

Top 10 Tips when Dealing with Taxes

By

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I. Introduction¹

In developing a restructuring plan for a business in bankruptcy, it is important to consider the potential for: (i) cash income taxes in the restructuring or following emergence from bankruptcy; and/or (ii) the preservation of favorable tax attributes. The Internal Revenue Code (the “**Code**”) provisions affecting the U.S. federal income tax consequences of a bankruptcy restructuring frequently offer the business several structural alternatives and U.S. federal income tax elections that can affect both the potential for cash taxes and the preservation of favorable tax attributes.² A quantitative analysis of these choices is often necessary because the best path to minimizing the net present value of the cash taxes and maximizing the value of the tax attributes of the restructured business is not intuitive. In addition, this analysis is important to demonstrate the relative value of these choices to a variety of stakeholders in the development of the bankruptcy plan. The most significant factors affecting this analysis are identified below.

II. Cancellation of Debt Income

A. Section 108 – In General

- 1. Inclusion of CODI in Gross Income.** Pursuant to section 61(a)(12), a taxpayer is generally required to include in gross income cancellation of debt income (“**CODI**”) to the extent its indebtedness is cancelled, satisfied, or repurchased for less than its adjusted issue price. However, pursuant to section 108, a taxpayer generally may exclude the CODI from its gross income if such taxpayer is in bankruptcy or is insolvent. In that case, the taxpayer is required to reduce its tax attributes such that the exclusion of the CODI from gross income is more in the nature of a deferral rather than a forgiveness of tax on the CODI.
- 2. Bankruptcy and Insolvency Exclusions**
 - a. Bankruptcy Exclusion.** Under section 108(a)(1), CODI is excluded from gross income if the discharge occurs in a “Title 11 case” and the discharge is “granted by the court” or “pursuant to a plan approved by the court” (the “**Bankruptcy Exclusion**”).³ As noted below, these requirements may create issues in the context of a discharge of partnership debt where the partnership and not the partners are in bankruptcy, and in the context of a discharge of debt of an entity that is disregarded as separate from its owner for U.S. federal income tax purposes (a “**DRE**”) where the DRE is in bankruptcy and its owner is not.
 - b. Insolvency Exclusion.** Under section 108(a)(3), the amount of CODI that an insolvent taxpayer may exclude under section 108 is limited to the amount of the

¹ Special thanks to Alexandra West for her assistance with the preparation of this outline.

² Unless otherwise indicated, all “**section**” references are to the United States (“**U.S.**”) Internal Revenue Code of 1986, as amended (the **Code**), and all “**Reg. §.**,” “**Prop. Reg. §.**,” and “**Temp. Reg. §.**” references are to the regulations promulgated thereunder by the U.S. Department of the Treasury (“**Treasury**”) and the Internal Revenue Service (the “**IRS**”), as in effect through the date of this outline.

³ Section 108(d)(2).

taxpayer's insolvency immediately before the discharge (the “**Insolvency Exclusion**”).

- i. **Insolvency Exclusion.** Under section 108(d)(3), insolvency “means the excess of liabilities over the fair market value of assets. ... [T]he amount by which a taxpayer is insolvent, shall be determined on the basis of the taxpayer’s assets and liabilities immediately before the discharge.”
 - (1) The insolvency exception gives rise to significant factual issues. In a theoretical arm’s-length transaction, a creditor will rarely forgive more debt than the portion by which the debtor is insolvent. However, there are times when a creditor may decide not to take the debtor’s “last dollar.” Consequently, if the taxpayer decides to rely on the insolvency exception and not file for bankruptcy in connection with a debt restructuring, there is often risk that taxable income and potentially cash tax liability may result. Accordingly, this may encourage a taxpayer to restructure its indebtedness in bankruptcy court.
 - (a) The valuation issue in proving insolvency may be less difficult when the debtor’s debt is traded on an established securities market. The courts and IRS both have recognized that a property’s public-trading price is the best indicator of its value.⁴ Thus, for example, if corporate debt is trading at a significant discount to par value, then the debtor may have a strong argument supporting insolvency.⁵ In contrast, the valuation issue may be made more difficult when the debtor’s stock is traded on an established securities market at more than a nominal amount.
- ii. **Nonrecourse Debt.** Special rules apply to determine insolvency in situations involving nonrecourse debt.
 - (1) Under Rev. Rul. 92-53, nonrecourse debt that exceeds the fair market value of the property securing the debt is only taken into account in determining the amount of the taxpayer’s insolvency to the extent that

⁴ See Reg. § 1.2031-2(b)(1) (“[I]f there is a market for stocks or bonds, on a stock exchange, in an over-the-counter market, or otherwise, the mean between the highest and lowest quoted selling prices on the valuation date is the fair market value per share or bond.”)

⁵ Courts have recognized that the public trading price of debt is the best available evidence to forecast cancellation of indebtedness income. See *In re UAL*, 412 F.3d 775, 777-78 (7th Cir. 2005) (“today’s price is the best estimate of the value of future events”); *Objection of American Real Estate Holdings Limited Partnership to Debtors’ Motion for Orders Establishing Procedures For Trading In Claims and Equity Securities*, *In re Dana Corporation*, No. 06-10354, at page 13 (public trading price of bonds “is the best available” evidence of CODI).

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