PREPARING FOR DISTRESSED DEBT TAX CHALLENGES AMID ECONOMIC TURBULENCE

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With you today

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Agenda

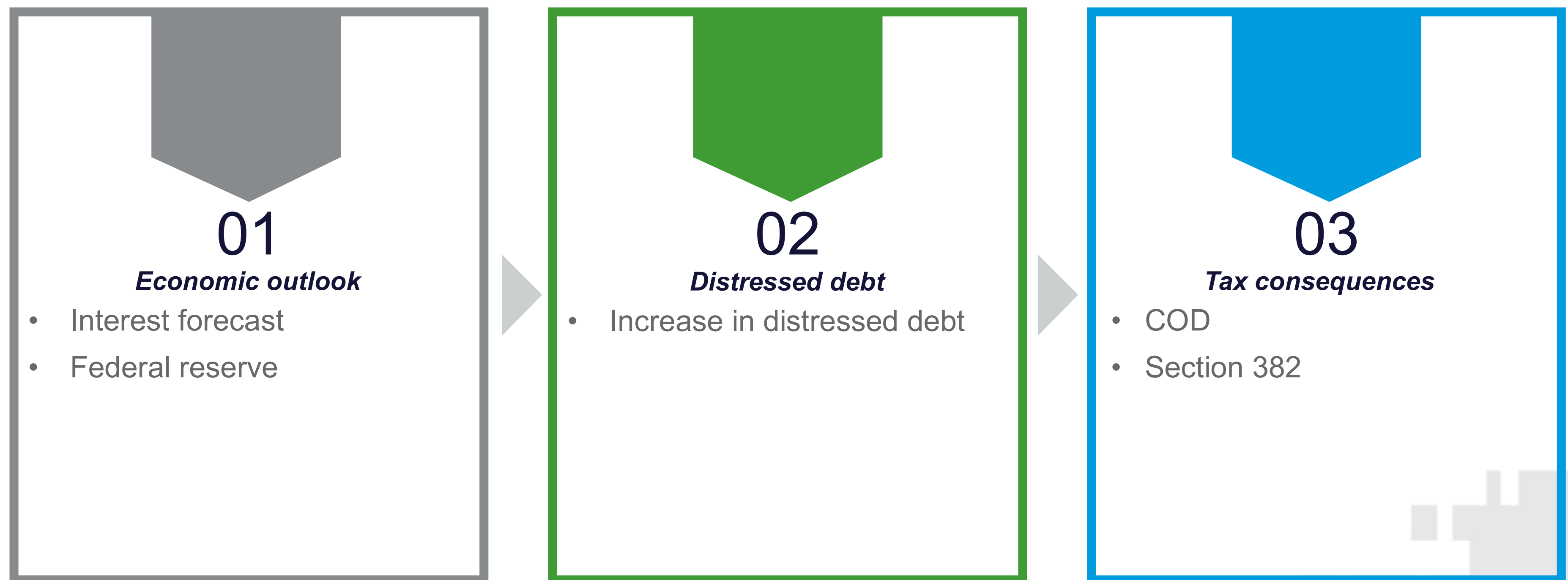
- Economic outlook
- Corporate debt
- Cancellation of debt (COD) income
- Section 382
- Chapter 11 bankruptcy
- Pre-packaged bankruptcies
- Section 363 asset sales
- Summary and questions / review

Learning objectives

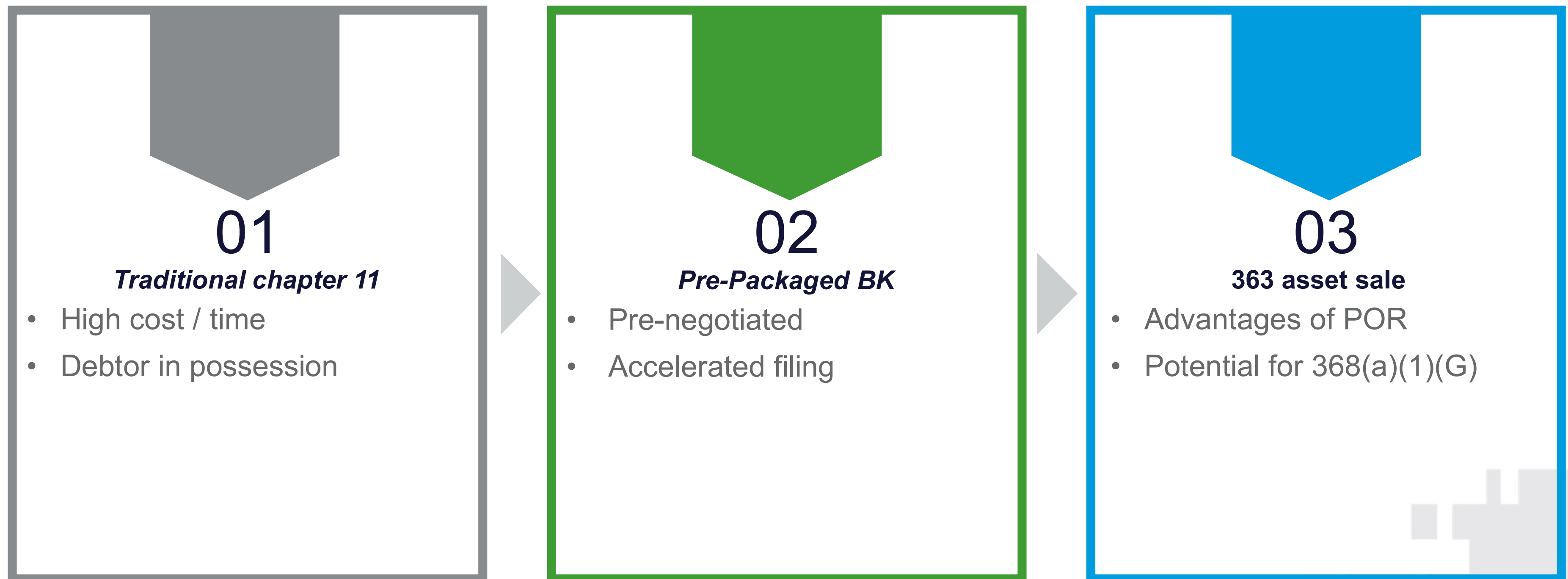
By the end of this course, you will be able to:

- Identify the looming maturity wall and funding gap
- Describe the factors that lead to impending debt funding issues
- Discuss the tax consequences of debt income cancellation

Topics – Economic outlook & tax consequences



Topics – Bankruptcy alternatives



Economic outlook

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Economic growth outlook

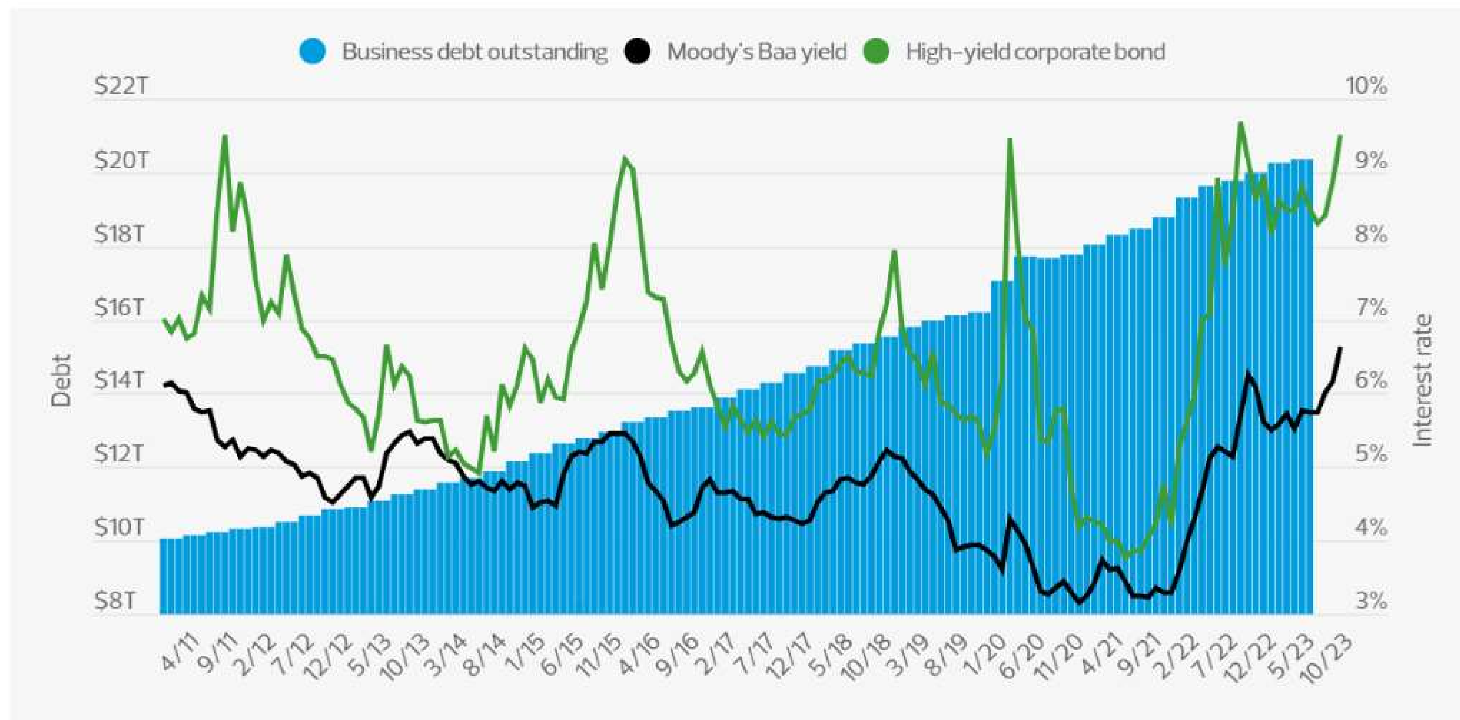
01
Economy more resilient than expected

02
GDP forecast raised to 2.2 percent

03
Recession probability very low at 15 percent

04
Upside risks outweigh downside

Day of reckoning approaches: 2025-26 will not be fun



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Looming maturity wall and funding gap

