AMERICAN BANKRUPTCY INSTITUTE

2018 Southwest Bankruptcy Conference

Ins and Outs of Dealing with Tax Claims

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CONCURRENT SESSION

2018

Grant Thornton

Bankruptcy Tax: It's not rocket science if you have the right vision

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Tax cost of debt restructuring for corporate debtors

If...

A financially distressed company settles its debt at less than face value, the company generally realizes income. The amount of income generally is the excess of the amount of the debt over the amount of money and/or the value of property given in exchange.

This can occur when:

A. The lender exchanges debt for equity,
B. Debt terms are modified,
C. New debt is exchanged for pre-existing debt,
D. Debt is acquired by the borrower or a related party at a discount
E. Debt is purchased and converted to equity, or
F. A combination of several of the above

Tax cost of debt restructuring for corporate debtors (cont.)

Then…

The tax law may not tax the cancellation of debt income (CODI) currently.

- The price for tax deferral usually is reduction of tax assets including net operating losses and tax basis of property.
  - ❖ The loss of tax assets is intended to create a greater tax liability in the future to repay the initial tax deferral. This is primarily about the timing of cash tax liabilities.
  - ❖ The policy is to give the reorganized debtor a fresh start but not necessarily a permanent benefit.

The remainder of this discussion focuses on **taxable corporations**;
not partnerships or Sub-Chapter S corporations.

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Why you should care…

Addressing the income tax issues early in a debt restructuring or Chapter 11 process is critical

1. Proper planning can save tax assets - reducing future taxes
2. Property planning and documentation is important for the financial statements
3. A future purchaser will evaluate the application of the tax law to the restructuring
4. The IRS will usually address in an examination

Deferral is available when either cancellation of debt income results from a Chapter 11 plan or to the extent the debtor is insolvent in an out of court debt restructuring.

Note: *The tax assets most commonly reduced are net operating losses and tax basis in depreciable and amortizable property. In some cases the tax basis of other assets including inventory and accounts receivable may be reduced.*

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The waterfall approach

Tax asset reduction in a parent-subsidiary consolidated group is a waterfall down the ownership chain subsidiary, by subsidiary

There are potential stopping points and branching points. The waterfall approach impacts the amount of surviving NOLs and tax basis of assets for each member of the consolidated group.

There are a number of tax elections that can impact future cash taxes. Each election is a trade-off of one potential tax benefit for another.

The tax elections and the waterfall of tax attribute reduction create a dynamic environment. The only way to predict alternative outcomes is through modeling.

Modeling needs to be done sooner rather than later to help inform and guide the restructuring process. Post closing or post plan confirmation is too late.

Effective modeling for a consolidated group includes:

- Constructing a tax basis balance sheet for each group member
- Determining the NOL and other tax attributes attributable to each member
- Analyze the impact of cancelling intercompany debt

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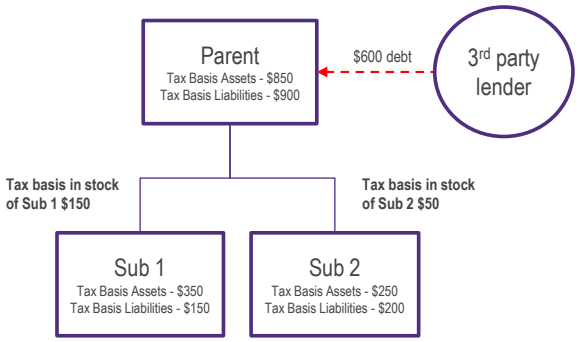
Example

- Parent borrows $600 from an unrelated 3rd party lender
- In year 1, Parent, Sub 1, and Sub 2, members of a consolidated group have cumulative operating losses of $250
- During Year 2, Parent files Ch. 11. Pursuant to the plan of reorganization 3rd party lender forgives $450 of the $600 debt owed by Parent. The $450 of cancellation of debt income is not taxable.



