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PLANNING FOR DISADVANTAGED CORPORATIONS

PAUL BRODERICK

Like healthy corporations, financially troubled corporations come in all shapes and sizes. The typical disadvantaged corporation is one which is a victim of high inflation and a recessionary sales slump. Exorbitant interest rates in recent years have wrought havoc on those companies which normally borrow to finance operations. Although companies, may be financially distressed for a number of reasons, including obsolescence and bad management, we will assume that the subject corporation is a viable turnaround company.

There are a number of remedies for helping troubled companies either to survive or to be good acquisition candidates. Some of those which we will consider are carryovers from prior law such as the exception from income when new stock is exchanged for old debt. Other result from recent changes in Federal tax and non-tax statutes which significantly improve the lot of distressed corporations. As will be seen, the Bankruptcy Reform Act of 1978 meant the difference between dissolution and continued vitality for many closely and widely held corporations. The Bankruptcy Tax of 1980 made disadvantaged corporations attractive merger candidates because it allows them to retain all of their favorable tax attributes. Lastly, other planning opportunities will be explored.

CONVENTIONAL REMEDIES FOR DISADVANTAGED CORPORATIONS: PRIOR LAW

More than 50 years ago in the *Kirby Lumber*¹ case, the U.S. Supreme Court held that a taxpayer whose debt was discharged without payment realized income to the extent of the discharge. The Court reasoned that any discharge of the liability at less than face value resulted in a realization of an increase in net worth thus producing taxable income. It was often possible to avoid the *Kirby* rule, however, through cash purchases of the debt by an affiliated corporation.²

The principal exception from the realization of income on the discharge of indebtedness occurred when the corporation was reorganized under Chapter X or XI of the Bankruptcy Act.³ The reason for the income exclusion was that Congress intended to free bankruptcy reorganizations from tax uncertainties. The cost to the corporation was that it was required to reduce the basis of its assets by the amount of the debt discharged in bankruptcy. The debtor could reduce the basis of any assets but was not required to reduce the basis below fair market

¹ 284 U.S. 1 (1931).

² See, Heng and Parker, Tax-Free Debt Repurchase Using Stock-for-Debt Exchanges, TAXES—The Tax Magazine, July, 1982.

³ 30 Stat. 544.

value. No basis reduction was required if the Chapter X reorganization also qualified as an insolvency reorganization under section 371 of the Code. Although asset basis reduction was required, tax attributes such as net operating loss and capital loss carryovers were not affected.

Bankruptcy was only one of a number of ways under prior law in which debtors could avoid the realization of income upon the discharge of indebtedness. The law outside of bankruptcy also permitted a number of exceptions from debt discharge income. The first exception was that no income was realized upon the discharge of debt if the corporate debtor was insolvent both before and after the discharge. If, however, the debtor became solvent as a result of the discharge, income was realized but only to the extent that the fair market value of the debtor's assets exceeded its liabilities after the discharge. The second major exception obtained where the deductions attributable to the debt discharged did not give rise to tax benefits. For purposes of the tax benefit rules,⁴ a deduction which increased net operating losses but did not reduce taxes was not a tax benefit. A third exception from the *Kirby* rule remains a principal element of current law. In the case of *Commissioner v. Morto Mart Trust*,⁵ the First Circuit held that no income was realized by a debtor corporation which exchanged new shares of its stock for outstanding debt. The exchange, which qualified as a recapitalization pursuant to the predecessor of section 368(a)(1)(E) of the Code, resulted in no income to the debtor even though the fair market value of the stock issued was less than the amount of the debt discharged. The recapitalization exchange continues to qualify for tax free treatment both of the debtor and the creditor. Under current law, the continuity of business enterprise and continuity of shareholder interest requirements of reorganization treatment do not apply to recapitalizations.⁶ A possible drawback to the stock for debt exchange occurs as a result of the fact that the no gain or loss rules of section 354 prevent the deduction of a loss in the case where the creditor's basis in the debt is higher than the fair market value of the stock received.

The recapitalization exchange may be of particular value after April 1, 1983, the proposed effective date of the pending debt/equity regulations.⁷ Those regulations will enable the IRS to reclassify excessive debt as preferred stock of the issuing corporation thereby depriving the debtor of an interest deduction while force-feeding the creditor with dividend income on the repayment of both interest and principal. A more practical reason for the recapitalization route is to improve the net worth of the corporation by eliminating debt while generating income for financial accounting purposes.

