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Reduction of Tax Attributes Following Cancellation of Debt

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The cancellation of debt, or satisfaction of debt for a payment less than the full amount owed, generally results in the debtor's realizing "gross income" for Federal income tax purposes, to the extent the amount owed by the debtor exceeds the amount paid (if any). However, if the discharge of debt arises in a bankruptcy case or when the debtor is insolvent, section 108 of the Internal Revenue Code ("IRC") permits the debtor to exclude the debt discharge income from gross income, but at the cost of reducing certain loss carryovers and other favorable tax attributes, including the basis of the debtor's property.

Recent attempts by taxpayers to take advantage of these rules in inappropriate ways have provoked reactions in the Treasury Department and Congress to clarify the proper application of the "attribute reduction" regime. Thus, the IRS has issued temporary and proposed regulations addressing, among other things, the application of the tax attribute reduction rules where the taxable year of the debtor in which the debt discharge occurs ends by reason of certain nontaxable transactions, including a liquidation to which IRC section 332 applies or a nontaxable reorganization.

In addition, legislation has been introduced in Congress that would address the reduction of tax attributes where the entity having COD income is a member of an affiliated group filing consolidated returns.

Background

Where COD income is excluded from a debtor's income under the circumstances described above, section 108(b) requires the reduction of certain tax attributes of the debtor, specifically: net operating losses ("NOLs"); general business credits; minimum tax credits; capital loss carryovers; the basis of the debtor's property; passive activity loss and credit carryovers; and foreign tax credit carryovers.

Tax attributes are generally reduced in the sequence listed above (NOLs first, then general business credits, etc.), but a debtor may elect to reduce the bases of its depreciable property first, to the extent that it has basis in such property as of the beginning of the taxable year following the year of the discharge. If the COD income exceeds the tax attributes available for reduction, the excess is effectively disregarded.

The reductions of tax attributes are made after the determination of the tax due for the year of the discharge. Thus, carryover attributes are reduced only to the extent that they are being carried to a taxable year of the debtor after the year of the debt discharge. Similarly, any reduction to basis is made to the basis of the taxpayer's property on the first day of the first taxable year after the year of the debt discharge.

Reorganization Rules

A transfer of property of one corporation to another which is described in IRC section 381(a), namely, a liquidating distribution by a subsidiary to a parent corporation described in IRC section 332 or a transfer of assets in connection with a

merger or other nontaxable reorganization (other than a "B" stock-for-stock exchange or an "E" recapitalization), will result in a carryover to the surviving "transferee" corporation pursuant to IRC section 381(c) of certain of the transferor's tax attributes, such as NOLs and capital loss carryovers. Similarly, the transferee generally takes a carryover basis in the assets transferred equal to the transferor's basis in those assets.

Moreover, in most such transactions described in section 381(a), the taxable year of the transferor corporation ends on the date of the transaction.

Interaction between COD and Reorganization Rules

Questions have been raised regarding how tax attributes are reduced under section 108 in a situation where the debtor's taxable year during which the debt discharge occurs ends with a transaction described in section 381(a).

Some taxpayers have apparently taken the position that the debtor's tax attributes are not reduced under section 108 until *after* the transfer of assets and the concomitant carryover of tax attributes to the transferee corporation under section 381(a). Under this theory, no tax attributes *of the debtor* remain to be reduced at year-end. The surviving corporation is thus in a better position than would be the debtor itself had no section 381(a) transaction occurred.

As a matter of tax policy, it seems clear that an entity that succeeds to the tax attributes of the debtor should receive those attributes subject to the reductions

contemplated by section 108. The legislative history for the Bankruptcy Tax Act of 1980 in fact indicates that Congress anticipated that tax attributes would be reduced under these circumstances. Section 108, however, does not expressly address this situation.

New Regulations

Temporary and proposed regulations were recently issued to address the application of the section 108 tax attribute rules in various circumstances.

With respect to a transaction described in section 381(a) that causes the taxable year of the transferring corporation to end, any tax attributes to which the acquiring corporation succeeds, and the basis of property acquired by the acquiring corporation, must reflect the reductions required by section 108(b).

The regulations include several examples. In one example, X, a corporation in bankruptcy, has one depreciable asset with a basis of \$75,000 and fair market value of \$100,000; trade debts of \$200,000; and no other assets or liabilities. It also has an NOL of \$80,000.

