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Code to Code

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Tax Tactics in Bankruptcy: Leveraging § 505 After *Loper Bright*

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The Bankruptcy Code has powerful, and arguably underutilized, tools to address tax liabilities for debtors. Those tools, in combination with the recent U.S. Supreme Court case of *Loper Bright Enterprises v. Raimondo*,[2] which overturned the longstanding *Chevron* doctrine,[3] potentially provide an avenue to mitigate a persistent problem for both in-court restructurings and out-of-court liability-management transactions: the adverse consequences of "cancellation of indebtedness income" (CODI) that exist only because of an arguably overreaching Treasury regulation relating to the treatment of "traded" debt instruments. This article briefly explains the relevant statutes and Treasury regulation, *Loper Bright*'s relevance to it, and the potential to turn to the bankruptcy court to discard certain objectionable consequences of the longstanding regulation.

General Rules and the Offending Regulation

CODI can arise under a range of circumstances, from the obvious (satisfying a $100 debt instrument for $80 of cash gives rise to $20 of CODI) to the absurd. For example, a "deemed exchange" may occur when a forbearance fee, which is essentially treated as an extra interest payment on the underlying debt, is paid and results in an overall change in the "yield to maturity" of the debt instrument.[4] The deemed exchange results in CODI because the underlying debt is "trading" for less than its face amount. Once CODI is triggered, depending on the facts and circumstances, it can either be taxable income like any other income (potentially generating an immediate cash tax liability), or it can be "excluded" from income under the "bankruptcy exclusion" (for in-court transactions) and "insolvency exclusion" (for out-of-court transactions).[5] Once CODI has been excluded, a detailed modeling analysis determines further tax consequences. Those consequences range from "nothing" (so-called "black hole CODI") to reductions in tax attributes (such as net operating losses and asset-tax basis) that result in medium-to-long-term increases in tax liability, and to certain situations where there is unfortunately still a short-term tax liability because of the excluded CODI.

Suffice it to say, while CODI might or might not have an immediate tax consequence, it is almost always better (and never worse) to have less CODI (or no CODI at all). While numerous rules control whether, and how much, CODI is triggered by any particular transaction, the focus of this article is on §§ 108(e)(10), 1273 and 1274 of the Internal Revenue Code (IRC), and § 1.1273-2 of the Treasury Regulation. These rules explain how to quantify the *amount* of CODI that arises where existing debt is "exchanged" (either actually exchanged, or deemed to be exchanged), at least in part, for "new" (or modified) debt. IRC § 108(e)(10) states that the amount of CODI is based on the "issue price" of the new debt,[6] with the "issue

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2 144 S. Ct. 2244 (2024).
3 *Chevron U.S.A. Inc. v. NRDC*, 467 U.S. 837 (1984). An in-depth discussion of *Loper Bright* and *Chevron* are beyond the scope of this article.
4 This is just one example. Fundamentally, almost any change to a debt instrument carries the risk of causing a deemed exchange and must be evaluated on a case-by-case basis.
5 The insolvency exclusion applies to exclude CODI from income to the extent of a company's insolvency (determined for tax purposes) immediately prior to the transaction and is a fact-intensive analysis.
6 There are so-called "investment unit" rules that apply where there is a mix of consideration; those rules are not discussed here for simplicity.

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price" being determined pursuant to IRC §§ 1273 and 1274. With some exceptions, IRC § 1274 generally provides that the principal amount of the new debt is the "issue price." However, IRC § 1274 generally applies only if the specific rules of IRC § 1273 do *not* apply.

In the context of a debt-for-debt exchange, IRC § 1273 generally provides, under a statutory header of "debt instruments issued for property where there is public trading," that the issue price of the new debt is the "fair market value" (FMV) of "such property" where *either* (1) the new debt instrument is "traded on an established securities market," or (2) the old debt is (a) "traded on an established securities market" (in the case of instruments that are "securities" for tax purposes) or (b) "to the extent provided in regulations," the old nonsecurity debt is "of a kind regularly traded on an established market." If these "trading" rules do not apply, then *either* (1) IRC § 1274 sets the issue price (which will often, but not always, be the principal amount), or (2) the issue price is the "stated redemption price at maturity," which is also often (but not always) the principal amount. In almost all circumstances, the "issue price" of the new debt will be higher — and often significantly higher — if the debt is not captured by the "trading" rules in IRC § 1273.