Net Operating Losses (NOL)

Parent	100
Sub 1	100
Sub 2	50
Consolidated NOL	$ 250

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Example – Parent Tax Asset Reduction

Bankruptcy Consolidated Group
PARENT

	Initial Tax Basis	Tax Basis Post Reduction	Difference	Comments
Net Operating Loss	100	-	(100)	Direct reduction due to $450 of CODI at Parent
Cash	100	100	-	
Inventory	450	400	(50)	Direct reduction due to CODI at Parent
PP&E (Depreciable)	100	-	(100)	Direct reduction due to CODI at Parent
Tax Basis in Sub1 Stock	150	-	(150)	Direct reduction due to CODI at Parent - Flows through to Sub1
Tax Basis in Sub2 Stock	50	-	(50)	Direct reduction due to CODI at Parent - Flows through to Sub2
Total Assets	**850**	**500**	**(350)**	
Accounts Payable	300	300		
Long Term Debt	600	150	(450)	
Total Liabilities	**900**	**450**	**(450)**	
Total Tax Asset Reduction (NOL and Asset Basis)			**(450)**	

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Example – Sub 1 Tax Asset Reduction

Bankruptcy Consolidated Group
Sub 1

	With Election to Reduce Depreciable Asset Basis before NOL			Without Election to Reduce Depreciable Asset Basis before NOL		
	Initial Tax Basis	Tax Basis Post Reduction	Difference	Initial Tax Basis	Tax Basis Post Reduction	Difference
Net Operating Loss	100	100	-	100	-	(100)
Cash	50	50	-	50	50	-
Inventory	100	100	-	100	100	-
PP&E (Depreciable)	150	-	(150)	150	100	(50)
Total Assets	**300**	**150**	**(150)**	**300**	**250**	**(50)**
Accounts Payable	150	150	-	150	150	-
Long Term Debt	-	-	-	-	-	-
Total Liabilities	**150**	**150**	**-**	**150**	**150**	**-**
Total Tax Asset Reduction (NOL and Asset Basis)			**(150)**			**(150)**

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Example – Sub 2 Tax Asset Reduction

Bankruptcy Consolidated Group
Sub 2

	Initial Tax Basis	Tax Basis Post Reduction	Difference
Net Operating Loss	50	-	(50)
Cash	30	30	-
Inventory	120	120	-
PP&E (Depreciable)	100	100	-
Total Assets	**250**	**250**	**-**
Accounts Payable	200	200	
Long Term Debt	-	-	-
Total Liabilities	**200**	**200**	**-**
Total Tax Asset Reduction (NOL and Asset Basis)			**(50)**

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Conclusion

Tax Planning is critical to ensuring that a reorganized debtor will achieve maximum benefit from the tax related variables that are created in a Chapter 11 case or out of court debt restructuring.

- Each case depends on its particular facts and circumstances.
- Each tax asset must be evaluated and considered in light of the reorganization plan and the debtors projected operations post reorganization.
- There are no general rules of thumb to short cut the process.

Modeling alternatives is the best, and frequently the only way, to identify and measure the impact of relevant trade offs.

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The specific tax modeling and quantitative analysis services we can provide are, of course, subject to compliance with applicable SEC, PCAOB, and AICPA independence standards.

IMPACT OF LATE-FILED TAX RETURNS ON DISCHARGEABILITY OF TAX DEBT

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September 7, 2018
ABI's 26th Annual SW Bankruptcy Conference
Las Vegas, Nevada

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When a debtor has not filed a required return and tax would be due on that return, the Bankruptcy Code excepts that tax debt from discharge. 11 U.S.C. § 523(a)(1)(B)(i). The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA") later amended various portions of this statute under Section 714 entitled "Income Tax Returns Prepared by Tax Authorities." P.L. 109–8, 119 Stat. 23. Section 714 added a hanging paragraph ("Hanging Paragraph") to the discharge rules of Section 523(a), often cited as 11 U.S.C. § 523(a)(*). The Hanging Paragraph provides:

> For purposes of this subsection, the term "return" means a return that satisfies the requirements of applicable nonbankruptcy law (including applicable filing requirements). Such term includes a return prepared pursuant to section 6020(a) of the Internal Revenue Code of 1986, or similar State or local law, or a written stipulation to a judgment or a final order entered by a nonbankruptcy tribunal, but does not include a return made pursuant to section 6020(b) of the Internal Revenue Code of 1986, or a similar State or local law.

Subsection 6020(a) of the Internal Revenue Code ("IRC") allows the Internal Revenue Service ("IRS") to prepare and receive a return of a taxpayer who failed to make the appropriate return when the taxpayer "consent[s] to disclose all information necessary for the preparation thereof" and signs the prepared return. Subsection 6020(b) of the IRC, on the other hand, provides that the IRS shall make a return "from his own knowledge" and information when the person fails to make any return or makes a false and fraudulent return. When a taxpayer fails to file an income tax return, the IRS will invoke such authority to conduct and file its own assessment of tax liability, commonly known as the Substitute for Return ("SFR"). See Millsap v. Commissioner, 91 T.C. 926, 930 (1988) (substitute returns containing enough information to compute tax liability constitute returns within the meaning of Section 6020(b)).

