Intersection of Tax Law and Bankruptcy Law

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Agenda

- Dischargeability of tax obligations in bankruptcy.
- Discharge of indebtedness income.
- Preserving tax attributes during bankruptcy.

Dischargeability of Tax Obligations in Bankruptcy

Jurisdiction of Bankruptcy Court

- Bankruptcy courts have jurisdiction to determine the amount or legality of any tax, fine, or penalty relating to a tax. Bankruptcy Code § 505(a).

- However, once the debtor's plan has been substantially consummated, the bankruptcy court will no longer hear tax issues related to that debtor.

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DEBT

Bankruptcy Overview

- The purpose of filing for bankruptcy protection is to discharge or reorganize one's debts.
- Ch. 7 – liquidation - debts are discharged once the window closes for objecting to discharge.
- Chs. 11, 12 & 13 – reorganization/payment plan - debts are discharged once the debtor completes all payments under the plan.

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Some tax obligations are dischargeable

- In the absence of fraud or evasion, the GENERAL RULE is that tax liabilities are dischargeable, provided a legitimate tax return, if required, was timely filed more than three years before the bankruptcy case commenced.

Some tax obligations are NOT dischargeable

- A debt for tax is excepted from discharge if it falls within one of the three categories set forth in § 523(a)(1) of the code:
  - Tax is entitled to priority.
  - Tax is related to a return that was never filed or was filed late and less than two years before commencement of the bankruptcy.
  - Tax involved a fraudulent return or a willful attempt to evade or defeat a tax.

Exceptions: Priority Taxes

- Types of taxes excepted from discharge:
  - Taxes on or measured by income or gross receipts.
  - Incurred property taxes.
  - Taxes required to be collected or withheld and for which the debtor is liable in any capacity.
  - Certain employment taxes.
  - Certain excise taxes.
  - Any penalty in compensation for actual pecuniary loss.

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Exceptions: Certain Returns 523(a)(1)(B)

- Excepts from discharge taxes relating to a return that the debtor was supposed to file but didn't, or filed as a late return, less than two years before bankruptcy case commenced.
- Returns prepared pursuant to 26 USC 6020(a) constitute legitimate returns and may be discharged.
- Section 6020(a) returns are those prepared by the IRS Commissioner with info from (and consent by) taxpayer.

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Exceptions: 523(a)(1)(B) (cont.)

- Returns filed on behalf of a taxpayer pursuant to 6020(b) do not constitute legitimate returns and may therefore NOT be discharged.

- 6020(b) returns are those prepared by the Commissioner without consent of or info from taxpayer OR taxpayer makes (willfully or otherwise) a false or fraudulent return.

- This simply means that a substitute return prepared by IRS is NOT a return for purposes of § 523 (a)(1)(B).

Exceptions: 523(a)(1)(C)

- Denies dischargeability of taxes relating to fraudulent returns or where debtor willfully attempted in any manner to evade or defeat such tax.
- It is immaterial when the fraud occurred.

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Exceptions: 523(a)(1)(C) (cont.)

- Bankruptcy Code does not define fraudulent return.
- Case law sets precedent that IRS bears burden of proving three elements with respect to a fraudulent return:
  1. Debtor's knowledge of falsity of return.
  2. Debtor's intent to evade the taxes.
  3. Underpayment of taxes.

Discharge of Indebtedness Income

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Discharge of Indebtedness Income

- IRC § 61(a)(12): "gross income" includes income from discharge of indebtedness.
- IRC § 108(a) sets forth two very important exceptions to Section 61:
  - Income from the discharge of indebtedness is generally **NOT** recognized in cases where discharge occurs in
    - context of debtor's bankruptcy OR
    - when debtor is insolvent.

