

State Tax Considerations in Bankruptcy: Attribute Reduction and “Old” 346(j)

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Agenda

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Introduction – 15 Largest Bankruptcies

Company (click for more info)	Bankruptcy Date	Total Assets Pre-Bankruptcy	Filing Court District
<u>Worldcom, Inc.</u>	07/21/2002	\$103,914,000,000	NY-S
<u>Enron Corp.*</u>	12/2/2001	\$63,392,000,000	NY-S
<u>Conseco, Inc.</u>	12/18/2002	\$61,392,000,000	IL-N
<u>Texaco, Inc.</u>	4/12/1987	\$35,892,000,000	NY-S
<u>Financial Corp. of America</u>	9/9/1988	\$33,864,000,000	CA-C
<u>Refco Inc.</u>	10/17/2005	\$33,333,172,000	NY-S
<u>Global Crossing Ltd.</u>	1/28/2002	\$30,185,000,000	NY-S
<u>Pacific Gas and Electric Co.</u>	4/6/2001	\$29,770,000,000	CA-N
<u>UAL Corp.</u>	12/9/2002	\$25,197,000,000	IL-N
<u>Delta Air Lines, Inc.</u>	9/14/2005	\$21,801,000,000	NY-S
<u>Adelphia Communications</u>	6/25/2002	\$21,499,000,000	NY-S
<u>MCorp</u>	3/31/1989	\$20,228,000,000	TX-S
<u>Mirant Corporation</u>	7/14/2003	\$19,415,000,000	TX-N
<u>Delphi Corporation</u>	10/8/2005	\$16,593,000,000	NY-S
<u>First Executive Corp.</u>	5/13/1991	\$15,193,000,000	CA-C

Cancellation of Indebtedness – Outside of Bankruptcy

- The general rule is that a discharge of debt for an amount that is less than the amount due must be recognized as taxable income. See *U.S. v. Kirby Lumber*, 284 U.S. 1 (1931).
- This general rule of income recognition is codified in I.R.C. Sec. 61(a)(12), which provides that gross income includes income from the discharge of indebtedness.
- The amount of income recognized is generally the difference between the amount due under the face of the instrument and the amount paid upon its discharge.

Cancellation of Indebtedness in Bankruptcy

- Gross income does not include any amount which would be includible in gross income by reason of the discharge of indebtedness if the discharge occurs in a title 11 case. I.R.C. Sec. 108(a)(1)(A).
- The quid pro quo for this favorable exclusion of what would otherwise be taxable income is that a taxpayer is required to reduce certain tax attributes.

Federal Legislation and Attribute Reduction Rules

- 11 U.S.C.A. Sec. 346 and I.R.C. Sec. 108.
- Revenue Reconciliation Act of 1993.
- U.S. Bankruptcy Abuse Prevention and Consumer Protection Act of 2005.

Attribute Reduction Under I.R.C. Sec. 108(b)

Attributes are required to be reduced in the following order:

1. NOLs for the current taxable year and any NOL carryovers.
2. General business credits under I.R.C. Sec. 38.
3. Minimum tax credits available under I.R.C. Sec. 53(b).
4. Capital loss carryovers.
5. Basis in property.
6. Passive activity loss and credit carryovers under I.R.C. Sec. 469(b).
7. Foreign tax credit carryovers.

Asset Basis Reduction

- The methodology for reducing the basis in assets is controlled by I.R.C. Sec. 1017.
- Ordering rules are set forth in Treas. Reg. 1.1017-1:
 1. Real property used in a trade or business or held for investment that secured discharged indebtedness.
 2. Personal property used in a trade or business or held for investment, but not inventory, accounts receivable or notes receivable, that secured the discharged indebtedness.
 3. Remaining property used in a trade or business or held for investment, but not inventory, accounts receivable, notes receivable or Sec. 1221(1) real property.
 4. Inventory, accounts receivable, notes receivable and Sec. 1221(1) real property.
 5. Property not used in a trade or business nor held for investment.
- Total reduction in basis is limited in that it cannot exceed the excess of the aggregate of the bases or the property held by the taxpayer immediately after the discharge over the aggregate of the liabilities of the taxpayer immediately after the discharge.

