The Peculiar World of Chapter 11 Bankruptcy Taxation

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As the U.S. looks to come back from what Warren Buffett described as a "big one-two punch" of a pandemic and collapsing oil prices, many industries are facing disruptions in business performance resulting in rapid and severe financial distress. As the premier advisor for restructuring and turnaround of troubled companies, Alvarez & Marsal has a long history of guiding companies through the unique business and tax matters encountered throughout the Chapter 11 bankruptcy process timeline. In this issue of the Tax Advisory Weekly, we provide an overview of several key tax challenges facing companies in Chapter 11 bankruptcy.

Impact of the bankruptcy filing

Although pre-filing analysis may be done, the formal process of filing bankruptcy begins with a petition to the Bankruptcy Court. Pre-petition debts, including taxes, cannot be paid without court approval. However, post-petition debts are generally paid in the ordinary course of business. Placing tax obligations in the proper pre- or post-petition bucket is not always intuitive, particularly for non-income taxes like property tax. In addition, certain pre-petition tax obligations may have different bankruptcy priorities based on when the tax was incurred. A thorough inventory of the company's tax obligations is required to insure no amounts are paid illegally.

The first day order

When the petition is filed, the Bankruptcy Court issues "first day orders," which allow certain, otherwise impermissible pre-petition liabilities to be paid (such as utilities, payroll, etc.). Taxes are a key element of the first day orders declared by the court. At this time, equity and debt trading orders are often handed out to restrict trading of equity and debt interests and to preserve and protect tax attributes like net operating losses.

Most importantly, the debtor company must receive authorization to pay trust fund taxes incurred before the petition is filed. Trust fund taxes typically include payroll withholding, sales taxes and certain excise taxes. The company's officers have a vital interest in ensuring the collected taxes are paid since as "responsible persons," they may have personal liability for trust fund taxes under federal or state law.

The claims process

All actual or potential creditors must be sent a notice of the bankruptcy filing. The court will set a "bar date," which is normally 180 days after commencement of the case. Claims filed after the bar date are generally not allowed. It is vital that all tax jurisdictions with potential claims be notified so their bar date period begins to run.

As a result of the bankruptcy notification, the company filing bankruptcy may suffer a deluge of federal and state audits. Excessive claims may also be filed as the jurisdiction seeks to protect its position until audits are completed and the correct amount owed is determined. All of these claims must be examined, reconciled and negotiated to ascertain the amount of allowed claim. If an agreement is not reached, the debtor may object to the claim, leaving the matter to be decided by the bankruptcy judge. This possibility encourages state and local taxing authorities to negotiate a reasonable settlement.

Priority of tax claims

In addition to the Internal Revenue Code (IRC), the Bankruptcy Code (B.C.) [1] includes many provisions that impact federal and state taxes, in which the Bankruptcy Court often becomes the final decision maker for tax issues. In particular, B.C. § 507(a)(8) defines which tax claims fall under the eighth priority in the pecking order of unsecured claims. Which taxes are included as a priority claim depends on the type of tax, filing date and other factors. Determining which claims are priority claims, however, can be complex.

Impact of bankruptcy on the statute of limitations

The statute of limitations for assessment is not impacted by bankruptcy. Governments can still issue notices and demands for payment, but collection actions and levies are stayed. Note that the Bankruptcy Code also has special provisions that stipulate what interest and penalties can be assessed for pre- and post-petition taxes.

Continuing tax compliance

Bankruptcy does not terminate a company's year-end or eliminate the requirement to file tax returns. Tax authorities can still audit the company and, as noted, often intensify their efforts during this inspection. In this period of increased compliance burden and uncertainty, the company's tax personnel may depart in short order. As such, and especially in the case of liquidating bankruptcies and B.C. §363 asset sales, the legacy company may need to outsource its tax function.

Special rules for loss carryforwards and other tax attributes

IRC §382 can severely limit the use of loss carryforwards when there is a significant change in ownership. This section also restricts the carryforward of interest disallowed under IRC 163(j) and governs the treatment of unrealized gains and losses. As previously noted, in order to help preserve these valuable attributes, bankruptcy judges often issue orders to halt trading in the company's stock or debt.

Companies in Chapter 11 bankruptcy may be eligible to utilize special rules under IRC §382(l)(5) to avoid imposition of the 382 limitation. There is, however, a "toll charge" for IRC §382(l)(5) relief. The NOL is reduced for interest paid to creditors who become shareholders as a result of the bankruptcy. This reduction includes interest deducted during the three-year period that precedes the tax year in which the ownership change occurs, and during the portion of the year before the ownership change.

The debtor may not qualify or elect out of IRC §382(l)(5) relief. Instead, the debtor can use the special valuation rule of IRC §382(l)(6), in which the value of the new loss corporation will be increased by the surrender or cancellation of creditor claims. This may greatly increase the amount of NOL that can be utilized under the normal 382 rules.

The decisions on how to best protect the valuable NOL asset require analysis of rules beyond the scope of this article, and frequently require modeling to determine the best course of action. Furthermore, many states do not fully conform to the federal provisions of IRC §382, so a state analysis of these provisions is often necessary.

Cash is king during reorganizations

Identifying and preserving cash is a key role that tax management can play during the bankruptcy. Management emphasis often shifts its focus from ASC 740 GAAP accrual accounting for income taxes to cash flow. Not only do accounting methods changes, but refund acceleration, negotiation assessments and reverse sales tax audits may all take on a new urgency. Tax Directors must stay on top of federal and state relief provisions currently enacted or considered, which would defer payments, provide payroll tax credits or allow utilization of NOLs.