This statutory regime can lead to harsh results that are magnified by an implementing regulation that arguably exceeds the statutory language. This regulation provides that there is "public trading" of debt for which, during the 31-day period ending 15 days after the new debt issuance, it has an accessible sales price; a quote, which is expected to be actionable, from an identified market maker (a "firm quote"); or a nonbinding price estimate from a market maker not covered in the previous price or quote categories (an "indicative quote").[7] Where sales prices or quotes exist, the regulations generally purport to make such pricing indications establish FMV for purposes of the statute, though it is possible to prove, through valuation, that indicative quotes do not fairly reflect FMV.

As previously noted, where the trading rules do *not* apply, in most cases the "issue price" of the new debt will be the face amount or close to it, which will generally result in less CODI. The "firm quote" and "indicative quote" rules cause debt to be "traded on an established [securities] market" where, almost definitionally, there is *no trading at all*, much less trading on any kind of "established [securities] market." (Even the "actual sale" rule, which is the least problematic, is often interpreted to apply to very thinly traded debt that is moving, if at all, only in "private" transactions.) We often derisively refer to "indicative quotes" as "fake quotes" on pricing services, such as BVAL and Markit, that can exist even when *as an absolute matter of fact* no trading has occurred. Therefore, these rules operate to cause debt that *is not trading at all* to be "traded," creating CODI in situations that appear contrary to the statutory language of IRC § 1273.[8]

The *Loper Bright* Decision

Section 1.1273-2 of the Treasury Regulation has been on the books for more than a decade, with tax professionals generally resigned to its outcomes in light of the longstanding *Chevron* doctrine, which generally required courts to defer to federal agencies' "reasonable interpretation" of ambiguous laws (or if the law was silent on an issue). On June 28, 2024, the Supreme Court overturned *Chevron* in *Loper Bright*, and it subsequently decided that having a regulation on the books for a long time does not preclude a challenge by someone harmed by that regulation today.[9]

Plenty has been written about the potentially significant ramifications of these cases to regulations issued by various federal agencies. Relevant to this article is that many tax regulations may now be much more susceptible to challenge, including § 1.1273-2.

It will take years to work through the ramifications of *Loper Bright* and *Corner Post*, particularly in the tax world, where the U.S. government may point to other sources of legislative rulemaking authority (and the sheer overwhelming complexity of the IRC and inability of Congress to fill all the holes itself) to justify the continued validity of tax regulations that may, on their face, appear inconsistent with the statute's plain language.[10] To be clear, there is no certainty at all that any court will ultimately rule that any part of § 1.1273-2 is invalid, but *Loper Bright* likely opens the door in a new way.

The § 505 Advantage (and More)

There are substantial barriers in challenging the validity of tax regulations in light of, among other things, the Tax Anti-Injunction Act (TAIA).[11] In short, the TAIA requires a taxpayer that wants to reduce its tax bill by challenging the validity of a tax-related statute or regulation to *either* (1) pay the full tax and sue for a refund, which can take many years; or (2) take the tax position, not pay the tax, potentially make required disclosures that "flag" the issue for Internal Revenue Service (IRS) auditors, and take the risk that they will lose the position years down the road, and be on the hook for substantial penalties and interest. Both options are particularly problematic for financially distressed companies that might not have the liquidity for (1) and whose plans may be compromised due to the uncertainty provided by (2).

Enter § 505 of the Bankruptcy Code, which grants bankruptcy courts broad *discretion* to decide substantive tax claims and claims to tax refunds, as long as certain procedural requirements are satisfied.[12] Section 505 applies to tax

7 Treas. Reg. § 1.1273-2(f)(1). There is an exception if the stated principal amount of the debt does not exceed $100 million, Treas. Reg. § 1.1273-2(f)(6), in which case the debt is deemed *not* to be trading, even if it actually is, which has its own potential problems, though it is often a taxpayer-favorable result.