Prior to the BAPCPA amendments, the recognized test for determining whether a document constituted a valid return was found in Beard v. Commissioner, 82 T.C. 766, 777 (1984) as follows:

> First, there must be sufficient data to calculate tax liability; second, the document must purport to be a return; third, there must be an honest and reasonable attempt to satisfy the requirements of the tax law; and fourth, the taxpayer must execute the return under penalties of perjury.

Under the Beard test, for a document to qualify as a valid return, "there must be an honest and reasonable attempt to" comply with the IRC. If the honest and reasonable attempt requirement is not met, the document would not be a return under applicable nonbankruptcy law, and any tax due would be nondischargeable.

Under pre-BAPCPA law, the majority of courts applied the honest and reasonable attempt requirement by analyzing the overall conduct of the taxpayer, sometimes referred to as a "subjective" test, while a small minority of courts looked only to the contents of the return, referred to as an "objective" test. See United States v. Martin (In re Martin), 542 B.R. 479, 482 (9th Cir. BAP 2015) (9th Circuit's honest and reasonable inquiry is "at least partially subjective in focus"); and compare In re Payne, 431 F.3d 1055, 1057 (7th Cir. 2005) (finding a return filed after the IRS has borne the burden of preparing a return does not serve the purpose of the filing requirement, which is to spare the IRS that burden) with Colsen v. United States (In re Colsen), 446 F.3d 836, 840 (8th Cir. 2006) ("[T]he honesty and genuineness of the filer's attempt to satisfy the tax laws should be determined from the face of the form itself, not from the filer's delinquency or the reasons for it"). Because Colsen objectively relies on the four corners of the document, it is considered an objective test.

BAPCPA's Hanging Paragraph heightened the debate among circuits about whether a late-filed return can save a tax debt from non-dischargeability, especially considering the Hanging Paragraph's express invocation of "filing requirements." Three circuit courts have concluded that the "applicable filing requirements" language of the Hanging Paragraph includes timeliness, making the tax due on any late-filed return *per se* nondischargeable. Fahey v. Mass. Dep't of Revenue (In re Fahey), 779 F.3d 1, 5 (1st Cir. 2015) ("[A] return filed after the due date is a return not filed as required, i.e., a return that does not satisfy 'applicable filing requirements.'"); Mallo v. IRS (In re Mallo), 774 F.3d 1313, 1321 (10th Cir. 2014) ("[T]he applicable filing requirements include filing deadlines, § 523(a)(*) plainly excludes late-filed Form 1040s from the definition of a return."); McCoy v. Miss. State Tax Comm'n (In re McCoy), 666 F.3d 924, 932 (5th Cir. 2012) ("Unless it is filed under a 'safe harbor' provision similar to § 6020(a), a state income tax return that is filed late under the applicable nonbankruptcy state law is not a 'return' for bankruptcy discharge purposes under § 523(a)."). Courts have referred to such a bright-line rule as the "One-Day-Late Rule." Under such a rule, late returns do not constitute returns for purposes of non-dischargeability as matter of law, foreclosing the ability of a taxpayer to discharge such tax obligation.

Other circuit courts have found that the Hanging Paragraph essentially codifies the rule already announced in Beard. The In re Martin decision by the Ninth Circuit B.A.P. highlights such reasoning by noting the various statutory conflicts and redundancy created by the One-Day-Late Rule. See generally In re Martin, 542 B.R. 479 (additionally refusing to rule that a post-assessment return fails the Beard test as a matter of law). While advocating case-by-case analysis under the Beard factors, circuit courts applying such rule continue to express doubt that late-filed returns, particularly when filed post-assessment, can constitute a reasonable and honest attempt to comply with the tax law under the subjective test. Giacchi v. United States (In re Giacchi), 856 F.3d 244, 248 (3d Cir. 2017) ("Forms filed after their due dates and after an IRS assessment rarely, if ever, qualify as an honest or reasonable attempt to satisfy the tax law."); Justice v. United States (In re Justice), 817 F.3d 738, 744 (11th Cir. 2016) ("Failure to file a timely return, at least without a legitimate excuse or explanation, evinces the lack of a reasonable effort to comply with the law."); Smith v. United States IRS (In re Smith), 828 F.3d 1094, 1097 (9th Cir. 2016) ("Under these circumstances, [the taxpayer]'s 'belated acceptance of responsibility' was not a reasonable attempt to comply with the tax code."). Notably, the Third and Eleventh Circuits expressly declined to address the One-Day-Late Rule. The Ninth Circuit never reached the issue as it relied on its previous decision in United States v. Hatton (In re Hatton), 220 F.3d 1057 (9th Cir. 2000).

