Tax Planning for Troubled Corporations

Bankruptcy and Nonbankruptcy Restructurings

Gordon D. Henderson
Stuart J. Goldring

2012

25th Anniversary Edition

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Highlights of the 2012 Edition

With updated material and expanded coverage, the 2012 Edition is thoroughly updated to account for all new developments that have occurred in this dynamic area of the law since publication of the past edition, including relevant legislation, important IRS rulings and regulations, and new case law.

New and revised discussions and tax planning strategies added to the book include information on the following:

- **IRS Finalizes Regulation Clarifying That Modification of Debt After the Financial Condition of the Debtor Has Deteriorated Will Not Cause the Obligation to Lose Its Status as Debt.** Since the issuance in 1996 of Reg. § 1.1001-3 governing debt modifications, there has been debated whether a debt obligation that undergoes a significant modification and, thus, is deemed reissued should take the interim financial deterioration of the debtor into account in determining whether the reissued obligation should more properly be considered stock for federal income tax purposes. Although Reg. § 1.1001-3(e)(5)(i) was apparently intended to disregard the interim financial deterioration as a factor, it clearly did not do so as a technical matter. Accordingly, in mid-2010, the IRS issued Prop. Reg. § 1.1001-3(f)(7) that, in most cases, would clarify that the interim financial deterioration would not cause the obligation to lose its classification as debt, unless there has been a change in obligor. This proposed regulation, with certain clarifying changes, was made final on January 7, 2011, with a provision stating that a taxpayer may rely on it before that date. See the discussion at § 402.12.

- **IRS Proposes Amendments to the Original Issue Discount Regulations to Clarify and Simplify the Determination of Whether, in a Debt-for-Debt Exchange, the Old or the New Debt Is Considered Publicly Traded.** When a company issues new debt in exchange for its old debt, the tax consequences of the exchange may depend on whether either the old or the new debt is considered to be publicly traded within the meaning of Code § 1273, in which case the tax consequence of the exchange will be governed by Code § 1273 rather than Code § 1274. Because of the frequently illiquid conditions of the markets for "public debt," whether the debt is "publicly traded" can be a source of uncertainty and controversy. On January 7, 2011, the IRS issued proposed amendments to the Code § 1273 regulations intended to clarify whether either the old or the new instrument in such an exchange is considered publicly traded. In general, the proposed regulation would make it more likely that debt with multiple holders as to which there have been purchases and sales would be considered publicly traded. See the discussion at § § 403.1.2 and 403.2.2.

- **IRS Proposes a Regulation to Clarify How the Cancellation of Debt (COD) Rules Should Be Applied When the Cancelled Debt Is Held by a Disregarded**

Entity. There has been uncertainty regarding how the rules of Code § 108, which sets forth the consequences of COD, should be applied where the discharged debt is debt that was issued by a disregarded entity or a grantor trust. In April of 2011, the IRS issued Prop. Reg. § 1.108-9, which provides that where debt issued by a disregarded entity or a grantor trust is cancelled, it is the owner of the disregarded entity or the grantor trust, and not the disregarded entity or grantor trust itself, that should be treated as the issuer of the debt for purposes of applying the provisions of Code § 108. See the discussion at § 404.

- **IRS Continues Liberal Policy of Approving Same-Year Rescissions.** A new discussion has been added to the book that addresses the importance of the authorities governing the treatment of rescissions for tax purposes. See the discussions at §§ 410, 513 and 610.

- **Delaware Supreme Court Affirms Validity of Poison Pill for Protection Against Code § 382 Ownership Change.** The Delaware Supreme Court, in *Versata Enterprises, Inc. v. Selectica, Inc.*, affirmed the important opinion of the Delaware Court of Chancery upholding the validity of a poison pill plan adopted to prevent a Code § 382 problem. See the discussion at § 508.2.3.1.

- **IRS Issues Proposed Regulations to Alter Consolidated Code § 382 Treatment of Member Stock for Net Built-in Gain or Loss Purposes.** Since their adoption, the consolidated Code § 382 regulations have excluded from the computation of a loss group's net built-in gain or loss the stock of a member that is part of the loss group, but treated a subsequent disposition of the stock similar to a disposition of any other built-in gain or loss asset. This exclusion of member stock from the determination of net built-in gain or loss can be beneficial or detrimental depending on the circumstances. In October 2011, the IRS proposed an amendment to the regulations that would, on a springing basis immediately prior to the sale of the member stock, adjust the group's net built-in gain of loss by the amount of any "unduplicated" built-in gain or loss with respect to the stock (computed as of the date of the group's Code § 382 ownership change). See the discussion at § 508.7.2.

