TAX CONSIDERATIONS FOR BUSINESSES CONSIDERING BANKRUPTCY

By David Gair and Brian Clark

"How did you go bankrupt?" Bill asked. "Two ways," Mike said. "Gradually and then suddenly."

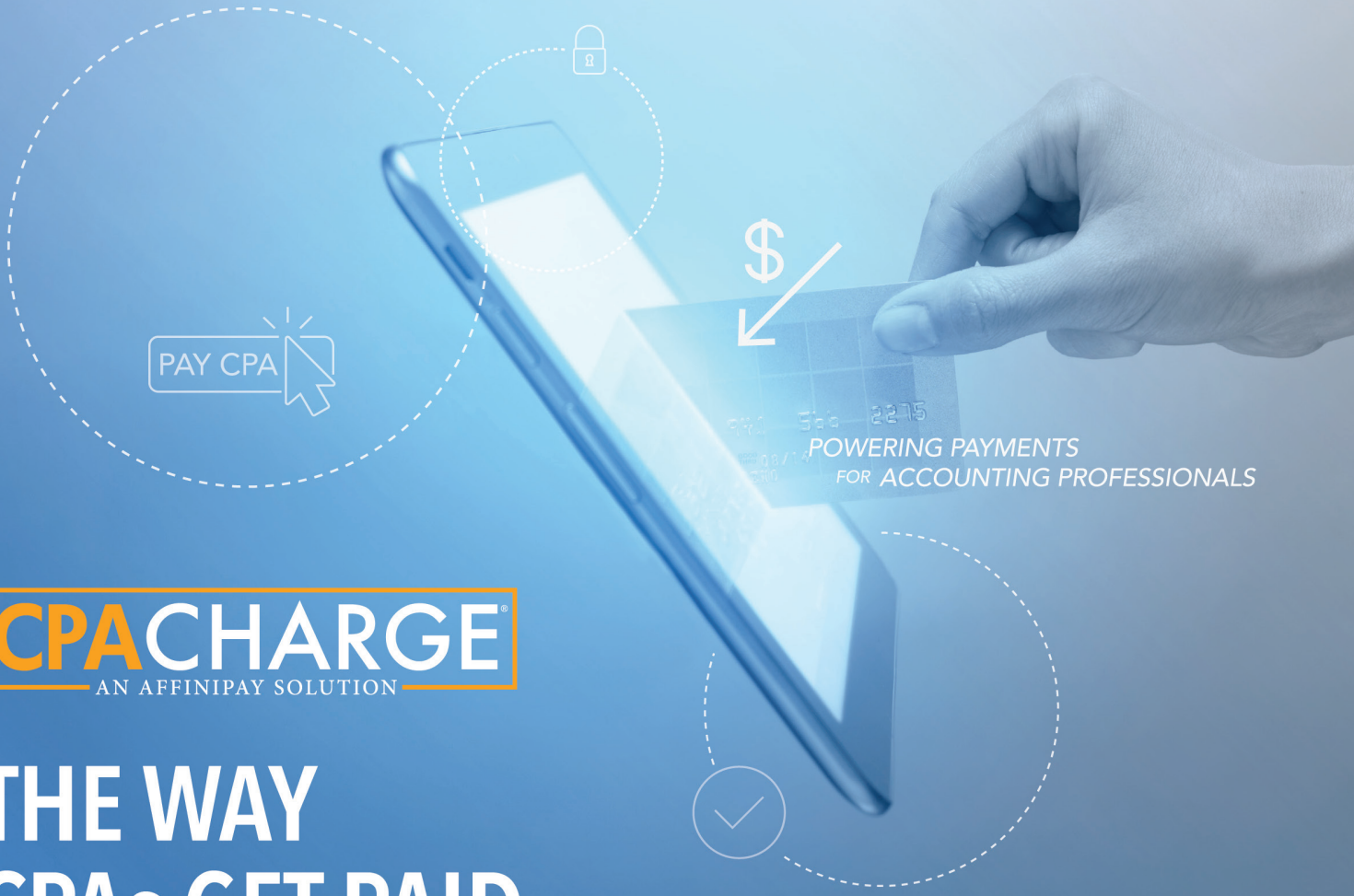
Ernest Hemingway, The Sun Also Rises (1926).

