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Surprising Interpretation of *Alabama Asphaltic*

Ralphs Grocery Co. v. Commissioner T.C. Memo 2011-25

In this recent opinion, the Tax Court substantially reinterpreted the historic opinion of the Supreme Court in *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942). That opinion generally has been thought to stand for the proposition that the creditors of a deeply underwater corporation displace the shareholders for purposes of being treated as the tax owners of the corporation. However, in the *Ralphs* case, the taxpayer did not want the creditors to be treated as owners because it wanted to effectuate a taxable reorganization of the Ralphs corporation as part of a bankruptcy reorganization of its parent.

The taxpayer was able to convince the court that the creditors who got the stock in the reorganization were not the prior owners. Because the events occurred in 1992, under a prior version of the continuity of proprietary interest rules, continuity of ownership was broken and a section 338(h)(10) election could be made and the basis in the assets inside the corporation stepped up to fair market value, with no tax liability because the seller was in bankruptcy with large net operating losses (NOLs).

The specific transaction that occurred is not typical because the target in the reorganization was not the bankrupt. However, the reading of *Alabama Asphaltic* asserted in the *Ralphs* opinion can affect the standard bankruptcy reorganization and make it difficult to have a carryover basis reorganization in bankruptcy where the creditors get the business in a new corporation.

Facts of Ralphs

The Ralphs transaction was made possible because not all members of the FSI group were in bankruptcy: only FSI, the parent, and Allied, a wholly owned subsidiary of FSI three steps down, were in bankruptcy. Allied (in bankruptcy) owned 16 percent, and Holdings III (solvent) owned 84 percent, of Ralphs. They exchanged the stock of Ralphs (solvent) for the stock of newly created RHC and exchanged the stock of RHC received for debt owed by Allied and by the parent of Holdings III, FSI (bankrupt). The FSI group reported a section 338(h)(10) sale of the stock of Ralphs to RHC. The FSI group owed no regular tax on the sale gain due to its NOLs. The creditors of the two bankrupts wound up with 93 percent of RHC, which owned Ralphs, which had been an asset of Allied (bankrupt) and Holdings III (not bankrupt).

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The taxpayer's theory, which the court agreed with, was that Holdings III was the shareholder; it got the stock of Ralphs and sold it to the creditors, thus breaking continuity because the creditors were not owners of its parent, FSI, much less of Ralphs or Holdings III. Under the then controlling law of cases such as *McDonald's Restaurants of Ill., Inc. v. Commissioner*, 688 F.2d 520 (7th Cir. 1982), the integrated exchange for boot of the stock received in the potential reorganization terminated continuity and prevented application of the tax reorganization rules.

Future Cases

Future bankruptcy cases, and indeed, many bankruptcy cases since 1998, when the regulations were changed to eliminate the rule of *McDonalds*, will involve a target bankrupt transferring all of its assets to a new corporation for stock, all of which is delivered to the creditors. Because the rule of the *Ralphs* case states that the creditors are not owners, the reorganization will be taxable.

The *Ralphs* case rested its reading of *Alabama Asphaltic*, and its conclusion that it did not apply to the facts, on the failure of the creditors in the FSI bankruptcy to take certain actions that the creditors took in *Alabama*: Ralphs creditors did not file an involuntary bankruptcy petition, did not require a trustee to be appointed rather than allow the debtor to remain in possession, did not propose the plan of reorganization and did not insist on absolute priority among creditors.

However, creditors today seldom do those things that the creditors did in 1942 under a prior bankruptcy code in the *Alabama* case. It is much more likely that the debtor will file the petition, will remain in possession and will file the plan, which may involve some stock going to junior creditors who are not entitled to stock under the former absolute priority rule. Therefore, considering such facts, the creditors cannot be treated as owners and their receipt of stock cannot provide continuity under Ralphs.

Whether taxpayers can get around this by having the creditors be more assertive or causing the stock to come first to the bankrupt's shareholders and then be retransferred to the creditors is unlikely; the *Ralphs* court may think the shareholders are owners, but their ownership interest is worth nothing.

Conclusion

Corporate taxpayers expecting a bankruptcy reorganization now must examine much more carefully whether their reorganizations will be treated as taxable or tax-free. Of course, a taxable reorganization usually does not produce tax liability for bankrupts with large NOLs or high basis, but it could disrupt the planning that most bankrupts do for the survival or most advantageous use of their tax attributes.

For additional information, call Jack Cummings at (919) 862-2302.

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