State Corporate Income Tax Issues
to Consider in Bankruptcy

American Bar Association
May 9, 2014
Washington, D.C.
General Overview
State Income Tax and Bankruptcy Restructurings

• In general, two key issues facing a corporation entering into bankruptcy are:
  – What are the implications of the potential cancellation of debt income ("CODI")?
  – What are the IRC § 382 ownership change implications on the prospective utilization of tax attributes after emergence?

• Because state tax regimes can vary significantly with respect to conformity with federal income tax rules, navigating the state income tax implications of a bankruptcy restructuring can be a complex and daunting exercise.
CODI and Attribute Reduction
Federal CODI – In General

Debt cancellation (reduction) or repurchase (and in certain cases modifications of the debt) for less than adjusted issue price generally results in CODI under IRC § 61, but may be excludible in certain circumstances. Such examples are the insolvency and bankruptcy exceptions.

- **Insolvency exception (to the extent of insolvency):**
  - “Insolvent” means the excess of liabilities over the fair market value of assets, determined on the basis of the taxpayer’s assets and liabilities immediately before the discharge (IRC §§ 108(d)(3) and 108(a)(1)(B)).

- **Bankruptcy exception:**
  - Debt must be discharged in a case under Title 11 of the U.S. Code (IRC § 108(a)(1)(A)).

- **Excluded COD income – Attribute Reduction**
  - CODI excluded under the insolvency or bankruptcy exceptions requires debtor to reduce its tax attributes as described in IRC § 108(b)(1).
State COD Income – In General

• 11 U.S.C. Bankruptcy Code ("B.C") § 346(j) (emphasis added)
  – For purposes of any state or local law imposing a tax on or measured by income, income is not realized by the estate, the debtor, or a successor to the debtor by reason of discharge of indebtedness in a case under this title, except to the extent, if any, that such income is subject to tax under the Internal Revenue Code of 1986.
  – Whenever the Internal Revenue Code of 1986 provides that the amount excluded from gross income in respect of the discharge of indebtedness in a case under this title shall be applied to reduce the tax attributes of the debtor or the estate, a similar reduction shall be made under any state or local law imposing a tax on or measured by income to the extent such state or local law recognizes such attributes. Such state or local law may also provide for the reduction of other attributes to the extent that the full amount of income from the discharge of indebtedness has not been applied.

• As a practical matter, what does this mean for corporate taxpayers for state income tax purposes?
Federal Attribute Reduction – Ordering Rules

• Exclusion of CODI under IRC § 108(a) (due to bankruptcy or insolvency) results in a reduction of tax attributes under section 108(b) for each debtor entity for which CODI was excluded. In general, attribute reduction occurs in the following order:
  – NOLs for the year of the discharge & NOL carryovers
  – General business credits
  – Minimum tax credits
  – Net capital losses & capital loss carryovers
  – Basis of assets (including subsidiary stock), subject to fresh start limitation (see below)
    – IRC § 267(f) & Treas. Reg. § 1.1502-13 deferred losses treated as asset basis
  – Passive activity losses
  – Foreign tax credit carryovers

• Other Considerations
  – Credits are reduced $1 for every $3 of CODI
  – Attribute reduction is made “after the determination of tax for the taxable year” of discharge and potential for carrybacks
  – Fresh start limitation – asset basis reduction limited to excess of total tax basis of assets over liabilities after the discharge (see IRC § 1017(b)(2))
Federal Attribute Reduction – Consolidated Group Considerations

- Regulations under Treas. Reg. § 1.1502-28 provide rules for reducing attributes within a consolidated group when one or more a member of the group recognizes excluded COD income. The rules have 3 key steps and are applied separately to each debtor member that has excluded COD income:
  
  • Step 1 – Reduce Tax Attributes of Debtor pursuant to IRC § 108(b) – Applies only to specific member that incurs the debt cancellation (“Debtor-First Rule”)
  
  • Step 2 – Apply “Look Through Rule” – Reduce attributes of debtor’s subsidiaries pursuant to IRC § 108(b) to the extent the tax basis of subsidiary member stock was reduced in Step 1 (i.e., ‘deemed’ COD income to the subsidiary)
  
  • Step 3 – Consolidated Attribute Reduction – Reduce remaining consolidated tax attributes (i.e., NOLs, capital losses and credits) of the group that are available to the debtor (“Fan-Out Rule”). Any excess COD Income is referred to as “black hole”.

- In the operation of the “Look Through Rule”, to the extent there is ‘deemed’ COD income to the subsidiary that does not reduce attributes, IRC § 1245 ‘taint’ in the stock of the subsidiary results.
  