In a nontaxable reorganization in connection with the bankruptcy proceedings, X transfers its assets to Y corporation in exchange for Y stock worth \$100,000 that is distributed to the trade creditors of X in full satisfaction of their claims. Apart from the debt discharge, X has \$10,000 of gross income for the year of the debt discharge and a \$10,000 deduction for depreciation.

Under section 108, the distribution of Y stock to the trade creditors of X causes X to have \$100,000 of COD income (the excess of the \$200,000 trade debt over the value of the stock transferred to satisfy the debt), all of which is excluded from gross income under section 108(a). Separately, the basis of the property of X is reduced by the \$10,000 of depreciation allowable for the year of the debt discharge, to \$65,000.

The attribute reduction rules then require that the NOL carryover of X be reduced from \$80,000 to zero and that the basis of its property be reduced by \$20,000 (\$100,000 - \$20,000), the portion of the COD income that exceeds the NOL available for reduction. Accordingly, Y does not succeed to any part of the NOL of X, and acquires the depreciable property of X with a basis of \$45,000.

Another example makes clear that, had X elected to reduce the basis of its depreciable property first, then (under the facts described above) the basis in the property would have been reduced from \$65,000 to zero and Y would have succeeded to the NOL of X as reduced by the balance of the COD income, that is, \$45,000 (\$80,000 - \$35,000).

The regulations are effective for discharges of debt occurring after July 17, 2003.

Proposed Legislation

The tax planning of MCI with regard to preservation of its NOLs and other tax attributes has attracted attention in the news media and in Congress.

The pending bankruptcy proceedings with respect to MCI, in which most creditors are expected to receive only a small fraction of their claims, would result, in the ordinary course, in a large amount of COD income subject to exclusion under section 108, and therefore in a large reduction in the tax attributes of MCI. Reportedly, however, MCI expects to emerge from bankruptcy proceedings with about \$10-15 billion of NOLs.

That expectation may be premised at least in part on a particular view of the application of section 108 in the context of discharge of debt of a corporation that joins in filing a consolidated Federal income tax return. This view would hold that section 108(b) potentially affects the tax attributes attributable to the activities of members of the MCI consolidated group on a "member-by-member" basis, with the effect that the attribute reduction attributable to each member's debt discharged would be limited to the lesser of that member's COD income or the tax attributes properly attributable to that member. This could result in a much greater survival of tax attributes than would a rule that required reduction of tax attributes of all members of the entire affiliated group.

Apparently in response, Senators Santorum and Conrad have introduced legislation that would amend section 108 to provide that, if a corporation the debt of which is discharged is a member of an affiliated group filing a consolidated return, the tax attributes subject to reduction under section 108 will be the aggregate tax attributes of the affiliated group.

The legislation is proposed to be effective with respect to discharges of debt after June 25, 2003. In the context of a

bankruptcy proceeding, a discharge of debt will be deemed to occur on the date the plan of reorganization is confirmed.

Given the extent of the attention that has been given by the competitors of MCI to the financial and tax-related positions of MCI, and the likelihood that other similarly situated corporations have or will take similar positions with respect to the section 108 attribute reduction rules as applicable to NOLs of members of an affiliated group filing a consolidated return, there appears to be a substantial possibility that this legislation will be enacted in some form.

It is not clear, however, that the legislation reflects an appropriate approach to attribute reduction in the consolidated return context. The proposed change to section 108, if enacted, could cause the bankruptcy of one subsidiary within an affiliated group to affect the tax attributes and ultimately the tax liabilities of other group members that have no connection (other than common ownership and the consolidated return) to the subsidiary with COD income, and which derived no benefit from the debt of the subsidiary or the discharge thereof. Also, although the motivating factor behind the proposed legislation may be to ensure that there is an appropriate reduction to the entire group's NOLs, in view of the fact that NOLs are often considered to be a "consolidated," rather than a "separate company," tax attribute, the legislation would also affect other tax attributes not generally computed on a consolidated basis, such as asset basis.

The proposed change might also provide further motivation to affiliated groups to take steps to terminate the filing of consolidated returns (or affiliated group membership) of corporations approaching insolvency or bankruptcy proceedings before a discharge of debt occurs, conceivably to the overall detriment of the affiliated group or the member or members of the group that are in financial difficulty.

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