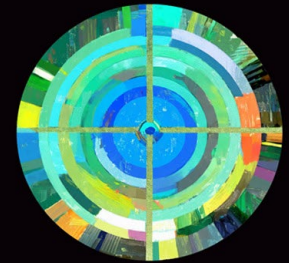


M&A Tax Talk

Tax implications of in-court and out-of-court debt restructurings



Introduction

Corporations may be considering a restructuring of their debt or capital structure, which may present challenges from a tax perspective, including giving rise to cancellation of debt income (CODI). [Refer to the M&A Tax Talk on debt modification tax rules for more information.](#)

Throughout the restructuring process, the tax implications of the various restructuring steps need to be considered, regardless of whether the restructuring occurs in or outside of court.

Often, restructuring the capital structure of a company includes reducing the amount of debt, which often can result in CODI. Thus, understanding whether the company can qualify for certain favorable tax rules is a critical part of the analysis for the company.

This article provides an overview of the specific tax rules that may apply in both in-court and out-of-court restructurings.

Tax considerations

CODI is generally taxable, even for a distressed company, unless the company qualifies for one of the exceptions discussed below. Thus, tax may be an important consideration in deciding whether to pursue an out-of-court or in-court debt restructuring because each route may affect the distressed corporation's net operating losses (NOLs) and other tax attributes.

Cancellation of debt income

In general, a corporation will recognize taxable income when debt is forgiven or discharged for less than its adjusted issue price (typically the face amount of the debt plus any accrued interest). A corporation may also realize CODI when debt is modified, even though the amount owed on the debt is not reduced.

	Out-of-court	In-court (Bankruptcy)
CODI	<ul style="list-style-type: none"> • General rule: CODI is taxable, including from debt modifications • Excluded from income only to the extent the company is insolvent immediately before the discharge 	<ul style="list-style-type: none"> • General rule: CODI is excluded from income, regardless of solvency
Ownership Change 382 Limitations	<ul style="list-style-type: none"> • General rule: Post ownership change limitation based on the pre-discharge value of the company's equity <ul style="list-style-type: none"> – In light of typical equity value of a distressed company, the utilization limitation is typically very low or zero – Limitation may be increased to the extent of RBIGs during the first five years following the change if in a NUBIG position – Additional deductions may be limited to the extent of RBILs during the first five years following the change if in a NUBIL position 	<ul style="list-style-type: none"> • Two bankruptcy-specific rules: <ul style="list-style-type: none"> – Section 382 (l)(5) – If qualifying creditors and shareholders own the post-change stock, no limitation on post-change utilization, but NOLs reduced for certain interest deductions – Section 382 (l)(6) – Equity value used to determine the utilization limitation is generally based on post-discharge value
Structuring considerations	<ul style="list-style-type: none"> • Structuring alternatives <ul style="list-style-type: none"> – Recapitalization – 368 (a)(1)(E) – “D” reorganization – 368(a)(1)(D) – Taxable asset sale 	<ul style="list-style-type: none"> • Structuring alternatives <ul style="list-style-type: none"> – Recapitalization – 368 (a)(1)(E) – “G” reorganization – 368 (a)(1)(G) – “Bruno’s” transaction – taxable asset sale

Under the “insolvency exception” (out-of-court), an insolvent corporation that recognizes CODI may exclude the CODI to the extent of its insolvency immediately prior to the discharge of the debt. On the other hand, a corporation under the jurisdiction of a court in a bankruptcy proceeding generally can exclude the entire amount of CODI, regardless of solvency. Thus, in some instances, the insolvency exception, which is dependent on asset value, may be more limited than the bankruptcy exception.

A taxpayer that excludes CODI under either of these exceptions must reduce its tax attributes under a complex set of rules. In general, tax attribute reduction occurs in the following order: NOLs (first to those generated in the taxable year of discharge, then to carryovers in the order in which they were generated), general business credits, alternative minimum tax credits, capital loss carryovers (first to those generated in the taxable year of the discharge,

then to carryovers in the order in which they were generated), basis of depreciable and non-depreciable assets (but generally not below the aggregate amount of the debtor's liabilities outstanding immediately after the discharge), carryovers of passive activity loss deductions, and foreign tax credit carryovers.

Furthermore, where the taxpayer is a consolidated group for US federal income tax purposes, special rules apply that may result in attribute reduction not only to the tax attributes of the member of the consolidated group realizing excluded CODI, but also to the tax attributes of other consolidated group members.

Limitations on attribute utilization

Section 382 Limitation – In general

In the case of a contemplated restructuring, whether in bankruptcy or not, a corporation with significant loss attributes should consider limitations on future utilization that may be triggered by a change in a corporation's capital structure. Section 382 imposes an annual limitation on a company's ability to utilize pre-change losses (e.g., NOLs, capital losses, certain credits, or disallowed business interest under Section 163(j)) and certain built-in losses or deductions to offset post-change income if the company has undergone a greater than 50% change in ownership (the "Section 382 Limitation" over a rolling three-year period). The annual "base limitation" is generally equal to the equity value of the company immediately before the change multiplied by the long-term tax-exempt rate.

