

Troubled Company Tax Issues: Understanding Opportunities and Pitfalls

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Changes to tax laws as well as historic provisions enacted in the Recovery and Reinvestment Act of 2009 raise a variety of issues that companies should consider as they evaluate their restructuring options. With effective analysis and planning, companies can maximize available tax benefits and mitigate tax costs associated with issues such as net operating losses, cancellation or modification of indebtedness, and the disposition of troubled subsidiaries.

Preserving NOLs and other attributes

Troubled companies often have significant net operating losses, credit carryovers and other attributes available to offset post-restructuring income. However, they can lose these attributes as a result of a bankruptcy or debt restructuring. Proper planning can help preserve the tax benefits associated with tax attributes such as:

- Net operating losses
- Capital loss carryovers
- Excess credit carryovers
- Tax basis in company assets
- Tax basis in subsidiary companies

The form that a restructuring takes (i.e. bankruptcy, debt modification or exchange for equity, taxable acquisition of assets by creditors) will greatly impact the survival or tax attributes. In any restructuring, how debt is addressed can significantly affect the preservation of tax attributes. Therefore, any cancellation of indebtedness (COD) also must be considered carefully to maximize benefits available in the post-restructuring period. Such planning may have to extend beyond the company itself.

Companies that file as a part of a consolidated group of corporations need to consider the impact of the consolidated tax return regulations. Where the debtor corporation is a member of a consolidated group, an additional set of attribute reduction rules come into play that could reduce tax attributes of companies other than the debtor company.

The effect of bankruptcy on tax attributes

The decision of a company to file for bankruptcy protection is not an easy one and is generally not driven by tax motivations. However, the tax ramifications of a restructuring are a key piece of the puzzle. For companies reorganizing through bankruptcy, special rules under sections 382(l)(5) and (6) provide benefits that allow increased utilization of attributes post-bankruptcy. However, there are a myriad of rules with which a company must comply. If section 382(l)(5) applies, the company's surviving NOLs are available post-bankruptcy without limitation. However, qualifying for the benefit of section 382(l)(5) can be difficult. On the other hand, companies applying section 382(l)(6), while not free from

the section 382 limitation, are allowed an increase in the amount of NOLs that they are eligible to utilize post-bankruptcy.

Managing debt modifications

The law broadly interprets the term "modification" when applying the term to debt instruments. Almost any change to the rights of the debtor or creditor will represent a modification. If the modification reaches the level of "significant," there is a deemed exchange of the debt, creating numerous tax consequences, including the potential for taxable gain to the company on the deemed exchange. Where the modified debt is not publicly traded and the principal of the debt remains the same, the company is generally able to avoid gain recognition with appropriate planning and analysis. If the deemed exchange occurs with debt that is publicly traded, the potential for gain recognition increases exponentially. Any company contemplating or negotiating a debt restructuring should carefully consider the impact of the debt modification rules prior to agreeing to the terms of the new or surviving debt.

Dealing with an insolvent subsidiary

Section 165(g)(3) provides a potential tax savings opportunity for companies that own an insolvent subsidiary upon its liquidation, whether actual or deemed, or upon other disposition of the subsidiary. Notably, section 165(g)(3) allows for the recognition of an ordinary rather than a capital loss on the liquidation or disposition of the subsidiary's stock for both domestic subsidiaries of a consolidated group or foreign subsidiaries. In addition, the use of disregarded entities could accelerate the loss into a tax year prior to the actual disposition of the business and, in some cases, allow a loss on the investment without the disposition of the subsidiary's business.

Opportunities to recognize a loss are likely to occur when winding down the subsidiary's business or where there is an interested buyer for a subsidiary, but the subsidiary has liabilities (including intercompany liabilities) that exceed the value of its assets. A worthless stock deduction may be available through structural changes that do not include disposition of the subsidiary. Companies considering claiming a worthless stock deduction should look closely at intercompany debt to make sure it represents true debt for federal tax purposes and should also consider having a valuation of the subsidiary's assets completed to document the insolvency.

Make the most of recent law changes

The recently enacted American Recovery and Reinvestment Act of 2009 (the Act) provides flexibility that will allow companies to increase cash flow through deleveraging or otherwise restructuring existing debt without the tax implications often associated with such restructurings. The Act added section 108(i), which significantly defers the impact of COD occurring as a result

of a cancellation, reacquisition or modification of a business debt occurring after Dec. 31, 2008 and before Jan. 1, 2011. At the election of the taxpayer, any COD income incurred upon the reacquisition of an applicable debt instrument is deferred and recognized ratably over the five-year period beginning in the fifth taxable year following a 2009 reacquisition and in the fourth taxable year following a 2010 reacquisition. Unlike the section 108(a) exclusions of COD income, the deferral offered under section 108(i) is not limited to insolvent or bankrupt taxpayers and does not require attribute reduction. As a result, both solvent and insolvent companies are able to defer the impact of the COD event while retaining valuable net operating losses, credit carryovers and asset basis. The new law has special rules for partnerships and other pass-through entities and also may defer future interest deductions on new debts issued in the restructuring. As a result, companies will want to carefully consider all potential exclusions and deferrals and their collateral side effects before electing to apply section 108(i).

The Act also added IRC §163(e)(5)(F), which suspends the application of the applicable high yield debt obligation (AHYDO) rules for certain debts issued after Sept. 30, 2008 and before Jan. 1, 2010, and perhaps beyond. The AHYDO rules defer or disallow the deductibility of interest on certain corporate debt instruments (or partnership debts of partnerships with corporate partners). Debt restructurings that significantly defer the payment of principal or interest often create an AHYDO instrument. As a result, newly issued corporate (and certain partnership) debt that would have otherwise created deferred or non-deductible interest will instead provide immediate tax deductions to the issuer under general interest deductibility principles.

Pass-through rules may differ

Where the company is not a C corporation but rather a Subchapter S corporation or partnership (including an LLC taxed as a partnership), the rules could provide quite different results. Perhaps the most significant difference is found in the application of the exclusions to recognition of COD income under section 108. Where the COD occurs at the partnership or LLC level, the exclusions do not apply at the partnership or LLC level, but rather at the partner or member level. As a result, the bankruptcy or level of insolvency of the partnership or LLC is of no consequence when determining whether the COD is excludable by the partner or member. This may come as quite a shock to an unsuspecting partner or member who has always assumed that a bankruptcy at the entity level is sufficient to avoid taxation on COD. For an S corporation, the rules are not as drastically different from the C corporation rules in that attribute reduction occurs at the S corporation level; however, unlike C corporation shareholders, shareholders of an S corporation could recognize taxable income upon a COD event. In addition, the company owner's basis in the company plays a significant role in determining their ability to utilize losses incurred.

Don't forget employee benefit matters

Both opportunities and pitfalls related to existing employee benefit plans must be considered when restructuring a troubled company. Issues to consider will include whether the company should contemplate amending the employee's retirement plan to reduce or eliminate future contributions; eliminating the pension and executive deferred compensation plans; obtaining a waiver of the minimum funding standard; and various considerations regarding repurchase obligations. Companies owned by an employee stock ownership plan also must consider a wide variety of issues.

Many companies are faced with restructuring concerns in the current economic environment. For these companies, taking advantage of every opportunity, including tax planning opportunities, can be the difference between a successful restructuring and failure.

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