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Building Litigation Prevention Into Your Transaction <i>By Andrew Schriever, Esq.</i>	10
The Do's and Don'ts of Adminstering a Special Needs Trust <i>By Anthony J. Enea, Esq.</i>	15
New York State Tax Certiorari, Eminent Domain And Real Property Tax Exemptions Law 2007-2008 <i>By Hon. Thomas A. Dickerson</i>	18
Advice to Law Clerks: How to Draft Your First Judicial Opinion <i>By Hon. Gerald Lebovits and Lucero Ramirez Hidalgo, Esq.</i>	29
Building the Pyramid: The Use of Cumulative Penalties in Municipal Code Prosecutions <i>By Desmond C.B. Lyons, Esq.</i>	38
Estate Litigation Tidbits <i>By Gary E. Bashian, Esq. and Michael Candela, Esq.</i>	41
Taxation of Real Estate Workouts <i>By Steven A. Ruskin, Esq.</i>	49
The Effect Of Tax Apportionment Clauses On Nontestamentary Assets <i>By Patricia M. Sheridan, Esq.</i>	58
Appellate Motion Practice: A Tactical Approach <i>By William B. Stock, Esq.</i>	64

Taxation of Real Estate Workouts



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Taxes are a critical element in any workout involving economically distressed real estate. There may be significant opportunities to reduce taxes, and on the flip side, there may be traps for the unwary. Some of these traps can be quite a surprise – and some can be very expensive.

A real estate workout may involve numerous different scenarios, including cancellation of debt, modification of the terms of a debt instrument, contribution of fresh cash to the venture, or satisfaction of some or all of the debt in exchange for an equity interest in the debtor. Of course, if a workout cannot be achieved, the specter of foreclosure or bankruptcy arises. Each of these alternatives is likely to have significant tax consequences. This article will describe some of those tax consequences, and it will point out important tax opportunities and tax pitfalls which may be relevant to owners of financially distressed real estate.

I. CANCELLATION OF DEBT

Cancellation of debt affects solvent and insolvent debtors differently. This section will begin with the basic tax rules affecting solvent debtors and then describe five important opportunities and exceptions. It will then describe various statutory and common-law tax benefits which are available to insolvent taxpayers.

SOLVENT DEBTORS

If a debt is settled for less than the amount owed, a solvent debtor will have ordinary income equal to the amount of the loan forgiveness.¹ The underlying principle is that an increase in the net worth of a taxpayer should result in income. Since there is no sale or exchange of property, as in a foreclosure, cancellation of indebtedness (“COD”) income is taxed as ordinary income rather than capital gain. It does not matter whether the debt is recourse or nonrecourse. Moreover, the debtor will have COD income even if it would have a loss if the property were sold for its fair market

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value.²

COD income can occur unexpectedly. The general rule is clear enough: COD income arises when it becomes clear that some portion, or all, of a debt will never have to be paid. In determining the timing of COD income, any identifiable event indicating that the debt will not be paid may be taken into consideration.³ For example, an entry on the lender's books writing down the debt normally is not an identifiable event.⁴ However, an agreement settling the debt clearly is an identifiable event, as is a judicial settlement.⁵ In the case of a judicial settlement, COD income arises at the time of the settlement, even if an appeal is pending.⁶ Similarly, if there is an unconditional agreement to cancel debt in the future, income arises at the time of the agreement, not when the debt is actually cancelled.⁷

Real estate is often held by a partnership or a limited liability company taxed as a partnership (a "LLC"). It is not surprising, therefore, that the intricacies of partnership taxation, especially the allocation of income and debt among partners, are at the heart of many real estate workouts. In light of the importance of partnership taxation, a brief overview of two basic partnership tax rules may help put some of the discussion which follows in context.

