruptcy Code and Rules.

Among the goals of the tax system are to raise revenue for the continued operation of the government and to spread the tax burden equitably among taxpayers generally. The Internal Revenue Code strictly confines the procedures under which a taxpayer may contest his liabilities, and forecloses other avenues of relief, such as injunctions and declaratory judgments. The Internal Revenue Code defines gross income to include most accessions to wealth, including those arising from debt relief.

It is readily apparent that the goals of the two systems may conflict when prescribing the tax obligations of debtors in bankruptcy. Sometimes, the Internal Revenue Code recognizes the bankruptcy interest directly. For example, under § 108(a)(1)(A), income from discharge of indebtedness in bankruptcy is excluded from gross income. Instead, a different regime is put in place. The reason for this is that taxing discharge of indebtedness in bankruptcy would cripple the bankruptcy system, which is designed to afford debt relief. As another example, changes of ownership of corporations generally result in diminution of loss carryovers and other tax attributes, implementing a policy against selling tax losses. However, in bankruptcy, changes in ownership may arise from satisfaction of debt with the corporate debtor's stock, with creditors supplanting stockholders. It seems clear that the losses were funded with the creditors' money, raising the question of whether a true economic ownership change has occurred, and so the harsh consequences of ownership changes should be mitigated. §382(l)(5) and 382(l)(6) attempt to do so.

The Bankruptcy Code contains its own concessions to the tax system. Recognizing the centrality of revenues to the functioning of government, § 507(a)(8) of that Code gives a priority to most tax claims over the claims of other "general" unsecured creditors.

Sometimes, each Code asserts its own primacy. The Internal Revenue Code may give bankruptcy relief to discharge of indebtedness, but gains on the disposition of the debtor's assets in bankruptcy are fully recognized, even if made to pay claims, and returns must continue to be timely filed, even in the case of deeply insolvent debtors. The Bankruptcy Code pulls almost all tax disputes within the jurisdiction of the Bankruptcy Court, shunting aside the Tax Court, which otherwise disposes of 95% of all litigated income tax cases.

On occasion, the Bankruptcy Code will intrude on the Internal Revenue Code in unexpected ways. Here are two of many examples:

Under § 382(g)(4) of the Internal Revenue Code, when a majority shareholder claims a worthless stock deduction, it is treated as the sale of that stock for nothing, a result that would wipe out the corporation's loss carryovers. In the *Prudential Lines* case, which we'll read in Class 13, a court enjoined such a stockholder (who was not a debtor before the bankruptcy court) from claiming a worthless stock deduction to which it was otherwise entitled because that action would have exercised control over "property" of the bankruptcy estate in violation of § 362(a)(3) of the Bankruptcy Code. In *Feiler* (which we read in Class 1) and a number of other cases, the court used the fraudulent conveyance provisions of the Bankruptcy Code to set aside an election made by the debtor under § 172(b)(3) of the Internal Revenue Code to forego an NOL carryback, notwithstanding that the tax provision said that once made, such an election is irrevocable.

*Begier v. IRS*, which you are reading for Class 2, is another illustration of this collision. In that case, the corporate debtor collected airline excise taxes from its passengers and paid after-tax wages to its employees, effectively withholding the taxes. After being delinquent for some time in remitting these taxes to the IRS, the corporation paid them in on the eve of bankruptcy. The taxes were due and owing. Had the debtor filed a claim for refund and thereafter brought suit, there would be no basis in the tax law to get back this money. However, the corporation went into bankruptcy, and its trustee attempted to recover these payments as a voidable preference. We'll see in class why he didn't succeed. Read the case carefully. What is important is that the result is driven by the principles of the bankruptcy law and not the tax law.

During the course we will be looking at specific tax rules and procedures as they play out in the context of bankruptcy. While as tax advisors it is critical to learn the rules, as participants in the policy debate, it is important in each case to ask how far the tax law should go in accommodating the bankruptcy system without compromising its own integrity.

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