⁴ § 111 of the IRC.

⁵ 156 F2d 122 (1st Circuit 1946).

⁶ See, Broderick, Recapitalization Provisions Offer A Tax-Free Way to Meet Exchanges in Stockholder's Needs, *Taxation for Lawyers*, September/October, 1982.

⁷ § 385 of the IRC.

A fourth exception from income realization occurs when debt is contributed to the capital of the issuing corporation by its shareholder/creditors.⁸ The IRS permitted the issuing corporation to avoid income recognition only to the extent of the principal, however.⁹

BANKRUPTCY REORGANIZATIONS: A NEED FOR CHANGE

Prior to its repeal by the Bankruptcy Tax Act,¹⁰ section 371 of the Code prescribed the tax treatment of the reorganization of a financially troubled corporation.¹¹ Section 371 provided for the non-recognition of gain to insolvent corporations upon the transfer of assets pursuant to the plan if stock or securities were received in the exchange. Gain was recognized, however, to the extent that boot received in the exchange by the transferor corporation was not distributed to its equity holders. The tax basis of assets carried over unchanged but tax attributes did not.¹²

BANKRUPTCY REFORM ACT OF 1978¹³

In 1978, Congress made a sweeping change in the treatment of financially troubled corporations. The Bankruptcy Reform Act of 1978 (Bankruptcy Reform Act) repealed the Bankruptcy Act of 1898. The changes made by the Bankruptcy Reform Act were so severe, however, that its own viability is in question.¹⁴ The Bankruptcy Reform Act generally stripped Federal district courts of their exclusive jurisdiction in bankruptcy matters and repealed the venerable referee system. Under the Bankruptcy Reform Act changes, the jurisdiction which Federal district courts had over bankruptcy matters was replaced by the much broader jurisdiction of the bankruptcy courts. Those courts would have jurisdiction over all civil matters arising in bankruptcy cases.¹⁵

⁸ § 118 of the IRC.

⁹ See, Rev. Rul. 73-432, 1973-2 CB 17.

¹⁰ Bankruptcy Tax Act, P.L. 96-589 (26 U.S.T.C.).

¹¹ The Provisions of § 371 do not apply to any proceeding begun after September 30, 1979. The rules relating to the reorganization of solvent corporations are contained in section 368 of the IRC.

¹² § 381 of the IRC does not apply unless the transaction also qualifies as a reorganization under § 368 of the IRC.

¹³ P.L. 95-598 (11 U.S.C. §§ 1-15326).

¹⁴ In *Northern Pipeline Co. v. Marathon Pipeline*, US Supreme Court 81-150 (June 28, 1982), the Supreme Court effectively eliminated the reforms made by the Congress by holding that Congress' assignment of jurisdiction to bankruptcy judges violated Art. III of the Constitution. The Court permitted the continued operation of the bankruptcy court through December 4, 1982. Although the jurisdiction over bankruptcy matters granted to U.S. District Courts appears to continue, the Court's action provides Congress with an opportunity to substantially amend its 1978 enactment.

¹⁵ 28 U.S.C. § 1471(b).

The Bankruptcy Reform Act has three principal chapters.¹⁶ Chapter 7, which applies to individuals or corporations, is the complete liquidation provision. In the case of a corporation, the entity dissolves. In the case of an individual, the individual is discharged, however, attorney fees survive. Chapter 7, which may be voluntary or involuntary, does not apply to railroads, financial institutions, or trusts. A non-profit entity may be voluntarily liquidated under Chapter 7.

Chapter 11 provides for the voluntary or involuntary reorganization of affairs of an individual or corporation. The principal effect of reorganization under chapter 11 is that the debtor is given an automatic stay as to old debts, including Federal taxes. Chapter 11's most important contribution is that it provides the debtor with time to get its financial house in order. The principal emphasis of the Bankruptcy Reform Act is on debtor in possession. Under Chapter 11, the debtor is permitted to retain all of its assets and to continue in business under the supervision of the Bankruptcy Court. There is no mandatory time table established with respect to Chapter 11 actions. Accordingly, financially troubled corporations can operate for years under the protection of Chapter 11 and, in some cases, prosper.¹⁷ It is usually the creditor that will instigate creation and implementation of the plan of reorganization as it is not always in the interest of the debtor to lose its Chapter 11 protection. Under Chapter 11, the debtor becomes a new debtor upon filing with the result that pre-filing debts are separate from post-filing debts. Accordingly, the debtor should start and keep new financial records, new bank accounts, and new employer identification numbers.

