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GIVE THEM MY REGARDS: A PROPOSAL FOR APPLYING THE COD RULES TO DISREGARDED ENTITIES

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This article discusses application of the COD rules to disregarded entities and concludes that the IRS should regard disregarded entities for that purpose. Hoffer argues that to do otherwise would not only engender uncertainty in lending transactions with single-member LLCs but would also distort the federal tax system's comprehension of underlying state law business arrangements.

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The greatest genius is the most indebted man.[1]

Section 108 of the Internal Revenue Code originally embodied a simple and equitable principle: A taxpayer who is insolvent or bankrupt should not be required to pay tax on cancellation of debt income (COD income) because that income produces no corresponding cash flow.[2] Like most expressions of simple tax principles, section 108 has grown in complexity over time in response to changing business practices. Through the Bankruptcy Act of 1980, Congress amended the operation of section 108 to require reduction of specified tax attributes in addition to basis.[3] When the mid-1980s brought drought to the Midwest, Congress addressed farm indebtedness.[4] The 1990s, a heyday for partnerships, brought amnesty for forgiven real property business indebtedness, as well as the addition of the passive activity and alternative minimum tax credits to the list of reduced tax attributes.[5] Finally, in 2002, Congress closed a perceived S corporation loophole in section 108.[6]

The advent of a new age in business entities, that of the disregarded entity, necessitates further change. Section 108 does not contemplate the existence of disregarded entities and, in its current rendering, yields two perennial tax woes when applied to them: taxpayer confusion and distortion of underlying business arrangements. To minimize those problems, the IRS should *regard* disregarded entities for purposes of section 108.

To support its proposal, this article first examines the section's treatment of partnerships and S corporations, comparing those entities to disregarded entities. Next, the article discusses the tax evolution of disregarded entities, focusing primarily on instances in which the IRS has respected them as separate from their owners. The article then explores the difficulty of applying current section 108 to bankrupt or insolvent disregarded entities and finally concludes that all state law entities possessing distinct property rights should be respected as such when assessing the tax results of forgiveness of indebtedness under section 108.

I. Section 108 Today

Generally, forgiveness or discharge of a taxpayer's indebtedness results in gross income.[7] Under section 108, a taxpayer may exclude that amount from gross income if the discharge occurs in a title 11 case, occurs when the

[1]Ralph Waldo Emerson, *Representative Men* (1850).

[2]*See generally* section 108. Section references are to the Internal Revenue Code of 1986, as amended, or the regulations thereunder, except as otherwise noted.

[3]*See* Bankruptcy Act of 1980, Pub. L. No. 96-589.

[4]*See* Tax Reform Act of 1986, Pub. L. No. 99-514; Technical and Miscellaneous Revenue Act of 1988, Pub. L. No. 100-647.

[5]*See* Omnibus Budget Reconciliation Act of 1993, Pub. L. No. 103-66.

[6]*See* Job Creation and Worker Assistance Act of 2002, Pub. L. No. 107-147, addressing *Gitlitz v. Comm'r*, 531 U.S. 206, 208, *Doc 2001-1085*, *2001 TNT 7-13* (2001).

[7]*See* section 61(a)(12).

taxpayer is insolvent, or satisfies certain other provisions of the statute.[8] That exclusion is not a blank check for the taxpayer. Section 108 requires a corresponding dollar-for-dollar reduction of various enumerated tax attributes.[9] Attributes must be reduced in the following order: net operating losses, general business credits under section 38, the section 53(b) minimum tax credit available in the year following the discharge, net capital losses, the basis of the taxpayer's property, any passive activity loss or credit carryover under section 469(b), and any foreign tax credits allowed under section 27.[10] The taxpayer may elect to apply the reduction in tax attributes first to the basis of its depreciable property if doing so will produce a more favorable result.[11]

Although the income exclusion and tax attribute reduction provisions of section 108 are easy to understand in relation to individual and corporate taxpayers, their application loses clarity in the context of passthrough entities. The statute treats partnerships and S corporations differently and does not address disregarded entities.[12] Also, special rules apply to the interaction between parents and their subsidiaries.[13]

In the partnership context, section 108 applies at the partner level.[14] In other words, discharge of indebtedness income is an item of income allocable to each partner under section 702(a).[15] That is because partners take a basis in their share of the partnership debt. A partner's basis is increased by its share of the discharge, but its basis is also reduced to reflect the reduction in the partner's share of partnership liabilities.[16] The application of section 108 is then determined with reference to the partner.[17] If COD income is excluded, the partner's tax attributes, rather than those of the partnership, are reduced.[18]

In contrast, section 108 applies to S corporations at the entity level.[19] Justification for that different treatment is not apparent at first blush. Like a partnership, an S corporation is not subject to income tax at the entity level. Instead, an S corporation's items of income, loss, and deduction are passed through to its shareholders much in the same way as a partnership's.[20] Like partners, S corporation shareholders may only deduct losses to the extent of their bases in the S corporation shares, but unlike partners, they do not take a basis in their entity's debt.[21] Any loss that the code disallows due to lack of shareholder basis is suspended at the corporate level and carried forward until a subsequent year when the shareholder's basis has increased.[22] Any reduction of tax attributes required by section 108 will work against those suspended losses.[23] The Joint Committee summary of P.L. 107-147 provides an example that illustrates those rules:

> [A]ssume that a sole shareholder of an S corporation has zero basis in its stock of the corporation. The S corporation borrows $100 from a third party and loses the entire $100. Because the shareholder has no basis in its stock, the $100 loss is ''suspended'' at the corporate level. If the $100 debt is forgiven when the corporation is in bankruptcy or insolvent, the $100 income from the discharge of indebtedness is excluded from income, and the $100 ''suspended'' loss should be eliminated in order to achieve a tax result that is consistent with the economics of the transactions in that the shareholder has no economic gain or loss from these transactions.[24]

Congress tightened application of section 108 to S corporations at the entity level in 2002 to close a loophole opened by the Supreme Court in *Gitlitz v. Commissioner*.[25] In *Gitlitz*, the commissioner argued that taxpayers had improperly used discharge of indebtedness income excluded under section 108 to adjust their bases in S corporation stock.[26] That adjustment allowed the shareholders to claim suspended losses that otherwise would not have been available.[27] The Supreme Court, speaking through Justice Thomas, held that excluded cancellation of indebtedness was an ''item of income'' subject to passthrough to shareholders before reduction of the S corporation's tax attributes under section 108.[28]

The effect of the Court's decision is best seen in the context of its facts. In 1991, the S corporation, P.D.W. & A., realized $2,021,296 of discharged indebtedness but was insolvent to the extent to $2,181,748.[29] Also, P.D.W. & A. had suspended losses of $1,010,648. Because the corporation's insolvency exceeded its income from discharge of indebtedness, section 108(a) applied to exclude that income from the shareholders' 1991 returns.[30] Nonetheless, the shareholders claimed, and the Court agreed, that the excluded COD income was an ''item of income'' for purposes of section 1366(a)(1)(A) and therefore must be included in the shareholders' bases under section 1367(a)(1)(A) before reduction of the corporation's tax attributes under section 108(b).[31] As a result of their increased share basis, the shareholders were able to deduct the entire amount of their suspended losses in

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[8]*See* section 108(a)(1).
[9]*See* section 108(b)(1), (3).
[10]*See* section 108(b)(2).
[11]*See* section 108(b)(5).
[12]*See generally* section 108.
[13]Section 108(e)(7)(C).
[14]*See* section 108(d)(6).
[15]Section 702(a).
[16]*See* section 752.
[17]*See* section 108(d)(6).
[18]*See id*.
[19]*See* section 108(d)(7).
[20]*See* section 1366(a).
[21]*See* section 1366(d).
[22]*See* section 108(b)(7)(A).
[23]Technical Explanation of the Job Creation and Worker Assistance Act of 2002, JCX-12-02 (March 6, 2002), *reprinted in* 2004(2) *CCH* para. 7702.
[24]*Id*.
[25]*See Gitlitz v. Comm'r*, *supra* note 6, at 208.
[26]*Id*.
[27]*See id*.
[28]*See id*. at 214, 218.
[29]*See id*. at 210.
[30]*See id*.
[31]*See id*. at 209, 213-14.