First, income cannot be allocated arbitrarily among the partners in a partnership. The Treasury Regulations (the "Treasury Regulations") promulgated under the Internal Revenue Code of 1986, as amended (the "Code"), contain specific rules which determine how income must be allocated in order to be given effect for tax purposes.⁸

Second, a partner's tax basis in the partnership is affected by that partner's share of the partnership's income and liabilities. To the extent that COD income is allocated to a partner, that partner's tax basis in the partnership is increased.⁹ Each partner's tax basis in the partnership is then decreased by that partner's share of the debt reduction, as if there were a cash distribution to the partners in an aggregate amount equal to the cancelled debt.¹⁰ Normally, this basis decrease will reverse the basis increase from the allocation of COD income. In some circumstances, however, particularly if the cancelled debt is recourse to one or more partners, there may not be a precise match for a partner between basis increase and basis decrease. If a mismatch occurs, debt cancellation can result in both COD income and a deemed taxable distribution without cash to the partner.¹¹

The recently enacted American Recovery and Reinvestment Act of 2009 (the "2009 Act") provides an extremely important opportunity for businesses to elect to defer taxation of COD income. The election can be made with respect to COD income arising from the "reacquisition" (as defined below) of certain debt instruments in 2009 or 2010.¹² Subject to various acceleration events, the income can be deferred until 2014 and then recognized ratably over 5 years.¹³ Obviously, this extended tax deferral will be a significant consideration affecting many real estate workouts in 2009 and 2010.

A reacquisition for purposes of the 2009 Act includes an acquisition by the debtor, or a party related to the debtor, of the debt instrument for cash or in exchange

for corporate stock or a partnership interest.¹⁴ The term also includes the contribution of the debt instrument to the capital of the debtor and the exchange of debt instruments (including an exchange resulting from a modification of the terms of the instrument).¹⁵

Acceleration of the deferred income will occur in the year the taxpayer dies, liquidates or sells substantially all of its assets, ceases to do business or is in similar circumstances.¹⁶ In the case of a pass-through entity, *i.e.*, a partnership, S corporation or other entity which passes income through to its owners, acceleration also occurs on a sale, exchange or redemption of an interest in the entity.¹⁷

An election under the 2009 Act is made on an instrument by instrument basis, and once made, it is irrevocable.¹⁸ If the debt was issued by a pass-through entity, the election must be made by the entity.¹⁹ This is significant, since the entity's decision will impact each of its owners whatever the owner's personal circumstances may be.

If a partnership elects to defer taxation of COD income under the 2009 Act, a decrease in a partner's share of liabilities will not be treated as a deemed distribution at the time of the discharge to the extent that the distribution would cause that partner to recognize income.²⁰ Instead, the deemed distribution will be deferred and taken into account when, and to the same extent, that COD income deferred under the 2009 Act is recognized by that partner.²¹

If an election is made, certain other exceptions from COD income are inapplicable, including the insolvency exception and the exception for income resulting from a discharge of certain real property business indebtedness, both of which are discussed below.²² Whereas under the 2009 Act COD income is deferred, in each of the other instances income is permanently avoided. The *quid pro quo*, however, is that the tax basis of the taxpayer's assets, or in some cases the taxpayer's tax attributes such as its net operating losses, must be reduced to reflect the amount of the excluded COD income.

A second major opportunity to exclude COD income applies to solvent individuals that own business real estate. If such an individual owes "qualified real property business indebtedness" ("QRPBI")²³ which is discharged, that individual can elect to exclude the resulting COD income and instead reduce the tax basis in certain of his or her depreciable property by the amount of the excluded income.²⁴ This tax break is subject to various limitations,²⁵ and it is not available to insolvent individuals, C corporations or, as previously mentioned, individuals that make an election under the 2009 Act.²⁶

If a QRPBI election is made, the required reduction in the tax basis of the taxpayer's depreciable property generally is made as of the first day of the taxable year following the discharge.²⁷ The basis of the depreciable real property that secured the discharged debt must be reduced first.²⁸ The amount of the reduction is treated as excess depreciation, which normally will result in ordinary income when the property is sold.²⁹ In order to maximize the benefit of a QRPBI election, it usually is wise to make the election if it is anticipated that the distressed real estate, and any other

depreciable property which may be affected, will be owned for an extended period of time. In 2009 and 2010, for those individuals that have a choice, the decision between a QRPBI election and an election under the 2009 Act probably will depend on how long the depreciable property is likely to be held. If the property is likely to be held indefinitely, it may be preferable to make a QRPBI election, and, if not, it may be preferable to make an election under the 2009 Act.