The COVID-19 pandemic has been horrendous in both human and economic costs. As of the end of May 2020, there were approximately 1,750,000 positive cases and over 100,000 deaths in the U.S. and they were continuing to climb.[i] By comparison to the country's wars, only the Civil War and World War II resulted in more U.S. deaths.[ii]

The combination of a global pandemic and sagging energy industry leads many economists to suggest growth will remain sluggish. Like Hemingway's Mike, a company's fortunes can decline over time, but its crash can be sudden. High profile companies in a variety of industries have already filed for bankruptcy, including J. Crew, Pioneer Energy, Pier 1, McDermott International, and Dean & Deluca.

Companies forced into bankruptcy or financial restructuring have debt and liquidity problems. The issues are loaded with tax consequences, such as income from the cancellation of indebtedness, loss of tax attributes and potential payroll tax liability risk for owners.

However, tax considerations alone are rarely the reason businesses seek bankruptcy protection or restructure debt. Although not the main driver, tax considerations are important, and thoughtful front-end planning can maximize tax benefits of bankruptcy and workouts. This



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article focuses on certain significant business bankruptcy and workout considerations, but does not attempt to cover all tax issues.

Exclusion of COD Income

The federal income tax consequences of restructuring a financially distressed business depend on whether the business is in bankruptcy, whether it is a pass through entity or C corporation, the nature of its debt, and the transactional structure chosen to address its debt.

Debtors typically recognize income (called "COD" income) to the extent they are relieved of an obligation to pay debt.[iii] However, a debtor can sometimes exclude recognition of some or all COD income arising from the repurchase, cancellation or satisfaction of its debt for less than the outstanding balance.[iv] The most common COD income exclusions apply to insolvent debtors or those in bankruptcy.[v]

> A TRAP FOR THE UNWARY SPRINGS UP IF THE MODIFIED DEBT DOES NOT INCLUDE ADEQUATE STATED INTEREST ...

The COD rules are complex and require in-depth study. Special rules apply to farm indebtedness, real property business indebtedness, related parties and principal residences.[vi] COD income exclusions are also affected by tax classification. For example, insolvency of an S Corporation is determined at the corporate level, but partnership insolvency is mainly determined at the partner level.[vii]

Bankruptcy COD income exclusions are granted by the court or pursuant to a plan approved by the court, meaning that some debtors may be ineligible for discharge, like corporate debtors in a Chapter 7 bankruptcy.[viii] Companies in a "reorganization" bankruptcy might avoid COD income altogether, but at the cost of reducing favorable tax attributes, starting with net operating losses (NOLs).[ix]

Insolvency COD income exclusions apply to debtors outside of bankruptcy proceedings. It excludes COD income up to the amount of the taxpayer's insolvency.[x] "Insolvent" means the excess of liabilities over the fair market value of assets immediately before discharge.[xi]

As an example, if a corporation has assets worth $100 and debts of $150, it is insolvent by $50. If the corporation's creditors cancelled their debts in exchange solely for debtor stock worth $100, the corporation has COD income of $50, which is excluded under Code § 108 because it does not exceed the amount of the corporation's insolvency. If the creditors had accepted stock worth $80 and forgave the remaining $20, the corporation would have $20 of COD income that would not be excludable under Code § 108, because the $70 of forgiven debt exceeds the insolvency amount by $20.

The insolvency exclusion applies the same tax attribute reduction rules as the bankruptcy exclusion.[xii] The burden of proof to establish insolvency rests with the taxpayer.[xiii] Retaining qualified appraisers and valuation experts when valuations are at issue is advisable.

Code § 108 only applies to COD income. Debtors should ensure that a workout transaction not be structured as, or deemed to be, a sale or exchange. A sale or exchange does not trigger potentially excludible COD income, but instead results in non-excludible ordinary or capital gain or loss.

Assume an insolvent debtor agreed to sell its sole asset, a building, to a third party for an amount less than the nonrecourse debt encumbering the building. The buyer conditioned the sale on cancellation of the debt, to which the lender agreed if it were assigned the sales proceeds. On first pass, it appears the debtor has COD income shielded by the insolvency exclusion. However, because the seller disposed of the building and debt in an integrated transaction, the debt discharge is not COD income potentially excludible by Code § 108, but instead sale proceeds in a taxable exchange.[xiv] This is just one example of a transaction that may appear to result in COD income exclusion, but is instead a taxable sale.