1991, even though their bases were not increased by corresponding items of taxable income.[32] In other words, the *Gitlitz* decision allowed P.D.W. & A.'s shareholders to deduct their suspended S corporation losses against income entirely unrelated to the S corporation.[33]

The Court aptly noted that ''[t]he benefit at issue in this case arises in part because section 108(d)(7)(A) permits the exclusion of discharge of indebtedness income from gross income for an insolvent S corporation even when the S corporation shareholder is personally solvent. We are aware of no other instance in which section 108 directly benefits a solvent entity.''[34] Justice Breyer's dissent explains the insolvent entity/solvent shareholder problem further, stating:

> [T]his deduction-related tax benefit would have very different tax consequences for identically situated taxpayers, depending only upon whether a single debt can be split into segments, each of which is canceled in a different year. For example, under the majority's interpretation, a $1 million debt canceled in one year would permit Taxpayer A to deduct $1 million of suspended losses in that year, thereby permitting A to shelter $1 million of unrelated income in that year. But because section 108 reduces tax attributes after the first year, five annual cancellations of $200,000 will not create a $1 million shelter. Timing is all important.[35]

Partnerships, in contrast, are subject to the same type of abuse only in rare circumstances. A partner, unlike an S corporation shareholder, increases the basis of its interest in a partnership by its share of the partnership debt.[36] As a result, the partner will have more basis available to offset the deduction of suspended losses than a similarly situated shareholder in an S corporation with identical indebtedness. Consider the following example: X owns a partnership interest with a basis of zero. The partnership borrows $200, and X's share of the debt is $100. X's basis is increased to $100.[37] The partnership suffers a loss and allocates $100 of that loss to X. X claims the loss and reduces its basis to zero.[38] The lender forgives the partnership's debt. X has $100 of COD income and increases its basis to $100.[39] Then X's basis is decreased by $100 to account for its reduced interest in the partnership debt.[40] X's basis is again zero.

Notice that in the example above, partner X claimed a loss against basis produced by a debt that was subsequently forgiven. Because X's basis was increased by the amount of the COD income on forgiveness, its concurrent basis reduction for the decrease in its share of partnership debt does not result in a negative basis, which would have produced taxable income to offset the previously claimed loss. Subchapter K does not call for recapture of the loss, which makes basis attributable to entity-level indebtedness an important distinction between S corporations and partnerships regarding COD income. In essence, *Gitlitz* allowed S corporation shareholders the benefit of basis in entity-level debt on the back end of the lending transaction. That observation does not, however, entirely foreclose the *Gitlitz* problem for partnerships. The basis increase at issue in *Gitlitz* resulted from COD income, an issue also present for partners.

As noted in the previous example, a partner's basis in its interest is increased by forgiveness of indebtedness income allocated to the partner.[41] That increase in basis will generally be offset by a corresponding decrease in basis attributable to the partner's share of the forgiven debt.[42] As a result, a *Gitlitz*-type shelter is possible when income allocated to the partner exceeds the dollar amount of the partner's share of the forgiven debt. Furthermore, the shelter is effective only when the excess basis partner is insolvent but nonetheless has income unrelated to the forgiven debt. That is because section 108 applies at the partner level rather than the partnership level.[43]

Consider the following example. A and B each contribute $100 of capital to a partnership. The partnership agreement allocates all items equally, except that 80 percent of all losses are allocated to A. The partners agree to maintain their capital accounts in accordance with section 704(b), including a deficit capital account restoration obligation upon liquidation. In year one, the partnership suffers a $1,000 loss. As a result, the partners' bases are reduced to zero and their capital accounts are reduced to ($700) for A and ($100) for B. Both A and B may claim $100 of loss for income tax purposes and the remainder of the loss, allocated $700 and $100, respectively, must be suspended until such time as the partners' bases increase in value.[44] Now assume that the partnership executes a recourse note in the amount of $1,000, which it uses to purchase a popsicle maker. Because both partners' capital accounts are negative, they will share the risk of loss on the note in the 80/20 ratio specified by the partnership agreement.[45] As winter approaches, it becomes clear that the partnership will be unable to satisfy the note, and the lender forgives the entire $1,000. The partners share the resulting COD income in accordance with the partnership agreement, with $500 allocated to each partner. As a result, A's capital account increases to ($200), and B's capital account increases to $400.[46] Each partner's basis increases to $500.[47] Next, the partners decrease their capital accounts and bases by the amount of the debt attributable to each partner.[48] As a result, A's capital account decreases to ($1,000) and B's

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[32] *Id*. at 220.
[33] *See id.* at 220-21 (Breyer, J., dissenting).
[34] *Id*. at n. 10.
[35] *Id*. at 222 (Breyer, J., dissenting).
[36] *See* sections 722, 752.
[37] *Id*.
[38] *See* Treas. reg. section 1.704-1(b)(2).
[39] Section 705.
[40] *Id*.
[41] *See* sections 722, 752.
[42] Section 752 (treating relief of indebtness as a distribution of cash to the partners).
[43] Section 108(d)(6).
[44] *See* Treas. reg. section 1.704-1(b)(2).
[45] Treas. reg. section 1.752-2(a).
[46] *See* Treas. reg. section 1.704-1(b)(2).
[47] *See* sections 705, 752.
[48] *See id.*

capital account decreases to $200. A's basis is reduced to zero, and B's basis is reduced to $200. Note that B's positive basis allows it to take advantage of the entire $100 of suspended loss attributable to it.

Ordinarily, that method of loss recognition would seem unattractive to B because it entails a corresponding recognition of COD income; however, if B were insolvent, B could claim the suspended loss without recognizing income. That is because section 108 applies to cancellation of indebtedness income at the partner level.[49] Unlike the transaction described by *Gitlitz*, that scenario does not place the sheltered income forever beyond the reach of the IRS. B must reduce its tax attributes under section 108(b). Furthermore, depending on the fortunes of the partnership, A's large negative capital account balance may result in a cash payment to B on liquidation.[50] For partners, then, it is possible to use a basis increase generated by COD income to defer, but not to defeat, tax on income completely unrelated to the partnership when the partner is both insolvent and has suspended losses.

Section 108's divergent treatment of partnerships and S corporations may shed some light on our disregarded entity query. One rationale for divergent treatment, the basis taken in entity level debt, is irrelevant to disregarded entities. A second rationale for treating the two entities differently, namely, prevention of the *Gitlitz* shelter, cannot serve as a basis for requiring section 108 to apply at the disregarded entity level. By the same token, that rationale cannot serve as a basis for rejecting the application of section 108 at the disregarded entity level. Because the owner of a disregarded entity has no federal tax basis in its ownership interest, and because losses are not suspended with reference to that basis, the *Gitlitz* problem cannot arise in a disregarded entity. As a result, Justice Breyer's one and only policy complaint in *Gitlitz* against allowing a solvent taxpayer to benefit from the insolvency of an entity owned in whole or in part by the taxpayer does not apply in the disregarded entity context.