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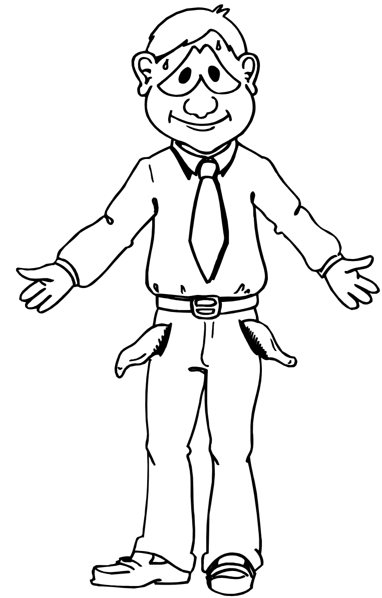
Discharge of Indebtedness Income



- IRC § 108(a) applies to cases under all different chapters (7, 11, 12 & 13).
- If the discharge occurs while taxpayer is insolvent, no income is recognized from the discharge. IRC § 108(a)(1)(B).
- The amount excluded from gross income due to taxpayer insolvency **CANNOT** exceed the amount by which the taxpayer is insolvent. IRC § 108(a)(3).

Side Note

- Bankruptcy Code defines "insolvency" as a financial condition where the sum of an entity's debts is **greater** than all of that entity's property "at a fair valuation."
- However, under IRC § 108(d)(3), "insolvent" is defined as the excess of liabilities over fair market value of assets immediately before the debt is discharged.
- Thus, IRC definition does not apply concepts of "fair value" or "fair market value" to liabilities.

Discharge of Indebtedness Income

- There is a string attached: as a tradeoff for not having to recognize income from discharge of indebtedness, Congress enacted § 108(b).
- Under § 108(b), the amount excluded from gross income must be applied to reduce tax attributes as set forth in § 108(b)(2).
- The reduction is applied to the income tax attributes of the subject debtor entity in the following order:

Discharge of Indebtedness Income

1. NOLs
2. General business tax credits
3. Minimum tax credits
4. Capital loss carryovers
5. Income tax basis reduction
6. Passive activity loss and credit carryovers
7. Foreign tax credit carryovers

Discharge of Indebtedness Income

- Under § 108(b)(3), the reduction of attributes is on a dollar-for-dollar basis **except** for reductions in credits and carryovers [2, 3, 6, & 7 on previous slide] which are reduced by 33⅓ cents for each dollar excluded from income.

Preserving Tax Attributes During Bankruptcy

This material is covered in the Bloomberg BNA Tax Management Portfolios, Volume 790-2nd.

Four significant events that could impair the debtor's tax attributes:

1. Greater than 50 % change of ownership.
2. Worthless stock deduction.
3. Use of attributes by profitable members of consolidated return group.
4. Acquisition of claims against debtor.

Greater than 50 % change of ownership

- IRC § 172 allows the deduction of net operating loss (NOL) carryovers and carrybacks.
- IRC § 382 places limits on the dollar value of NOLs that can be deducted.
- If a debtor corporation undergoes an ownership change as defined in § 382, it will only be able to use its NOLs at an annual rate equal to the value of the debtor's stock multiplied by the long-term tax-exempt bond rate.

Greater than 50 % change of ownership (cont.)

- The value of debtor's stock is likely to be quite small, which could cause the value of the NOLs to be worthless.
- For purposes of § 382, an ownership change occurs if the percentage of the debtor's stock that is owned by shareholders holding 5% or more of the company increased by more than 50% during the previous three years or since the last ownership change, whichever is more recent.

Greater than 50 % change of ownership (cont.)

- Results can be significant (and negative) for the debtor.
- *In re: Midway Games, Inc.*
  - On the eve of bankruptcy filing, majority shareholder sold stock in corporation for $100,000 which eliminated debtor/corporation's ability to use $700 million in NOLs.
  - Unsecured creditors' committee sued directors and priority shareholder on several grounds including breach of fiduciary duty, but the bankruptcy court dismissed claims, holding that majority shareholder owed no fiduciary duty.

Greater than 50 % change of ownership

- Practically speaking, it is hard to avoid an ownership change under § 382.
- Debtors often need new equity to survive and the new equity investors will inevitably demand a majority stake in the newly-reorganized entity, thereby triggering an ownership change.

Worthless Stock Deduction

- Under § 382(g)(4)(D), a change of ownership occurs when a shareholder with at least a 50% interest in the company treats his interest as worthless but retains ownership of the interest at the end of that reportedly worthless year.
- The shareholder is then treated as though he/she did not own the stock during the prior period but instead acquired the stock on the first day of the **following** period.

Worthless Stock Deduction (cont.)