Chapter 11 treatment is available to all business entities including sole proprietorships. No court order is needed to continue in business and the debtor in possession has the exclusive right to file a plan with the Court during the first 120 days. Other parties may file a plan or reorganization with the Court only upon expiration of the 120 day period. The plan must be approved by the Court before it can be submitted to creditors, following which the debtor has 60 days within which to gain acceptance. Chapter 11 provides a significant break for tenants, and thus a significant burden for landlords, by providing that a lease cannot be terminated at any time after the commencement of a Chapter 11 action even though the terms of the lease call for termination upon the default. Chapter 11 also provides for a 20 day stay in the payment of some of a business's utility bills.

Chapter 13 of the Bankruptcy Reform Act is a voluntary action available to individual debtors with regular income. Unlike Chapter 11, which is not easily dismissed by the debtor, the debtor under Chapter 13 can move in and out of Chapter 13 protection at will. Ironically, it is

¹⁶ Bankruptcy chapters under prior law are designated by Roman Numerals and current chapters by Arabic Numerals.

¹⁷ For example, creditors of the Manville Corporation are growing increasingly impatient while, according to all accounts, the corporation is thriving in Chapter 11.

the liberal provisions of Chapter 13 relating to individuals which may eventually cause the Congress to take back some of the gifts which it bestowed on corporations through Chapter 11. Chapter 13 is particularly offensive to creditors because, under that section, a debtor may repeatedly thwart the foreclosure activities of the creditor by dismissing and reinstating bankruptcy actions without penalty.

BANKRUPTCY TAX ACT OF 1980¹⁸

The Bankruptcy Tax Act makes many important changes to the tax law regarding discharge of indebtedness income. Generally, the Bankruptcy Tax Act continues the rule of law that no income is realized by the debtor when debt is discharged in a bankruptcy proceeding or when the debtor is insolvent. Unlike the basis reduction rules of the Bankruptcy Act, which permitted the debtor to reduce the basis of any property which it owned, the new law requires the reduction of tax attributes in addition to asset bases. The apparent theory behind the tax attribute reduction rules is that valuable tax attributes may have been created with borrowed funds. Thus a revitalized debtor should not obtain benefits both from debt cancellation and tax savings through subsequent use of tax attributes. The Bankruptcy Tax Act made major changes affecting financially troubled corporations. Two changes, which will be discussed in detail are those relating to tax attributes and the introduction of the "Type G" reorganization.²⁰ Other changes include the amendment of section 382(b) of the Code to permit creditors to step into the shoes of shareholders in order to maximize the retention and utilization of net operating losses.

SECTION 108 CHANGES

Section 108(a), as amended, provides that gross income does not include income from the discharge of indebtedness if the discharge occurs (1) in a title 11 case, (2) when the debtor is insolvent (but only to the extent of the insolvency), or (3) when the debt discharged is qualified business indebtedness.²¹ Section 108 also provides that the rules relating to discharge of debt in Title 11 cases take precedence of the exception from income for insolvency or qualified business debts and that insolvency takes precedence over the qualified business debt exclusion.²²

New Section 108 requires that the amount excluded from gross income shall be applied to reduce tax attributes in the following order:

- (1) Net operating losses arising in the taxable year of discharge plus carryovers to such years,

¹⁸ *Supra*, Note 10.

¹⁹ But only to the extent of the insolvency. See, §§ 108(a)(1) and 108(a)(3).

²⁰ § 368(a)(1)(G) of the IRC.

²¹ § 108(a)(1)(C) of the IRC.

²² § 108(a)(2)(A) of the IRC.

- (2) Carryover of investment tax credit (section 38), WIN credits (section 40), targeted jobs tax credit (section 44B), and alcohol use credits (section 44E),
- (3) Capital loss carryovers arising in the taxable year of discharge plus carryovers to such years,
- (4) Basis reductions²³ but limited to the excess of the aggregate tax basis over the aggregate liabilities remaining after the discharge, and
- (5) Foreign tax credit carryovers to or from the year of discharge.