Disregarded entities share key characteristics of both partnerships and S corporations. Like a partnership or an S corporation, a disregarded entity passes its tax attributes through to an ultimate stakeholder.[51] Also, both S corporations and disregarded entities are creatures solely of the federal tax code and regulations.[52] As a result, their federal tax treatment may have little or no connection to the state laws governing their creation, their management, and the disposition of their property. This disconnect between state and federal law creates a potential for federal tax distortion of state law business arrangements. When a disregarded entity behaves like or is a corporation at the state level, it is inappropriate to treat that entity in the same manner as a partnership under section 108. Conversely, because the disregarded entity is a nonentity for federal tax purposes, it is inappropriate to treat it in the same manner as an S corporation, even though both are limited liability pass-through vehicles.

Consider the following example. X is a single-member limited liability company owned by Corporation Y. X manufactures a special battery, which Y uses in its hybrid automobile. Y has owned X for several years. As time passes, Y's hybrid automobile business becomes unprofitable because of stiff competition from Corporation Z, whose product is less expensive but uses an inferior battery. X borrows money from Lender to continue its operations and subsequently becomes insolvent in an amount in excess of the debt. Y is unwilling to contribute additional capital to X for obvious reasons. Because Y is a good customer, Lender forgives X's indebtedness. Some time later, Y and Z agree that Z will acquire X by purchasing Y's interest in X for cash.

Assume for the moment that section 108 can apply to a disregarded entity. If X is treated like a partnership, COD income generated by X will be evaluated under section 108 with reference to Y. If Y is neither bankrupt nor insolvent, it must recognize ordinary income from relief of indebtedness under section 61(a)(12). Because section 108(a) does not apply to Y's COD income, Y is not required to reduce any tax attributes under section 108(b). That treatment does not reflect the financial reality of Y's transaction. The debt was not a debt of Y, and for state law purposes, Lender could not collect from Y. Furthermore, X, the actual debtor and a juridically separate entity, receives the benefit of debt forgiveness without the corresponding burden of attribute reduction. When Z purchases X, the basis of X's assets will not reflect adjustment for forgiveness of indebtedness income. That treatment has the effect of accelerating income that Y would have recognized on the sale of X to the year in which X's debt is forgiven. And while not all would agree that this distortion warrants treatment of a disregarded entity in a manner similar to S corporations, the tax result becomes more extraordinary in transferred basis situations.

Assume, for instance, that Y is an individual who is taxed at a rate of 25 percent. If X is treated like a partnership under section 108, Y realizes COD income that is taxed at a rate of 25 percent. The bases of X's assets are not affected by section 108(b). After X's debt is forgiven, Y realizes that X's business may be attractive to Z if Z can acquire X in a tax-free reorganization. Y contributes her interest in X to newly formed corporation A in exchange for all of A's stock. Y's basis in her A stock will equal the basis of X's assets under section 358(a) because Y's interest in X is disregarded for federal tax

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[49]*See* section 108(d)(6).

[50]*See* Treas. reg. section 1.704-1(b)(2)(ii)(b)(3).

[51]Indeed, it is ''[d]isregarded as an entity separate from its owner.'' Treas. reg. section 301.7701-3(b).

[52]An S corporation is a state law corporation that meets the requirements of section 1361 and which elects to be an S corporation under section 1362. Likewise, under Treas. reg. section 301.7701-3(a) an entity with a single owner may elect to be treated as an association or as an entity disregarded as separate from its owner. The federal tax choices of the S corporation and disregarded entity owners create the illusion for federal tax purposes that the entity has been transformed into a new being when, in reality, the entity remains unchanged for purposes of the state law that governs the management and disposition of its property.

purposes.[53] In other words, Y must pay tax at 25 percent on COD attributable to X, but in return she is permitted to take a high basis in her A stock. In addition, A will take the same high basis in X's assets under section 362(a).[54] Last but not least, A's high inside basis will be transferred to Z under section 362(b).[55] As a result, Z, which is taxed at a higher rate than Y, will recognize less gain on the sale of the former X assets. In that case, the spread between Y's rate and Z's rate is 10 percent, which is not insignificant.

If, in the example above, X were treated like an S corporation, the result would be different. X's COD income would be excluded from Y's gross income under section 108(a), and tax attributes attributable to X would be reduced under section 108(b). Because X is disregarded for federal tax purposes, its sole identifiable tax attribute is asset basis, which would be reduced. In the section 351 exchange, Y would take a lower basis in her A stock, and A would take a lower basis in the X assets. Finally, Z would take the same low basis in the tax-free reorganization. In this version of the example, the unrealized COD income follows the X assets.

Which of those two examples more closely reflects the underlying state law business transactions? Clearly, it is the second. In the first example, Y is taxed on income generated by forgiveness of a debt that Y did not incur and was not even remotely responsible for satisfying. Furthermore, X probably incurred the canceled debt to purchase assets whose basis remains unaffected by the debt's subsequent forgiveness. The resulting COD income was taxed at Y's low marginal rate, leaving the assets available for disposition by a higher-rate taxpayer without reflection of an income-producing transaction directly related to their acquisition and retention. That treatment reflects the underlying transactions no better than a funhouse mirror. As demonstrated by the second example, applying section 108(a) to X at the entity level remedies that distortion because it takes into consideration X's state law rights and duties regarding its property.

There is no precedent for allowing application of section 108(a) at the level of a disregarded entity, and it is unlikely that a taxpayer could prevail on such a claim under current law. Section 108, by its plain language, applies only to "indebtedness of the taxpayer."[56] By definition, a disregarded entity is *not* a taxpayer. As a result, change can come only from a conscious and written decision of Congress or Treasury. Such a decision is not beyond the realm of possibility. Treasury has elected to regard disregarded entities in certain other circumstances.[57]

II. Tax Treatment of Disregarded Entities

A. Treatment Generally

Under the check-the-box regulations, an unincorporated single-member entity will generally be "disregarded as an entity separate from its owner"[58] that is treated "in the same manner as a sole proprietorship, branch or division of the owner."[59] In other words, the assets and characteristics of the disregarded entity are not independently reported, but instead must be taken into account when determining the characterization of its owner's assets, indebtedness, income, loss, and other tax attributes.[60]

That treatment is significantly different from that accorded to single-owner entities under Treasury's former classification regime.[61] Before enactment of the check-the-box regulations, no authority permitted or required taxpayers to disregard single-owner state law entities.[62] Indeed, taxpayers frequently treated those entities as partnerships.[63] Consequently, there is little authority and much confusion over the characterization and tax implications of transactions involving those entities.[64] As this article demonstrates regarding indebtedness, the uncertainty can often be reduced to a single inquiry: When will Treasury regard the state law rights of disregarded entities?

B. Debt Characterization

The area of debt characterization is particularly murky. In the easy case, in which a disregarded entity holds one asset and that asset secures a debt, practitioners generally treat the debt as nonrecourse debt of the single member.[65] Nonetheless, for federal tax purposes, the character of debt is wholly dependent on a lender's right of recourse under state law. Terrence Cuff, in his article entitled "Indebtedness of a Disregarded Entity," demonstrates the confusion resulting from that characterization through several examples.[66] In the first example, a taxpayer purchases an asset using $1,000 cash

[53]Section 358 provides that in the case of an exchange under section 351, "[t]he basis of the property permitted to be received under such section without the recognition of gain or loss shall be the same as that of the property exchanged. . . . " Note, however, that if X's asset basis exceeds the fair market value of X's assets, A's basis in the assets will be limited to their fair market value unless Y and A elect instead to reduce Y's stock basis by the excess amount. *See* section 362(e)(2), which was added by P.L. 108-357 for transactions after October 22, 2004.