Debtors may also engage with creditors in pre-bankruptcy workouts by reducing interest rates or principal or deferring payments on existing debt. Changing debt terms may have significant tax consequences. The analysis requires three steps:

1) Did a "modification" occur;

2) If so, is it "significant"; and

3) If significant, determine the tax consequences.[xv]

The Code requires evaluating "significant" debt modifications using a hypothetical transaction exchanging old debt for modified "new" debt.[xvi] The debtor is treated as paying the old debt with cash equal to the issue price of the new debt, not the new debt's face amount.[xvii] For non-

publicly traded debt, the issue price is its stated principal amount if it includes adequate stated interest.[xviii]

A trap for the unwary springs up if the modified debt does not include adequate stated interest, because the debtor will constructively pay off the old debt's principal with the lesser priced "new" debt, resulting in COD income. As an example, if a debtor partnership and its lender modified debt, but did not provide adequate stated interest, the partnership would have COD income allocable to its partners. The difference between the old debt's principal amount and the new debt's issue price is deductible as original issue discount by the partnership and taxable to the lender over the remaining term of the debt.

Basic Code § 382 Limitation Issues

Corporate debtors should also be aware of the possible effects of Code § 382, which operates to prevent a "loss corporation" from offsetting taxable income after an ownership change with pre-ownership change losses. Non-bankruptcy restructurings by insolvent debtors typically eliminate all debtor NOLs if the workout involves an ownership change under Code § 382.[xix]

For instance, assume a corporate debtor owes its lender $100 million, but negotiates to retire the debt for $90 million of corporate stock representing more than 50 percent of all the corporation's stock. The corporation has $15 million of NOLs and is insolvent by $10 million immediately before the restructuring. Outside bankruptcy, the corporation will generate $10 million in COD income, which is likely excluded under the insolvency rules. The corporation's NOLs will be reduced by $10 million and its remaining $5 million of NOLs are lost because the corporation underwent an ownership change for Code § 382 purposes when the corporation itself was worthless.[xx]

Outside bankruptcy, Code § 382 limits the use of pre-ownership change tax attributes to the product of the fair value of the loss corporation's equity immediately before the ownership change multiplied by the applicable long-term tax-exempt rate (currently around 1 percent[xxi]).

Inside bankruptcy, the rules are more lenient. In the foregoing example, instead of being eliminated, the corporation's remaining NOLs can receive a relaxed Code § 382 limitation or no limitation at all.[xxii]

Code § 382 also limits pre-ownership change built-in gains and losses. The premise of these rules is that items of unrecognized gain and loss at the time of an ownership change may be treated as if they were recognized at such time.

Focusing only on the built-in gain rules and ignoring specific exceptions[xxiii], a gain on the disposition of an asset recognized within five years of an ownership change (to the extent the gain was built-in at the time of such change), will increase the Code § 382 limitation in the year of recognition.[xxiv] The total increase is limited to the net unrealized built-in gains on all assets of the corporation, reduced by recognized built-in gains for prior years ending in the recognition period.[xxv]

If a target corporation has appreciated assets at the time of ownership change that may be disposed of post-ownership change, it may be able to use NOLs to offset the built-in gains on asset sales for five years.

Type G Reorganizations

The Code provides a special form of reorganization in bankruptcy that mitigates some of the negative tax consequences of financial restructuring.

IN SOME CASES, A TAXABLE ASSET SALE MAY BE MORE BENEFICIAL THAN AN INSOLVENCY REORGANIZATION.

Nature and Benefits of Insolvency Reorganizations

Insolvent corporate debtors can transfer their assets to other corporations during bankruptcy proceedings in furtherance of their rehabilitation efforts. The Type G reorganization provides a mechanism to accomplish those efforts wholly or partially tax-free while the debtor is in Title 11 bankruptcy.[xxvi]

Code § 382 allows the survival of large NOLs if a bankrupt corporation can effect a Type G reorganization.[xxvii] A prominent example of a transaction structured in bankruptcy is the Sears' bankruptcy, in which Sears' qualified creditor could inherit Sears' NOLs and tax attributes in a Type G reorganization, permitting the creditor to offset future taxable income with Sears' massive pre-ownership change NOLs.[xxviii]

In some cases, a taxable asset sale may be more beneficial than an insolvency reorganization. For example, if a corporation controlled by the bankrupt corporation's creditors purchases assets in a taxable transaction, it receives a basis step-up. If cost recovery deductions exceed the value of the losses the creditor could retain as a transferee in an insolvency reorganization, the reorganization is less desirable. In effect, the bankrupt corporation's losses can reduce or eliminate its gain from the asset sale, converting its losses into depreciation and amortization deductions for the creditor.[xxix]

Statutory Requirements

Type G reorganizations require meeting certain statutory and common-law tests. In addition to requiring a "plan of reorganization," there are three statutory requirements:

1) The corporation transfers all or part of its assets to an acquiring corporation;

2) The transfer occurs in a Title 11 or similar case; and

3) Stock or securities of the acquiring corporation are distributed in a transaction qualifying under Code §§ 354, 355 or 356.