8 The rules also establish, in the case of actual sales and "firm quotes," an *irrebutable presumption* that pricing indications constitute FMV. This is another fight for another article, but suffice it to say the authors believe that there are plenty of circumstances where a handful of small trades in a comparatively illiquid market do not reflect the FMV within the statute's meaning. That said, FMV is *simply not relevant* unless the debt is traded, so the "trading" question is the "threshold" question.

9 *Corner Post Inc. v. Bd. of Governors of the Fed. Rsrv. Sys.*, 144 S. Ct. 2440 (2024).

10 As an example of the special complexity of these developments in the tax world, IRC § 7805(a) expressly authorizes the Treasury Department to issue "all needful rules and regulations for the enforcement of" the IRC. It is unclear how broadly courts will apply this statute to "save" regulations that would otherwise be struck down.

11 With respect to federal income taxes, IRC § 7421(a), and with respect to state taxes, 28 U.S.C. § 1341.

12 11 U.S.C. § 505(a). It is worth noting that there are cases that have — wrongly, in the authors' view — held that § 505 and its companion provision do not extend to determining the federal income tax consequences of a bankruptcy plan itself (though a bankruptcy court can undeniably determine the *state* tax consequences of a plan, and that will often be impossible to do without also resolving the federal tax consequences). Section 505(a) is not generally understood to permit a bankruptcy court to determine a troubled company's tax attributes if those attributes do not have an impact on an actual tax liability or tax refund that is within the ambit of § 505.

returns for "administrative" tax years, as well as to pre-petition taxable years.

Thus, the bankruptcy court provides a path for troubled companies to challenge tax liabilities predicated on § 1.1273-2 of the Treasury Regulation. The regulation can affirmatively discourage, or at least significantly increase the risk associated with, some out-of-court transactions, given the risk that some or all of the CODI might be taxable outright given the fact-intensive nature of the "insolvency exclusion," an outcome fundamentally at odds with the general bankruptcy policy of encouraging out-of-court transactions (meaning a bankruptcy court may view this as a systemic issue). In any event, in most (but not all) situations, at a minimum, higher amounts of CODI mean higher tax bills for a company over the long run.

Accordingly, while a bankruptcy court may, at first glance, be inclined to abstain from addressing a tax argument predicated on striking down a longstanding tax regulation, it could be well positioned to appreciate the absurdity of the outcomes that the regulation generates. This may be particularly true where a debtor is burdened with a pre-petition tax liability that it would not otherwise have had if § 1.1273-2 of the Treasury Regulation had not applied in a way that artificially inflated the taxpayer's CODI. As such, the most direct path to creating precedent establishing the invalidity of § 1.1273-2 might be through the bankruptcy courts, rather than the years-long path, subject to interest and penalty accrual risk, that will otherwise apply to challenges outside of the bankruptcy context.

Notably, the power of the bankruptcy court process to move tax disputes along has been evident in recent cases. In each case, the deft use of bankruptcy tools — both § 505 and claims estimation — has at least coincided with moving large tax disputes along at a pace that tax-controversy practitioners and companies outside of bankruptcy could typically only dream of. In fact, it is often said that the mere *possibility* of facing a § 505 action can sometimes (but not always) have a settlement "forcing function" in tax disputes. To be sure, the ordinary course tax-claim process in bankruptcy has not typically considered the bankruptcy court as a venue to strike down Treasury Regulations. However, there is no time like the present for a more robust use of § 505 to improve the outcome for *all* distressed companies.

Conclusion

As a result of *Loper Bright*, statutory interpretative authority has shifted from federal agencies to the judiciary. Taxpayers in bankruptcy might be able to strategically use § 505 to expeditiously seek a refund, reduce the IRS's proof of claim, or preserve its tax attributes by challenging the validity of a regulation.

One such opportunity exists regarding debt instruments, because what constitutes "publicly traded" debt has been broadly construed under Treasury Regulations to include indicative quotes and could have significant consequences in determining CODI. However, how the courts will apply *Loper Bright* will continue to evolve for years (particularly for tax regulations), making it essential that practitioners stay informed and proactive to leverage new developments and opportunities that may arise for their clients. abi

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