[54]Section 362(a), like section 358, calls for a transferred basis. The section provides that if property is acquired by a corporation in a section 351 exchange, "the basis shall be the same as it would be in the hands of the transferor. . . . "

[55]Section 362(b) states that when property is acquired in a reorganization to which part III of subchapter C applies, "the basis shall be the same as it would be in the hands of the transferor. . . . "

[56]Section 108(a).

[57]*See infra* Part II.C.

[58]Treas. reg. section 301-7701-3(a).

[59]Treas. reg. section 301-7701-2(a).

[60]*See* Marc D. Teitelbaum, "A Disregarded Entity Must Be Taken into Account," *Tax Notes*, Dec. 2, 2002, p. 1205 at 1206.

[61]*See id*. at 1207.

[62]*See id*. at 1208.

[63]*See id*.

[64]*See id*.

[65]*See* Jenks et al., *Corporate Bankruptcy* 790 T.M. section X.B.1.A (2004).

[66]Terrence Floyd Cuff, "Indebtedness of a Disregarded Entity," 81 *Taxes* 303, 338-340 (March 2003).

and a $9,000 note.[67] The lender has full recourse to all of the taxpayer's assets. Clearly, the debt is recourse.[68]

In Cuff's second example, the taxpayer transfers $1,000 in cash to a single-member LLC.[69] The LLC purchases the asset for $1,000 cash and a $9,000 note.[70] The lender has full recourse to all of the LLC's assets.[71] Cuff writes of that example, ''[t]he debt is recourse in form. There, however, is no practical difference under the facts of [the second example] between a nonrecourse debt secured by the asset and a recourse debt with recourse only to the assets of the LLC.''[72]

Characterization in the third example is also unclear. In that example, the taxpayer transfers $10,000 to a single-member LLC.[73] The LLC purchases a $10,000 asset using $1,000 in cash and a $9,000 note.[74] The LLC then invests its remaining $9,000 cash in other assets.[75] The lender has full recourse to all of the LLC's assets.[76] The debt is again recourse in form as to the LLC, but nonrecourse as to the assets of the single member.[77] Cuff, however, finds ''a significant economic distinction'' between the second and third examples, suggesting that the debt could be viewed as either recourse or nonrecourse.[78] Using those and other examples, Cuff points out that the tax law regarding characterization of the debts of disregarded entities is ''not clear.''[79]

The distinction between recourse and nonrecourse debt is vitally important for purposes of section 108.

The distinction between recourse and nonrecourse debt is vitally important for purposes of section 108. In the case of an insolvent entity that transfers property to a lender, it can mean the difference between application of section 108 deferral and immediate inclusion of the forgiven amount in ordinary income.[80] Those divergent results stem from court cases and regulations passed down before disregarded entities were even a twinkle in Treasury's eye. Nonetheless, because of confusion over characterization of the indebtedness of disregarded entities, the older rules and rulings retain vitality in the disregarded entity context.

The Treasury regulations provide that ''the amount realized from a sale or other disposition of property includes the amount of liabilities from which the transferor is discharged as a result of the sale or disposition.''[81] The regulations also specify that the ''amount realized'' from the sale of property securing a *recourse* debt does not include cancellation of indebtedness income.[82] In contrast, ''[t]he sale or other disposition of property that secures a nonrecourse liability discharges the transferor from the liability.''[83] There is no regulatory exclusion of this amount from the general rule. Because they are ''liabilities from which the transferor is discharged,'' any amounts of nonrecourse indebtedness forgiven on transfer of property to a lender will increase the transferor's amount realized.[84] Those regulations dovetail closely with the Supreme Court's decision in the *Tufts* case, which held that the amount realized from the sale of property subject to a nonrecourse debt includes the full amount of that debt.[85] The First Circuit's decision in *Parker v. Delaney*, which held that tax results on disposition of property subject to nonrecourse debt are the same regardless of whether the property is transferred to a third party or to the lender, is also in agreement.[86] Also, the Fifth Circuit in the *Yarbro* case held that nonrecourse debt must be included in the amount realized even when property subject to the debt is simply abandoned.[87] The upshot of those regulations and decisions is that section 108 deferral is simply not available to a taxpayer who transfers property that secures a nonrecourse debt to a lender in satisfaction of that debt.

Cuff's article demonstrates that valid arguments exist for treating debt of a disregarded entity as recourse debt of the entity or as nonrecourse debt of the entity's owner based on the facts and circumstances.[88] He aptly notes that, as of yet, neither Congress nor Treasury have provided adequate guidance on the classification of that debt.[89] If future guidance were to provide that availability of section 108 must be judged at the disregarded entity level, the question of debt classification would have added significance, particularly to disregarded entities that are insolvent for purposes of state law.

The lack of clarity demonstrated by Cuff's article stems from treatment of a state law entity with independent rights and duties as though it has no legal existence. That treatment creates uncertainty in every instance in which federal tax results rely in whole or in part on the state law characterization of a transaction. To deal effectively with questions arising from increased use of disregarded entities, the IRS must determine to what extent state law will inform its policies. Unfortunately, rulings and regulations in that vein have not been a paragon of consistency.[90]

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[67]*See id*.
[68]*See id*.
[69]*See id*. at 339.
[70]*See id*.
[71]*See id*.
[72]*See* Cuff, *supra* note 66.
[73]*Id*. at 340.
[74]*See id*.
[75]*See id*.
[76]*See id*.
[77]*See id*.
[78]*Id*.
[79]*Id*. For further discussion of this point, see also Debra J. Bennett, ''To Be or Not to Be, That Is the Question: Disregarded Entities and Debt Modification,'' 81 *Taxes* 9 (December 2003).
[80]Cuff, *supra* note 66, at 338.
[81]Treas. reg. section 1.1001-2(a)(1).
[82]Treas. reg. section 1.1001-2(a)(2).
[83]Treas. reg. section 1.1001-2(a)(4)(i).
[84]Treas. reg. section 1.1001-2(a)(1).
[85]*Comm'r v. Tufts*, 461 U.S. 300 (1983).
[86]*Parker v. Delaney*, 186 F.2d 455 (1st Cir. 1950).
[87]*Yarbro v. Commissioner*, 737 F.2d 479 (5th Cir. 1984).
[88]*See generally supra* note 66.
[89]*See id.* at 362.
[90]*See supra* note 65; Jasper L. Cummings, ''The Disregarded Entity Is and Isn't (Disregarded),'' *Tax Notes*, May 5, 2003, p. 743

(Footnote continued on next page.)

C. When a Disregarded Entity May Be *Regarded*

The IRS does not always disregard single-owner entities. It acknowledges them in some instances in which state property laws or basic tax principles require it. A Treasury adviser has described that department's approach to disregarded entities as that of "putting a square peg in a round hole — it doesn't always make sense."[91] Addressing a meeting of the District of Columbia Bar Taxation Section, she noted that Treasury "obviously recognize[s] the inconsistencies" in its treatment of disregarded entities.[92] Indeed, in one recent case, the IRS actually urged the Tax Court to regard a disregarded entity in the context of a deemed asset sale.[93] In some circumstances, such as application of section 108 to the forgiven debt of a disregarded entity, inconsistent treatment may be warranted. The rulings and regulations described below provide much needed precedent for regarding a disregarded entity under section 108.

