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Code to Code

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Debtors, Restructurings and Bankruptcy: Possible Tax Traps

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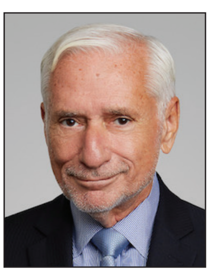

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Many tax issues can arise when a financially distressed business decides to restructure or file for bankruptcy. Among others, the tax consequences will depend on the recourse taken, the business's type of entity, the nature of the business's debt and the transactional structure chosen to address it. This article is a discussion of the tax issues that arise most often and provides recommendations on what else businesses should consider when contemplating a restructuring of their operations. All section references herein are to the Internal Revenue Code of 1986 (IRC), as amended, and the Treasury Regulations thereunder, unless otherwise noted.

Cancellation of Debt Income and the Bankruptcy and Insolvency Exclusions

Under § 61(a)(12) of the IRC and the principles of *United States v. Kirby Lumber Co.*,[2] gross income includes "income from discharge of indebtedness." Therefore, a debtor relieved of an obligation to pay debt is generally required to include the discharged debt ("discharge of indebtedness income" or CODI) in its gross income.

CODI is generally realized when the debtor satisfies the debt for less than the principal amount due.[3] The amount of CODI realized by the debtor is equal to the difference between the "adjusted issue price" of the discharged debt and the amount the debtor paid for its discharge, if any.[4] However, special rules apply when debt is acquired at a discount by a person related to the debtor.

Bankruptcy and Insolvency Exclusions

Section 108 of the IRC provides for exceptions to the recognition of income in discharge-of-indebtedness situations. Specifically, CODI is excluded from gross income when it's realized in a title 11 bankruptcy case (the "bankruptcy exclusion"), when the taxpayer is insolvent (the "insolvency exclusion"), and in certain other situations, such as if repayment of the debt would have created a deduction.[5] For purposes of the insolvency exclusion, "insolvency" is defined as the excess of liabilities over the fair-market value of the debtor's assets.

Even though the bankruptcy and insolvency exclusions avoid the recognition of CODI, the taxpayer is required to reduce its tax attributes by the amount of the discharged debt. The attributes are reduced in the following order: net operating losses (NOLs), carryover of general business credits, minimum tax credits, net capital loss, basis, passive activity loss or credits and foreign tax credits.[6]

The bankruptcy exclusion to recognition of CODI is granted by the court or pursuant to a plan approved by the court. Therefore, some debtors may be ineligible for discharge. Nonetheless, from a practical standpoint, it may be easier for a taxpayer to exclude CODI in bankruptcy rather than having to prove insolvency, since the bankruptcy exclusion is available even if the debtor is not insolvent. In addition, the burden to prove insolvency rests with the taxpayer and often requires the retention of qualified appraisers and valuation experts. Nevertheless, some debtors may benefit more from filing for insolvency, thus both avenues should be considered.

Partnerships

Partnerships raise a number of unique issues related to CODI. Because of their pass-through

1 The advice contained herein is for informational purposes only and is not intended or written to be used, and cannot be used, for the purpose of avoiding penalties under the Internal Revenue Code, or promoting, marketing or recommending to another party any transaction or matter that is contained in this article.
2 284 U.S. 1 (1931).
3 Treas. Reg. § 1.61-12.
4 Treas. Reg. § 1.61-12(c)(2)(ii).
5 I.R.C. § 108.
6 I.R.C. § 108(b); Treas. Reg. § 1.108-7(a)(1).

nature, the insolvency and bankruptcy exceptions to CODI apply at the partner level. Therefore, any CODI recognized at the partnership level must be allocated among the partners based on their respective ownership percentages under the rules of §§ 702(a) and 704(b). Whether individual partners are able to exclude the CODI allocated to them will depend on their individual insolvency or bankruptcy status, regardless of the underlying level of insolvency of the partnership.

One way to remedy this issue is to convert the partnership (including a limited liability company treated as a partnership for federal income tax purposes) to a corporation under § 351 of the IRC. However, such conversion could have unintended tax consequences, the discussion of which is beyond the scope of this article.