- The shareholder thus becomes a “new” shareholder for the purposes of determining whether the § 382 limitations apply.
- 50% shareholder is any person owning 50% or more of the stock of the corporation at any time during the three year period ending on the last day of the taxable year in which that stock was treated as worthless.

Worthless Stock Deduction (cont.)

- So, even if the shareholder currently owns a small interest in corporation, if he/she owned 50% or more during previous three years, he/she is considered a "50% shareholder."
- However, just because a "50% shareholder" treats his/her stock as worthless does **not** mean there has been a § 382 "change of ownership."

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Worthless Stock Deduction (cont.)

Example:

- Shareholder owned 50% of stock within the last three years but now owns 10%.
- Shareholder treats stock as worthless in 2013, but still owns 10% at the end of the year.
- Shareholder is treated as though he/she acquired interest on January 1, 2014.

Use of Attributes by Profitable Members of Consolidated Return Group

- IRC § 1501 allows an affiliated group of corporations to file a consolidated return as long as all members of the group consent.
- If one or more members of the group files for bankruptcy, that member is still part of the affiliated group.
- The debtor's NOLs and other tax attributes may still be used by other (profitable) members of the group that are not in bankruptcy.

Use of Attributes by Profitable Members of Consolidated Return Group (cont.)

- Members of affiliated groups often enter into tax sharing agreements that spell out the economic expectations among the members regarding tax consequences of the combined return.
- Tax sharing agreements are executory contracts; if a member of the group files for bankruptcy, that member has the power to assume or reject the tax sharing agreement under § 365 of the Bankruptcy Code.

Use of Attributes by Profitable Members of Consolidated Return Group (cont.)

- If the member rejects the contract, the member will be deemed to have breached the tax sharing agreement immediately prior to the date of the bankruptcy filing.
- The other parties to the tax sharing agreement may have a claim for damages flowing from the breach/rejection, but their claim will be a general, unsecured claim.

Acquisition of Claims Against the Debtor

- § 382 of the IRC limits the ability to utilize NOLs that existed prior to a corporation's "ownership change" *(discussed a moment ago).*
- However, in chapter 11 cases debtor companies often pay off creditors by issuing new equity.
- This often triggers a § 382 ownership change to the extent the old equity is completely replaced.

Acquisition of Claims Against the Debtor (cont.)

- If debtor is insolvent, the § 382 limitation formula **will not** work. Debtor's stock is worth $0, and when multiplied by the long-term tax-exempt rate, that fails to yield a § 382 loss allowance.

- Thus, a bankrupt company would not be able to use **any** of its NOLs.

Acquisition of Claims Against the Debtor (cont.)

- Congress saw this and implemented § 382(l)(5) and (l)(6).
- Under § 382(l)(5), if a debtor company meets the requirements of that section, it is allowed to use **all** of its pre-change of ownership NOLs.

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Acquisition of Claims Against the Debtor (cont.)

- To qualify for unlimited use of NOLs under § 382(l)(5), the debtor corporation's pre-change shareholders and "qualified creditors" together must own 50% or more of FMV *and* voting power of debtor corp. immediately after change.
- Qualified creditors are those that either held the stock/debt for at least 18 months prior to bankruptcy or holds ordinary course of business debt.

Acquisition of Claims Against the Debtor (cont.)

- Section 382(l)(5) also carries two important caveats. First, debtor corp. must recalculate its NOLs as if it did not receive interest deductions the year of the change and the prior three years.

- Second, if debtor corp. experiences a second 382 ownership change within two years, the 382 limitation on second change is zero and debtor is prohibited from using *any* of its pre-change NOLs.

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Acquisition of Claims Against the Debtor (cont.)

- Under § 382(l)(6), an insolvent company is allowed to use its NOLs but its use is limited [as opposed to unlimited use under § 382(l)(5)].
- The valuation under (l)(6) is the **lesser** of:
  - The value of the corporation's **stock** immediately **after** the ownership change **OR**
  - The value of the corporation's **assets before** the change.

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Acquisition of Claims Against the Debtor (cont.)

- One additional requirement under § 382(l)(5) **and** § 382(l)(6):
- Continuity of Business Enterprise (“COBE”).
- The debtor corporation must either continue its historical business or use a significant portion of its pre-change assets in the new business.

Questions?

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