- **IRS Rules That the Special Code § 382 Bankruptcy Rules Can Apply to the Entire Consolidated Group Where the Common Parent Is in Bankruptcy.** The consolidated return regulations do not address the special Code § 382 limitation rules for companies in bankruptcy, which are contained in Code §§ 382(l)(5) and 382(l)(6). Despite the absence of regulations, and in a first of its kind ruling, the IRS has ruled, in a case involving a bankruptcy reorganization of *only* the common parent of a consolidated group, that Code §§ 382(l)(5) and 382(l)(6)—whichever of the two is applicable—could be applied with respect to the entire consolidated group. This made the entire group's attributes essentially available for the benefits of Code §§ 382(l)(5) and 382(l)(6). See the discussion at § 508.7.7.

- **Tax Court Holds Continuity of Interest Requirement Not Satisfied with Respect to Bankruptcy Restructuring in a Poorly Reasoned Opinion.** In *Ralphs Grocery Co. v. Commissioner*, the Tax Court held that a bankruptcy restructuring did not qualify as a tax-free reorganization because the continuity of interest requirement was not satisfied. The court's analysis, however, was flawed,

particularly as it would mean that continuity of interest would be lacking in most bankruptcy reorganizations. See the discussion at § 709.

- **Courts Consider the Pre- Versus Postpetition Status of Tax Refunds From Retroactive Changes in Law, With Differing Results.** In recent years, Congress has on a number of occasions enacted legislation that retroactively entitles taxpayers to a refund of prior year taxes. For corporations, the latest major legislation of this sort was the extended five-year carryback electively permitted by Congress for 2008 net operating losses (NOLs), or alternatively 2009 NOLs. Not surprisingly, in some instances the taxpayer's bankruptcy filing intervenes, such that the legislation occurs postpetition and the taxes were paid prepetition. Some of the courts considering the pre-versus postpetition status of the resulting tax refund allocated the refund based on the effective date of the enacting legislation, while others gave retroactive effect to the legislation and looked at the facts and circumstances.

  In addition to taking a facts and circumstances approach, an Arizona bankruptcy court also indicated that, in the case of a tax refund resulting from a filing year NOL carryback, no portion of the refund would be allocable to the postpetition period if as of the date of the bankruptcy filing sufficient losses had been incurred to generate the refund, even though additional losses continued to be incurred during the remainder of the taxable year. See the discussion at § 1006.1.1.

- **Tax Court Finds That Reasonable Cause Existed for a Corporation's Failure to Timely Remit Withholding Taxes.** Due to Hurricane Ivan, a construction company failed to timely remit its withholding taxes for the periods shortly thereafter. For subsequent periods, the company diligently remitted the proper amount of withholding, along with additional amounts toward the payment of the earlier taxes. The company failed to allocate the deposited amounts to the current periods, however, with only any excess amounts toward the earlier unpaid taxes. As a result, the IRS treated all amounts as paying the earlier taxes, causing the more current taxes to be unpaid and the imposition of additional penalties. It therefore appeared that the company was continuously in arrears. The IRS denied the company's request for relief from all penalties. The Tax Court, however, examined the totality of the circumstances and the company's efforts to pay all of its taxes (which it ultimately did), and held that the company qualified for the reasonable cause exception to the imposition of penalties. See the discussion at § 1006.1.2.

- **District Court Holds That IRS Does Not Have an Affirmative Duty to Ensure That a Debtor's Withholding Taxes Are Paid.** In the *M&S Grading, Inc.* bankruptcy case, the IRS proactively obtained a court-approved stipulation with the debtor and its secured creditor providing for the deposit of ongoing payroll taxes into a separate account that would not be subject to the lien of the secured creditor. However, the IRS apparently failed to monitor compliance with the stipulation, with the result that the debtor's funds remained in its general operating account and were subsequently seized by the secured creditor. The IRS therefore continued to have an administrative claim against the estate to the detriment of the debtor's unsecured creditors. Certain of the creditors (namely,

the debtor's multi-employer health and pension plans) therefore sought to have the IRS's continuing claim equitably subordinated. The district court affirmed the bankruptcy court's denial of relief, holding that the creditors were not intended third-party beneficiaries of the stipulation and that the IRS did not have an affirmative (or fiduciary) duty to ensure that the debtor's withholding taxes were paid. See the discussion at § 1006.3.