The new law provides a major tax planning opportunity to taxpayers which are in Chapter 11 bankruptcy or are insolvent by allowing the taxpayer to elect to apply the income from debt discharge against the basis of depreciable property instead of in the regular order provided for tax attribute reduction.²⁴ The election is not the exclusive remedy. That is the taxpayer is free to reduce the tax attributes in any manner. Thus, part of the reduction may be made with respect to depreciable property with the remainder of the reduction being applied to net operating losses or other tax attributes. In addition, the debtor has the option of treating as depreciable property real property held as inventory or stock of a subsidiary. If the debtor and its subsidiary file a consolidated return in the year of discharge, the subsidiary must reduce its basis in depreciable property by a like amount.²⁵ The reduction of tax attributes in the normal order provided in section 108(b) cannot exceed the excess of the aggregate basis of the property held immediately after the discharge over the amount of total liabilities of the taxpayer immediately after such discharge. This is not true in the case of the election.²⁶ In addition, care is required in selecting those tax attributes which are to be reduced. For example, it may be wise to reduce those tax attributes which will expire within fixed time limits such as net operating loss and investment credit carryovers. The reason for reducing net operating loss carryovers first is that it may be years before the corporation is again profitable whereas the basis of depreciable property usually has a longer useful life which the debtor may wish to preserve for the future.

QUALIFIED BUSINESS INDEBTEDNESS EXCEPTION

Unlike Chapter 11 cases and insolvencies, the rules for qualified business indebtedness²⁷ are significantly different.²⁸ The immediate difference is that the debtor need not be bankrupt or insolvent. If the debt to be discharged meets the definition of qualified business indebtedness, the amount excluded from gross income will be applied

²³ § 1017 of the IRC.

²⁴ See, §§ 108(b)(5) and 1017(b)(2) of the IRC.

²⁵ §§ 1017(b)(3)(E) and 1017(b)(3)(D) of the IRC.

²⁶ § 1017(b)(2) of the IRC.

²⁷ § 108(a)(1)(C) of the IRC.

²⁸ See, § 1017(b)(2) of the IRC.

to reduce the basis of depreciable property only.²⁹ Thus, the taxpayer may be required to reduce the basis of depreciable property below the basis of such property with the result that the debtor immediately recognizes ordinary income to the extent that the debt discharged exceeds the basis of depreciable property. This fact may be sufficient to force a marginal taxpayer into formal bankruptcy in order to escape the ordinary income consequence.

RECAPITALIZATION

The Committee Reports under section 108(e) make it clear that the stock for debt rules of *Motor Mart Trust*³⁰ continue under present law. Thus, there is no debt discharge income or attribute reduction when a financially troubled corporation issues new stock in exchange for old debt. Recapitalizations may also be encouraged because of the fact that recapitalizations are not subject to the section 382 limitations on the use of net operating loss carryovers. Congress has carved out a de minimis exception from the income exclusion rules of section 108 where only a nominal or token amount of shares is issued for the old debt or where a creditor receives less than 50% of what he would have received if all unsecured creditors participated in the workout.³¹

When the basis of property is reduced pursuant to the regular order or the special election rules of section 108, such property becomes section 1245 or section 1250 property thus subjecting the basis reduction amount to recapture upon the sale or disposition of such asset.³²

TYPE G REORGANIZATIONS

The passage of the Bankruptcy Tax Act has made the acquisition of financially troubled corporations significantly more attractive. Often, so-called insolvent corporations have viable businesses, usable assets, and extremely valuable net operating loss carryovers which can be used to offset future income of the acquiring corporation. These changes should be studied to see how the new law benefits shareholders, creditors, and potential acquirers. It may be best to bet on a corporate loser.

BACKGROUND

Prior to the enactment of the Bankruptcy Tax Act, two sets of rules applied to corporate reorganizations. Section 368 of the Code applied to reorganizations of solvent corporations and sections 371-374 dealt with the reorganization of insolvent corporations. The insolvency reorganization rules provided for the non-recognition of gain to the insolvent corporation upon the transfer of its assets to another cor-

²⁹ § 108(c)(1)(A) of the IRC.