Cancellation of indebtedness (COD) income

When debt is forgiven by creditors, insolvent businesses and companies in Chapter 11 bankruptcy also get a break from including COD in taxable income. Although COD may not be taxable to them at that time, loss carryforwards or other tax attributes must be reduced for the excluded income at the beginning of the following tax year. When the forgiven debt exceeds the debtor company's loss carryovers and other tax attribute basis, a permanent benefit may occur. Debtors should also consider the election under IRC §108(b)(5) to reduce the basis of its depreciable assets before reducing their NOLs. Similar to IRC §382, these rules are complex, so a detailed analysis is often necessary to identify and optimize the emerging company's tax position.

Much like the IRC §382, state conformity with IRC §108 varies by jurisdiction and should be carefully reviewed.

Consolidated groups can get tricky

Note that some members of a consolidated tax return may not declare bankruptcy. In this situation, the old tax sharing agreement between affiliated companies (which no one previously cared about) can become crucial. Some members of the group could become creditors in the bankruptcy. As a result, there may be different interpretations of how refunds and liabilities are split between the companies in or out of bankruptcy proceedings.

This situation can also be tricky for the Tax Director. In bankruptcy, the management's fiduciary duty shifts from the shareholders to the creditors. Allocating tax liabilities between group members in and out of bankruptcy means the tax professional has split loyalties. In extreme circumstances, it might be necessary to appoint a different tax advisor for different members of the affiliated group. In February, the U.S. Supreme Court in Rodriguez v. FDIC upended a long history of how tax refunds are allocated between consolidated group members. [2] Accordingly, it is imperative to update the tax sharing agreement prior to declaring bankruptcy.

New entities may be created

After filing for Chapter 11 bankruptcy, the debtor has 120 days to submit a Chapter 11 reorganization plan which is the playbook by which the company hopes to emerge as a successful enterprise. The plan and its amendments can provide for the establishment of one or more "liquidating trusts" for the benefit of certain classes of creditors or equity holders. Some funds may be taxable as grantor trusts while funds for disputed claims are usually taxable under IRC §468B, like corporations with certain modifications.

Note that these funds have their own technical and compliance challenges that could last for many years. Our firm, for example, is still advising liquidating trusts formed as a result of the 2008 financial crisis.

Who would invite an IRS audit?

B.C. §505(b) allows the bankruptcy trustee to request a final determination of any tax incurred during the administration of the estate. The taxing authority has 60 days after notification to tell the trustee whether the return has been selected for audit. If the return is selected for audit, the tax authority has 180 days to complete the examination and notify the trustee of the amount of tax due.

Most tax practitioners are not eager to trigger a tax audit due the effort involved. However, bankruptcy counsel often recommends a §505(b) filing to ensure that fiduciaries have no continuing exposure and close the statute of limitations while the bankruptcy court is still providing oversight.
Emerging with a fresh start

When the company emerges from bankruptcy, GAAP rules do their part with "fresh-start" accounting under ASC 852-10-45-17 and ASC 852-10-45-18. Balance sheets are adjusted to "reorganization value," which is essentially fair market value. The analysis is conceptually similar to accounting for business combinations under ASC 805 (with certain nuances).

Deferred tax assets and liabilities will need to be re-stated to reflect the difference in fair market value and tax basis. Additionally, the impact of special provisions related to attribute carryforwards and COD adjustments, as previously discussed, will need to be further examined. Valuation allowances for deferred tax assets also require analysis and judgment to assess whether the company will be profitable in the future under its new debt structure.

A&M Says

This article only touches upon some of the complex issues that a tax department can expect to face in Chapter 11 bankruptcy. It is important to keep in mind that in bankruptcy, the tax rules are sometimes unclear and the Internal Revenue Code and Bankruptcy Code occasionally conflict. Alvarez & Marsal's history as the preeminent advisor to troubled companies gives us deep expertise and practical experience in all of the topics discussed, as well as many other issues not addressed in this overview. We have provided tax advice and compliance services during all phases of the Chapter 11 bankruptcy process timeline and assisted many companies to emerge successfully from the ordeal.

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[1] 11 U.S.C. §§ 101-1532

[2] See our prior discussion of the Rodriguez case at https://www.alvarezandmarsal.com/insights/supreme-court-unanimously-upends-47-year-old-bankruptcy-tax-principle-regarding-ownership

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Related Insights:

Supreme Court Unanimously Upends 47-Year Old Bankruptcy Tax Principle Regarding Ownership of Corporate Tax Refunds

On February 25, 2020, the U.S. Supreme Court in Rodriguez v. FDIC unanimously ended the practice of determining the ownership of a tax refund based upon federal common law. Hereafter, the ownership will generally be determined based upon state corporate law, which takes into account contractual arrangements (e.g., tax sharing agreements) between the parties.

Limitations on Corporate Tax Attributes: An Analysis of Section 382 and Related Provisions (May 2019 Update)

As a result of the recent economic recession, many corporations found themselves with unprecedented losses from investments and operations. These losses can result in the creation of tax attributes for the corporation that can be used as deductions against future profits. Corporations with such attributes have to understand the rules that limit the use of these tax attributes.

Finders-Keepers: Who Owns The Tax Refund Of An Insolvent Company

This paper discusses United Western Bancorp in depth since it represents the most current thinking by the courts as to how these cases should be analyzed. It also attempts to make some sense of the rules and cases, which can be inconsistent or vary based on fine distinctions.

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Authors:

Christopher Howe
Douglas Sayuk
Kim Barr

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