01 Debt taken at near-zero rates in pandemic will need to be rolled over at much higher rates

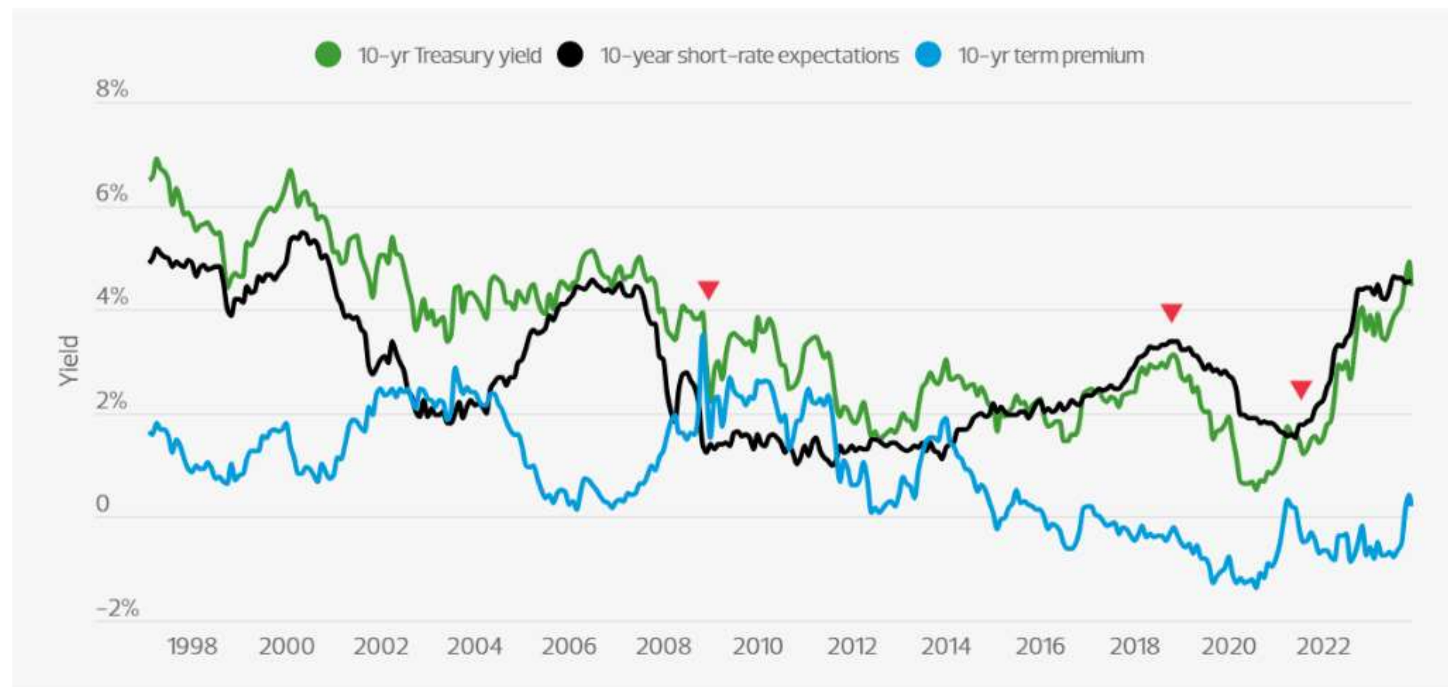
02 $1.5 trillion in commercial real estate debt is going to be rolled over during 2024 and 2025

03 $3 trillion in corporate debt needs to be rolled over in coming years

04 10-year forecast 4-5 percent; higher for longer

Real rates: 2.5 percent versus average of 0.26 percent since 2013

Policy expectations and risk components of 10-year yields*



Source: Federal Reserve Bank of New York; Adrian Crump & Moench; Bloomberg; RSM US LLP

*Expectations of the path of short-term rates and the term premium built into 10-year Treasury yields

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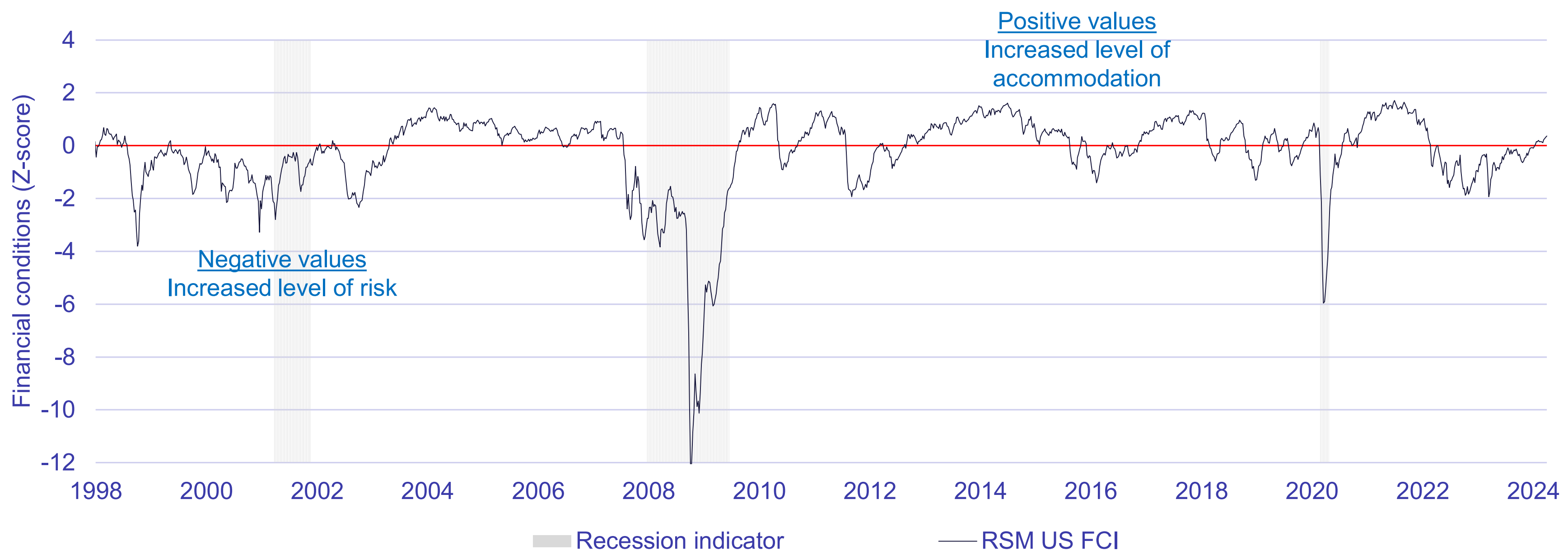
Financial conditions at neutral, adding to our call for a soft landing

