



AMERICAN
BANKRUPTCY
INSTITUTE

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The Clash of the Codes: Cancellation of Debt and Tax Strategies to Preserve Value

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David Plastino



David Plastino is a Principal at The Brattle Group, based in Boston. He is the Practice Leader of Brattle's Bankruptcy & Restructuring practice, and co-leads the firm's Tax Controversy and Transfer Pricing practice. He specializes in transaction advisory and litigation services relating to bankruptcy, restructuring and tax issues.

David has over 25 years of experience in finance, with 20 of those as a consultant. He has particular experience in valuation, credit analysis, and complex financial modeling. His work regularly includes economic assessments of highly leveraged or distressed companies, hard to value assets, and intercompany arrangements. In addition to acting as an testifying expert witness, David assists in the out-of-court negotiation and settlement of tax and bankruptcy issues, provides guidance in the structuring and documentation of transactions for tax purposes, and advises management and corporate boards on strategic alternatives.

David has an MBA and a MS in Information Systems from Boston University. He is also a Certified Public Accountant (CPA) and Accredited in Business Valuation (ABV) by the AICPA. He is a Lecturer at Boston University's Questrom School of Business where he teaches a graduate-level course in corporate financial management.



Howard Steinberg



Howard Steinberg is a Managing Director and Global Head of Tax Restructuring within Houlihan Lokey's Financial Advisory business.

Howard has more than three decades of experience on the consulting and client sides. He has advised numerous debtor companies, creditors and acquirors of distressed assets and has advised on many of the largest and most complex US bankruptcies. He served as an expert witness in the Toys R Us bankruptcy.

Howard most recently had been the Global Head of Restructuring, Tax and Legal, for KPMG International. He previously served as the Partner in Charge of M&A Tax for KPMG US.

Howard holds a B.A. from The Wharton School of the University of Pennsylvania and an MBA with distinction from Columbia University. He is also a licensed CPA in New York and a Certified Insolvency and Restructuring Advisor (CIRA). He is a frequent speaker at industry functions and has been a guest lecturer at Georgetown University Law Center.



Virginia L. Tate, CFE/CIRA/EA



President
FAI International

Virginia Tate is the president of FAI International – Forensic Accounting & Investigations, a division of the EP Global Corporation. Virginia heads up the Tax, Accounting and Forensic Division which focuses on Litigation Support, Taxation and Financial Investigation with clientele throughout the world.

Virginia is a *Certified Fraud Examiner*, a *Certified Insolvency and Restructuring Accountant* and an *Enrolled Agent* licensed by the US Treasury with extensive professional development and training in fraud, damages/loss calculations and financial investigations. Virginia is a member of the American Bankruptcy Institute, serving as chair emeritus of the ABI's Commercial Fraud Committee

and serves on their Litigation and Taxation Committees. Regular speaking engagements include continuing professional education providers such as the Association of Certified Fraud Examiners, National Business Institute, Association of Insolvency & Restructuring Advisors, American Bankruptcy Institute, Chambers of Commerce, CPA Societies, televised crime documentaries and investigation series as well as exclusive presentations in private industry and non-profit sectors.



The Insolvency Exception Under IRC 108

COD may be excluded from income up to the amount by which the borrower is insolvent. Generally this issue comes up in out-of-court restructurings. A borrower that has filed for Chapter 11 protection is assumed to be insolvent under IRC 108.

In assessing solvency for the purposes of the IRC 108 exception, the balance sheet test applies. In other words, inability to pay debts or lack of adequate capital is not a consideration.

It is the solvency of the borrower that matters, not of the consolidated group.

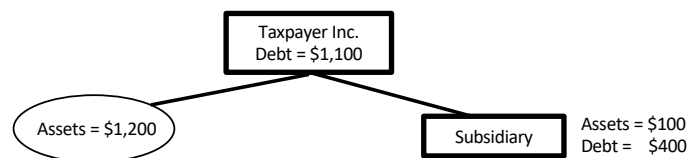
- In its simplest form, is the assets and liabilities of the borrower that matter.
- Analyzing and valuing a single member of an integrated corporate group presents certain technical challenges. For example, the borrower may have no standalone financial projections, or may have significant intercompany payables and receivables.

Things get complicated when the legal borrower is a Disregarded Entity (DRE) for tax purposes – e.g. in the eyes of the internal revenue code, your borrower does not exist.

- Treasury Reg. 1.108-9 states that the insolvency exception must be analyzed by looking at the tax recognized owner of a DRE borrower, rather than the DRE itself.



Insolvency Exception Under IRC 108 (cont.)



Is Taxpayer Inc. solvent or insolvent for the purposes of the insolvency exception under IRC 108?

Both economic and legal analysis may be required to answer this seemingly simple question.