³⁰ *Supra*, Note 5.

³¹ § 108(e)(8) of the IRC.

³² §§ 1017(d)(1) and 1017(d)(2) of the IRC.

poration pursuant to a plan of reorganization if stock or securities of the transferee corporation were received in the exchange. Gain was recognized to the insolvent corporation, however, to the extent that the fair market value of any property, other than stock or securities, which was received in the exchange was not distributed in the reorganization. The tax basis of the transferred assets carried over to the acquiring corporation, increased by the amount of gain recognized by the insolvent corporation. Further, no basis adjustments were required as a result of any discharge of indebtedness pursuant to the plan of reorganization.

The insolvency reorganization rules did not provide for the survival of tax attributes under section 381, unless the transaction also qualified as a tax free reorganization pursuant to section 368 of the Code. There was also some conflict under the insolvency reorganization rules concerning continuity of shareholder interest. The courts held that creditors were treated as stepping into the shoes of former shareholders for the purpose of meeting the continuity of interest test of sections 368 and 371. However, the courts also held that the continuing interest of creditors in the reorganized corporation would not satisfy the minimum ownership requirement in order to preserve net operating losses under section 382(b) of the Code. Lastly, the insolvency reorganization rules did not permit triangular mergers and dropdowns common to tax free reorganizations under section 368.

Generally, in order to ensure the retention of corporate tax attributes, it was necessary for the reorganization of an insolvent corporation to qualify under both section 371 and section 368. This resulted in many problems for practitioners. For example, the rules for determining the basis of transferred property in insolvency and solvency reorganizations were different. Also, the tax attribute carryover rules of section 381 applied only to section 368 reorganizations. Although creditors were permitted to obtain a significant interest in the debtor corporation under section 371, such creditors were not recognized as shareholders for the purpose of meeting the minimum ownership requirement of section 382(b).

Thus, it was necessary for the former shareholders to participate in order to ensure that the net operating losses survived. Unsecured creditors could avoid the net operating loss reduction rules by transferring the indebtedness to the debtor corporation in exchange for stock of such corporation in a transaction which qualified under section 351 of the Code. Although the creditor acquired control of the insolvent corporation by a transfer of debt, such transfer was neither a purchase for the purposes of section 382(a), nor a reorganization as described in section 382(b). Provided that the creditor controlled the transferee corporation, the transfer was tax free and the debtor corporation retained all of its tax attributes.

The Bankruptcy Tax Act was intended to promote the reorganization rather than the liquidation of financially troubled corporations by extending the provisions of solvency reorganizations to insolvency reorganizations. The effect of the Bankruptcy Tax Act is as follows:

- Repeal of the insolvency reorganization provisions and the introduction of a Type G reorganization designed to assist financially troubled corporations.
- Amendment of section 382(b) to treat creditors of the debtor corporation as stockholders in order to meet the minimum continuous ownership requirement to maximize net operating loss carryovers.
- Permit the use of triangular and reverse mergers as well as drop-downs in a Type G reorganization.
- Elimination of the use of section 351 transfers to avoid the application of section 382 by revising the definition of property for the purposes of section 351.
- The new rules apply only to cases instituted under Title 11 of the United States Code or similar proceedings such as receivership, foreclosure, or a similar proceeding in a Federal or State Court. The same rules apply to asset transfers by a financial institution in a receivership, foreclosure, or similar proceeding before a Federal or State agency.
- The new rules apply to bankruptcy cases commencing after December 31, 1980 and to proceedings commenced on or after October 1, 1979, if so elected by the taxpayer.

APPLICATION OF SECTION 382

Corporate tax attributes of a transferor corporation, such as NOL's, carryover from the transferor corporation to the acquiring corporation in certain section 332 liquidations as well as in Type A, Type C, Type D, Type F, and, now, Type G reorganizations. Section 382(a) of the Code provides that the tax attributes of a corporation are lost if the stock of such a corporation is acquired by purchase. Section 382(b) provides for the reduction or loss of tax attributes of a corporation acquired in a corporate reorganization in which a minimum continuity of shareholder interest is not maintained by the former shareholders of the acquired corporation. As noted above, under prior law, the continuity of shareholder interest requirement of section 382 was not satisfied where the former shareholders of the insolvent corporation transferred their proprietary interest to creditors of the insolvent corporation.