The remaining circuits, other than the Eighth, have not revisited the matter post-BAPCPA, but their district courts continue to apply a similar, subjective version of the Beard analysis. Earls v. United States (In re Earls), 549 B.R. 871, 879 (Bankr. S.D. Ohio 2016) ("[T]he Sixth Circuit in Hindenlang clearly considered timing to be a relevant factor in determining whether there was a reasonable effort to comply with the tax laws.") (citing United States v. Hindenlang (In re Hindenlang), 164 F.3d 1029 (6th Cir. 1999)); United States v. Dew, Civil Action No. 4:14-cv-0166-TLW-TER, 2015 U.S. Dist. LEXIS 113757, at *14 n.5, 116 A.F.T.R.2d (RIA) 5854 (D.S.C. May 28, 2015) ("[T]he Fourth Circuit held that a debtor may not discharge a tax liability by submitting a purported return years after it was due and after the IRS had determined the debtor's tax liability and assessed the tax.") (citing In re Moroney, 352 F.3d 902, 907 (4th Cir. 2003)); Pansier v. Wis. Dep't of Revenue, No. 10-C-0550, 2010 U.S. Dist. LEXIS 112990, at *14 (E.D. Wis. Oct. 13, 2010) ("This [Seventh] Circuit has refused to recognize a post-assessment filing as a "return" for purposes of § 523(a)(1)(B)(i).") (citing In re Payne, 431 F.3d 1055, 1057 (7th Cir. 2005)). Similarly, while the Second Circuit has not decided the issue either pre- or post- BAPCPA, its bankruptcy courts have followed a similar analysis under Beard. See, e.g., Selbst v. United States Dep't of Treasury (In re Selbst), 544 B.R. 289, 296 (Bankr. E.D.N.Y. 2016) ("Because the Debtor waited until after the IRS had performed its assessments before filing his returns, the Debtor's Forms 1040 did not demonstrate an honest and reasonable attempt to comply

with the tax law and therefore cannot be considered returns under the definition provided by the Section 523 of the Bankruptcy Code.").

Lower courts continue to apply the Beard analysis, which leaves open the possibility that a late return, possibly even a post-assessment return, may still represent an honest and reasonable attempt to comply with the Tax Code. The right circumstances might justify the taxpayer's untimely return, thereby qualifying the debt for discharge. See, e.g., Biggers v. IRS, 557 B.R. 589, 597 (M.D. Tenn. 2016) ("[T]he Court concludes that the determination of the fourth prong of Beard is a subjective test that allows for circumstances in which there can be an honest and reasonable attempt to comply with the tax law even after assessment by the IRS and even when untimely forms do not report additional tax liability."). To date, a taxpayer has yet to ultimately prevail in such circumstances. If the taxpayer files a return after the IRS assesses and reports an additional amount of tax, the additional tax that was not previously assessed would be dischargeable. See Chief Counsel Notice 2010-016 at p.3.

The objective test still holds sway in the Eighth Circuit. Even though the Eighth Circuit's use of the objective test provides the greatest potential for discharging tax debt arising from late-filed returns, the Hanging Paragraph presents a potential challenge to such precedent. A recently published lower court decision in the Eight Circuit found that the Hanging Paragraph effectively made late-filed state tax returns void for dischargeability purposes under state law. Kline v. IRS (In re Kline), 581 B.R. 597, 604 (Bankr. W.D. Ark. 2018) ("With the added specific requirement that returns must meet the "applicable filing requirements," Congress has limited the tax liabilities that can be discharged in bankruptcy by requiring that a debtor timely comply with the relevant law, in this case the filing of the debtor's state returns on or before April 15 of the following year."). While Colsen still remains good law according to the IRS, see IRM 5.9.17.7.1(3) (December 9, 2016), the Kline decision highlights the conflict between the objective test and the *per se* rule.