- **Tax Court Upholds IRS Imposition of Tax Lien Against Assets in a Receivership Proceeding.** In contrast to a bankruptcy case, the IRS is generally not stayed from imposing a tax lien against assets that are the subject of a receivership proceeding. In a recent decision, the Tax Court upheld the IRS's filing of a tax lien where the lien did not impair the receiver's right to control, and the receiver's access to, the property. See the discussion at § 1007.3.

- **Bankruptcy Court Holds IRS to the Classification of Its Claim as a Secured Claim.** In an amended proof of claim, the IRS asserted that all amounts owed it were fully secured. The debtor did not object to the classification of the claim as a secured claim and, in its confirmed plan, provided for the transfer of the debtor's property (or the net proceeds thereof) to the IRS, with an agreed carve-out for general unsecured creditors. As it turned out, the underlying assets were only worth a small fraction of the tax owing. The IRS therefore sought to have the excess portion of the tax owing characterized as an unsecured claim. The bankruptcy court denied the IRS's request, emphasizing the importance of the bankruptcy trustee and other creditors being able to rely on a claim as filed, absent a party in interest objecting to the claim. See the discussion at § 1010.

- **A Bankruptcy Turnover Action for Asserted Refunds Cannot Preempt the Tax Refund Process.** Both the Tenth Circuit Court of Appeals, in a decision involving a turnover action brought by the trustee of two individual bankruptcy estates against the individual debtors with respect to pending refund claims, and the IRS, in a Chief Counsel Advice discussing the propriety of turnover actions against the IRS for claimed refunds, concluded that a turnover action was premature and inappropriate where the IRS had not yet determined that an overpayment and, therefore, a refund existed. See the discussion at § 1012.2.

- **Ninth Circuit Allows IRS to Pursue a Reorganized Debtor's Officers for Unpaid Withholding Taxes Despite a Chapter 11 Plan Injunction.** Even though the reorganized debtor was in compliance with the provisions of its Chapter 11 plan, which provided for the full payment in installments of all unpaid withholding taxes, the IRS sought the prompt collection of the withholding taxes from the debtors' officers. The debtor asserted that the IRS's actions violated the injunction provisions of the Chapter 11 plan, and brought an action to hold the IRS in contempt. The IRS had neither objected to the confirmation of the plan nor appealed the confirmation order. The Ninth Circuit Court of Appeals held (as had the bankruptcy court and the Bankruptcy Appellate Panel) that the bankruptcy court lacked the jurisdiction to enforce the plan injunction against the IRS due to the Anti-Injunction Act. See the discussion at § 1014.

- **Subrogated Tax Claim Continues to Be Entitled to Non-Bankruptcy Interest Rate.** In a bankruptcy case involving a transferee of an *ad valorem* tax claim, the

bankruptcy court considered the status of the transferred tax claim for purposes of determining the applicable rate of interest to be accrued on the claim following the effective date of the Chapter 11 plan. where the plan provided for the claim to be paid in installments. The Fifth Circuit Court of Appeals held that the transferred claim retained its status as a "tax claim" under section 511 of the Bankruptcy Code, which requires the use of the applicable non-bankruptcy (i.e., deficiency) rate of interest wherever the Bankruptcy Code requires the payment of interest on a tax claim. See the discussion at §§ 1015.3 and 1102.13.2.

- **Bankruptcy Court Declares New Hampshire Property Tax Delinquency and Lien Notices in Violation of the Automatic Stay.** In a decision that ultimately impacts all the cities and towns in the State of New Hampshire, a New Hampshire bankruptcy court concluded that the standard "Notice of Tax Delinquencies on Unredeemed Tax Liens" and "Notice of Impending Tax Lien" issued by two towns in New Hampshire violated the automatic stay. Although certain actions are statutorily exempt from the automatic stay with respect to the perfection of liens for property taxes, the notices demanded the payment of taxes from the debtors even though such demand was not necessary under state law for the perfection of the tax lien. Recognizing that its decision could have far-reaching effects within New Hampshire, the bankruptcy court indicated that it would only apply its ruling on a prospective basis with respect to other bankruptcy cases. See the discussion at § 1102.7.

