Office of Chief Counsel
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Memorandum

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subject: Interest Accrual on Debt when Debtor in Bankruptcy

This Chief Counsel Advice responds to your request for assistance dated June 22, 2007. This advice may not be used or cited as precedent.

LEGEND

Taxpayer	=
Subsidiary	=
Bankruptcy Court	=
Bank 1	=
Bank 2	=
Date 1	=
Date 2	=
Date 3	=
Date 4	=
Date 5	=
Date 6	=

Date 7	=	
Date 8	=	
Amount A	=	
Amount B	=	

ISSUE

May Taxpayer (through its consolidated return with Subsidiary) properly treat a liability for interest expense on Subsidiary's contractual borrowings as incurred and deductible during the pendency of Subsidiary's bankruptcy proceeding?

CONCLUSION

Taxpayer (through Subsidiary) may treat a liability for interest expense on Subsidiary's contractual borrowings as incurred and deductible until the resolution of the bankruptcy proceeding, in this case, through confirmation of the plan of reorganization. To the extent that interest expense deducted in an earlier taxable year (taxable year ending Date 2) is determined not to be owed and payable in a later taxable year (the situation here, by Date 4), the tax benefit rule requires that the taxpayer include an amount in income in the taxable year of the determination (taxable year ending Date 5).

FACTS

For the taxable years ended Date 2 and Date 5, Subsidiary was included in the consolidated tax return of Taxpayer.

On Date 1, Subsidiary filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code in Bankruptcy Court. As of the date of the filing of the petition, Subsidiary owed third party debt (sometimes referred to below as "contractual borrowings"). The debt consisted of senior unsecured notes ("notes") held by Bank 1 and two credit facilities from Bank 2.

Under the plan of reorganization, these debts were classified as part of the Class Three group of general unsecured claims ("Class Three Claims"). The Modified Third Amended Plan of Reorganization for Subsidiary was confirmed on Date 4. The confirming order states that Class Three voted to accept the plan.[1]

All of Class Three claims were impaired. Based upon the Disclosure Statement filed by Subsidiary on Date 7, it was estimated that the projected recovery by the Class Three creditors would be in the range of 51-62%. As of Date 6, the estimated recovery percentage was 44%. No interest was provided in the confirmation order and in the plan of reorganization.

[1] Order Confirming the Modified Third Amended Plan of Reorganization for Subsidiary (Date 4).

Subsidiary did not accrue interest for the contractual borrowings on its financial books post bankruptcy petition. Subsidiary also did not report a deduction for postpetition accrued interest on the consolidated tax returns for taxable years ending Date 2 and Date 5.

Subsequent to filing the returns for taxable years ending Date 2 and Date 5, Taxpayer submitted an informal claim on Date 8 for these taxable years based upon its belief that interest should have accrued for tax purposes and should have been allowed as a deduction on the consolidated tax returns. For the period Date 1 through Date 2, the Taxpayer is claiming an interest deduction of Amount A (the amount of interest owed on the contractual borrowings for the period Date 1 through Date 2). For the taxable year ending Date 5, the Taxpayer is claiming an interest deduction of Amount B (the amount of interest owed on the contractual borrowings of Subsidiary for that year).

LAW AND ANALYSIS

Section 163 of the Internal Revenue Code provides that there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness. Section 461 provides the general rules for determining the taxable year in which a deduction may be taken. Section 1.461-1(a)(2)(i) of the Income Tax Regulations provides that a liability is incurred, and is generally taken into account for federal income tax purposes, in the taxable year in which: (1) all the events have occurred that establish the fact of the liability, (2) the amount of the liability can be determined with reasonable accuracy, and (3) economic performance has occurred with respect to the liability. *See also* § 1.446-1(c)(1)(ii)(A).

A liability for interest expense is fixed for purposes of deductibility under § 163 when the debtor has a legal obligation to pay it and the obligation is not contingent on the occurrence of some future event. *Central Cuba Sugar Co. v. Commissioner*, 198 F.2d 214, 216-7 (2d Cir. 1952), *cert. denied*, 344 U.S. 874 (1952) ("Accrued interest can be deducted only when and to the extent that there exists a legally binding obligation to pay it, fixed in all its terms within the taxable year" (citations omitted)). Generally, the amount of interest to be deducted is based on the loan agreements or similar lender/borrower contracts that both fix the obligation and determine the amount of interest to be paid on the borrowing. Economic performance for an interest expense liability is satisfied with the passage of time (as the interest cost economically accrues). Section 1.461-4(e).

Section 502(b)(2) of the Bankruptcy Code (11 U.S.C. § 502(b)(2)) provides that a claim for "unmatured interest" will not be "allowed" in bankruptcy for unsecured creditors. Claims for interest accruing on or after the bankruptcy petition filing are disallowed. *See United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs., Ltd.*, 484 U.S. 365, 379 (1981) ("… denial of postpetition interest to undersecured creditors merely codified pre-Code bankruptcy law, in which that denial was part of the conscious allocation of reorganization benefits and losses between undersecured and unsecured creditors").