In summary, the First, Fifth, and Tenth Circuits apply a *per se* rule and hold nondischargeable any tax due on a late-filed document. The Third, Ninth, and Eleventh Circuits still use a subjective test to determine whether an honest and reasonable attempt was made to satisfy the requirements of the tax law. The Third and Eleventh Circuits expressly declined an opportunity to follow the One-Day-Late Rule. The Ninth Circuit relied on its prior precedent in United States v. Hatton (In re Hatton), 220 F.3d 1057 (9th Cir. 2000) and never mentioned the One-Day-Late Rule. The Ninth Circuit Bankruptcy Appellate Panel has expressly rejected the One-Day-Late Rule. In the Eighth Circuit, if the issue arises under federal tax law, the IRS still follows Colsen and the objective test applies. IRM § 5.9.17.7.1 (3) (December 9, 2016). If the issue arises under state tax law, one can expect the applicable state taxing authority to advocate for the One-Day-Late Rule. In the remaining circuits, it appears the subjective test still holds sway. To date, no taxpayer has won a case under the subjective test if the taxpayer's purported return is filed after the IRS makes its assessment.

WEIL'S OBSERVATIONS ON TAX YEAR 2001 TRANSCRIPT

>SFR designation. The transcript states the tax return was secured in 2010. This is a strong indication that the SFR assessment and accompanying nondischarge of liability determination are correct.

Do not assume an SFR designation means the IRS assessed before a tax return was filed by the taxpayer. Sometimes, which came first can be determined by reviewing the transcript. More often, a follow-up phone call is needed. For example, in this instance, there is a 599 code related to securing the tax return. IRM 5.19.2.6.4.4(5) (July 14, 2017) tells us that a closing code (CC) of 89 means the taxpayer filed before the assessment and a CC of 88 means the IRS assessed first. You have to phone the tax practitioner hotline (866-860-4259) and ask for the CC. Another way to uncover which came first is to ask for the assessment statute end date (ASED). If the ASED is not given, then, the IRS filed for the taxpayer, and, a subsequent return has not been secured. This is because the time to assess does not start to run until a return is secured from the taxpayer. If the ASED is way more than three years past the assessment date, that is another indicator that the IRS assessed first.

In the Ninth Circuit, we still seem to be safe from the one-day-late rule. *United States v. Martin (In re Martin)*, 542 B.R. 479 (9th Cir. B.A.P. 2015) (Kurtz, J.); and *see*, *Smith v. United States (In re Smith)*, 828 F.3d 1094 (9th Cir. 2016) (not citing *Martin* and not applying the one-day-late rule but essentially making it almost impossible to discharge tax debt after the IRS's SFR assessment).

>Bankruptcy filing in 2013, and, bankruptcy ended in 2017. It appears a discharge was granted, as penalties are abated even though underlying tax is not discharged. In Chapter 7, penalties are a strict three-year rule. In Chapter 13, the last vestige of the superdischarge rule discharges all penalties. (When a prior bankruptcy is indicated, a careful practitioner reviews the prior case docket and filings.)

>The lien was removed. That seems odd. This was either a Chapter 11 or Chapter 13 plan. You can tell because the bankruptcy started 7/9/13 and continued until 2/14/17. There are no payments from the bankruptcy schedules on the 2001 transcript. If the tax is not discharged, the lien remains valid after the bankruptcy is concluded.

Internal Revenue Service
United States Department of the Treasury

This Product Contains Sensitive Taxpayer Data

Account Transcript

Request Date: 05-04-2017
Response Date: 05-04-2017
Tracking Number: [redacted]

FORM NUMBER: 1040A
TAX PERIOD: Dec. 31, 2001

TAXPAYER IDENTIFICATION NUMBER: [redacted]
SPOUSE TAXPAYER IDENTIFICATION NUMBER: [redacted]

[redacted]

--- ANY MINUS SIGN SHOWN BELOW SIGNIFIES A CREDIT AMOUNT ---

ACCOUNT BALANCE:	25,837.71	
ACCRUED INTEREST:	9,402.41	AS OF: May 15, 2017
ACCRUED PENALTY:	0.00	AS OF: May 15, 2017
ACCOUNT BALANCE PLUS ACCRUALS (this is not a payoff amount):	35,240.12	

** INFORMATION FROM THE RETURN OR AS ADJUSTED **

EXEMPTIONS:	01
FILING STATUS:	Married Filing Separate
ADJUSTED GROSS INCOME:	121,160.66
TAXABLE INCOME:	113,710.66
TAX PER RETURN:	0.00
SE TAXABLE INCOME TAXPAYER:	0.00
SE TAXABLE INCOME SPOUSE:	0.00
TOTAL SELF EMPLOYMENT TAX:	0.00

RETURN DUE DATE OR RETURN RECEIVED DATE (WHICHEVER IS LATER)	Feb. 16, 2005
PROCESSING DATE	Mar. 07, 2005

TRANSACTIONS

CODE	EXPLANATION OF TRANSACTION	CYCLE	DATE	AMOUNT
150	Substitute tax return prepared by IRS		03-07-2005	$0.00
n/a	49210-888-00000-5			