Debt Modifications

Debtors considering a business restructuring should ensure that any attempted debt restructuring does not result in a taxable modification of such debt. In general, a "significant" modification of a debt instrument is treated for tax purposes as an exchange of original debt for new modified debt, potentially resulting in taxable income to the debtor to the extent there is any debt relief in the exchange.[7] A significant modification of a debt instrument generally occurs if the legal rights and obligations that are altered and the degree to which they are altered are economically important.[8] Significant modifications include, but are not limited to, the following:

1. a change in the timing of payments that results in the material deferral of scheduled payments;
2. a change in the annual yield of a debt instrument by more than the greater of a quarter of 1 percent or 5 percent of the annual yield of the unmodified instrument;[9]
3. a change in payment expectations if, as a result of a transaction, (a) there is a substantial enhancement of the obligor's (previously speculative) capacity to meet the payment obligations under a debt instrument; or (b) there is a substantial impairment of the obligor's (previously adequate) capacity to meet the payment obligations under a debt instrument;[10]
4. the substitution of a new obligor on a recourse debt instrument, except for certain transactions;[11]
5. a change in payment priority of debt if, as a result of the change, there is a change in the priority of a debt instrument relative to other debt of the issuer that results in a change in payment expectations;[12]
6. an alteration of the collateral for, a guarantee on or other form of credit enhancement for, a recourse debt, where the modification results in a change in payment expectations;[13] and
7. a change in the nature of debt if the debt instrument is changed into an instrument that is not debt for federal income tax purposes,[14] or where there is a change from a recourse to a nonrecourse instrument or vice versa, subject to certain exceptions.[15]

If a significant modification of a debt instrument results, the debtor could recognize gain or loss on the deemed exchange (depending on whether the exchange qualifies as a tax-free recapitalization) and could have CODI. In addition, original issue discount can arise. Therefore, debtors should be aware of any changes to existing debt instruments that may trigger a significant modification and thus potentially a taxable exchange of a debt instrument resulting in (taxable) CODI. The bankruptcy and insolvency exceptions are available if CODI does result.

The Limitations of § 382

In title 11 and similar cases, corporate debtors often pay off creditors by issuing new equity. This stock-for-debt exchange could trigger an "ownership change" under § 382 of the IRC to the extent that "old" equity is replaced, limiting a corporation's use of NOLs and other tax attributes when the change occurs.

Under the general rule of § 382, the company's ability to use its NOLs is significantly limited to the extent that the company undergoes an "ownership change." If such an ownership change occurs, the amount of the taxable income the company for any taxable year that ends post-change of ownership, which may be offset by NOLs generated before the ownership change shall not exceed the "§ 382 limitation" for such year.[16] For this purpose, an ownership change occurs if, immediately after the close of a testing date, there is a more than 50 percent "change of ownership" of the company's stock owned by majority shareholders.[17] The transactions that typically result in such a change include stock acquisitions and corporate reorganizations, including those pursuant to a bankruptcy.

The § 382 limitation is based on an amount equal to the value of the equity of the company before the ownership change, multiplied by the long-term tax-exempt rate of return.[18] If the corporation has certain built-in gains or losses in its assets as of the date of the ownership change, the limitation may increase or decrease respectively. Notably, because the equity value of the company shortly before or during bankruptcy will often be minimal (sometimes even zero), limiting the company's ability to use NOLs to that value will most often prevent the company from using the NOLs after the ownership change altogether.

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7 Treas. Reg. § 1.1001-3(b).
8 Treas. Reg. § 1.1001-3(e)(1).
9 Treas. Reg. § 1.1001-1-3(e)(2).
10 Treas. Reg. § 1.1001-1-3(e)(4)(vi).
11 Treas. Reg. § 1.1001-1-3(e)(4)(i).
12 Treas. Reg. § 1.1001-1-3(e)(4)(v).
13 Treas. Reg. § 1.1001-1-3(e)(4)(iv)(A).
14 Treas. Reg. § 1.1001-1-3(e)(5)(i).
15 Treas. Reg. § 1.1001-1-3(e)(5)(ii).
16 I.R.C. § 382(a).
17 I.R.C. § 382(g).
18 I.R.C. § 382(b).

Under § 382(l) of the IRC, two special rules similar to the CODI exceptions may apply: one for debtors in bankruptcy, provided that the requirements of § 382(l)(5) are satisfied, and one for debtors that are insolvent, subject to § 382(l)(6). These special rules either prevent application of the NOL limitation or increase the value of the corporation, allowing the debtor to retain more NOLs for use. Sections 382(l)(5) and 382(l)(6) are mutually exclusive and should be carefully reviewed by a debtor before undergoing an ownership change to properly assess any prospective limitations of the debtor's tax attributes and what option results in the best tax optimization.