Despite the seemingly conclusive language of 11 U.S.C. § 502(b)(2), the effect of that provision's disallowance of postpetition interest in a Chapter 11 case depends on the outcome of the case. Typically, postpetition interest will not be paid on prepetition claims under a Chapter 11 plan; the oft-termed "cram-down provisions" of Chapter 11 allow a plan to be confirmed over the dissenting vote of an impaired class of claims if the plan provides for payment of the "allowed" amount of the claims in the class, that is, the claim absent postpetition interest. However, if the case is dismissed before confirmation, 11 U.S.C. § 502(b)(2) has no effect, and the debtor will owe interest on its prepetition claims as if no bankruptcy had been filed. While less common, a plan could be confirmed that does not alter the contractual rights of its creditors and pays postpetition interest at the prepetition contract rate. *See* 11 U.S.C. §§ 1123(b)(1) (a plan "may" impair classes of claims); 1124(1) (a class of claims is impaired if its legal, equitable, or contractual rights are altered). In Chapter 11 cases of individuals, certain debts may be excepted from discharge, in which case the debtor will remain liable for postpetition interest even if the interest is not provided for under the Chapter 11 plan. *See* 11 U.S.C. § 1141(d)(5). Finally, a Chapter 11 plan must provide for the payment of interest to the extent interest would be paid if the case were converted to Chapter 7 and liquidated. 11 U.S.C. § 1129(a)(7). In Chapter 7 cases, 11 U.S.C. § 726(a)(5) directs the payment of postpetition interest at the "legal rate" on allowed claims if there are sufficient funds in the bankruptcy estate to do so after the payment of allowed claims.[2] Thus, 11 U.S.C. § 502(b)(2) diminishes, but does not foreclose, the possibility that a debtor will be required to pay postpetition interest.

The issue here is whether the filing of the bankruptcy petition by Subsidiary affected its liability for the interest expense, in particular in light of the language of 11 U.S.C. § 502(b)(2). Since the amount of Subsidiary's interest expense can be determined with reasonable accuracy (based on the terms of the lender/borrower contracts) and economic performance is satisfied with the economic accrual of interest, the question is whether the filing of a bankruptcy petition changes the fixed nature of the liability for the interest expense.

If an obligation to pay is established, but the ability to pay is uncertain, or even very remote, generally an accrual-basis taxpayer nonetheless may deduct interest as incurred. Rev. Rul. 70-367, 1970-2 C.B. 37. Rev. Rul. 70-367 concludes that interest on outstanding obligations (bonds) of a railroad corporation involved in reorganization proceedings under the Bankruptcy Act (the predecessor to the current Bankruptcy Code) was properly deductible in a year in which the plan had not yet been accepted by the creditors, even though it was unlikely that the full amount would be paid. Until the year the plan was consummated, the obligations of the taxpayer continued to bear interest at the rate determined under its initial terms. The ruling holds that the doubt as

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[2] Courts disagree on the legal rate. A leading bankruptcy treatise opines that the reference in the statute to the "legal rate" suggests that Congress envisioned a single rate, probably the federal statutory rate for interest on judgments set by 28 U.S.C. § 1961. 6 Collier on Bankruptcy-15th Edition Rev. § 726.02. *See also In re Cardelucci*, 285 F.3d 1231 (9th Cir. 2002).

to the payment of the interest is not a contingency of a kind that postpones the accrual of the liability until the contingency is resolved.

Revenue Ruling 70-367 predated the Bankruptcy Code and enactment of 11 U.S.C. § 502(b)(2) and therefore did not address its effect. Additionally, because the debtor was a railroad, § 63(a), the predecessor to § 502(b)(2), did not apply. Nonetheless, we conclude that any contingency that results from the effect of 11 U.S.C. § 502(b)(2) is not a contingency preventing accrual. *See Spring City Foundry Co. v. Commissioner*, 292 U.S. 182 (1934); *Helvering v. Russian Finance & Construction Corporation,* 77 F.2d 324 (2nd Cir. 1935); *Zimmerman Steel Co. v. Commissioner,* 130 F. 2d 1011 (8th Cir. 1942); Rev. Rul. 77-266, 1977-2 C.B. 236; Rev. Rul. 72-34, 1972-1 C.B. 132 (inability to pay or unlikelihood of payment is not a contingency preventing accrual).