140	Inquiry for non-filing of tax return		02-20-2003	$0.00
595	Account referred for review		03-07-2005	$0.00
570	Additional account action pending		03-07-2005	$0.00
420	Examination of tax return		02-24-2005	$0.00
560	IRS can assess tax until 11-04-2006		07-07-2006	$0.00
270	Penalty for late payment of tax	20062908	07-31-2006	$5,096.12
173	Penalty for not pre-paying tax	20062908	07-31-2006	$523.00
160	Penalty for filing tax return after the due date 09-05-2020	20062908	07-31-2006	$1,358.32
806	W-2 or 1099 withholding		04-15-2002	-$11,534.00
300	Additional tax assessed by examination 09-05-2020	20062908	07-31-2006	$37,014.60
n/a	19247-592-21215-6			
421	Closed examination of tax return		07-31-2006	$0.00
336	Interest charged for late payment	20062908	07-31-2006	$8,338.42
270	Penalty for late payment of tax	20064108	10-23-2006	$1,274.03
290	Additional tax assessed 00-00-0000	20064108	10-23-2006	$0.00
n/a	29254-678-05153-6			
971	Collection due process Notice of Intent to Levy -- issued		03-11-2010	$0.00
971	Collection due process Notice of Intent to Levy -- undeliverable		04-06-2010	$0.00
599	Tax return secured		08-27-2010	$0.00
470	Claim pending		09-02-2010	$0.00
171	Reduced or removed penalty for not pre-paying tax		07-31-2006	-$444.07
173	Penalty for not pre-paying tax	20062908	07-31-2006	$444.07
806	W-2 or 1099 withholding		04-15-2002	-$0.71
291	Reduced or removed prior tax assessed		11-14-2011	-$7,980.60
n/a	19254-699-00182-1			
472	Resolved claim		10-22-2011	$0.00
599	Tax return secured		08-02-2010	$0.00
167	Reduced or removed penalty for filing tax return after the due date		11-14-2011	-$1,358.32
277	Reduced or removed penalty for late payment of tax		11-14-2011	-$1,995.32
971	Notice issued CP 0021		11-14-2011	$0.00
971	Notice issued CP 071C		09-24-2012	$0.00
582	Lien placed on assets due to balance owed		11-30-2012	$0.00
971	Issued notice of lien filing and right to Collection Due Process hearing		12-04-2012	$0.00
520	Bankruptcy or other legal action filed		07-09-2013	$0.00
971	Account match for federal levy payment program		08-05-2013	$0.00
971	Notice issued		08-05-2013	$0.00

Account Transcript [redacted] 1040A Dec. 31, 2001 [redacted] Page 3 of 3

	CP 0091			
971	Final notice before levy on social security benefits		08-05-2013	$0.00
520	Bankruptcy or other legal action filed		07-09-2013	$0.00
520	Bankruptcy or other legal action filed		07-09-2013	$0.00
271	Reduced or removed penalty for late payment of tax		03-20-2017	-$4,374.83
171	Reduced or removed penalty for not pre-paying tax		07-31-2006	-$523.00
161	Reduced or removed penalty for filing tax return after the due date		07-31-2006	-$4,374.82
163	Penalty for filing tax return after the due date	20062908	07-31-2006	$4,374.82
290	Additional tax assessed 00-00-0000	20170905	03-20-2017	$0.00
n/a	28254-460-06693-7			
971	Partial bankruptcy abatement		02-14-2017	$0.00
583	Removed lien		03-10-2017	$0.00
521	Removed bankruptcy or other legal action		02-14-2017	$0.00
971	Initial levy imposed		04-10-2017	$0.00

This Product Contains Sensitive Taxpayer Data

AMERICAN BANKRUPTCY INSTITUTE
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The Essential Resource for Today's Busy Insolvency Professional

Feature

BY RICHARD LIEBMAN AND BRIAN ANGSTADT

The Effect of Tax Reform on Debt Discharged in Chapter 11

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On Dec. 22, 2017, President Donald Trump signed into law the Tax Cuts and Jobs Act (the "2017 Tax Act"),[1] the largest change to the federal income tax code since the enactment of the Internal Revenue Code of 1986. It made substantial changes to individual, business and international taxation. Of most relevance to companies reorganizing in chapter 11, the 2017 Tax Act made changes related to the expensing of newly acquired assets, the deductibility of interest and the utilization of net operating losses (NOLs) for federal income tax purposes. The effect of these changes may have a significant impact to the after-tax cash flow in the years following an emergence from bankruptcy.