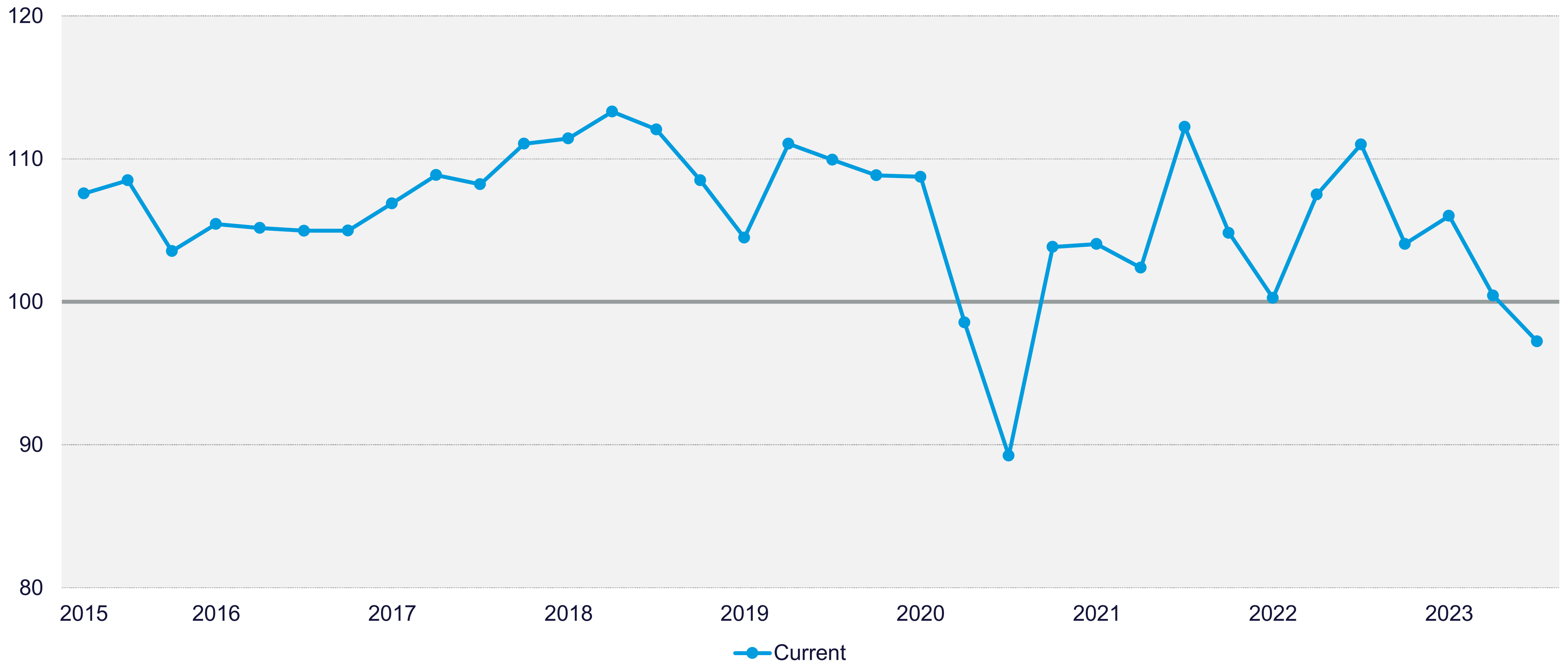
After 18 months of increased levels of risk priced into financial assets, financial conditions have been slightly accommodative since mid-January

U.S. financial conditions



Source: Bloomberg, RSM US

Middle market access to credit declining…



Reading of 100 (orange line) is neutral; reading above 100 indicates optimism; reading below 100 indicates pessimism. Data is seasonally adjusted.

I82 Thinking about the availability or ease with which your organization can borrow money this quarter versus last quarter, how would you describe current access to credit? Would you say that accessing credit is . . .

Case study

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Fabco, Inc. (Formation)

- Fabco, Inc. was formed by four founders (the “Fab Four”) in 2019 with $100 million of capitalization and raised an additional $50 million in an IPO in that year.
- In February of 2020, Fabco opened their semiconductor “fab” (fabrication factory) that was the most automated fab in the world at the time.
- During 2020, Fabco took out $200 million of debt at 2.5 percent interest that is due in 2025.

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Fabco, Inc. (2020 to 2023)

- Due to supply chain issues, Fabco was unable to meet demand for its microchips.
- By 2023 – the company had generated $300 million of losses – and the fab had become obsolete due to “Moore’s Law”.
- Fabco thus closed the fab – and pursued patent litigation relating to its robotic automation and specific alleged patent violations relating to its microchip designs.
- Fabco’s market capitalization decreased from $50 million to $2 million from 2020 through 2023.

Fabco, Inc. (2024)

- Fabco issued a “clean” 10-K for the year ended Dec. 31, 2023, and for the first quarter ended March 30, 2024.
  - In other words, its auditor did not issue a “going concern” opinion.
    - This was based partially on the prospects that Fabco might prevail in some of its IP litigation.