Any such answer will depend on the facts and circumstances, including: Is Subsidiary a DRE? Is Subsidiary's debt recourse to Taxpayer, Inc.? Are the businesses interdependent, such that the value of the Assets is dependent on services provided by Subsidiary?



Analysis of Debt Modifications

Under Treasury Reg 1.1001-3, modification of an existing debt is “significant” if the legal rights or obligations are altered in a way that is economically significant.

A determination of “significance” can be impacted by changes to both legal and economic provisions of the instrument. The regulations specifically address:

- Change in yield
- Change in payment timing
- Change in the obligor or the security
- Change in the nature of the instrument
- Change in covenants

Despite this additional specific guidance, considerable judgment is required in determining whether modifications are significant. The combination of two or more modifications which are not significant on their own, may result in a determination that a significant modification has occurred.

If a modification is deemed to be a significant modification, the existing debt is deemed to be exchanged for debt with the new terms, resulting in a gain or loss. To compute this gain/loss, the modified debt instrument must be valued and compared to the adjusted tax basis of pre-existing debt.



Adjustment of Tax Attributes Due to Debt Discharge

The Internal Revenue Code mandates the reduction of tax attributes in the following order:

1. Net Operating Loss
2. General Tax Credit Carryovers
3. Alternative Minimum Tax Credits
4. Capital Loss
5. Cost Basis of Owned Property
6. Passive Activity Loss
7. Foreign Tax Credit Carryover.

After all named attributes are reduced to zero, any remaining amount of discharge is treated as forgiven. Note that disallowed interest deductions under IRC 163(j) are not enumerated as an attribute to be reduced.

Accurate valuation of the gain resulting from a debt discharge or modification is required to accurately identify and reduce impacted attributes.



Alternatives for a Debtor in a Title 11 Case

No ownership change occurs pursuant to plan	➡	Neither 382(1)(5) nor (1)(6) applies
Ownership change but does not qualify for (1)(5)	➡	(1)(6) applied by default
Ownership change qualifies for (1)(5)	➡	(1)(5) applies
Ownership change qualifies for (1)(5) but (1)(6) is better	➡	(1)(6) will be applied provided the Debtor makes a timely election not to apply (1)(5)



Bankruptcy Exception: Section 382(1)(5)

Qualifying ownership change pursuant to a plan of reorganization approved by a bankruptcy court in a Title 11 case does not result in a limitation of prechange NOLs and certain other tax attributes

- Cost of Section 382(1)(5):
 - Potential NOL Reduction: Interest paid in (i) any taxable year ending during the three year period preceding the tax year of the change and (ii) the prechange portion of the change year
 - Potential Zero 382 Limitation: If there is a subsequent ownership change within two years, resulting limitation is zero.



Bankruptcy Exception: Section 382(1)(5) (cont.)

Qualifying ownership

- 50% or more of the loss company is owned by former shareholders or qualified creditors immediately following the ownership change, and is owned as a result of such former shareholder or creditor status
 - Qualified creditors
 - Ordinary course of business
 - Old and cold creditors (18 months)
 - Presumptions
 - Options



Bankruptcy Exception: Section 382(1)(5) (cont.)

Qualified creditors

- **Ordinary course** - The indebtedness is incurred by the loss corporation in connection with the normal, usual, or customary conduct of business, determined without regard to whether the indebtedness funds ordinary or capital expenditures of the loss corporation and has been owned at all times by the same beneficial owner.
- Examples provided in the regulations include, trade debt, a tax liability, a liability arising from a past or present employment, supplier, customer or competitor relationship, a tort, or indebtedness incurred to pay an expense deductible under Section 162 or included in cost of goods sold.
- Exception for indebtedness acquired for a principal purpose of being exchanged for stock of the loss corporation.



Bankruptcy Exception: Section 382(1)(5) (cont.)

Qualified creditors (cont.)

- **Old and cold** – The indebtedness has been owned by the same beneficial owner since the date that is 18 months before the date of the filing of the Title 11 or similar case.
- A loss corporation may treat indebtedness as always having been owned by the beneficial owner of the indebtedness immediately before the ownership change if the beneficial owner is not, immediately after the ownership change, a 5% shareholder, as long as such indebtedness was not owned by a person whose participation in formulating a plan of reorganization makes evident to the loss corporation that the person has not owned the indebtedness for the requisite 18 month period.
- Certain transfers of the indebtedness are permitted, e.g., between related parties.
- Exception for a transfer of indebtedness acquired for a principal purpose of benefiting from the losses of the loss corporation by exchanging the indebtedness for stock of the loss corporation pursuant to the Title 11 or similar case.