1. Proposed regulations on the treatment of disregarded entities for purposes of characterizing and allocating partnership liabilities under section 752. Under section 752, a partner's basis in its interest includes the partner's share of partnership liabilities. For recourse debt, that share is generally equal to the amount that the partner would be required to pay another person if the partnership sold all of its assets for zero dollars and then liquidated.[94] In other words, a partner's share of partnership liability is the amount for which it bears the "economic risk of loss."[95]

A partner's economic risk of loss hinges on whether it has an obligation to pay a certain amount on constructive liquidation.[96] That is essentially a state law question. As a result, use of a disregarded entity as a partner introduces friction. For purposes of federal tax law, the disregarded entity cannot be a partner. Instead, the entity's owner bears that title.[97] Therefore, for purposes of section 752, the relevant inquiry would seem to be the economic risk of loss of the *owner* of the disregarded entity/partner, rather than the risk of the entity itself.

Under state law, the owner may have little or no risk of loss because it is not a partner for state law purposes. However, the disregarded entity itself, if capitalized, may have a large risk of loss that should be accounted for under section 752. Because the owner's assets and the disregarded entity's assets are separate for state law purposes, a proper section 752 analysis can be made only by regarding the disregarded entity. Treasury has summarized the problem as follows:

> Because a disregarded entity and its owner are treated as a single entity, the presumption of deemed satisfaction of obligations undertaken by the owner arguably should include payment obligations undertaken by the disregarded entity. However, because of statutory limitations on liability, the owner of a disregarded entity may have no obligation to satisfy payment obligations undertaken by the disregarded entity. The current regulations consider such limitations on the payment obligations of a partner or a related person to be relevant in determining the extent to which the partner or related person is treated as bearing the economic risk of loss for a partnership liability. The IRS and Treasury Department believe that because only the assets of the disregarded entity may be available to satisfy payment obligations undertaken by the disregarded entity, a partner should be treated as bearing the economic risk of loss for a partnership liability as a result of those payment obligations only to the extent of the net value of the disregarded entity's assets.[98]

Recently proposed regulations provide that when determining a partner's economic risk of loss, "payment obligations of a disregarded entity are taken into account only to the extent of the net value of the disregarded entity."[99] In other words, the conflict between states' laws on debt obligations and the federal law on disregarded entities has been resolved in favor of recognizing state law. One IRS official has categorized this approach as an "economic reality theory," and it is one that the IRS should consider in its application of section 108 to disregarded entities.[100]

2. Collection of a disregarded entity's tax liability from the entity's owner. States' laws on debts and debt collection have affected IRS policy in areas outside of subchapter K. In legal memorandum 200338012, the IRS concluded that it could not levy the property of a disregarded entity for employment taxes incurred by that entity because it was separate from its owner (the federally liable party) under state law.[101] Remarkably, the IRS began its decision by writing that "[t]axpayer, a debtor in a Chapter 11 bankruptcy, is a single member LLC."[102] The plain language implication of that sentence under section 108 is that a single-member LLC could be a "taxpayer" if the entity's indebtedness is discharged in a title 11 case.[103] If that were the case, forgiveness of indebtedness income arising from such a discharge would be excluded from gross income of the owner under section 108(a)(1)(A).

(discussing IRS's consideration of creditors' state law rights in debt instruments of corporation that merged into disregarded entity).

[91]Kenneth A. Gary, "Treasury, IRS Seek Comments on Disregarded Entity Treatment," *Doc 2004-20124*, *2004 TNT 199-1* (Oct. 13, 2004).

[92]*Id*., quoting Stephanie Robinson, attorney-adviser with the Treasury Office of Tax Legislative Counsel.

[93]*See Dover Corp. v. Comm'r*, 122 T.C. 324, 355, *Doc 2004-9660*, *2004 TNT 88-15* (2004).

[94]*See* Treas. reg. section 1.752-2(b).

[95]*Id*.

[96]*See* Treas. reg. section 1.752-2(b)(3).

[97]*See* Treas. reg. section 301.7701-1 — 3.

[98]Preamble to prop. Treas. reg. section 1.752-2(k)(1), 69 *Fed. Reg.* 49832-49836 (2004).

[99]Prop. Treas. reg. section 1.752-2(k)(1), 69 *Fed. Reg.* 49832-49836 (2004).

[100]Gary, *supra* note 91.

[101]ILM 200338012, *Doc 2003-20842*, *2003 TNT 185-19*.

[102]*Id*.

[103]*See* section 108(a)(1)(A).

Even if read without the happy accident of its first sentence, the chief counsel advisory highlights the IRS's willingness to regard disregarded entities in some circumstances. The ruling describes a disregarded entity that is delinquent on its employment taxes.[104] Notice 99-6, which is cited by the advisory, provides the owner of a disregarded entity with a choice between calculating and paying employment taxes attributable to the entity itself or allowing the entity to calculate and pay those taxes.[105] ''The Notice states that, regardless of the choice made, the single member owner of an LLC disregarded as a separate entity is the employer for purposes of employment tax liability.''[106] Therefore, the IRS must look primarily to the owner for recompense.[107]

One might assume that because a disregarded entity is ''treated in the same manner as a sole proprietorship, branch, or division of the owner,'' the assets of the entity would be subject to lien and levy stemming from delinquent tax debts of the owner.[108] That is not the case. Lien and levy analyses depend on the taxpayer's state law property rights under *Drye v. United States*.[109] Once again, the intersection of federal tax law and state property law results in confusion where disregarded entities are concerned. In ILM 200338012, the IRS wrote that the lien and levy analyses are ''complicated by the fact that state and federal law view the business from different perspectives.''[110] The IRS explained:

> Under state law, the taxpayer/single member owner has no interest in the LLC's property. From this perspective, it appears that the LLC is a separate entity, which, as the direct payer of the payroll, may be held liable for failure to remit withholdings. However, for purposes of federal tax law, the LLC has been disregarded as an entity separate from the company's single member owner. It is treated like a trade name by which the company's single member owner conducts business.[111]

Based on *Drye*, the IRS concluded that it could not levy against assets of the disregarded entity because the owner had no right to those assets under state law.[112] Similar considerations apply regarding section 108: Lenders have no recourse to the owner's assets under state law.

3. Metamorphosis into a disregarded entity. When an entity that was once a taxpayer becomes a disregarded entity, the IRS may continue to regard it for purposes of determining and possibly collecting its outstanding liability. There are a variety of ways that a regarded entity may become a disregarded one. For instance, if a real estate investment trust acquires all of the stock of a corporation, it will become a qualified REIT subsidiary, which is disregarded.[113] Similarly, an S corporation may elect to treat a wholly owned subsidiary as a QSub, which is also disregarded.[114] A disregarded entity may also be the surviving corporation in a tax-free merger.[115] Those metamorphoses bring with them the question of how to treat pre-disregarded-entity tax liability in the post-disregarded-entity period. According to the IRS, ''[a]lthough a disregarded entity generally is not liable for Federal tax liabilities of its owner . . . [it] may be liable for Federal taxes with respect to taxable periods during which it was not disregarded or because it is the successor or transferee of a taxable entity.''[116]

In the preamble to recently released regulations on conversion to disregarded entity status, the IRS stated, ''[t]he proposed regulations do not address the question of whether the disregarded entity, is, in fact, either liable for Federal taxes or entitled to a refund or credit of Federal tax.'' Instead, the regulations:

> clarify that if a disregarded entity is liable for Federal taxes, the disregarded entity will be treated as an entity separate from its owner for purposes of those liabilities, such that an assessment may be made against the disregarded entity, the assets of the disregarded entity may be subject to lien and levy, and the disregarded entity may consent to extend the period of limitations on assessment. In addition, the regulations clarify that if a disregarded entity is entitled to a refund or credit of Federal tax, the disregarded entity will be treated as an entity separate from its owner for purposes of that refund or credit.[117]