The common-law requirements apply to all reorganizations other than recapitalizations under Code § 368(a)(1)(E) and include continuity of proprietary interest (COI), continuity of business enterprise (COBE) and a valid business purpose. Because Type G requirements can overlap with other reorganization definitions, parent-subsidiary liquidations and incorporation transactions, the Code prescribes that Type G requirements take primacy in the event of overlap.[xxx]

For example, when substantially all of a corporation's assets are transferred to another corporation, the resulting transaction resembles a Type C reorganization; however, if the transferor is in bankruptcy, Type G controls.

Nondivisive Type G reorganizations must meet the requirements of Code § 354. Code § 354 provides nonrecognition treatment in reorganizations when stock or securities of parties to the reorganization are exchanged. A simple example is nonrecognition afforded to target shareholders in a basic "Type B" reorganization where the target corporation's shareholders exchange target stock for acquiring corporation stock.[xxxi]

In a Type G reorganization, Code § 354 imposes additional requirements. First, the acquiring corporation must obtain substantially all of the transferor's assets.

Second, the transferor must distribute all stock or securities received from the acquiring corporation to its stock or security holders, which are generally creditors.[xxxii] When executed properly, the distributee recognizes no income, except to the extent consideration is attributable to accrued interest on the security holders' transferred securities.

Type G reorganizations can be divisive under Code § 355. Code § 355 applies to distributions by a controlling corporation of controlled subsidiary stock or securities, and provides nonrecognition treatment at the distributee level.

In a classic Code § 355 split-off, a controlling corporation distributes subsidiary stock to some existing stockholders in exchange for their controlling corporation stock. After the transaction, the distributee will have exchanged on a tax-free basis its controlling corporation equity for a split-off piece of the controlling corporation's business. In a Type G transaction, Code § 355 can facilitate tax-free distributions of pieces of the bankrupt corporation's business to its security holders in satisfaction of their claims. Code § 356 applies to boot included in Code §§ 354 or 355 transactions. In general, if a distributee receives property not permitted by the foregoing statutes, it recognizes gain.[xxxiii]

Common-Law Requirements

Common-law requirements of a Type G reorganization should be documented in the plan of reorganization and ancillary documents. COI is a measure of a security holder's continued investment in a modified corporate package. In an insolvency reorganization in a Title 11 bankruptcy, a creditor's claim against the bankrupt target can be a proprietary interest.[xxxiv] Therefore, if a bankrupt target's senior class of creditors, together with all junior creditors and shareholders not eliminated by the transaction receive a proprietary interest like stock in the acquiring corporation in exchange for their claims, the COI requirements can be met.

COBE generally requires that the acquiring corporation either continues the bankrupt target's historic business or uses a significant portion of the target's assets in a business. Because an insolvency reorganization is implemented to restructure financially distressed corporations, the corporation continues in a different form and COBE is relatively straightforward.

INSOLVENT CORPORATE DEBTORS CAN TRANSFER THEIR ASSETS TO OTHER CORPORATIONS DURING BANKRUPTCY PROCEEDINGS IN FURTHERANCE OF THEIR REHABILITATION EFFORTS.

Type G reorganizations also require a valid business purpose. Since insolvency reorganizations are typically undertaken to rehabilitate distressed corporations to allow them to continue as a going concern, the business purpose of this type of reorganization is clear.

Planning is Key

Do not let the tax tail wag the dog. It is almost never a good idea to file for bankruptcy merely for tax purposes. In fact, if tax is the only issue, a company runs the risk of not having a plan confirmed because courts can disallow plans if the principal purpose is the avoidance of taxes.[xxxv]

The decision to file should focus on the business realities imposed by creditors and prevailing economic forces. Importantly, obtain the advice of qualified bankruptcy counsel, tax counsel and valuation experts when considering bankruptcy or debt workouts.

Ideally, a restructuring and tax strategy is implemented well before a bankruptcy filing becomes necessary. If bankruptcy is unavoidable, make sure it is thoughtfully planned.