Most Relevant 2017 Tax Law Changes

Depending on the specific facts of each case, the greatest changes under the 2017 Tax Act relevant to chapter 11 reorganizations include some or all of the following.

Expensing Newly Acquired Assets

Taxpayers are now entitled to an immediate tax deduction for 100 percent of the cost of most new and used fixed assets acquired in an asset purchase or a transaction (provided the tax law treats it as an asset purchase) ("bonus depreciation").[2] The amount of cost eligible for a bonus depreciation is reduced by 20 percentage points each year beginning in 2023 through 2027, at which point this provision will be fully phased out.

Taxpayers may opt out of a bonus depreciation. If a taxpayer makes such an election or to the extent that less than a 100 percent deduction is available beginning in 2023, the regular tax depreciation rules apply. The regular tax depreciation rules generate tax deductions over a number of years depending on the specific type of depreciable assets and a number of other factors.

Deducting Interest Expense

The deductibility of interest expense for federal income tax purposes is subject to a new limitation.[3] Generally, this limitation consisted of an interest expense deduction of no more than 30 percent of earnings before interest, taxes, depreciation and amortization through 2021, then 30 percent of earnings before interest and taxes in 2022 and thereafter.

Utilizing NOLs

NOL carryforwards generated after Dec. 31, 2017, reduce no more than 80 percent of taxable income in any one year. However, these NOL carryforwards might be carried forward indefinitely.[4] NOL carryforwards generated in tax years prior to 2018 are not subject to the 80 percent limitation when used to reduce taxable income in 2018 and later years. Pre-2018 NOL carryforwards may generally be carried forward for a maximum of 20 years.

Overview of Federal Income Taxation in Chapter 11 Reorganizations

For federal income tax purposes, a corporate debtor generally realizes cancellation of debt income (CODI) to the extent that its indebtedness is cancelled or satisfied for an amount less than the amount of the debt.[5] If the indebtedness is cancelled or satisfied at a discount in connection with a confirmed chapter 11 reorganization plan, then the

1 An act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018.
2 I.R.C. § 168(k).
3 I.R.C. § 163(j).
4 I.R.C. § 172(a).
5 I.R.C. § 61(a)(11), as modified by the 2017 Tax Act.

debtor excludes the CODI from taxable income.[6] However, the tax law requires that the corporate debtor must reduce its tax attributes, such as NOL carryforwards and tax basis in assets, to the extent that it excludes the CODI from taxable income.[7]

Tax attributes generally are reduced in a specified order until either all of the CODI excluded from taxable income has been offset by attribute reduction or no tax attributes remain to be reduced. The specified order of attribute reduction is (1) NOL carryovers, (2) general business credit carryovers, (3) minimum tax credit carryovers, (4) capital loss carryovers, (5) tax basis of assets, (6) passive activity losses and credit carryovers, and (7) foreign tax credit carryovers.[8] If there are no attributes of a particular type, the process moves to the next available category in the specified order. Although the corporate debtor might have no immediate cash tax cost upon the cancellation of its indebtedness, the savings created by excluding CODI from taxable income are "repaid" through a reduction in the debtor's tax attributes that are no longer available to reduce taxable income post-bankruptcy.

Impact of the 2017 Tax Act Changes on Chapter 11 Reorganizations

To understand the after-tax cash flow in years following emergence from bankruptcy (including the impact of alternative plan arrangements on such cash flow), it is critical to perform detailed modeling. This modeling must incorporate applicable tax law and the debtor's particular facts, including the amount of CODI, tax attributes and projected post-chapter 11 revenue, operating expenses, interest expense, capital expenditures, etc.

The 2017 Tax Act impacts the detailed modeling for corporate bankruptcies in several ways. First, an asset-purchaser in an acquisition under § 363 of the Bankruptcy Code might benefit significantly from the new bonus-depreciation rule. The benefit will depend on how much of the overall purchase price can be allocated to depreciable fixed assets available for bonus depreciation and on the buyer's overall tax posture. The cost of purchased intangibles such as goodwill is not eligible for bonus depreciation, and generally must be deducted on a straight-line basis over 15 years.

Second, the limitation on deductibility of interest expense might influence the amount of debt that a buyer is willing to incur to finance an acquisition under § 363 or the amount of post-emergence debt that a reorganized debtor can carry following a chapter 11 reorganization. This limitation applies to all debt outstanding after Dec. 31, 2017, including debt that was issued prior to that date.