If QRPBI is owed by a partnership, each partner can make a separate election.³⁰ This provides much greater flexibility than permitted under the 2009 Act. For purposes of the required reduction in the tax basis of depreciable property, a partner can treat his or her partnership interest in the partnership that owed the QRPBI as depreciable real property to the extent of the partner's proportionate share of that partnership's depreciable property.³¹ It is not entirely clear, but a partner may be able to reduce his or her tax basis in other partnerships which own depreciable property.³² Whether or not a QRPBI election is made, each partner must reduce his or her tax basis in the partnership by the deemed distribution to that partner resulting from the debt cancellation.³³

A third important opportunity is that the original seller of property can agree with the original buyer of that property to reduce the amount of a purchase money note without causing the buyer to have COD income. Instead, the buyer's tax basis in the property is reduced.³⁴ Once again, the exception applies only to solvent taxpayers, but in this case it includes C corporations.

An exception of some importance is that COD income does not arise if payment of the cancelled debt would have resulted in a tax deduction.³⁵ For example, cancellation of a cash basis taxpayer's obligation to pay accrued interest or accrued operating expenses does not generate COD income.

Finally, the Mortgage Forgiveness Debt Relief Act of 2007, as amended by the Emergency Economic Stabilization Act of 2008, permits a solvent individual to avoid COD income on up to \$2 million of discharged "qualified principal residence indebtedness," but only if the discharge occurs after 2006 and before 2013.³⁶

INSOLVENT DEBTORS

Since the tax principle underlying taxation of COD income is that a debt discharge increases the taxpayer's net worth, normally an insolvent debtor will not have COD income except to the extent that the discharge makes the debtor solvent.³⁷

The insolvency exception is not a "Get Out of Jail Free" card, since the taxpayer must reduce its net operating losses, and possibly other of its tax attributes, by the amount excluded from income.³⁸ Alternatively, the taxpayer may elect to reduce its tax basis in its depreciable assets by all or part of the COD income.³⁹ A taxpayer presumably would make this election if it could use its net operating losses or tax credits relatively quickly.

If the discharged debt is owed by an entity, a preliminary question is whether insolvency is tested at the entity level or at the owner level. The answer may not be

intuitively obvious. In the case of a partnership, insolvency is determined partner by partner.⁴⁰ Accordingly, the exemption is inapplicable to solvent partners even if the partnership is insolvent. If the debtor is an S corporation, insolvency is tested at the S corporation level.⁴¹ An LLC, however, has attributes of both a partnership and an S corporation in that it is taxed like a partnership, yet it provides liability protection for all of its members like an S corporation. For this purpose, an LLC is treated as a partnership, and insolvency is tested member by member.⁴²

There may be planning opportunities to take advantage of the fact that insolvency is tested at the S corporation level. For example, can a partnership convert into an S corporation in anticipation of having COD income and thereby protect its partners from COD income? Similarly, can individuals contribute financially distressed real property to an S corporation and avoid COD income? In either case, depending on the specific facts, various tax principles could apply to treat the COD income as if it had occurred before the transaction.⁴³ Also, a transfer of real property subject to nonrecourse debt, including a deemed transfer incident to a conversion of a partnership, may result in taxable gain to the transferor equal to the excess of the principal amount of the debt over the transferor's adjusted tax basis in the property.⁴⁴

A partnership may be tempted to amend its partnership agreement in order to allocate its COD income mainly to its insolvent partners in an effort to protect its solvent partners from taxation. Unless the special allocation has "substantial economic effect," as determined under the applicable Treasury Regulations, it will be disregarded.⁴⁵

A major planning opportunity arises from the fact that the reduction in tax attributes, or the downward adjustment in the tax basis of depreciable assets, is made as of the beginning of the year following the year in which the debt is cancelled.⁴⁶ As a result, the taxpayer's net operating losses and its adjusted tax basis in its assets can be used to reduce its taxable income in the year of the debt cancellation. For example, a taxpayer can sell assets and apply its net operating losses – which otherwise might be reduced to zero the following year – against the gain. If the taxpayer is liquidated or has mainly cash at the beginning of the following year, there will be nothing against which to reduce basis. This can be called the Cheshire Cat strategy – income tax is avoided and all that is left is a smile.⁴⁷

II. MODIFICATION OF THE TERMS OF A DEBT INSTRUMENT

In many real estate workouts, the terms of a debt instrument are modified to make it more affordable for the debtor. If the modifications are "significant," the modified instrument will be treated for tax purposes as having been exchanged for the old debt instrument.⁴⁸ Significant modifications are those that, considered collectively, alter legal rights or obligations in an "economically significant" manner.⁴⁹ The Treasury Regulations provide a number of examples of economically significant modifications, including a more than a *de minimis* change in the debt instrument's yield, an alteration in the timing of payments, and, in the case of a recourse obligation, a change in the obligor.⁵⁰