Section 363 of the Bankruptcy Code

Sales of businesses of a distressed debtor are often structured as asset sales under § 363(b) of the Bankruptcy Code to give the debtor more control over the disposition of its assets than under a chapter 7 liquidation bankruptcy proceeding. However, § 363 sales are for the most part taxable transactions, raising questions regarding the income tax consequences to the parties and the applicability of any transfer, sales and use taxes.

More specifically, an asset sale may result in a taxable gain for the seller, and although it is possible that NOLs can offset the gain, any resulting income tax is generally required to be paid to the extent that there is sufficient cash to pay secured creditors of the debtor. The sale may also be subject to real estate and other transfer taxes, although if real property is sold pursuant to a confirmed plan in a chapter 11 case, the sale (if properly structured) would be exempt from transfer and similar stamp taxes pursuant to 11 U.S.C. § 1146(a). The sale may be subject to sales and use taxes, unless an exemption applies.

Finally, in some asset purchases, the portion of the purchase price allocated to accounts receivable and inventory might be less than the face amount of accounts receivable and original basis of the inventory. This would result in a lower original tax basis for those items to the buyer, and a more substantial gain and increased taxable income to the buyer when the assets are subsequently sold.

In appropriate circumstances, a § 363 sale can be structured to qualify as a tax reorganization under § 368(a)(1)(G) of the IRC (the so-called "G" reorganization). However, the discussion of this topic is beyond the scope of this article.

Failure to Take Advantage of Available Cash Infusions

Worthless Stock Loss Deduction

Corporate taxpayers contemplating bankruptcy should consider whether a worthless securities deduction may be available to its shareholders under § 165(g) of the IRC. In order to take advantage of this deduction, there must be a corporate security that becomes worthless during a taxable year. If the security is a capital asset, the loss will be a capital loss; otherwise, the loss will be ordinary.[19]

The inquiry of whether and when a security becomes "worthless" is a facts-and-circumstances determination, but it is generally required that the corporation be insolvent in the taxable year for which a worthless stock loss deduction is sought by the corporation's shareholders. In addition, shareholders must show evidence that the corporation has no future potential value, which is generally demonstrated by the occurrence of an "identifiable event" permanently fixing the loss (bankruptcy or liquidation), or by a showing that liabilities are so greatly in excess of assets and the nature of assets are such that there is no reasonable hope that continuation of the business will result in any profits for the shareholder.[20]

If the securities-holder is a domestic corporation, such corporation may be eligible for an ordinary loss (rather than a capital loss) with respect to the worthless securities of a qualifying affiliated subsidiary.[21] The affiliated subsidiary must satisfy an active gross-receipts test calculated over the entirety of the subsidiary's gross receipts history.

Worthless-Debt Deduction

In addition to the worthless securities deduction, taxpayers may be able to avail themselves of the worthless-debt deduction under § 166 of the IRC. This deduction is generally available for debt instruments that do not meet the definition of "security" and may be available for debt that is only "partially worthless."[22]

In order to qualify for the deduction, the debt must be *bona fide* debt (*i.e.*, it must arise from a debtor/creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable sum of money).[23] The debt (or partial debt) must also be worthless. Factors considered in establishing worthlessness include the subordinated status of the debt, the insolvency of the debtor or the decline in the debtor's business, the debtor's refusal to pay, abandonment of the debtor's assets or businesses, the decline in value of property securing the debt, bankruptcy or receivership, and others.

If the debt-holder is not a corporation, deductibility depends on whether the debt is business or nonbusiness debt. In general, nonbusiness debt is any debt other than (1) debt created or acquired by the creditor in connection with the creditor's trade or business, or (2) debt that the loss from the worthlessness of which was incurred during the operation of the creditor's trade or business.[24]

Conclusion

Many tax issues can arise in bankruptcy or restructuring proceedings that could result in unintended tax consequences to debtors. Not only could debtors attempting a restructuring or a workout incur CODI, they also could subject their business to a variety of limitations imposed by the IRC, such as the § 382 limitation on the use of NOLs and other tax attributes. In addition, if not properly advised, the opportunity to take valuable deductions may be lost. abi

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19 Treas. Reg. § 1.165-5.

20 *Morton v. Comm'r*, 38 B.T.A. 1270 (1938), *aff'd*, 112 F.2d 320 (7th Cir. 1940); Rev. Rul. 77-17, 1977-1 C.B. 44.
21 I.R.C. § 165(g)(3).
22 I.R.C. § 166(a)(2); Treas. Reg. § 1.166-5.
23 Treas. Reg. § 1.166-1(c).
24 I.R.C. § 166(d)(2).