Third, NOLs will need to be evaluated from a new perspective in many cases. As previously noted, NOLs generated prior to Dec. 31, 2017, remain subject to the tax law for periods prior to Dec. 31, 2017. This means that such NOLs can be carried back up to two tax years and carried forward for up to 20 tax years. Most importantly, such NOLs can reduce up to 100 percent of taxable income in each tax year to which the NOL is carried. Under the 2017 Tax Act, NOLs arising in tax years beginning after Dec. 31, 2017, (1) cannot be carried back; (2) can be carried forward indefinitely; and most importantly (3) can only reduce taxable income by a maximum of 80 percent of such amount in each tax year to which such NOLs are carried.

Depending on the specific circumstances, preserving the utility of pre-2018 NOLs might be beneficial for a corporation reorganizing in chapter 11 as opposed to such NOLs being reduced or eliminated by tax attribute reduction. Determining whether preserving NOL carryforwards are beneficial and implementing a strategy to preserve such NOL carryforwards, require professionals with expertise.

Impact of 2017 Tax Law on Certain Tax Elections in Chapter 11 Reorganizations

In addition to the overall complexity of the tax law, the detailed modeling should consider the impact of several choices in the form of tax elections that can significantly affect tax attribute reduction, which then has a material impact on the after-tax cash flow following a chapter 11 reorganization. These tax elections are not new, but they must now be considered in light of the 2017 Tax Act.

As previously noted, CODI excluded from taxable income reduces tax attributes beginning with NOL carryforwards. If the amount of NOL carryforward is less than the amount of CODI excluded from taxable income, other tax attributes, including the basis of depreciable assets, are reduced in the specified order. However, a debtor can make a tax election to cause the tax basis of depreciable assets to be reduced before NOL carryforwards are reduced.[9] This election might be beneficial, particularly if the NOL carryforwards preserved were generated before Dec. 31, 2017, so that they can be deducted against 100 percent of post-emergence taxable income, as opposed to only 80 percent of post-emergence taxable income. However, this election is not always beneficial, even after considering the 2017 Tax Law, because if the election is made, certain other tax law provisions become operative.[10] Depending on the specific facts, these provisions might cause the reorganized debtor to lose more total tax attributes than if this election was not made.

Following the tax-attribute reduction, the surviving NOL carryforwards that can be used to reduce post-emergence taxable income might be limited if the reorganized debtor has a "change in control" as defined in the tax law.[11] A change in control frequently occurs in a reorganization plan in which some or all of the creditors exchange their debt for new stock of the reorganized debtor. The amount of limitation is based on the value of the corporate debtor, with certain adjustments under the tax law, and applies to all surviving NOL carryforwards generated prior to the effective date of the reorganization plan. This limitation might make the surviving NOL carryforwards less valuable than if no limitation had applied.

However, if certain requirements are met in the case of a chapter 11 reorganization, the surviving NOL carryforwards might be reduced by an amount determined by a formula in

6 I.R.C. § 108(a)(1)(A).
7 I.R.C. § 108(b)(1).
8 I.R.C. § 108(b)(2).
9 I.R.C. § 108(b)(5).
10 I.R.C. § 1017(b)(2).
11 I.R.C. § 382.

the tax law, but any remaining NOL carryforwards are not subject to the limitation on use as long as another change in control does not occur for at least two years (the "bankruptcy NOL limitation rule").[12] Applying the bankruptcy NOL limitation rule might be detrimental if there is a significant risk of a second change in control within two years, the limitation under the basic rule is not excessively restrictive, the reduction to the NOL carryforward under the bankruptcy NOL limitation rule is significant, or some combination of these factors exists. A tax election is available to cause the bankruptcy NOL limitation rule not to apply, and the limitation is calculated under a different rule applicable to chapter 11 reorganizations.[13] This election may allow the reorganized debtor to preserve the maximum amount of a pre-Dec. 31, 2017, NOL carryforward, which are very valuable as they can be deducted against 100 percent of post-emergence taxable income.

Conclusion

The 2017 Tax Act will have a substantial impact on the after-tax cash flow of corporate taxpayers emerging from bankruptcy. Debtors, creditors and their advisors should consider these impacts prior to finalizing a reorganization plan, as they will affect the financial health of the taxpayer and its ability to service any post-reorganization debt. While there have always been many variables in a chapter 11 reorganization that need to be modeled, including whether certain tax elections should be made, in order to achieve the best tax results, the changes under the 2017 Tax Act increase the complexity of these factors, which requires effective modeling now more than ever. abi

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12 I.R.C. § 382(l)(5).
13 I.R.C. § 382(l)(6).