Fabco, Inc.

- While Fabco's debt is not publicly traded on an exchange, S&P / IHS Markit does reflect "indicative quotes" for its debt.
  - These quotes reflect the $200 million of debt is currently "trading" at 40 percent of face value.

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Fabco, Inc. (Debt exchange offer)

- Fabco received an unsolicited offer from its lead senior secured creditor to modify its $200 million debt to extend the maturity from 2025 to 2029.
  - The modified debt has an adjusted issue price of $50 million with 12 percent PIK interest and “out of the money” warrants.
  - As such, if the IP litigation is successful, the creditors would have an equity “upside”.
- Fabco’s board of directors has reached out to its professional advisors to determine how to respond to this offer.

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Fabco, Inc. (Cancellation of debt)

Fabco's advisors noted that:

- As the debt:

  (1) is considered publicly traded due to the indicative quotes; and,

  (2) is in excess of $100 million:

- The proposed debt transaction would be treated as a taxable exchange – that would result in $150 million of taxable cancellation of debt (CODI) income.

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Fabco, Inc. (Solvency issue)

To the extent the company is insolvent immediately prior to the debt exchange – such CODI would be excluded from taxable income.

- The company would then reduce its tax attributes (such as its net operating losses) by the amount of such excluded CODI.
- For example – if the company was insolvent by $100 million – then $50 million would be taxable and $100 would be excluded taxable income.

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Fabco, Inc. (Solvency determination)

- Fabco's advisors noted the following:
  - The company still has a positive market capitalization – which might indicate that the FMV of the assets exceeds its liabilities.
  - The SEC filings:
    - (1) did not reflect going concern opinions; and
    - (2) there were not significant impairments to intangibles for GAAP purposes.
  - It then appears it might be difficult to achieve an appropriate level of comfort that Fabco would prevail arguing to IRS that they are insolvent.

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Cancellation of debt (COD) income – Related party transactions

- The company then asked if they could attempt to avoid CODI by arranging for a related party to acquire its debt from the creditor at a discount.
- The advisors noted that section 108(e)(4) was enacted to prevent this tactic.
  - Section 108(e)(4) provides that if a person or entity related to the debtor purchases debt from an unrelated creditor, the purchase is treated for federal tax purposes as if the debtor purchased the debt from the creditor.
  - The purchase would therefore generate CODI to the extent of the discount.

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Fabco, Inc. (Taxable income scenario)

To the extent an insolvency is an uphill battle, Fabco's advisors discussed several alternatives:

- Reflecting $150 million of taxable CODI on their 2024 tax return.
- Such taxable income could be offset dollar-for-dollar by the small projected 2024 loss (related to patent litigation costs) – and could likely use 2019 through 2023 net operating losses subject to the 80 percent taxable income limitation applicable to post-2017 net operating losses.

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Fabco, Inc. (Consequences of taxable scenario 1/2)

- Assuming $0 operating income or loss for 2024 before $150 million of taxable income – $120 million could be offset by net operating losses from 2019 through 2023:
  - This would result in $30 million of taxable income with a $7.5 million tax liability (assuming 25 percent combined federal and state tax rate).
  - Note that net operating loss carryforwards generated after 2017 are subject to an 80 percent taxable income limitation.
    - For example, if there is $100 of taxable income – only $80 of net operating losses generated after 2017 could offset such income.

Fabco, Inc. (Consequences of taxable scenario 2/2)

In this scenario – the existing equity holders would continue to own the company in the short-term.

- Best case – However, if there if there is a substantial windfall from the litigation claims – then the warrants issued to the creditor would be "in the money" and they would then own a considerable amount of equity.
- Worst case – The litigation claims generally fail – the company will not be able to ultimately pay the PIK interest – and they may have to subsequently file a chapter 11 bankruptcy.

Fabco, Inc. (Pre-packaged bankruptcy)

Fabco could negotiate terms of a pre-packaged bankruptcy with its creditors.

- The existing shareholders would likely not retain their equity as the creditors would receive equity in exchange for their debt.
- However, the existing shareholders could take a section 165(g)(1) capital loss.
- As the creditors would likely own 100 percent of the equity upon the effective date of the bankruptcy plan of reorganization.
  - The company could avail itself of special bankruptcy rules under section 382(l)(5) or (l)(6) which might preserve some of the company's net operating losses.
  - Such losses might then be available to offset any gains from IP litigation or sales.

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Fabco, Inc. (Section 363 asset sale)

- As an alternative to a pre-packaged bankruptcy, the company may choose to enter into bankruptcy and undertake a section 363 asset sale where they would sell the assets (IP litigation rights free and clear of liabilities) and satisfy the debt by the amount of the proceeds.
  - The creditors would likely receive the IP – though query whether the creditors might accept the purchase of the IP by the founders if they could mutually agree on value.
    - The creditors might accept a sale of the IP to the founders – if the founders believe there is a higher NPV for the IP claims than the creditors.

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Cancellation of debt (cod) income

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Cancellation of debt (COD) income

- IRC section 61(a)(11) provides that taxable income includes income from the cancellation of indebtedness (“COD”).
- From an economic viewpoint – the relief of a liability results in an increase to the taxpayer’s net assets – and thus results in income recognition.

Cancellation of debt (COD) income

- If the debtor is a partnership, the COD income is recognized by the partners.
- Can occur in a debt-for-debt or debt-for-equity exchange.

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Cancellation of debt (COD) income – Example

- If a corporation (that is solvent and not in a title 11 bankruptcy) owed $100 of debt to its creditors – but satisfies the debt for $60
  - the corporation would generally have $40 of taxable income (and the creditors would have a correlative $40 bad debt deduction).