The Fifth Circuit has held that the filing of a petition for bankruptcy makes a liability for postpetition interest contingent until and unless a determination is made that there are sufficient assets to pay the interest. *Matter of West Texas Marketing Corporation v. United States*, 54 F.3d 1194 (5th Cir. 1995), *cert. denied sub nom. Kellogg v. United States*, 516 U.S. 991 (1995). However, *West Texas Marketing* was a Chapter 7 case in which the trustee sought to deduct postpetition interest that arguably accrued during the administration of the bankruptcy case on all general unsecured claims. The court considered the effect of 11 U.S.C. § 502(b) and the fact that interest might be paid under 11 U.S.C. § 726(a)(5) if there are sufficient funds after the full payment of allowed claims, stating:

> Implicit in the obligation under [the Bankruptcy Code] to pay post-petition interest on unsecured claims is the necessary condition that sufficient assets remain following distributions … Similarly, if, in the distribution of [the taxpayer's] assets in accordance with the [Bankruptcy Code], all assets are depleted, then the estate will not have incurred any obligation to pay interest on unsecured claims. This is not due to the fact that payment became impossible, but because the condition necessary to create the liability for the post-petition interest failed to occur.

54 F.3d at 1198. The court concluded that the condition necessary to create the liability to pay postpetition interest under 11 U.S.C. § 726(a)(5), the full payment of allowed claims, had not occurred. Therefore, the trustee was not allowed to deduct the interest. 54 F.3d at 1198.

In contrast, a debtor's obligation to pay interest under a prepetition contract is fixed by the contract, not 11 U.S.C. § 726(a)(5). As the 5th Circuit later explained:

> We agree wholeheartedly with the bankruptcy court's determination that a debtor's obligation with respect to postpetition interest

> terminates only “if and when” the debtor obtains a discharge from the bankruptcy court. *See* 11 U.S.C. §§ 727(b), 1141(d). As the Supreme Court stated over eighty years ago, although as a general rule postpetition interest is not allowed on undersecured debts, “that is not because the [debts] had lost their interest-bearing quality during that period.... and if, as a result of good fortune or good management, the estate proved sufficient to discharge the claims in full, interest as well as principal should be paid.” *American Iron & Steel Mfg. Co. v. Seaboard Air Line Ry.,* 233 U.S. 261, 266, (1914); *see Kellogg v. United States (In re West Tex. Marketing Corp.),* 54 F.3d 1194, 1203 (5th Cir.1995) (Smith, J., dissenting) (stating that a debtor's obligation to pay interest during bankruptcy “is not extinguished, but, for purposes of the bankruptcy proceedings, is ignored until the time the court determines whether the debtor's assets can meet the obligation. Only upon discharge, *see* § 727, is the state law obligation to pay extinguished.” (footnote omitted).)

In re Cajun Electric Power Coop., Inc., 185 F.3d 446, 455 (5th Cir. 1999). *See also In re Dow Corning Corp.*, 244 B.R. 678 (Bankr. E.D. Mich. 1999). Accordingly, the liability to pay interest on borrowings remains unchanged until the bankruptcy proceedings are concluded when, through confirmation of a plan, dismissal, or other resolution, there is a determination as to the disposition of the claims and distribution of the assets and the liability may be altered or extinguished.

Thus, while Subsidiary’s filing of a bankruptcy petition created doubt as to the likelihood of the payment of interest on the Subsidiary’s contractual borrowings, the bankruptcy petition did not change Subsidiary’s obligation to pay the interest. Subsidiary (and thus Taxpayer under the consolidated return) was entitled to treat its interest expense liability on Subsidiary’s contractual borrowings as properly incurred and deductible during the pendency of the bankruptcy proceeding. Accordingly, Subsidiary (and Taxpayer) may properly deduct these amounts, the amount of contractual interest due from Date 1 (the filing of the bankruptcy petition) to Date 2, on its return for the taxable year ending Date 2.

No interest may be properly treated as incurred and deducted for the taxable year ending Date 5, however, because by Date 4 it was determined that no interest would be required to be paid. Thus, for the taxable year ending Date 5, there was no longer a fixed liability to pay interest. Furthermore, Taxpayer must include in income for the taxable year ending Date 5 the amount Taxpayer (through Subsidiary) deducted for the taxable year ending Date 2. Under the tax benefit rule, a taxpayer using an accrual method of accounting must recognize income if the taxpayer accrues and deducts an expense in a taxable year before it becomes payable and eventually does not have to pay the liability. *Hillsboro National Bank v. Commissioner*, 460 U.S. 370, 381-2 (1983). To the extent Taxpayer (through Subsidiary) received the benefit of a deduction for interest expense for the taxable year ending Date 2, and because that tax benefit is fundamentally inconsistent with a later event (the confirmation and acceptance of the plan of reorganization that does not provide for the payment of interest on Subsidiary's contractual borrowings), Taxpayer must include an offsetting amount in income for the taxable year ending Date 5.

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Please call (202) 622-7900 if you have any further questions.

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