- **Bankruptcy Courts Split as to Time Period Within Which a Property Tax Action May Be Brought Before the Bankruptcy Court.** Bankruptcy Code section 505(a)(2)(C) provides that a bankruptcy court action with respect to the determination of an *ad valorem* tax can only be brought within the period for contesting or redetermining such tax under applicable non-bankruptcy law. Meanwhile, ordinarily, under Bankruptcy Code section 108, when an action can be commenced as of the filing of the bankruptcy case, the time period for bringing the action is extended for a specified period. In 2010, in a case of first impression, a Texas bankruptcy court held that such an extension of time was inapplicable to Bankruptcy Code section 505(a)(2)(C). In a 2011 decision, however, a Florida bankruptcy court disagreed, concluding that the limited extension of time was consistent with the purposes and language of the two sections. See the discussion at § 1102.11.

- **Illinois Challenges Application of Bankruptcy Code Stock-for-Debt Exception to COD Income.** More than eight years after confirmation of Kmart Corporation's Chapter 11 plan, Kmart and the Illinois Dept. of Revenue are still debating the application of the equity-security-for-debt exception in Bankruptcy Code section 346, as in effect prior to the 2005 bankruptcy reforms (which brought section 346 into closer conformity with the federal tax treatment of COD). For federal income tax purposes, the stock-for-debt exception was repealed in 1993. Despite a retention of jurisdiction provision in Kmart's plan, the bankruptcy court has tentatively concluded that it does not have subject matter jurisdiction under the Bankruptcy Code to consider the postconfirmation dispute. See the discussions at §§ 1013, 1102.17 and 1103.2.2.

- **IRS Issues Two Significant Rulings Regarding Liquidating Bankruptcies.** The rulings involved the transfer of the assets of the debtor corporation to its creditor(s), which are then transferred to a new entity—in one case, a partnership, and in the other, a corporation. The rulings respect the form of the transactions and, thus, in the latter, did not treat the transaction as a "G" reorganization. The first ruling concludes, after lengthy consideration, that Code §267 would not disallow the debtor's loss on the transfer of its assets. The other also holds that the debtor could deduct the losses from the transfer of its assets and, among other things, that although the debtor had to capitalize its bankruptcy expenses until the date of its liquidation, it could deduct them at that date. See the discussion at §1201.
- **IRS Issues Revenue Procedure Giving Taxpayers the Option to Deduct 70 Percent of "Success-Based" Contingent Fees, Rather Than Having to Capitalize Them.** The IRS had issued Reg. §1.263(a)-5 in 2004 to limit the amount of overhead expenses that might otherwise be thought to be required to be capitalized by the overly broad language of the Supreme Court's opinion in *INDOPCO, Inc. v. Commissioner*. However, the regulation did not extend its limitation to fees that are contingent on the successful closing of the transaction, i.e. "success-based" fees, except to the extent the taxpayer maintains sufficient documentation to establish that a portion of the fee is allocable to activities that do not facilitate the transaction. Because this provision had become the source of considerable controversy between taxpayers and the IRS, the IRS in 2011 issued Rev. Proc. 2011-29, which gives the taxpayer the right—for "success-based" fees paid or incurred in taxable years ending on or after April 8, 2011—to elect to treat 70 percent of the fee as an amount that does not facilitate the transaction, and 30 percent as an amount that does facilitate the transaction. See the discussion at §1301.

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About the Authors

Gordon D. Henderson has been a partner, and is now of counsel, in the law firm of Weil, Gotshal & Manges LLP in New York City. He received his A.B. degree *magna cum laude* from Harvard College in 1951, where he was elected to Phi Beta Kappa, and his J.D. degree *magna cum laude* from Harvard Law School in 1957, where he was an editor of the *Harvard Law Review*. He has had extensive experience in major bankruptcy cases extending over 25 years. He has Chaired the Tax Section of the New York State Bar Association, the Committee on Corporation Law of the Association of the Bar of the City of New York, and the Policy Advisory Group for the New York Joint Legislative Commission to Study the New York State Tax Laws. He has been a member of the New York City Tax Study Commission. He has been a visiting lecturer on corporation tax law at Yale Law School and has been a frequent speaker at tax institutes and a writer of numerous articles on tax subjects. He served as Special Counsel to the SEC and Associate Director of one of its divisions during the Kennedy Administration. He has also been a member of the Little, Brown Tax Practice Advisory Board.