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COD – Modification of a debt instrument

- Many changes to debt agreements are ‘modifications’ as defined in treasury regulations.
- Generally, any alteration of a legal right or obligation of the issuer or a holder of a debt instrument is a modification.

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COD – Modification of a debt instrument

- Modifications likely to occur under current economic conditions:
  - Deferral of payments of interest and extension of maturity date
  - Interest holidays
  - Changes in interest rates
  - Subordination of debt
  - Reduced collateral on debt
  - Change from recourse to nonrecourse

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COD – Effect of a significant modification

- Under complex rules, a “significant modification” to a debt instrument can result in cancellation of indebtedness income (CODI).
- A modification is significant only if, based on all facts and circumstances, the legal rights or obligations that are altered and the degree to which they are altered are economically significant.

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COD – Definition of publicly traded debt

- Where the business has over $100 million in outstanding debt, the likelihood of a COD income event increases because of special rules for debt considered traded on an established market.

- For this purpose, debt is publicly traded if:

1. It is listed on an exchange;
2. There is a “sale’s price” for the property;
3. There are one or more “firm quote” for the property; or
4. There are one or more “indicative quotes” for the property.

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COD – Example

- For example, debtor has $100X of 10-year fixed interest loan outstanding that is publicly traded.
    - The debt is trading at a 20 percent discount.
    - Debtor negotiates to modify the debt from 10-year to 15-year maturity.
    - This is considered a significant modification and is thus a taxable exchange.

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COD – Effect of a significant modification

- Even though the face amount of the debt did not change, as this is taxable transaction, the note is deemed reissued for $80X FMV with $100X stated redemption price at maturity (SPRM).
- As such $20X of CODI is recognized equal to the new issue price of $80X and the original amount borrowed of $100X.
- The $20 difference between the $80X issue price and the $100X SRPM is deducted by the borrower over the remaining term of the new debt.

Cancellation of debt (COD) income – Solvency test

- To the extent a debtor is insolvent, IRC section 108(a)(1)(B) generally provides that COD is excluded from taxable income.
- In the example above, if the debtor was insolvent by $10 – then $30 of COD would taxable and $10 would be excluded from income.
- Burden of proof is on taxpayer to prove extent of insolvency.

Cancellation of debt (COD) income – Solvency issues

- The taxpayer may, for example, argue they were insolvent to the extent the debt was forgiven, as the debtor would not have otherwise discharged the debt by that amount.
- Another issue arises when various debts are forgiven over time, it is possible that at some point the taxpayer may become solvent, or the amount of insolvency may differ from the COD income recognized.

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Cancellation of debt (COD) income – Bankruptcy exception

- IRC section 108(a)(1)(A) provides that all debt discharged in a “title 11 case” is excluded from gross income.
  - Avoids requirement to prove solvency.

Cancellation of debt (COD) income – Tax effects

- To the extent the debtor is insolvent, or in a chapter 11 bankruptcy proceeding, the CODI will be excluded from taxable income and will generally reduce tax attributes in the following order:

1. Net operating losses
2. General business credit
3. Minimum tax credit
4. Capital loss carryovers
5. Basis reductions

Cancellation of debt (COD) income – Tax effects

- While a taxpayer in a title 11 case -- or to the extent of insolvency -- will not pay tax on excluded CODI – the resulting attribute reduction may result in higher taxes in the future.
  - For example – the reduction to net operating losses may result in the loss of a tax shield against future income.
  - In a worst-case scenario – tax basis in accounts receivable and inventory may be reduced – which can result in taxable income as soon as such receivable and inventory “turn”.

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Cancellation of debt (COD) income – Related party transactions

- A debtor might attempt to avoid CODI by arranging for a related party to acquire its debt from the creditor at a discount. Section 108(e)(4) was enacted to prevent this tactic.
- Section 108(e)(4) provides that if a person or entity related to the debtor purchases debt from an unrelated creditor, the purchase is treated for federal tax purposes as if the debtor purchased the debt from the creditor.
- The purchase would therefore generate CODI to the extent of the discount.

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Cancellation of debt (COD) income – Related party transactions

- Related entities for this purpose include, among others, controlled partnerships and entities treated as a single employer.

- Various transaction structures can implicate the section 108(e)(4) CODI trigger.
  - For example, use of an unrelated entity to purchase debt from a creditor followed by an acquisition (of that entity or of the debtor) can be drawn into section 108(e)(4)'s ambit.
  - This is because a section 108(e)(4) CODI event can occur in two situations—via a "direct acquisition" or an "indirect acquisition."

Cancellation of debt (COD) income – Related party transactions

- A direct acquisition occurs where an acquirer acquires debt from a party unrelated to the debtor and either
- (i) the debtor and the acquiror are related at the time of the acquisition or
- (ii) the debtor and creditor become related on the date the debt is acquired.

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Cancellation of debt (COD) income – Related party transactions

- An indirect acquisition occurs where the holder of debt becomes related to the debtor after the transaction, if the holder acquired the debt in anticipation of becoming related to the debtor.
- To determine whether debt was acquired in anticipation of the creditor and debtor becoming related, all relevant facts and circumstances must be examined.
  - If, however, the creditor acquires the debt less than six months before the parties became related, the debt is presumed to be acquired in anticipation of the debtor and creditor being related, and this presumption cannot be rebutted.