The proposed regulations provide examples of when a newly disregarded entity will be treated as a regarded one.[118] For instance, consider domestic corporation X, which merges into disregarded entity Z. If the IRS seeks to extend the period of limitations on a tax year of X that closed before the merger, the regulations provide that Z is the proper party to sign the consent.[119] Furthermore, if the IRS determines that X underreported its income tax

[104]*See* ILM 200338012, *supra* note 101.
[105]*Id.*, citing 1999-3 IRB 12, *Doc 1999-1059*, *1999 TNT 3-8*.
[106]*Id.*
[107]*See id.*
[108]Treas. reg. section 301.7701-2(a).
[109]528 U.S. 49, *Doc 1999-38535*, *1999 TNT 235-4* (1999).
[110]ILM 200338012, *supra* note 101.
[111]*Id.*
[112]*See id.*

[113]*See* section 856(i).
[114]*See* section 1362(b)(3).
[115]*See* temp. Treas. reg. section 1.368-2T.
[116]Preamble to Proposed Regulations, 69 *Fed. Reg.* 17117-17119 (2004). The regulations are consistent with the IRS's position in the *Dover* case. In that case, the IRS argued that a controlled foreign corporation's election of disregarded status should be ignored for purposes of determining whether income from the sale of the corporation's assets was foreign personal holding company income. The Tax Court held for the taxpayer, finding that the disregarded entity's assets were a part of the parent corporation even though the entity's check-the-box election was made retroactive to just moments before the sale of all of its stock to an unrelated third party. Despite the court's refusal to regard the disregarded entity, the *Dover* case demonstrates that the IRS will attempt to thwart transition to disregarded entity status for tax avoidance purposes by separating owner from entity when necessary. *See Dover Corp. v. Comm'r*, *supra* note 93.
[117]*Id.*
[118]*See* Treas. reg. section 301.7701-2(c)(2)(iii)(B).
[119]*See id.*

liability for a year before the merger, ''Z is a successor to X and is liable for X's [prior year] taxes that remain unpaid.''[120] The regulations provide that in such a case, ''the deficiency may be assessed against Z and, in the event that Z fails to pay the liability after notice and demand, a general tax lien will arise against all of Z's property and rights to property.''[121]

This treatment is distinguishable from that recommended by ILM 200338012.[122] In that case, the federal tax debtor was the owner of the disregarded entity, even though the debt was attributable to the entity itself.[123] In the regulations, the debtor is a disregarded entity that was formerly taxable. The IRS arguably is not required to consider the respective state law property rights of the owner and the entity, because the entity itself incurred the debt. Nonetheless, might not the IRS have chosen to attribute the debt to the owner of the newly disregarded entity, because the entity is treated as merely a ''branch'' of the owner? In that case, the IRS would have recourse to the assets of both the owner and the entity. The IRS does not explain its choice in the preamble to its regulations.[124] One might argue that the IRS has chosen to regard the newly disregarded entity to prevent distortion of the underlying business reality, a reason that is equally compelling in the context of section 108.

4. The effect of conversion on nongovernmental creditors. Conversion of a regarded entity into a disregarded one has the potential to affect not only tax debts, but also debts owed to nongovernmental creditors. In a recent private letter ruling, the IRS took the position that for purposes of the *Cottage Savings* regulations, a disregarded entity should be viewed as separate from its owner. While that position is consistent with the proposed regulations discussed above,[125] it ''fuels a simmering uncertainty as to when a disregarded entity will be disregarded and when it will not.''[126]

In the ruling, a corporation with both domestic and international lines of business proposed to restructure itself along geographical lines.[127] It merged with a corporate subsidiary of a new parent corporation, and that subsidiary immediately converted to a single-member LLC under state law.[128] The single-member LLC formed a second LLC to hold the international line of business and distributed its interest in this newly formed entity to the new parent corporation.[129] The original corporation had outstanding publicly traded debt, which was allocated to the first newly formed single-member LLC.[130]

Pursuant to state law, the corporation's conversion to an LLC did not create a new legal entity or alter the legal rights or obligations of the corporation to the debt holders.[131] However, for federal tax purposes, the identity of the debtor changed.[132] The original debtor became a disregarded entity, meaning that the new parent corporation should be regarded as the new debtor.[133]

Under the *Cottage Savings* regulations, the substitution of a new debtor on an instrument is generally a significant modification that will result in a constructive sale or exchange of the instrument under section 1001.[134] The IRS, however, took a different position in its ruling.[135] It concluded that ''[t]he legal rights and obligations referred to in section 1.1001-3(c) are rights that are determined under State law.''[136] Because state law caused the newly formed LLC to ''remain the same legal entity'' as the original corporation, the debt holders' legal rights before and after the conversion remained the same.[137] As a result, the IRS concluded that there was no constructive sale or exchange of the debt under section 1001.[138] In doing so, it was forced yet again to regard a disregarded entity due to the effect of state law on creditors' rights.

5. Giving effect to congressional intent. Both the S corporation and check-the-box regulations make allowances for disregarded entities that are banks or that are owned by banks. In both instances, the regulations provide that special rules applicable to banks will apply separately to the disregarded subsidiary and its owner.[139] That is because application of those rules to both the owner and the entity would not accurately reflect the underlying business arrangement and would produce results not intended by Congress. Nonetheless, items of income and deduction generated by the bank generally continue to pass through to its owner.[140]

The choice to regard disregarded bank entities raises an interesting parallel to section 108. Section 7507 provides that when a bank no longer does business with customers due to insolvency or bankruptcy, the bank will not be liable for federal tax to the extent that the tax would diminish bank assets available to repay depositors.[141] That includes instances when the depositors release the bank's obligation in return for a lien on its future profits.[142] Given that an insolvent bank may have no future profits, that provision is remarkably similar to the amnesty provided by section 108 when a creditor forgives the debt of an insolvent entity. As a result, it is unclear how that section applies to disregarded bank entities. If the owner of an insolvent bank is obligated to pay tax attributable to the bank's earnings, one would assume that payment of the tax would not result in

[120]*Id.*
[121]*Id.*
[122]*See supra* section II.C.2.
[123]*See* ILM 200338012, *supra* note 101.
[124]Preamble to Proposed Regulations, 69 *Fed. Reg.* 17117-17119 (2004).
[125]*See* Treas. reg. section 301.7701-2(c)(2)(iii)(B).
[126]Cummings, *supra* note 90.
[127]*See* LTR 200315001, *Doc 2003-9291*, *2003 TNT 71-17*.
[128]*See id.*
[129]*See id.*
[130]*See id.*
[131]*See id.*
[132]*See* Treas. reg. section 301.7701-3(b)(1)(ii).
[133]*See id. See also* Bennett, *supra* note 79 at 13.
[134]*See* Treas. reg. section 1.1001-3(c)(2), (e).
[135]*See* LTR 200315001, *supra* note 127.
[136]*Id.*
[137]*Id.*
[138]*See id.*
[139]*See* Treas. reg. section 1.1361-4(a)(3); Treas. reg. section 301.7701-2(c)(2)(ii).
[140]*See id.*
[141]Section 7507(a).
[142]*See* section 7507(b).

diminished assets available to depositors under section 7507 unless the owner or a relevant provision of the bank's governing documents causes a distribution of assets to the owner in the amount of the tax. Nonetheless, the regulations seem to call for the application of section 7507 as a special rule for banks, causing recognition of insolvent disregarded bank entities and possibly excluding portions of their income from the taxable income of their owners.