Section 382 of the Code acts to impose limitations on the carryover of corporate tax attributes described in section 381. Section 382(a) of the Code provides that if in a taxable year there is a 50% or more increase in stock ownership attributable to a purchase of stock, the net operating loss carryovers of the purchased corporation will be lost. A purchase is defined as an acquisition of stock in which the basis of the acquired stock is determined by reference to its cost to the holder. Section 382(b) of the Code permits the carryover of net operating losses from the loss corporation to the acquiring corporation in Type A, Type C, Type D, Type F, and Type G reorganizations. If the former

shareholders of the loss corporation receive at least 20% of the fair market value of the stock of the acquiring corporation, the net operating loss is allowed in full. The net operating loss carryover is reduced 5% for each 1% less than 20% of the stock ownership that the former shareholders of the acquired corporation own in the acquiring corporation. For example, if the shareholders of the loss corporation own only 10% of the stock of the acquiring corporation, only 50% of the net operating loss carryover of the loss corporation is available to the acquiring corporation.

The United States Supreme Court has long held that creditors of an insolvent corporation are treated as shareholders in order to satisfy the continuity of shareholder interest requirement of section 368. There has been no similar authority for treating the creditors of an insolvent corporation as shareholders for the purpose of satisfying the 20% rule of section 382(b). Accordingly, while an insolvent corporation could be successfully reorganized, net operating loss carryovers were usually lost unless the creditors took steps to convert their notes to stock prior to the reorganization.

Congress has eliminated the inconsistent treatment of creditors in insolvency reorganizations by amending section 381 to include Type G reorganizations and by the enactment of section 382(b)(7). That section provides that a creditor who receives stock in a reorganization in a title 11 or similar case shall be treated as a stockholder immediately before the reorganization. The new provision also treats depositors of an insolvent bank or S&L as stockholders. As a result, a financially troubled corporation undergoing a corporate reorganization may retain its entire NOL's if, as a result of the reorganization, creditors and former shareholders of the debtor corporation collectively own 20% or more of the stock of the acquiring corporation immediately after the reorganization. Only voting common stock will suffice, however. If shareholders and creditors of the insolvent corporation receive only non-voting, preferred stock in the reorganization, the minimum continuity requirement of section 382(b) will not be met and the NOL's will be lost.

TYPE G REORGANIZATIONS

A Type G reorganization is one in which no gain or loss is recognized to a financially troubled corporation upon the transfer of all or a part of its assets to another corporation in a title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the acquiring corporation are distributed in a transaction which qualifies under section 354, 355, or 356. Type G reorganizations involve asset transfers, hence there is no conflict with stock for stock, recapitalization, or other reorganizations. Where asset transfers pursuant to Type G reorganizations also qualify as liquidations, property for stock transfers, or other types of tax free reorganization, the Type G provisions override.

Section 368(a)(1)(G) of the Code requires that there be a transfer

of assets but does not require that the debtor corporation be the transferor. Unlike previous bankruptcy reorganizations, triangular reorganizations and dropdowns are now permissible. The Code now permits the acquiring corporation to transfer the assets received in a Type G reorganization to a new subsidiary of the acquiring corporation. Similarly, the Code has been amended to permit a debtor corporation to be merged into a subsidiary of the acquiring corporation. The Type G reorganization, also applies to so-called reverse mergers in which a subsidiary of the acquiring corporation is merged into the debtor corporation with the result that the insolvent corporation becomes a wholly owned subsidiary of the acquiring corporation. The reverse merger rules prohibit, however, a former shareholder from receiving any consideration for his stock of the insolvent corporation.

QUALIFICATION REQUIREMENTS

In order to qualify as a Type G reorganization, stock or securities of the acquiring corporation must be distributed in a transaction which qualifies under section 354, section 355, or section 356. In order to qualify under section 354, the acquiring corporation must acquire "substantially all" of the assets of the transferor corporation. The Courts currently construe the term substantially all much more liberally for Type D reorganizations than does IRS. The Committee report accompanying the Bankruptcy Tax Act states that the term substantially all should be construed more liberally than it is for Type D purposes. For example, asset sales and payments to creditors preceeding the reorganization will not preclude the insolvent corporation from satisfying the substantially all test. The liberalization is not intended to apply to other types of reorganizations, however. Accordingly, if the insolvent corporation is the acquiring corporation, the transaction is likely to qualify as a Type D reorganization rather than as a Type G and the more rigorous substantially all test required in the Type D reorganization will be applied.