Chapter 11 bankruptcy

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Bankruptcy – Fresh start

- One of the primary purposes of bankruptcy is to discharge certain debts to provide distressed debtors with a "fresh start.“
- Economists have credited the US bankruptcy system with the ability to restructure or liquidate distressed companies.
  - this prevents the proliferation of “zombie” companies that can impede a countries' ability to recover from a recession.
  - Japan adopted US bankruptcy-type laws in 2021 to address this issue.

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Chapter 11 bankruptcy

- In a traditional chapter 11 bankruptcy, the debtor usually proposes a plan of reorganization to keep its business alive and pay creditors over time.
- A case filed under chapter 11 of the United States Bankruptcy Code is frequently referred to as a "reorganization" bankruptcy.
- The “Automatic Stay” stops all collection efforts all foreclosure actions.

Chapter 11 bankruptcy – DIP & POR

- Usually, the debtor remains “in possession,” has the powers and duties of a trustee, may continue to operate its business, and may, with court approval, borrow new money.
- A plan of reorganization is proposed, creditors whose rights are affected may vote on the plan, and the plan may be confirmed by the court if it gets the required votes and satisfies certain legal requirements.

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Chapter 11 bankruptcy – Length and fees

- These “reorganizing” chapter 11 filings historically can be quite lengthy and expensive for all parties involved.
- For example, the Sears bankruptcy that was filed in October of 2018 and the May 2020 J.C. Penney bankruptcy – collectively generated more than $150 million in combined legal fees.

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Chapter 11 bankruptcy

- In order to prevent the time and expense of these extended chapter 11 reorganizations, an increasing number of recent bankruptcies were “pre-packaged” and/or involved bankruptcy code section 363 asset sales.

Pre-packaged bankruptcies

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Pre-packaged bankruptcy

- A pre-packaged bankruptcy is a chapter 11 bankruptcy proceeding that has been pre-negotiated with creditors prior to the bankruptcy court filings.
- Through the use of a pre-packaged bankruptcy, a debtor can simplify and accelerate the bankruptcy proceedings.
- Pre-packaged bankruptcies come with substantial cost savings over a traditional chapter 11 proceeding.

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Pre-packaged bankruptcy – Pros and cons

- The justice department has raised concerns over pre-packaged bankruptcies' lack of transparency and fairness to creditors. In some cases, pre-packaged bankruptcies can be approved within days and may not give adequate notice to creditors or shareholders.
- Advocates note that the more efficient proceedings help preserve money for shareholders and creditors.
- Pre-packaged bankruptcies are not effective for rejecting executory contracts – such as generous airline employee contracts.

Section 363 asset sales

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Section 363 asset sales

- A section 363 asset sale occurs when a court grants a corporation the power to satisfy its credit obligations through the sale of a corporation’s assets, rather than pursuant to a plan of reorganization.
- Unlike a traditional chapter 11 filing, a 363 sale gives a company (or trustee, as applicable) more control over the sale process. Additionally, the purchaser of assets sold through a 363 sale generally takes title free and clear of any encumbrances.

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Section 363 – Taxable transaction

- In general, 363 sales are treated as taxable transactions. As such, any debtor tax attributes would generally not transfer to the acquiror.
- If the debtor liquidates after the 363 asset sale, all of the tax attributes would thus be lost after the debtor’s final tax return is filed.

Section 363 – 368(a)(1)(G) reorganization

- The consideration for a section 363 asset sale may in the form of a "credit bid".
- A credit bid is where a secured creditor in connection with a section 363 sale uses (or "bids") all or a portion of its secured debt as full or partial consideration for the debtor's assets."
- If structured properly, such a transaction may qualify as a tax-free "G" reorganization. In such case, the debtor's tax attributes would transfer to the acquiring corporation.

Bruno's transaction

- Prior to bankruptcy a taxpayer may choose to execute a so called "Bruno's Transaction".
- In a Bruno's Transaction the debtor corporation executes a taxable assets sale, whereby the debtor then uses its NOLs to offset the amount realized on the taxable asset sale. The buyer entity takes a fair market value tax basis in the transferred assets, but the transferred assets are not subject to attribute reduction.

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Bruno's facts

- Bruno's Inc. was a southern regional supermarket chain with about $1 billion in debt at the time it filed for chapter 11.
  - The debt include approximately $462 million in secured bank debt, $421 million in junk debt, and $135 million in unsecured trade debt.
  - At the same time, Bruno's had approximately $180 million of NOLs and $550 million in asset tax basis.
- Under the chapter 11 reorganization the Bruno's shareholders and the junk bond holders received no distribution in the reorganization.
- An exchange of equity for debt would have resulted in Bruno's realizing $700 million of COD income.
- Accordingly, rather than exchange its debt for equity in a reorganization, Bruno's chose to sell its assets in a taxable asset sale to its creditors.

Section 382

Section 382 – Base limitation

- When more than 50 percent of the ownership of a company changes hands (generally over a 3-year rolling period) IRC sections 382 and 383 limit the utilization of NOLs and other tax attributes, respectively.
- The “base” section 382 limitation is based on the equity value of the company immediately before the 50 percent change in ownership, times a prescribed rate.

Section 382 – Base limitation

- If an insolvent corporation is sold in exchange for debt, the pre-change value of the company would be $0 and thus the "base" section 382 limitation would be $0, which could result in the effective elimination of the corporation's NOLs (and potentially other tax attributes – such as section 163(j) carryforwards).