Miscellaneous Rules Affecting Attribute Reduction

- Attribute reduction is done after the determination of tax for the taxable year of the discharge. I.R.C. Sec. 108(b)(4)(A).
- Attributes are reduced on a dollar-for-dollar basis, except for credit carryovers which are reduced by 33 and 1/3 cents for each dollar of excluded income.
- Reduction of NOLs are first applied to current year losses and then to loss carryovers in the order of the taxable years for which they arose.

Stock for Debt

- Historically, a corporate debtor did not realize income from the discharge of indebtedness in exchange for the issuance of its stock.
- Exception was progressively limited beginning with the Bankruptcy Tax Act of 1980.
- Exception was repealed in its entirety by the Revenue Reconciliation Act of 1993.
- If a corporation transfers stock to a creditor in satisfaction of its debt, such corporation shall be treated as having satisfied its debt in an amount of money equal to the fair market value of the stock. I.R.C. Sec. 108(e)(8).

I.R.C. Sec. 382 Limitations

- NOL and other attribute limitations pursuant to I.R.C. Sec. 382 are common in a bankruptcy due to the frequency of exchanges of stock for debt.
- I.R.C. Sec. 382(l)(5) enables a corporation reorganized in context of a Ch. 11 case to avoid the 382 limitation, but cannot have an ownership triggering event within 2 years.
- In general, the loss limitation rules will not apply if the shareholders and creditors of the old loss corporation own 50% of the stock of the new loss corporation

State Tax Issues – What Law Controls?

Except to the extent otherwise provided in this section, subsections (b), (c), (d), (e), (g), (h), (i), and (j) of this section apply notwithstanding any State or local law imposing a tax, but subject to the Internal Revenue Code of 1986. 11 U.S.C.A. Sec. 346(a).

The Congress shall have the power to . . . establish . . . uniform Laws on the subject of Bankruptcies throughout the United States. Art. I, Sec. 8 of the U.S. Constitution.

This Constitution and the Laws of the United States which shall be made in Pursuance thereof . . . shall be the supreme Law of the Land; and the Judges in every State shall be bound thereby Art. VI of the U.S. Constitution.

11 U.S.C.A. Sec. 346 – Exclusion of Income

- *Except as otherwise provided in this subsection, income is not realized by the estate, the debtor, or a successor to the debtor by reason of forgiveness or discharge of indebtedness in a case under this title. 11 U.S.C.A. Sec. 346(j)(1).*
- Sec. 346 of the bankruptcy code provides for the reduction of only two attributes, net operating losses and basis in assets, in that order.

The Stock for Debt Exception

- Probably one of the most significant differences between the bankruptcy code and the I.R.C. is the bankruptcy code's preservation of the stock for debt exception.
- Pursuant to 11 U.S.C.A. Sec. 346(j)(7), “[i]ndebtedness with respect to which an equity security . . . is issued to the creditor to whom such indebtedness was owed, or that is forgiven as a contribution to capital by an equity security holder . . . is not forgiven or discharged in a case under this title”

Summary of Significant Federal/State Differences Under Old 346(j)

Federal rules not applicable under the bankruptcy code:

1. Election to adjust basis in depreciable assets first.
2. Attribute reduction includes certain credit carryovers, capital loss carryovers and passive activity losses.

Current State Cases – Bankr § 346 v IRC § 108?

1. A Northeastern State

- Northeastern State - TP reduced federal asset basis by \$600M, from \$700M to \$100M.
- Federal 1120 depreciation expense was based on \$100M and was approx. \$10M.
- TP took an “Other” subtraction of \$50M add’l depreciation expense based on restoring the \$600M federal asset basis reduction
 - $\$50M \times 11\%$ state apportionment = \$5.5M add’l state expense
 - $\$5.5M \times 6\%$ tax rate = \$330,000 tax assessment per year

Taxpayer's Argument

- The federal asset basis reduction was caused by COD from a stock for debt exchange. Federally this required attribute reduction. TP noted that Sec. 346 retained the stock for debt exception to attribute reduction:
- Pursuant to 11 U.S.C.A. Sec. 346(j)(7), “[i]ndebtedness with respect to which an equity security . . . is issued to the creditor to whom such indebtedness was owed, or that is forgiven as a contribution to capital by an equity security holder . . . is not forgiven or discharged in a case under this title”
- Therefore the TP argued that it was entitled to restore the \$600M of asset basis and take the add'l \$50M of depreciation expense.