The IRS has also chosen to regard disregarded entities for purposes of congressionally prescribed audit provisions. In a 2002 chief counsel advisory, the IRS found that a disregarded entity, and not the owner of that entity, was the partner for purposes of applying the small partnership exception to the unified audit procedure.[143] Under the Tax Equity and Fiscal Responsibility Act of 1982, ''small partnerships'' are defined as those having ten or fewer partners, ''each of whom is an individual, a C corporation, or an estate of a deceased partner.''[144] The small partnership exception does not apply if one of the partners is a ''pass-thru'' partner such as ''a partnership, estate, trust, S corporation, nominee or other similar person. . . .''[145] The IRS noted that ordinarily a disregarded entity would not be regarded as a partner.[146] Nonetheless, the IRS found that disregarded entities must be regarded for purposes of the small partnership exception because statutory language indicated congressional intent to make the unified audit procedures ''apply whenever indirect partners exist whose identity will not be reflected on the face of the partnership return.''[147]

In both the banking and audit arenas, the IRS has evinced a willingness to regard a disregarded entity if doing so will give effect to congressional intent. That reason for regarding the entities seems, at first blush, to cut against doing so the context of section 108. Despite the fact that a disregarded entity may become insolvent or bankrupt independent from its owner, it is ultimately the owner who must shoulder the tax burden generated by the entity. Section 108 was no doubt enacted to provide tax relief to individuals and businesses who realize forgiveness of indebtedness income at a time when they have no assets available to pay the corresponding tax. Arguably, a solvent owner of an insolvent disregarded entity has no need for that relief and therefore should not have recourse to section 108 at the disregarded entity level.

Further consideration of section 108's effects belies that superficial reasoning. Section 108 works not only to provide relief to a cash-poor taxpayer, but it also requires the taxpayer to adjust its tax attributes.[148] The adjusted attributes, including net operating losses, tax credits, and asset basis, are affected by code provisions other than section 108 and reflect a significant economic occurrence in the life of a business. To divine a method that will fully carry out Congress's intent regarding those attributes, one must look beyond section 108 and understand that in most cases, the code is designed to tax underlying business realities. When a disregarded entity is a debtor, the underlying business reality is that the entity's owner will never be called on to pay the debt. As a result, section 108 should be applied at the entity level.

III. Problem and Proposal

A. Applying COD Rules to Disregarded Entities

A disregarded entity that is respected for state law purposes may become insolvent or may declare bankruptcy. If the entity's debt is forgiven at a time when its owner is not also insolvent or bankrupt, it is not clear whether or how section 108 should apply to forgiveness of the debt.

Section 108 does not contemplate disregarded entities. The statute provides that ''[g]ross income does not include any amount which (but for this subsection) would be includible in gross income by reason of the discharge (in whole or in part) of indebtedness of the *taxpayer*'' if the indebtedness is forgiven ''in a title 11 case'' or if ''the discharge occurs when the *taxpayer* is insolvent.''[149] When the debtor is a disregarded entity, the check-the-box regulations specify that the taxpayer is the entity's owner.[150] In other words, the debtor and the taxpayer may be different entities. Section 108 clearly does not anticipate this disunity.

An unintended consequence of the section's lack of foresight is that its plain language suggests different results for the bankruptcy of disregarded entities versus their insolvency. Section 108 works to exclude forgiveness of indebtedness from gross income when the forgiveness occurs in a title 11 case.[151] Paragraph (a) of the statute does not require the title 11 case to be the taxpayer's case; therefore, section 108 should apply to debt forgiveness arising from the title 11 case of a disregarded entity.[152] In contrast, the insolvency exception excludes forgiven indebtedness only if the taxpayer is insolvent.[153] Seemingly, the insolvency of the disregarded entity is irrelevant under the statute's current rendering.

It is difficult to suggest a policy distinction between bankruptcy and insolvency that would justify disparate

[143]*See* ILM 200250012, *Doc 2002-27222*, *2002 TNT 241-52*.
[144]*See id.*, citing section 6231(a)(1)(B)(i).
[145]Section 6231(g)(9).
[146]*See* ILM 200250012, *supra* note 143.
[147]*Id.*
[148]Section 108(b).

[149]Section 108(a)(1) (emphasis added).
[150]Treas. reg. section 301.7701-3(b).
[151]Section 108(a)(1)(A).
[152]Note that this conclusion is thrown somewhat into doubt by the statute's definition of ''title 11 case,'' which describes ''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 is granted by the court or is pursuant to a plan approved by the court.'' Section 108(d)(2). However, the statute later provides that ''for purposes of paragraphs (1) and (5) of subsection (b), the estate (and not the individual) shall be treated as the taxpayer.'' Section 108(d)(8). Taken together with paragraph (a), those provisions suggest that section 108 could apply to the bankruptcy estate of a disregarded entity.
[153]Section 108(a)(1)(B).

treatment of those conditions in disregarded entities. Perhaps one difference is brought to light by the Eighth Circuit's rationale in *In re Wagner*.[154] In that case, the court held that a debtor could not be denied discharge in bankruptcy even though the debtor failed to turn over proceeds of the sale of a lender's collateral.[155] The collateral had been held inside of an LLC owned jointly by the debtor and his wife.[156] The court found that the debtor had no more than a derivative interest in the property; therefore, the property was not part of the debtor's estate.[157] A similar rationale might be applied in reverse. If a single-member LLC were a chapter 11 debtor, the entity's creditors would not have recourse to its owner's assets. In other words, the bankruptcy query is state entity specific. In contrast, the question of insolvency is a question of federal tax law and, as such, merges entity and owner when disregarded entities are concerned.

Nonetheless, assuming that the primary purpose of section 108 is to provide relief to a taxpayer who recognizes income without a corresponding cash flow, the section should have equal force in cases of bankruptcy or insolvency. Either it should apply in both situations or it should apply in neither. Commentators agree that section 108 in its current form is difficult to understand, so the choice between the two is not obvious.[158]

In light of our assumed primary purpose, it could be argued that section 108 should not apply to either the bankruptcy or insolvency of a disregarded entity. That approach, however, results in the problem demonstrated at the end of section I. Recall the example of X, a single-member LLC owned by Y. X manufactured a special battery, which Y used in its hybrid automobile. X's business suffered, some of its debt was forgiven, and it was finally acquired by Z, an unrelated corporation. Failing to apply section 108 at X's level resulted in Y bearing a tax burden attributable to debt for which it was not the obligor. Also, that approach resulted in no reflection of the forgiven debt in the X business. Finally, if Y were an individual taxed at a rate lower than the corporate rate, it resulted in overall revenue loss to the government. Conversely, if section 108 were applied at X's level, tax on the COD income generated by X was deferred, and tax attributes attributable to X were adjusted to reflect the deferral. As a result, income generated by the debt followed the debtor's assets, creating a more accurate reflection of the state law business arrangement.

The example described above demonstrates why all state law entities possessing distinct property rights should be respected when assessing the federal income tax effects of forgiveness of indebtedness under section 108. Regarding disregarded entities in that context would not only alleviate taxpayer confusion, but would also result in a much clearer reflection of the businesses involved in the underlying transaction. That approach would also resolve section 108's internal inconsistency regarding bankruptcy and insolvency of disregarded entities.

As discussed in section II, precedent exists for recognizing disregarded entities in contexts in which state law rights or congressional intent require it. Most notably, the IRS has repeatedly acknowledged disregarded entities when debt is at issue. Under section 752, when a disregarded entity owns a partnership interest, the disregarded entity, and not its owner, is the partner for purposes of debt allocation.[159] Tax debt of the owner will not result in a levy against a disregarded entity's property.[160] Conversely, prior years' tax debt of an entity that has recently converted to disregarded status will not result in a levy against the owner's property.[161] Finally, conversion of a regarded entity into a disregarded one will not significantly modify outstanding debt of the entity if state law preserves the debt holders' rights.[162]

The IRS took each of the positions described above in response to its analysis of state law property rights in various debt scenarios. It should undertake a similar analysis regarding section 108. While a single-member LLC may be disregarded for federal purposes, for state purposes it is an independent juridical entity. It may own property and incur debt independent of its owner, and its owner may have no more than a derivative right to property of the entity. Applying section 108 at the owner level rather than the entity level disregards those state rights and consequently distorts the IRS's interaction with both the owner and the entity in future years.