Bankruptcy Exception: Section 382(1)(6)

Ownership change pursuant to a plan of reorganization approved by a bankruptcy court in a Title 11 case results in a limitation based on the lesser of:

Value of Pre-Change Assets




- Without regard to liabilities
- No reduction for corporate contraction
- Reduction for capital contributions within two years
- Reduction for substantial nonbusiness assets

Value of Post-Change Assets

- Cannot exceed value of cash and other property received in consideration for stock issuance
- Reduction for corporate contractions
- No reduction for capital contributions unless abusive
- Reduction for substantial non-business assets



Regular Section 382 versus Bankruptcy Exceptions

Regular	Section 382(1)(5)	Section 382(1)(6)
Ownership change	Qualifying ownership change in Title 11 case	Ownership change by election or default in a Title 11 case
		
<ul style="list-style-type: none"> Annual limitation based on prechange stock value subject to adjustments 	<ul style="list-style-type: none"> No limitation Reduction to prechange NOLs Zero limitation if an ownership occurs within two years 	<ul style="list-style-type: none"> Annual limitation based on lesser of prechange asset value or postchange stock value



The IRS - Real World Transactions and Resolutions

- The IRS is still Working From Home.
- Multiple Complaints filed with US Congressman daily.
- Congressman on Finance Committee stating that the IRS refuses to divulge how the 80,000 agents have been assigned.
- On March 17, 2023, the IRS posted the following notice on their E-News publication:

"Professional responsibility and the Employee Retention Credit: The IRS warns employers to beware of third parties promoting improper Employee Retention Credit (ERC) claims. With the filing season underway, the IRS is providing guidance to ensure tax professionals are meeting their Circular 230 professional responsibilities and the standards required to prepare and sign original tax returns, amended returns or claims for refunds relating to the credits. The IRS urges filers to carefully review the ERC guidelines before trying to claim the credit as promoters continue pushing ineligible people to file."



Client's Imaginative Tax Returns & Financial Statements...

Glimpses from the Individual/Small Business Bankruptcy

- Lies, Damn Lies and.....Financial Statements written for specific purposes require thorough understanding of how and why a particular statement is utilized.
- Previous Tax Strategies Causing Recapture Pain that are often not recognizable to debtor.
- Fraudulent or misstated financial statements take time to sort through, give your financial expert time to get this sorted through.
- Smaller banks have relaxed formal financial statements due to cost and lack of available licensed accountants.
- Real Estate Values causing pain in loan to value ratios.



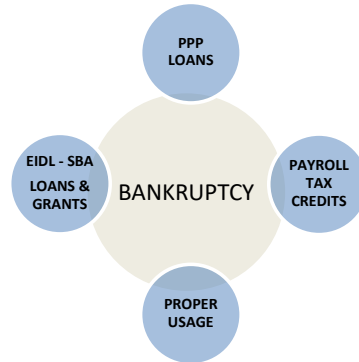
Not My Circus but the Monkeys May Appear in Court..





PPP – EIDL BANKRUPTCY CONCERNS

- Owners do NOT guarantee PPP loans
- PPP No Collateral – Non-Recourse Loans
- EIDL Requires Collateral and Physical Presence
- Lack of Real Estate Collateral requires borrowers to pledge Available Assets



PPP – EIDL BANKRUPTCY CONCERNS

- 20% Owners Must Certify PPP Applications
 - What does Certify Mean?
 - Can Owner/Officer wages/draws/distributions be clawed back?
- Cares Act Payroll Retention Tax Credits and Payroll Delayed Deposit programs adversely affect PPP and EIDL loans.
- SBA regulations require misused funds to be repaid at once
 - Does the SBA have a priority claim?
- Is the obligation to return misused funds dischargeable?
- Misused funds paid to owner or officers – the SBA suggests that it might pursue those funds directly.
 - Does the estate have also claim for those?
 - Does the SBA have a priority interest in estate's recovery?



World Economics Impact Value At Every Level

- SEC Continues Streak of Enforcement Actions BKCoin for Alleged \$100MFraud
- Pandemic Food Schemes
- PPP/EIDL Audits
- Home/Commercial Real Estate Values
- WFH Impacts to Value of Properties
- Work from Home and Real Estate Agent Fever phenomena cycle of employability in a the post-covid era.
- Employee Migration Impacts
- Generational Work Product Impact
- Fraud Brings Challenges
 - Ownership of assets is uncertain and the tax implications
 - Core contractual relationships may not be enforceable or even real
 - Records do not match reality – if they exist at all
 - Money is missing



The Intersections of IRS, Legal Transactions & Tax Application

- When it comes to the IRS, every past transaction can be a minefield.
- Audits have been expanded and will include:
 - EVERY transaction will be examined for intersection with personal use, related parties and REAL documentation,
 - Enforcement of 1099 filings and subsequent vendor & customer tax filings are on deck for audit,
 - Physical inspections of real and personal property business use have returned.