State's Argument

- Yes, we have to follow old 346 based on Supremacy Clause & Bankruptcy Clause
 - Federal bankruptcy law involves a dominant federal interest that preempts state law where the state law is “an obstacle to the accomplishment and execution of the full purposes and objectives of Congress.” *Hines v. Davidowicz*, 312 U.S. 52, 67 (1941).
 - The federal bankruptcy power may constitutionally impinge on the state taxing power just as the federal commerce clause power prevents the states from enacting non-discriminatory taxes on out-of-state businesses. *Bondholder Committee v. Williamson County*, 43 F.3d 256, 265.

State's Argument

- BUT, the state's Line 28 FTI starting point already includes the effect of the federal asset basis reduction!
 - Nothing in old 346 requires a state to disregard or adjust the federal reduction of attributes.
 - The issue is merely the result of the inconsistencies in applying BR Sec. 346 to state taxation and IRC Sec. 108 to federal taxation
- SO, we have to follow Sec. 346 but we can essentially give it no effect.
- Does TP have an argument that in order to give effect to Sec. 346, it has to be treated as a state subtraction or addition? Or are the specific mechanics required?

Do States Really Have to Follow Old 346?

- [The Congress shall have power] To establish...*uniform* Laws on the subject of Bankruptcies throughout the United States. (Emphasis added.) U.S. CONST. art. I, § 8, cl. 4.
- The Bankruptcy Clause, which grants Congress the power to make bankruptcy laws, stresses that such rules must be “*uniform*.” (Emphasis added.) *Sherwood Partners, Inc. v. Lycos, Inc.*, 394 F.3d 1198, 1201 (9th Cir. 2005).
- The states’ taxing powers are an attribute of their sovereignty. Can a state argue that it is not bound by old Sec. 346 because it does not promote the purposes of the Bankruptcy Clause?
 - The supremacy of the bankruptcy code over state law flows from the need for a national *uniform* law to efficiently and effectively administer the bankruptcy estate and provide a fresh start for the debtor. Following Sec. 346 is opposed to that goal since it prescribes state tax treatment that is substantially different from federal treatment under Sec. 108.
 - Is there a counterargument that old Sec. 346 at least created uniformity among the 50 states if not with the federal government?

Ring One Up for the States

- In 2003, the Va. Cmm'r of Rev. ruled that IRC § 108(d)(6) applied over Bankr. Code § 346(a) and (j). Va. Pub. Dec. 03-72 (2003).
- In his ruling, the Cmm'r cited the legislative history of the special bankruptcy tax provisions from the 1978 Bankruptcy Reform Act:
 - [T]here is a strong bankruptcy policy that these provisions apply equally to Federal, State, and local taxes. However, in order to avoid any possible jurisdictional conflict with the Ways and Means Committee over the applicability of these provisions to Federal taxes, H.R. 8200 has been amended to make the sections inapplicable to Federal taxes
 - Though the bill has been amended to remove Federal taxes from the scope of the four sections, the discussion in this section will proceed as though the bill has not been so amended. This will give a better picture of how these provisions would apply to Federal taxes should the Ways and Means Committee decide in its bankruptcy-tax bill to follow with respect to Federal taxes the proposals made here with respect to State and local taxes. (Emphasis added.) H.R. Rep. No. 595 (1978).

Ring One Up for the States

- Based on this expressed legislative intent, the Va. Cmm'r reasoned:
 - “The clear intention of Congress is to treat federal, state, and local taxes equally. To treat state and local taxes differently from the federal tax laws after they were excluded from the 1978 Act would be inconsistent with the clear congressional intent of the bankruptcy laws. .”
- Thus the Va. Cmm'r, despite the supremacy of federal bankruptcy law, ruled that Va. treatment of COD income should not be different from federal treatment; Va. would therefore apply IRC § 108(d)(6), and not follow Bankr. Code § 346.

Current State Cases – Bankr § 346 v IRC § 108?

2. Southeastern State

- Taxpayer refund claim for \$1.6M driven by fed-state adjustments
- 2004 return showed the following addbacks to federal income
 - IRC Sec. 382 Depreciation = \$2.3M
 - IRC Sec. 1017 COD Adj. = \$51.7M
- 2004 return showed the following subtraction
 - IRC Sec. 382 Bad Debt Deduction = (\$189.3M)
- Refund Claim of \$1.6M was based on 4% GA apportionment
- Note: The 2005 return showed the following addback to federal income
 - Attribute Reduction Allowed for State Purposes = \$45.6M

Current State Cases – Bankr § 346 v IRC § 108?