In general, an exchange of debt instruments will be a taxable event.⁵¹ The debtor will have COD income if the “issue price” of the new instrument is less than the “adjusted issue price” of the old instrument.⁵² Determining the issue price and the adjusted issue price depends on a number of factors. In the case of a nonpublicly traded debt instrument with adequate stated interest, as defined in the Treasury Regulations, the issue price of the new instrument normally is its stated principal amount.⁵³ If the debtor is a partnership, the partnership tax rules previously described will apply.⁵⁴

A major pitfall to avoid is that modification of a partnership’s debt instrument may so weaken the debt characteristics of the instrument that the modified instrument will be treated as equity for tax purposes.⁵⁵ In planning a restructuring of partnership debt, it is especially important to be careful about a substitution of equity for debt, since in that event there will be a deemed cash distribution to the partners equal to the entire principal amount of the debt.

Similarly, extreme care must be taken in modifying the terms of a debt instrument of an S corporation. If the modifications cause the instrument to be treated as a second class of stock, the corporation will lose its qualification as an S corporation.⁵⁶

There are a whole range of modifications which will ease the burden on a debtor without amounting to a significant modification, much less causing a conversion of debt into equity. For example, a modification does not necessarily arise because of a “temporary” forbearance,⁵⁷ a substitution of a new obligor on a nonrecourse obligation⁵⁸ or a modification that adds, deletes or alters customary accounting or financial covenants.⁵⁹ Clearly, any modification must be carefully tailored to the particular circumstances with tax considerations in mind.

III. NEW MONEY

If a partnership raises fresh money from investors to pay off its debt, there will be some shift of the partnership’s nonrecourse liabilities to the contributing partners.⁶⁰ This will cause a deemed cash distribution to the other partners.⁶¹ Similarly, if there is a new guarantee by a partner, there is likely to be a reallocation of the partnership’s liabilities to the guarantor which will result in a deemed cash distribution to all partners other than the guarantor.⁶²

IV. SATISFACTION OF DEBT FOR EQUITY IN THE DEBTOR

If a corporation issues stock, or if a partnership issues a partnership interest, in whole or partial satisfaction of its debt, the corporation or partnership will have COD income in an amount equal to the excess of the adjusted issue price (generally, the principal amount) of the debt instrument over the fair market value of the stock or partnership interest.⁶³

When restructuring partnership debt, it is important to be especially careful of a major pitfall which is not at all obvious. If a lender takes more than a 10% interest in the partnership, and the economic risk of loss on the debt owed to the lender is not borne by another partner, the entire principal amount of the debt will be allocated to the lender.⁶⁴ This will cause a deemed cash distribution to the other partners equal

to the full amount of the debt.⁶⁵ To make matters even worse, future deductions attributable to the debt will be specially allocated to the lender.⁶⁶

V. FORECLOSURE

The tax consequences of a foreclosure differ materially depending on whether the underlying debt is recourse or nonrecourse to the debtor. In the case of recourse debt, the property securing the debt is treated as if it were sold for its fair value and the proceeds were used to pay down the debt. The debtor will have COD income when, and to the extent, the remaining balance of the debt is cancelled.

In contrast, in a foreclosure in which the debt is nonrecourse, the real property is treated as if it were sold for the face amount of the outstanding debt, whatever the property's fair value may be.⁶⁷ The tax result is that the debtor may have mainly capital gain on the deemed sale as opposed to ordinary income from cancellation of the excess of the face amount of the debt over the property's fair value. This presents planning opportunities, as a debtor that can benefit from capital gains, *e.g.*, an individual, may prefer a foreclosure to an outright cancellation of debt. On the other hand, if an exception to COD income applies, *e.g.* the insolvency exception, a debtor may prefer an outright cancellation of the debt.