  • If basis of stock of a member is reduced and the member subsequently liquidates or merges, IRC § 1245 may override non-recognition treatment (i.e., unexpected gain – even in a IRC § 332 liquidation).
Illustrative Example: Attribute Reduction

- Debtor HoldCo Parent, the common parent of a consolidated group, to exchange $700 ($450 debt and $250 stock) in cancellation of $1,000 of debt in bankruptcy
- Resulting CODI of $300 realized, but excluded under IRC § 108(a)

**Amended Example:**

Excluded CODI: $300
NOL Reduction (1.1502-28(a)(2)): $(50)
COD After NOL Absorption: $250

Asset Basis Subject to Reduction (1017(b)(2) limited to liability): $250

**Significant Reductions (1.1502-28(a)(2))**
Reduction of Sub 2 Basis (80%): $200
Reduction of Sub 1 Basis (20%): $50

**Beginning Stock Basis:**
$100
Reduction of Stock Basis: $(50)
Remaining Stock Basis: $50

Deemed CODI (1.1502-28(a)(3)): $50
NOL: $(10)
CODI After NOL Absorption: $40
Basis Subject to Reduction: $90
Est. Basis Reduction: $40

Debtor Holdco Parent

Bank

$1,000

Debtor Sub 1

Debtor Sub 2

Bank

Beginning Stock Basis: $400
Reduction of Stock Basis: $(200)
Remaining Stock Basis: $200

Deemed CODI (1.1502-28(a)(3)): $200
NOL: $(25)
CODI After NOL Absorption: $175
Asset Basis Subject to Reduction: $375
Est. Basis Reduction: $175
State Conformity to Federal Bankruptcy-Related Rules

- Under B.C. § 346(j), are states required to perform a “similar” attribute reduction computation for income tax purposes if CODI is recognized in bankruptcy and attribute reduction computation is done for federal income tax purposes?
  - Controversy as to whether B.C. § 346(j) is binding on state and local taxing authorities.
  - Several states contend that they only follow federal asset reduction result and do not allow a separate state computation
  - Issues regarding taxpayer-favorable positions taken under pre-2005 version of B.C. § 346(j)
  - Contrast with CODI resulting from insolvency, for which no “requirement” of state attribute reduction exists
Issues in Applying IRC § 108 to State Attributes

• State conformity to the federal consolidated return regulations (in general)
  – For filing separate returns, states generally do not conform (with minor exceptions)
  – At least half of states requiring unitary combined reports do not conform
  – Certain “separate filing states” may have elective combined / consolidated filing options that may or may not conform (and can result in unique application of such rules)

• Conformity, or lack thereof, can impact various aspects of a state’s attribute reduction computation, for example:
  – Amount of CODI
  – NOL of subsidiaries in combined reports
  – Potential “push-down” of CODI to subsidiaries and “fan out” of actual CODI otherwise not reducing an attribute
  – Basis in stock of subsidiaries
  – Basis in subsidiary stock having IRC § 1245 “taint”
State Conformity to Federal Bankruptcy-Related Rules

• Example - Determining State CODI
  
  – Federal CODI determined on an “as if separate” basis
  
  – Plan must be scrutinized as to how intercompany payables are handled
    – Not addressed?
    – Discharged?
    – Contributed / Distributed?
    – Offset?

  – Intercompany payables, in whole or part, may be treated as discharged under Plan and constitute CODI on “as if separate” basis

  – Under federal consolidated return regulations, CODI from intercompany payable is not subject to IRC § 108(a)
    – Similar methodology typically used in pre-apportionment combined reporting states
Issues in Applying IRC § 108 to State Attributes

• Determining Current Year and Carryover State NOL
  – In separate return states, NOL determination typically is pretty straight-forward
    – Be mindful of pre- v. post-apportionment distinction
  – Certain states rely more exclusively on federal NOL and may not have a state NOL per se
  – In most combined reporting states, overall combined NOL becomes a separate company NOL (i.e., attribute) only for members that have nexus and in proportion to their relative presence in the state
    – Contrast to the federal consolidated return regulations methodology (consolidated NOL becomes separate company NOL based upon relative contribution to consolidated NOL)
Issues in Applying IRC § 108 to State Attributes

• Applying State CODI Against State Attributes – Methodology Issues
  – How do we compare apples with apples?
    – CODI is a gross amount (i.e., pre-apportionment); state NOL, in many states, is post-apportionment; asset basis is pre-apportionment
  – Potential methods:
    – “Step-down” CODI
    – “Gross-up” state NOL
    – Apportioning federal NOL reduction
    – Others
Issues in Applying IRC § 108 to State Attributes