3. MCI/Worldcom

- Per TP's 2005 10-k, it estimated the following effects of the reduction of tax attributes for federal and state purposes:
- After federal attribute reduction, MCI/Worldcom would have
 - Zero NOL Carryovers
 - Zero Capital Loss Carryovers
 - Zero Credit Carryforwards
 - And a further \$7.2 Billion reduction in asset basis (of which \$5.7 B is a reduction in depreciable asset basis)
- After state attribute reduction, MCI/Worldcom would have
 - \$557Million in State NOL Carryovers
 - Presumably no other attributes would be reduced

The Apportionment Conundrum

The Commerce and Due Process Clause requirements of fair apportionment raise a mix of issues in the context of attribute reduction, particularly with respect to NOLs.

The problems derive from the fact that the relationships between the actual discharge, the origination and utilization of the debt and the creation of affected attributes involve a blend of historical and contemporaneous events that likely occurred over a period of time wherein the taxpayer's in-state apportionment may have changed dramatically.

Fresh Start Accounting

- Statement of Position No. 90-7 requires firms in Chapter 11 bankruptcy to estimate and report the fair market value of the assets, liabilities and equity of the entity that is expected to emerge from bankruptcy.
- This restatement must be applied to GAAP financials if the following conditions are met:
 1. The reorganization value of the emerging entity is less than the total amount of all postpetition liabilities, plus all allowed prepetition liabilities, and
 2. Prepetition voting shareholders receive less than 50% of the voting shares in the new entity.

State Tax Issues Raised by Fresh Start Accounting

1. Franchise tax implications.
2. May create significant differences between tax and book basis of assets.
3. Impact on apportionment in states that use adjusted basis for purposes of the property factor.
4. Does it apply in a separate reporting state context when the taxpayer did not undergo a change in direct ownership?

Companies Recently in Chapter 11

2005 Companies over \$1B in Assets prior to bankruptcy

Company	Business Type	Coverage Starting Date
<u>American Business Financial Services, Inc.</u>	Provides Mortgage Loan Services	1/21/2005
<u>ASARCO LLC</u>	Copper Mining	8/9/2005
<u>Calpine Corporation</u>	Integrated Power Company	12/20/2005
<u>Collins & Aikman Corporation</u>	Manufacturer of Interior Automobile Components	5/17/2005
<u>Delphi Corporation</u>	Automotive Systems Manufacturing	10/8/2005
<u>Delta Air Lines, Inc.</u>	Passenger Airline	9/14/2005
<u>McLeodUSA Incorporated (2005)</u>	Communication Services	10/28/2005
<u>Northwest Airlines Corporation</u>	Passenger Airline	9/14/2005
<u>Refco Inc.</u>	Brokerage Services	10/17/2005
<u>Tower Automotive, Inc.</u>	Structural Component Designer for Automobiles	2/2/2005
<u>Winn-Dixie Stores, Inc.</u>	Operates Grocery Stores	2/21/2005

Companies Recently in Chapter 11

2004 Companies over \$1B in Assets prior to bankruptcy

Company	Business Type	Coverage Starting Date
Atlas Air Worldwide Holdings, Inc.	Provides aircraft, crew, maintenance and insurance	1/30/2004
Interstate Bakeries Corporation	Wholesale Baker & Distributor	9/22/2004
Metropolitan Mortgage & Securities Co., Inc.	Insurance	2/4/2004
Pegasus Satellite Communications, Inc.	Provides Satellite Television	6/2/2004
RCN Corporation	Delivers bundled communication services	5/27/2004
Stelco Inc.	Steel Producer	1/29/2004
Telewest Communications plc	Broadcasting Network	4/28/2004
Trump Hotels & Casino Resorts, Inc.	Operates Hotels and Casinos	11/21/2004
US Airways Group, Inc. (2004)	Holding Company for Passenger Airlines	9/12/2004
Yukos Oil Company	Oil Production and Distribution	12/14/2004