VI. BANKRUPTCY

If debt is discharged in a title 11 bankruptcy proceeding, the debtor will not have COD income even if it is solvent after the discharge.⁶⁸ The debtor, however, must reduce its tax attributes or the basis in its assets by the amount of the discharged debt.⁶⁹

In addition, a corporate debtor may also be subject to limitations on the use of its remaining tax attributes. In general, if there is an "ownership change," future use of the corporation's net operating losses will be limited to an annual amount based on a percentage of the fair market value of the corporation.⁷⁰ The definition of an ownership change is highly technical. It includes an increase of more than 50 percentage points in the ownership of a corporation's stock within a specified 36 month period by one or more 5% shareholders.⁷¹ With careful tax planning, it may be possible to avoid an ownership change, for example, by purchasing the corporation's stock over a period of years.

Two provisions of the Code may assist a bankrupt corporation in retaining its tax attributes. First, if lenders to the corporation are "historic" lenders, equity received by those lenders in exchange for debt will not count in the calculation of an ownership change.⁷² Second, in limited cases, the corporation may increase the cap on the future use of its tax attributes by reflecting the increase in value of the corporation from a surrender or cancellation of creditors' claims.⁷³

There are many other alternatives to consider, but the scenarios mentioned above should be sufficient to demonstrate the importance of tax planning in any real estate workout. Each situation is unique, and, therefore, it can be extremely helpful to involve a tax professional in the early stages of any workout.

Endnotes

¹ Section 61(a)(12). Unless otherwise indicated, section references are to the Internal Revenue Code of 1986, as amended (the “Code”), or to the Treasury Regulations promulgated under the Code.

² *Comr. v. Tufts*, 461 U.S. 300 (1983); *Vukasovich v. Comr.*, 790 F.2d 1409 (9th Cir. 1986).

³ *Cozzi v. Comr.*, 88 TC 435 (1987); see Reg. § 1.6050P-1(b)(1).

⁴ *K&S Electric Co.*, 28 TCM. 1499 (1974).

⁵ See Reg. § 1.6050P-1(b)(2)(i)(F); *Capital Coal Corp. v. Comr.*, 250 F.2d 361 (2d Cir. 1957), cert. denied, 356 U.S. 936 (1958).

⁶ *Exchange Security Bank v. U.S.*, 492 F.2d 1096 (5th Cir. 1974).

⁷ Reg. § 1.1001-3(c)(6)(i).

⁸ Reg. § 1.704-1(b)(1)(i); see Rev. Rul. 92-97, 1992-2 CB 124, Rev. Rul. 99-43, 1999-2 CB 506.

⁹ Section 705(a)(1)(A).

¹⁰ Sections 705(a)(2), 731(a)(1), 733(1), 752(b); Reg. § 1.752-1(c).

¹¹ Section 731(a).

¹² P. L. 111-5; Section 108(i)(1).

¹³ *Id.*

¹⁴ Section 108(i)(4).

¹⁵ *Id.*

¹⁶ Section 108(i)(5)(D)(i).

¹⁷ Section 108(i)(5)(D)(ii).

¹⁸ Section 108(i)(5)(B)(ii).

¹⁹ Section 108(i)(5)(B)(iii).

²⁰ Section 108(i)(6).

²¹ *Id.*

²² Section 108(i)(5)(C).

²³ In general, QRPBI is indebtedness which was incurred or assumed by the taxpayer in connection with real property used in a trade or business and is secured by such real property. In addition, QRPBI must have been incurred or assumed before January 1, 1993, or it must be “qualified acquisition indebtedness.” Section 108(c)(3). “Qualified acquisition indebtedness” is “indebtedness incurred or assumed to acquire, construct, reconstruct, or substantially improve such real property.” Section 108(c)(4).

²⁴ Sections 108(b)(1), 1017(a). For this purpose, the basis of real property held as inventory may not be reduced. Section 1017(b)(3)(F)(ii).

²⁵ Limitations apply on the amount of excludable QRPBI, including a limitation based on the excess, if any, of the outstanding principal amount of the discharged QRPBI immediately before the discharge over the net fair market value of the real property after the discharge and a limitation based on the aggregate adjusted tax bases of all depreciable real property owned by the taxpayer immediately before the discharge (other than depreciable real property acquired in contemplation of the discharge). Section 108(c)(2); Reg. § 1.108-6(a), (b).

²⁶ Section 108(a)(1)(D), (a)(2)(B).

²⁷ Sections 108(c)(1)(A), 1017(a). If an election applies to depreciable property disposed of in the year the debt is discharged, the basis reduction is made immediately before the disposition. Section 1017(b)(3)(F)(iii).