B. Potential for Abuse

Some commentators might note that application of section 108 to disregarded entities would create an opportunity for abuse. A savvy owner might undercapitalize its disregarded entity or might cause the entity to distribute assets to the owner in anticipation of debt forgiveness. By doing so, the owner would increase the possible application of section 108(a) while decreasing assets available for basis adjustment under section 108(b). Both of those abuses may be avoided through regulatory planning.

The prevalence of the first possible abuse, undercapitalization, will depend on state law capitalization requirements as well as lenders' willingness to expose themselves to risk. One way to curb that abuse at the federal level might be to attribute a portion of an owner's assets to its undercapitalized disregarded entity when judging the entity's insolvency under section 108. That approach seems unduly complicated and therefore unfavorable. It would require the IRS to establish capitalization guidelines and to relate those guidelines to the size of the disregarded entity's debt. That would make adequate capitalization a moving target for owners. Also, that approach would, by definition, produce different

[154] *In re Wagner*, B.A.P. 8th Cir., No. 03-6083NE (Feb. 23, 2004).
[155] *See id.*
[156] *See id.*
[157] *See id.*
[158] *See* Jenks, *supra* note 65.

[159] *See* prop. Treas. reg. section 1.752-2(k)(1), 69 *Fed. Reg.* 49832-49836 (2004).
[160] *See* ILM 200338012, *supra* note 101.
[161] Preamble to Proposed Regulations, 69 *Fed. Reg.* 17117-17119 (2004).
[162] *See* LTR 200315001, *supra* note 127.

results in cases of bankruptcy and insolvency. Finally, it would break the system that it was designed to fix by further distorting the IRS's relationship with the owner, the disregarded entity, and the assets and attributes of each in future years. A better approach would be to allow the lenders' market to establish a minimum rate of capitalization in conjunction with state regulation.

The prevalence of the second possible abuse, anticipatory withdrawal of assets before debt forgiveness, will depend largely on the relationship between lenders and owners. Most states' fraudulent conveyance laws would prohibit such a transaction when the lender and owner were not acting in concert. If a lender's relationship were solely with a disregarded entity, it would not be in the financial best interest of the lender to consent to an owner's withdrawal. However, if the lender also had an established relationship with the owner, it might be in the financial best interest of both the lender and the owner to act in concert.[163] For instance, the lender might be willing to make unprofitable concessions to the failing disregarded entity to protect its profitable relationship with the successful owner. To avoid that situation, any modification to section 108 allowing its application to disregarded entities should provide that assets transferred from a disregarded entity to its owner during a three-year period preceding forgiveness of indebtedness will be treated as assets of the disregarded entity for purposes of section 108.

C. Attribute Reduction

Regarding a disregarded entity under section 108(a) raises the question of how one should apply section 108(b). Technically, a disregarded entity has no tax attributes because it is ''disregarded as an entity separate from its owner.''[164] Operations of the disregarded entity might be combined with operations of the owner's business or those of its other disregarded subsidiaries to produce losses, credits, and other tax attributes for the owner. Because loss and credit items are commingled, asset basis is the only tax attribute that clearly belongs to the disregarded entity. As a result, the ordering rule found in section 108(b)(2), which requires adjustment of certain losses and credits before adjustment of basis, is unworkable for disregarded entities.[165]

A different method of reduction must apply, and that method must focus on the disregarded entity's only clear-cut tax attribute: asset basis. The disregarded entity should be treated as though it has made an election under section 108(b)(5), which provides that ''[t]he taxpayer may elect to apply any portion of the reduction referred to in [section 108(b)(1)] to the reduction under section 1017 of the basis of the depreciable property of the taxpayer.''[166] Any remaining amount should then be used to reduce the basis of the disregarded entity's nondepreciable assets according to section 108(b)(2)(E). That approach will correct the basis distortion produced by applying section 108 at the level of the solvent owner rather than that of the insolvent entity. That approach will also respect the distinct state law property rights of the disregarded entity. Finally, it works to protect the government's interest in limiting depreciation deductions taken on a disregarded entity's property following transferred basis transactions.

If income from forgiveness of indebtedness exceeds the disregarded entity's basis in all of its property, the excess amount can be dealt with in one of three ways. First, the amount could simply vanish, as happens generally under section 108 when a taxpayer's excluded income exceeds its tax attributes. Second, the excess amount could work to reduce the owner's tax attributes under section 108(b). Finally, it could be included in the gross income of the disregarded entity's owner. Because allowing the amount to disappear might encourage owners and lenders to abuse the system, either the second or third option should apply.

IV. Conclusion

Section 108, as it is currently drafted, does not contemplate disregarded entities; however, those entities are becoming an increasingly important part of our business landscape.[167] They are ''now routinely used in various forms of taxable and tax-free corporate transactions,'' and ''when used in acquisitive and other corporate transactions, can achieve structural flexibility and versatility that might not be achievable in the traditional formats using exclusively corporate entities.''[168] As a consequence of the increasing popularity of disregarded entities, there has been increasing confusion over how to apply section 108 and other code provisions whose operation depends on state property rights.

Failing to apply section 108 to disregarded entities at the entity level results in federal tax distortion of the state law business arrangement as well as a potential reduction in government revenue. These are problems the code should avoid in the interests of federalism, equity, and taxpayer ease of use. Failing to regard a disregarded entity in debt situations fails to respect the state law rights of the entity and is an approach that should be rejected.

[163]For instance, consider Enron and its many special purpose entities. Several well-known and otherwise well-regarded banking institutions engaged in questionable transactions with Enron subsidiaries based on the financial strength of their relationship with the parent company. Enron paid approximately $88 million in fees to its advisers and promoters. *See Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues and Policy Recommendations* (JCX-3-03), v.1, p. 8 at http://www.access.gpo.gov/congress/joint/hjoint01cp108.html.

[164]Treas. reg. section 301-7701-3(a).

[165]The ordering rule requires attributes to be reduced ''in the following order'': NOLs, general business credit, minimum tax credit, capital loss carryovers, basis reduction, passive activity loss and carryovers, and foreign tax credit carryovers. Section 108(b)(2).

[166]Section 108(b)(5)(1).

[167]*See* Edwin G. Schuck Jr., ''Treatment Under Section 368(a)(1)(A) of a Merger or Conversion of the Target Corporation Into a Disregarded Entity Following a Reverse Triangular Corporate Merger,'' *Doc 2004-10099*, *2004 TNT 97-40* (May 14, 2004).

[168]*Id*.

Section 108 should instead be applied to disregarded entities without regard to the bankruptcy or insolvency of their owners. Any amount consequently excluded from the owner's gross income should be used to reduce the basis of the disregarded entity's assets. The remainder of the excluded income may then either reduce the owner's tax attributes or be included in the owner's gross income. Under that approach, reduced asset basis causes COD income generated by a disregarded entity to follow its assets to the fullest extent possible. That produces a more accurate reflection of the underlying rights and obligations of the disregarded entity and its owner. Finally, and perhaps most importantly, regarding disregarded entities under section 108 would provide taxpayers with certainty when engaging in debt transactions involving those entities, to the collective relief of advisers and owners alike.