Section 382 – Bankruptcy exceptions

- Under IRC section 382(l)(5), if certain conditions are met, there is no section 382 ownership change upon emergence from a title 11 or similar case, but certain interest deductions paid to creditors who become shareholders are eliminated from the post-emergence NOL.
- Under IRC section 382(l)(6), an ownership change occurs, but the limitation is based on the value of the corporation after taking into account any surrender or cancellation of creditors' claims in a title 11 or similar case (i.e, post-emergence value).

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Section 382 – Bankruptcy exceptions

- Very broad definition of the term modification
  - Any alteration of a legal right or obligation of the issuer or a holder of a debt instrument
- Modifications likely to occur under current economic conditions:
  - Deferral of payments of interest and extension of maturity date
  - Interest holidays
  - Changes in interest rates
  - Subordination of debt
  - Reduced collateral on debt
  - Change from recourse to nonrecourse

Consolidated attribute reduction

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WorldCom case

- Prior to the issuance of the section 1.1502-28 regulations, it was not settled whether attribute reduction would only occur to the debtor(s) in the group (separate) or to the group as a whole (consolidated).

- This issue dramatically presented itself when WorldCom, Inc. (renamed "MCI") filed for bankruptcy in 2002 after an $11 billion accounting scandal. It was the largest bankruptcy ever in the United States when it filed.

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WorldCom case

- Virtually all MCI's subsidiaries had NOLs though the parent had no NOLs but had incurred most of the third-party debt.
  - If separate entity attribution reduction occurred, MCI would have no separate company NOLs to reduce, and would only reduce its basis in its first-tier subsidiaries, after recognizing approximately $35 billion of excluded COD income in the bankruptcy.
  - Under consolidated attribute reduction, MCI would instead lose virtually all of its NOLs.

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WorldCom case

- MCI had generated great antipathy with its competitors. William Barr, then Verizon's general counsel, "helped orchestrate objections to the reorganization plan (in order to force MCI to liquidate rather than reorganize in bankruptcy). . . Mr. Barr contends the (fraud) turned the phone company into a 'criminal enterprise' and that 'bankruptcy is not a mechanism for laundering stolen goods.'"

- Besides trying to force MCI to liquidate, its competitors lobbied Congress to enact legislation that would force consolidated groups to apply consolidated attribute reduction such that the reorganized MCI would not have billions of NOLs to shield future taxable income. "In the summer of 2003, Senator Santorum introduced legislation to resolve this issue …. (but) the senate judiciary committee took no action of the Santorum proposal."

- "Verizon to MCI: Drop Dead; Campaign Is on for Liquidation," Wall Street Journal, May 15, 2003. The article noted that MCI would reduce its debt from $41 billion to $6 billion post-emergence, while Verizon had debt of about the $54 billion at the time.

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Regulation section 1.1502-28

The 1.1502-28 regulations were issued in finalized form on March 21, 2005. While the Treasury stated the regulations take a “consolidated” approach, the regulations actually adopt a hybrid approach.

The regulations provide a three-part analysis:

- -28(a)(2) debtor attribute reduction
- -28(a)(3) look-through (or “push down”) rules and
- -28(a)(4) “fan out”

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Regulation section 1.1502-28

- 1.1502-28(a)(2) – Reduction of tax attributes attributable to the debtor. With respect to a member that realizes excluded COD income in a taxable year, the tax attributes attributable to that member shall be reduced as provided in sections 108 and 1017 and this section. Basis of subsidiary stock, however, shall not be reduced below zero under this section.

- 1.1502-28(a)(3) – Look-through ("push down" rules) – To the extent the stock basis of a lower-tier member is reduced in -28(a)(2), that subsidiary is treated as having recognized excluded COD in amount equal to such basis reduction.

- 1.1502-28(a)(4) – Reduction of certain tax attributes attributable to other members ("fan out") to the extent that, pursuant to paragraph (a)(2) of this section, the excluded COD income is not applied to reduce the tax attributes attributable to the member that realizes the excluded COD income, after the application of paragraph (a)(3) of this section, such amount shall be applied to reduce the remaining consolidated tax attributes of the group, as provided in section 108 and this section.

MCI post note

- MCI emerged from bankruptcy on April 20, 2004, shedding $35 billion of debt. If it had been allowed to apply separate company attribute reduction, it would have reduced tax basis in first-tier subsidiaries and retained all other tax attributes, including its NOLs. However, the 1.1502-28T regulations were written to prevent that outcome. MCI thus emerged bankruptcy shorn of approximately $15.5 billion of tax attributes.
- On July 13, 2005, Bernie Ebbers, the co-founder and CEO of MCI, was sentenced to 25 years in prison for securities fraud and conspiracy charges.
- On Jan. 6, 2006, Verizon, who had previously tried to force MCI into liquidation, merged with MCI. The business unit was renamed “Verizon Business”.

Summary

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Summary – Distressed debt

- Increased interest rates will continue to cause an increase in distressed debt, debt workouts and bankruptcy filings.
- Due to their high cost and length, the prevalence of traditional chapter 11 reorganizations is expected to continue to decrease relative to the filings of pre-packaged bankruptcies and section 363 asset sales.

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Summary – Importance of form

- The form of the debt workout or reorganization can result in dramatically different tax results, as well as non-tax consequences, to the parties involved.

- The earlier a debtor can identify potential cash flow and insolvency issues, the more control the company may have over the ensuing process.

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Summary – BK options

- Pre-packaged bankruptcies and section 363 asset sales may offer advantages over traditional reorganizing chapter 11 bankruptcies, based on a debtor's specific facts and circumstances, though all of these options are generally preferable to waiting too late and "falling" into a liquidating chapter 7 bankruptcy.

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