²⁸ Reg. § 1.1017-1(c)(1).

²⁹ Section 1017(d).

³⁰ Section 108(d)(6).

³¹ Section 1017(b)(3)(C), which is applicable only if the partnership makes a corresponding reduction in its basis in depreciable property with respect to that partner. Reg. § 1.1017-1(g)(2)(i).

³² *Id.*

³³ H.R. Rep., P.L. 103-66 (Omnibus Budget Reconciliation Act of 1993); see *supra* note 10.

³⁴ Section 108(e)(5), which is inapplicable if the reduction occurs in a title 11 case or when

the purchaser is insolvent. See Rev. Rul. 92-99, 1992-2 C.B. 35. A similar, but more limited, common law exception may be available to insolvent taxpayers. See *Hirsch v. Comr.*, 115 F.2d 656 (7th Cir. 1940); *Suthphin v. U.S.* 88 - 1 USTC ¶ 9269 (Cl. Ct. 1988) (dicta).

³⁵ Section 108(e)(2).

³⁶ P.L. 110-142; P.L. 110-343; Sections 108(a)(1)(E), (h).

³⁷ Section 108(a)(1)(B), (a)(3); see *supra* note 22.

³⁸ Section 108(b)(1), (b)(2).

³⁹ Section 108(b)(5).

⁴⁰ Section 108(d)(6).

⁴¹ Section 108(d)(7)(A).

⁴² See *supra* note 41.

⁴³ *Comr. v. Court Holding Co.*, 324 US 331 (1945).

⁴⁴ Section 357(c)(1); see also Section 357(b), which treats all liabilities as boot if the principal purpose of the transfer is to avoid federal income tax on the exchange or is not for a bona fide business purpose.

⁴⁵ Section 704(b); Reg. § 1.704-1(b)(2); see Rev. Rul. 92-97; Rev. Rul. 99-43; see also *Gershkowitz v. Comr.*, 88 TC 984, 1017 (1987).

⁴⁶ Sections 108(b)(4)(A), 108(b)(5), 1017(a).

⁴⁷ See Lewis Carroll, *Alice's Adventures in Wonderland*, Macmillan and Co. (1865).

⁴⁸ Reg. § 1.1001-3(b).

⁴⁹ Reg. § 1.1001-3(e)(1).

⁵⁰ Reg. § 1.1001-3(e)(2)-(6).

⁵¹ Reg. § 1.1001-1(a). If the debtor is a corporation and the debt instruments are "securities," the exchange may be a tax-free recapitalization. Section 368(a)(1)(E).

⁵² Section 108(e)(10); Reg. § 1.61-12(c)(2)(ii).

⁵³ Sections 1273(b)(4), 1274(a); Regs. §§ 1.1273-2, 1.1274-2.

⁵⁴ See *supra* note 10.

⁵⁵ See Reg. § 1.1001-3(c)(2)(ii), (e)(5)(i).

⁵⁶ Section 1361(b)(1)(D); see also Section 1365(c)(5), which provides that "straight debt" is not a second class of stock.

⁵⁷ Reg. § 1.1001-3(c)(4)(ii).

⁵⁸ Compare Reg. § 1.1001-3(e)(4)(i)(A), which provides that substitution of a new obligor on a recourse debt instrument is a significant modification.

⁵⁹ Reg. § 1.1001-3(e)(6).

⁶⁰ Section 752(b).

⁶¹ See *supra* note 10.

⁶² *Id.* Reg. §§ 1.752-2(b)(1), (d)(2), (e).

⁶³ Section 108(e)(8); Proposed Reg. § 1.108-8; see *supra* notes 10, 22.

⁶⁴ Reg. §§ 1.752-2(c)(1), (d)(1).

⁶⁵ See *supra* note 10.

⁶⁶ Reg. § 1.704-2(i).

⁶⁷ Section 7701(g); see also Reg. § 1.1001-2(a)(1).

⁶⁸ Section 108(a)(2)(A).

⁶⁹ See *supra* notes 38, 39.

⁷⁰ Section 382(b)(1); see Section 383.

⁷¹ Section 382(g); Reg. § 1.382-2T(a) - (m).

⁷² Sections 382(l)(5)(A), (E).

⁷³ Section 382(l)(6).