Stuart J. Goldring is a partner in the law firm of Weil, Gotshal & Manges LLP in New York City. He received a bachelor's in Business Administration degree with high distinction from the University of Michigan in 1979 and graduated *magna cum laude* from the University of Michigan Law School in 1982, where he was elected to the Order of the Coif. He also received an LL.M. in Taxation from the New York University School of Law, where he was a Graduate Editor of the *Tax Law Review*. He has extensive experience in advising debtors, creditors, and potential acquirers and investors in troubled companies, spanning over 25 years. He serves on the Executive Committee of the Tax Section of the New York State Bar Association and is Co-Chairman of the Committee on Bankruptcy and Losses. He also served on the former Tax Council of the Association of the Bar of the City of New York, and chaired a special subcommittee of the Tax Council and the Committee on Bankruptcy and Corporate Reorganization with respect to tax-related proposals of the National Bankruptcy Review Commission. He is also a member of the Tax Section of the American Bar Association. He is an adjunct professor of law at New York University Law School on *Bankruptcy Tax*, is a frequent speaker at tax institutes, and has published numerous articles on tax issues relating to financially troubled companies. He is also a member of the Corporate Tax and Business Planning Advisory Board for *Tax Management*.

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Introduction: Dealing with the Troubled Corporation

Businesses begin with optimism. Some succeed beyond their dreams. Some meet projections. Some do less well than had been hoped. More than a few—occasionally after many years of success—become failing businesses whose survival is threatened. Some failing businesses can be reorganized and turned into survivors. Others will end up as failed businesses that must be liquidated.

This volume is about failing and failed businesses. A failing business is one whose cash flow becomes insufficient to meet its cash obligations. Indeed, the fundamental problem facing every failing business is the need to reduce its cash obligations. Cash obligations include obligations to pay wages to employees; to pay employment and withholding taxes on such wages; to pay trade creditors for such items as inventory, supplies, utilities, and rent; to purchase capital plant and equipment; and to pay interest and principal on short- and long-term debt.

A failing business will try to solve its cash flow problems initially by cutting operating expenses. If this does not solve the problem, more drastic steps will be taken. The enterprise may consider selling some of its assets to provide funds to pay down debt, thereby shrinking its business. The enterprise may consider asking its various creditors to restructure its debt, perhaps by stretching out due dates for payments of principal and interest or by reducing the amount of principal and interest payable on the debt or by converting debt into equity.

Failing businesses will usually have generated significant net operating losses (NOLs) and, perhaps, various tax credit carryovers. These are valuable assets. Maximizing their use will be an important element of the business plan for the company. Sometimes, perhaps after shrinking its failing business by selling off assets, a failing company may decide to buy an existing successful business whose income can be sheltered for a time by the NOLs and credit carryovers generated by the failing business. Or, instead of being the buyer, the failing company may become a target for a successful company, whose owners see possibilities in combining the two businesses.

A basic question faced by every failing business is whether restructuring the company in one or more of the above ways will be practicable from a business and tax point of view without resorting to proceedings under the Bankruptcy Code, or whether, instead, the business will have to resort to the Chapter 11 reorganization provisions of the Bankruptcy Code.

If restructuring the company—whether within or without a Bankruptcy Code proceeding—does not prove feasible, the company will have to be liquidated. A liquidation, like a restructuring, can occur by consent, without resort to the Bank-

ruptcy Code, or by a liquidating bankruptcy proceeding under Chapter 7, or possibly Chapter 11, of the Bankruptcy Code.

At the same time as company management is deciding on a strategy, the company's creditors and stockholders should be doing their own strategic thinking, keeping in mind the consequences to themselves. Because the various classes of creditors and shareholders will usually have conflicting tax and nontax interests, resolving these conflicts becomes the main problem to be solved in the restructuring process, once a business plan for the survival of the business operation has been developed.

This volume will describe the various transactions that may typically take place in the effort to deal with a failing or failed business and will focus on their tax consequences to the company and its various classes of creditors and shareholders. It will be limited to corporate businesses and will not cover proprietorships or partnerships.

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