The Intersections of IRS, Legal Transactions & Tax Application

- Get your tax expert on board at the beginning.
- This is going to take some time.
- Tax Professionals are buried in deadlines.
- A restructuring or liquidation has tax implications at every level.
 - Entity
 - Individual
 - Divorce is often concurrent
- Records requests take more time than you think.
- Back tax returns often have to be amended for missing or misstated assets.
- Financing is tough for the smaller filer.
- Tracing missing assets takes time.
- Most small businesses are familial in nature and a restructure may not be possible, but it most likely will be taxable at some level.
- Potential loss of entity tax elections.



Documenting Tax Planning Positions

The IRS has been under-resourced for years. Has recently received \$80 billion in new funding, including for enforcement under the Inflation Reduction Act of 2022.

The IRS is hiring at all levels, including litigation attorneys in the Office of Chief Counsel, and have made clear they will be targeting a broader range of corporate and individual issues.

Tax court can be an appealing venue for taxpayers, especially those with short term liquidity constraints, because tax is not due and payable until a final judgment has been rendered. However:

- Interest accrues on any amounts adjudged to be owed.
- The IRS can assess (and the tax court frequently upholds) substantial penalties for frivolous tax positions or transactions which lack economic substance. These penalties also accrue interest.

IRS audits and tax court proceedings can advance at a slow pace. It's not unusual for issues to be tried 10 or more years after the tax years in question. This makes proper documentation of planning transactions (e.g. structure charts, legal agreements, tax opinions, valuation reports, etc.) extremely important in ensuring these planning activities are of long-term benefit to the taxpayer.

Faculty

David T. Plastino, CPA, ABV is a principal with The Brattle Group, Inc. in Boston, where he serves as practice leader of its Bankruptcy & Restructuring department and co-leader of its Tax Controversy & Transfer Pricing group. He is an expert in financial economics, with more than 20 years of finance and consulting experience. Mr. Plastino leads engagements related to bankruptcy, restructuring, tax controversy and complex litigation. He regularly advises on corporate transactions, including mergers and acquisitions, recapitalizations, and the formation and restructuring of joint ventures. He also specializes in economic and financial analyses, with a particular emphasis on corporate valuation, securities analysis and complex financial modeling. Mr. Plastino has experience analyzing, valuing and assessing the credit quality of companies, and regularly advises on the economics of related-party transactions. His clients include leading nonprofits, corporations, investment funds, law firms and government entities. In addition to his consulting practice, Mr. Plastino is a lecturer in finance at the Boston University Questrom School of Business, where he teaches an advanced course in corporate financial management. His research interests focus on the modeling and valuation of privately held companies and illiquid securities. He has published numerous articles and regularly presents to attorneys, corporate managers, law students and academics. Prior to joining Brattle, Mr. Plastino spent several years in the national tax department of a Big Four accounting firm and more than 13 years at a boutique corporate finance and litigation consulting firm. He received his B.A. from Swarthmore College and his M.B.A. and M.S.I.S. from the Boston University Graduate School of Management.

Howard Steinberg, CPA, CIRA is a managing director in Houlihan Lokey's Financial and Valuation Advisory business in New York, where he provides tax structuring and due-diligence services to strategic and financial clients. He has advised numerous debtor companies, creditors and acquirers of distressed assets. He also has advised on many of the largest and most complex U.S. bankruptcies and served as an expert witness for the Toys "R" Us bankruptcy. Prior to joining Houlihan Lokey, Mr. Steinberg was a partner at KPMG, where he held senior leadership roles such as global head of Restructuring, Tax and Legal for KPMG International, partner in charge for KPMG U.S. M&A Tax, and partner in charge for KPMG U.S. Tax Restructuring Services. He also is a frequent speaker at industry functions. Mr. Steinberg received his Bachelor's degree in economics from the Wharton School of the University of Pennsylvania, and his M.B.A. with Beta Gamma Sigma distinction from Columbia University.

Virginia Tate, CFE, CIRA, EA is president and co-founder of FAI International in Coeur d'Alene, Idaho, and has experience in bookkeeping, tax, forensic, audit, restructuring and fraud examination accounting methods. She also has experience in human resources and holds certifications in taxation, fraud and insolvency accounting. Ms. Tate is a member of ABI's Bankruptcy Taxation and Legislation Committees, as well as the Association of Certified Fraud Examiners and the Association of Insolvency & Restructuring Advisors, and she is a frequent speaker. She also is Communications co-chair of IWIRC's Bayou Network. Ms. Tate received her B.S. in business administration with a focus on accounting from the University of Washington.