Because the value of a distressed corporation's stock immediately before an ownership change is typically depressed, an ownership change will often significantly limit or effectively eliminate a distressed corporation's ability to utilize its NOLs and other tax attributes following such ownership change.

The annual limitation can often be significantly increased over the first five years after an ownership change if there is a net unrealized built-in gain (NUBIG) in the corporation's assets at the time of change (i.e., the fair market value of the assets of the corporation immediately before an ownership change exceeds the aggregate adjusted basis of the assets at the time). On the other hand, for corporations that have a net unrealized built-in loss (NUBIL) in their assets, recognized built-in losses (RBILs) are subject to the Section 382 Limitation. Accurately calculating the Section 382 Limitation is imperative to analyzing the future utilization of a corporation's tax attributes.

Bankruptcy exceptions

Creditors' claims in bankruptcy are often settled, at least in part, with debtor equity, typically for an amount less than the face amount of the debt. This stock-for-debt exchange may trigger an ownership change under Section 382 and subject the company to a limitation at a time that it has a depressed equity value. However, there are certain favorable rules specific to corporations undergoing an ownership change in bankruptcy that may help preserve value of the company's NOLs and other tax attributes. Note that these rules are not available to an out-of-court restructuring where the taxpayer is using the insolvency exception.

Section 382(l)(5), the default rule for taxpayers in bankruptcy, permits a corporation to avoid any limitation on use of its losses (NOLs and RBILs) after an ownership change if it satisfies certain conditions. First, the corporation must be under the jurisdiction of a court in a Title 11 bankruptcy case immediately before the ownership change. Second, shareholders and qualifying creditors of the corporation immediately before the change must own at least 50% of the corporation's stock post-

change as a result of being shareholders or qualifying creditors immediately before the ownership change. If Section 382(l)(5) applies, the corporation must recompute its pre-change losses (and excess credits) by excluding deductions for its interest paid or accrued during the portion of its taxable year preceding the ownership change and the three prior taxable years on any debt converted to stock pursuant to the bankruptcy case (the "interest haircut").

Although Section 382(l)(5) can provide favorable results for taxpayers, this is not always the case. For some companies, the interest haircut may result in a significant reduction to the NOL balance. In addition, many companies may not be able to meet all the requirements of Section 382(l)(5). Finally, if a second ownership change occurs during the two-year period following the ownership change to which Section 382(l)(5) applied, then the Section 382 Limitation with respect to the subsequent ownership change is zero. This "two-year rule" often prompts companies to impose charter restrictions on stock trading during this period, which can be problematic from a commercial or corporate governance perspective. [Refer to the M&A Tax Talk on attribute preservation strategies for more information.](#) In these circumstances, the corporation may decide to elect out of Section 382(l)(5) and seek the benefits of Section 382(l)(6).

Unlike under Section 382(l)(5), the Section 382 Limitation does apply to NOLs and certain built-in losses under Section 382(l)(6). However, under Section 382(l)(6), the equity value of the corporation is computed immediately after the ownership change. The value of the corporation used for purposes of calculating the Section 382 Limitation should thus be significantly higher, as the postemergence company is usually leveraged, which increases the amount of pre-change losses that can be used to offset taxable income in post-change years.

A corporation that is contemplating its options for debt workouts or corporate reorganizations due to a distressed situation should consider the differences in the applicable Section 382 rules in an in-court versus out-of-court context. Because losses and other tax attributes can be significant assets of the corporation, their preservation may have a significant impact on the post-restructuring financial condition of the corporation.

Transaction structuring considerations in a bankruptcy setting

There are a variety of transaction structuring alternatives available to a distressed corporation. The desirability of each depends on the objectives of the corporation and its creditors. For example, in the bankruptcy context, a taxable asset transaction (commonly referred to as a "Bruno's" transaction) may be pursued, as it can be favorable in certain fact patterns. The debtor corporation can use its tax basis in the assets and NOLs to offset the amount realized on the taxable asset sale. The buyer entity takes a fair market value tax basis in the transferred assets, but the transferred assets are not subject to attribute reduction.

Other bankruptcy transaction structuring alternatives include a tax-deferred recapitalization, whereby creditors exchange debt for equity, or a tax-deferred "G" reorganization, but the

requirements to qualify for tax-deferred "G" reorganization treatment are relaxed as compared with the tax provisions that apply outside of bankruptcy. In both of these situations, the tax attributes remain intact, but are subject to attribute reduction and Section 382. Alternatively, a distressed company in bankruptcy may seek to sell its assets under Section 363 of the Bankruptcy Code and enter an auction process. The tax characterization of a Section 363 transaction can take on various forms (e.g., tax-free, taxable stock, or taxable asset).

Conclusion

A fundamental question for most distressed companies is whether to attempt restructuring outside the provisions of the Bankruptcy Code or whether to seek the protections of the Bankruptcy Code by filing a Title 11 petition. Although tax may not be the driving force, it is important to understand the tax consequences of different workout and restructuring plans in order to fully assess potential alternatives. Preserving a corporation's tax attributes may prove to be valuable, especially for the future financial health of the corporation. A distressed corporation should carefully evaluate the tax issues identified in this article prior to creating a debt workout or restructuring plan.

Want to learn more?

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