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FOOTNOTES

[i] See https://coronavirus.jhu.edu/data.
[ii] See https://www.va.gov/opa/publications/factsheets/fs_americas_wars.pdf.
[iii] See Code § 61(a)(11). The "Code" refers to the Internal Revenue Code of 1986, as amended, and "Treas. Reg." refers to the Treasury Regulations promulgated thereunder.
[iv] Code § 108. Also see *United States v. Kirby Lumber Co.*, 284 U.S. 1 (1931) (a taxpayer must recognize income when it settles its debt for less than face value) and *Slavin v. Commissioner*, T.C. Memo 1989-221 ("A taxpayer has been forgiven or released from a debt when the facts reasonably establish that the debt will probably never be paid, that the taxpayer does not intend to repay the loan and that the party who loaned the money does not intend to enforce its claim against the taxpayer").
[v] Code § 108(a)(1)(A), (B).
[vi] See Code § 108(a)(C)-(E).
[vii] Code § 108(d)(6), (7).
[viii] Code § 108(d)(2). See also 11 U.S.C. § 727.
[ix] See Code § 108(b); Treas. Reg. § 1.108-7(a)(1)(i)-(vii). Taxpayers may elect to first reduce the bases of depreciable property before using the general ordering rule. Code § 108(b)(5).
[x] Code § 108(a)(3).
[xi] Code § 108(d)(3).
[xii] Code § 108(b)(1); Treas. Reg. § 1.108-7(a).
[xiii] See *Welch v. Helvering*, 290 U.S. 111, 115 (1933) and *Bressi v. Commissioner*, T.C. Memo 1991-651 (citing Tax Court Rule

142(a) and *Welch*, 209 U.S. 111 (1933)). In certain cases, the burden of proof for relevant factual issues may shift to the IRS under Code § 7491(a).

[xiv] See 2925 Briarpark, Limited, T.C. Memo 1997-298, aff'd, 163 F.3d 313 (5th Cir. 1999). Also see *Commissioner v. Tufts*, 461 U.S. 300 (1983) (establishing that where a taxpayer disposes of property encumbered by a nonrecourse obligation exceeding the fair market value of the property sold, the taxpayer's amount realized on the sale can include the outstanding amount of the obligation).

[xv] See Treas. Reg. § 1.1001-3.

[xvi] Id.

[xvii] Code § 108(e)(10)(A).

[xviii] See Code § 1274; Treas. Reg. § 1.1274-2.

[xix] Code § 382(g).

[xx] See Code § 382(b), (e)(1). (Loss corporation's NOLs are subject to annual limitation equal to the value of old loss corporation immediately before the ownership change times the long-term exempt rate. The limitation is zero whenever the loss corporation is insolvent immediately before the ownership change.)

[xxi] Published rates are available at https://apps.irs.gov/app/picklist/list/federalRates.html.

[xxii] Code § 382(b)(1), (l)(6), and (l)(5).

[xxiii] See, e.g., Code § 382(h)(3)(B).

[xxiv] Code § 382(h)(1)(A).

[xxv] Id. See also footnote 23.

[xxvi] Code § 368(a)(1)(G) ("Type G" or "insolvency reorganization"). Title 11 refers to a case under Title 11 of the United States Code. Code § 368(a)(3)(A)(i). As a technical matter, a Type G reorganization can also be used in receivership or foreclosure type procedures in state or federal court. Code § 368(a)(3)(A)(ii). Unless otherwise noted, "reorganization" as used herein refers to transactions defined by Code § 368.

[xxvii] See Code § 382(l)(5).

[xxviii] See https://www.sec.gov/Archives/edgar/data/923727/000119312519012110/d687440dex9986.htm, as amended.

[xxix] The substitution of acquirer's higher cost basis in purchased assets for losses is often called a "Bruno's transaction" after In re PWS Holding Corp., Case No. 98-212 through 98-223 (SLR) (Bankr. D. Del), Second Amended Joint Plan of Reorganization dated Oct. 15, 1999, Second Amended Joint Disclosure Statement dated Oct. 15, 1999.

[xxx] See Code § 368(a)(3)(C). The foregoing control rule does not apply to the excess liability gain-recognition rule of Code § 357(c)(1).

[xxxi] See Code § 368(a)(1)(B) (a "Type B" reorganization).

[xxxii] Code § 354(a), (b). In other words, the bankrupt corporation exchanges its assets for acquiring's stock or securities and then distributes acquiring's securities to the bankrupt corporation's creditors. The asset exchange and distribution are shielded from corporate level tax under Code §§ 368(a)(1)(G) and 361, and at the security holder level by Code § 354.

[xxxiii] Code § 356(a).

[xxxiv] Treas. Reg. § 1.368-1(e)(6)(i).

[xxxv] 11 U.S.C. § 1129(d).