• States With Nonconformity to Federal Consolidated Return Regulations – Methodology Issues
  – Attribute reduction for combined reporting states not conforming to the federal consolidated return regulations
    – As noted previously, combined NOL generally becomes separate attribute of group members having nexus and in proportion to that member’s relative presence in the state
      – Location of NOL and CODI potentially are mismatched
    – Without federal consolidated return regulation conformity (or guidance to the contrary), attribute reduction possibly likely still done on “as if separate” basis for CODI and attributes of each member
      – Issue exists of whether, as an alternative, “group” CODI possibly should be apportioned to nexus members (rather than members actually incurring CODI)
    – Another approach seen in practice for combined reporting states is that attribute reduction is performed using “combined” NOL and “combined” assets (although no technical basis seems to exist for such a methodology)
Issues in Applying IRC § 108 to State Attributes

• States With Nonconformity to Federal Consolidated Return Regulations – Other Issues
  – Differences in asset basis. Examples include:
    – Depreciable Property – Non-conformity with bonus depreciation.
    – Subsidiary stock basis
      – May be computed on “as if separate” basis (i.e., no “tiering-up” of adjustments that occurs for federal purposes) - often results in state basis approximating original cost, adjusted for contributions and returns of capital.
  – Application of the Federal “Look Through Rules” (discussed previously)
    – In states not following consolidated return regulations, the lack of “look through” generally increases instance of IRC § 1245 taint on subsidiary stock.
    – While not reducing attributes currently, subsequent liquidation (even tax free IRC § 332 liquidation) can result in recognition of gain (if gain in the stock).
    – In some instances, it can require a deferred tax liability to be recorded for financial reporting purposes.
  – Other Practical Considerations
    – Data needs and availability
    – Taxpayer with CODI moving in and/or out of states
Section 382
State Adoption of IRC § 382

– Most states appear to adopt IRC § 382 through their general incorporation of the Internal Revenue Code
  – Some states explicitly adopt IRC § 382 via statute but limited guidance provided in regulations
  – A few states specifically do not adopt IRC § 382
  – Arguments may be made that IRC § 382 does not apply where states have adopted separate NOL regimes

– Loss corporation may exist for state purposes but not federal (e.g., separate state NOLs, but no federal consolidated NOLs)

– IRC § 382(l)(5) vs. IRC § 382(l)(6)
Separate vs. Consolidated Methodology

- Different filing methodologies for state (e.g., separate, nexus consolidated, unitary combined, etc.)

- Determination of Value
  - Allocating value among the members
  - Value is first determined for lowest tier subsidiary and that value is subtracted from value determined for its parent.
  - Restoring value of lower tier subsidiaries: Treas. Reg. § 1.382-8 elections
  - Positions may potentially exist in unitary combined reporting states to use combined value vs. separate company.

- NUBIG/NUBIL
  - Investment in subsidiaries: stock basis differences
  - Intercompany Accounts
  - Application of Notice 2003-65
Application of State Apportionment

- Many states in which NOLs are computed on a post-apportionment basis do not provide guidance as to whether to reduce NOLs on a pre- or post-apportionment basis.
  - If post-apportionment, which years’ apportionment information to use?
- In states where NOLs are computed on a post-apportionment basis, a question arises as to whether IRC § 382 limitations (if applicable) are computed pre- or post-apportionment.
  - If the state statues are silent regarding the application of IRC § 382 limitations, does a position exist to apply the entity’s federal limitation pre-apportionment?
Other Applicable State Considerations
Other Applicable Considerations

– Prompt Determination of Tax (B.C. § 505(b))

  – Authorizes the trustee or debtor to request a prompt determination by the tax authorities of its tax liability in respect of any unpaid post-petition tax for a completed taxable year for which a return has been filed.

  – If authority fails to act, the debtor is typically discharged from any liability associated with that return.

– State Transfer Tax (B.C. § 1146(a))

  – State and local tax authorities are precluded from imposing a stamp tax or similar tax on a transfer pursuant to a court approved plan of reorganization.
Questions
Contact Information

Brian Sullivan  
Deloitte Tax LLP  
+1.404.220.1673  
briansullivan@deloitte.com

Derek Krozek  
Deloitte Tax LLP  
+1.313.394.5082  
dkrozek@deloitte.com

Scott Salmon  
KPMG LLP  
+1. 202.533.4202  
ssalmon@kpmg.com
Notice

KPMG LLP, a Delaware limited liability partnership and the U.S. member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative (“KPMG International”), a Swiss entity.

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity.

This presentation contains general information only and Deloitte and KPMG are not, by means of this presentation, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This presentation is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte and KPMG shall not be responsible for any loss sustained by any person who relies on this presentation.

Any tax advice in this communication is not intended or written by Deloitte and KPMG to be used, and cannot be used, by a client or any other person or entity for the purpose of (i) avoiding penalties that may be imposed on any taxpayer or (ii) promoting, marketing or recommending to another party any matters addressed herein.

You (and your employees, representatives, or agents) may disclose to any and all persons, without limitation, the tax treatment or tax structure, or both, of any transaction described in the associated materials we provide to you, including, but not limited to, any tax opinions, memoranda, or other tax analyses contained in those materials.

The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.