Companies Recently in Chapter 11

2003 Companies over \$1B in Assets prior to bankruptcy

Company	Business Type	Coverage Starting Date
Acterna Corp.	Communications Equipment	5/6/2003
Allegiance Telecom, Inc.	Telecommunications	5/14/2003
Alterra Healthcare Corp.	Healthcare Services	1/22/2003
AMERCO	Auto Rental & Leasing Services	6/20/2003
Aurora Foods Inc.	Miscellaneous Food Preparations & Kindred Products	12/8/2003
DVI, Inc.	Finance Lessors	8/25/2003
Fleming Companies, Inc.	Wholesale Distributor	4/1/2003
Key3Media Group, Inc.	Information Technology Services	2/3/2003
Leap Wireless International, Inc.	Wireless Communications	4/13/2003
Loral Space & Communications Ltd.	Radio , TV Broadcasting & Communications Equipment	7/15/2003
Magellan Health Services, Inc.	Hospitals and Healthcare Provider	3/11/2003
Mirant Corporation	Electric Services	7/14/2003
Northwestern Corporation	Utility Provider	9/14/2003
NRG Energy, Inc.	Energy Production	5/14/2003
Petroleum Geo-Services ASA	Oil & Gas Field Exploration Services	7/29/2003
Solutia Inc.	Chemicals & Allied Products	12/17/2003
Spiegel, Inc.	Specialty Retailer	3/17/2003
Touch America Holdings, Inc.	Telecommunications	6/19/2003
Trenwick Group Ltd.	Fire, Marine & Casualty Insurance	8/20/2003
Venture Holdings Company, LLC	Plastics Components	3/28/2003
Westpoint Stevens, Inc.	Bed and Bath Products Manufacturer	6/1/2003

Companies Recently in Chapter 11

2002 Companies over \$1B in Assets prior to bankruptcy

Company	Business Type	Coverage Starting Date
Adelphia Business Solutions, Inc.	Integrated Communications Services	3/27/2002
Adelphia Communications Corp.	Telecommunications	6/25/2002
Agway, Inc.	Agricultural Cooperative	10/1/2002
APW Ltd.	Electronics Manufacturer	5/16/2002
Asia Global Crossing, Ltd.	Telecommunications	11/18/2002
Budget Group, Inc.	Automobile/Truck Rental	7/29/2002
Conseco, Inc.	Accident and Health Insurance	12/18/2002
Covanta Energy Corp.	Energy Production	4/1/2002
Dade Behring Holdings, Inc.	Medical Diagnostic Equipment	8/1/2002
Encompass Services Corp.	Electrical and Mechanical Services Installation	11/19/2002
EOTT Energy Partners	Energy Production	10/8/2002
Exide Technologies, Inc.	Lead Acid Batteries Producer	4/14/2002
Farmland Industries, Inc.	Agricultural Cooperative	5/31/2002
FLAG Telecom Holdings, Ltd.	Global Network Services Provider	4/12/2002
GenTek, Inc.	Communication Product Manufacturer	10/11/2002
Genuity, Inc.	Tier 1 Fiber-Optic Network and Data Centers	11/27/2002
Global Crossing, Ltd.	Global Telecommunications Carrier	1/28/2002
Highlands Insurance Group, Inc.	Commercial Property and Casualty Insurance	10/31/2002
Horizon Natural Resources Company	Energy Production	11/13/2002
IT Group, Inc. (The)	Facilities/Hazardous Waste Management	1/16/2002
Kaiser Aluminum Corporation	Aluminum Production	2/12/2002

Companies Recently in Chapter 11

2002 Companies (Continued)

Kmart Corporation	Retail Discount Stores	1/22/2002
McLeodUSA, Inc. (2002)	Integrated Communications Services	1/30/2002
Motient Corp.	Mobile Internet Provider	1/10/2002
National Century Financial Enterprises, Inc.	Healthcare Finance	11/18/2002
National Steel Corporation	Carbon Steel Product Manufacturer	3/6/2002
NII Holdings, Inc.	Communications	5/24/2002
NTL Incorporated	Telecommunications	5/8/2002
Peregrine Systems, Inc.	Software/Service Provider	9/22/2002
Pinnacle Holdings, Inc.	Wireless Communications	5/21/2002
Polymer Group, Inc.	Nonwoven Material Manufacturer	5/11/2002
SpectraSite Holdings, Inc.	Telecommunications	11/15/2002
UAL Corporation	Passenger Air Carrier	12/9/2002
United Pan-Europe Communications N.V.	Communications	12/3/2002
US Airways Group, Inc. (2002)	Passenger Airline	8/11/2002
Versatel Telecom International, NV	Telecommunications	6/19/2002
Williams Communications Group, Inc.	Telecommunications	4/22/2002
WorldCom, Inc.	Telecommunications	7/21/2002
XO Communications, Inc.	Telecommunications	6/17/2002