Section 354 applies only to stockholders and security holders. It has no application in a Type G reorganization to creditors other than security holders. Accordingly, in some cases a transfer of assets by an insolvent corporation may not qualify as a Type G reorganization if no shareholders or secured creditors participate in the plan. Failure of the plan to qualify as a tax free reorganization will cause a loss of the debtor corporation's NOL's. Accordingly, creditors may wish to include the insolvent corporation's stockholders in the plan of reorganization. Another way to preserve the NOL's of the insolvent corporation absent shareholder participation is for the solvent corporation to merge into the debtor corporation. This will probably be objectional, however, from a business standpoint as well as a tax standpoint since it will subject the acquired corporation's assets to claims of the insolvent corporation's creditors.

APPLICATION OF SECTION 355

An insolvent corporation may transfer all of its assets to two or more new corporations followed by the distribution of the stock of the new subsidiaries to creditors in a transaction which qualifies as a tax free Type G reorganization. Although the transaction will be tax free, section 381 applies only to transactions qualifying under section 354. Accordingly, the NOL's would be lost.

APPLICATION OF SECTION 357

Gain may be recognized in an otherwise tax free Type G reorganization if the liabilities to be assumed by the acquiring corporation, plus the amount of the liabilities to which the transferred assets are subject, exceed the total of the adjusted tax basis of the property transferred. There is an exception to the application of this rule, however, where the shareholders of the insolvent corporation do not participate in the reorganization. This rule cannot be avoided by merging a solvent corporation into the insolvent because the latter transaction would probably qualify as a Type D reorganization to which section 357(c) is specifically applicable.

OTHER PROPERTY

If creditors receive cash or other property as part of the plan of reorganization in lieu of stock or securities of the transferee corporation, the insolvent corporation will recognize cancellation of indebtedness income under section 108(a) thereby reducing its net operating loss carryovers or other tax attributes.

Gain or loss may be recognized by stockholders and security holders if, in addition to stock of the acquiring corporation, money or other property is received, or securities are received with a principal amount in excess of the principal amount of securities surrendered, or if any property is attributable to accrued interest on surrendered securities. The subsequent disposition of stock at a gain may subject the seller to ordinary income recapture under section 1245 to the extent of deductions or losses previously allowed with respect to the debt.

CONTINUITY OF INTEREST AND BUSINESS ENTERPRISE REQUIREMENTS

The Committee Report indicates that the continuity of interest rules should be satisfied where shareholders and creditors, including short term unsecured creditors, have a continuing interest in the acquiring corporation. The continuity of business enterprise requirements were amended in 1980 to require that the acquiring corporation continue the acquired corporation's historic business or use a significant portion of its business assets in a business. It is likely that this requirement will

be modified in the case of a Type G reorganization since the debtor corporation may have ceased operations and may have disposed of all or part of its historic business assets.

SECTION 351 LOOPHOLE CLOSED

Prior to the enactment of the Bankruptcy Tax Act, creditors could transfer debt instruments to the insolvent corporation in a section 351 transfer and still avoid the purchase of stock limitation contained in section 382. This was because the transferor's basis in the transferee corporation's stock was a substituted basis under section 358 rather than a cost basis, as contemplated by section 382(a). New section 351(d) closes the loophole by excluding from the definition of property, stock issued for services, unsecured indebtedness, and accrued interest.

OTHER PLANNING OPPORTUNITIES FOR FINANCIALLY DISADVANTAGED CORPORATIONS

There are a number of often overlooked tax opportunities for significantly improving the cash flow of a financially distressed corporation.

Quickie Refund is a catchall phrase used to describe the two principal ways of expediting the refund of Federal taxes paid. Form 1139 enables the corporation to get a quick refund resulting from the carryback of net operating losses, net capital losses, unused investment tax credit, as well as unused WIN or jobs tax credits. The IRS is required to act within 90 days from the later of the date of application or the last day for filing the tax return.

Form 4466 permits a corporation to receive a quick refund of overpaid estimated taxes. A quick refund is permitted only if the overpayment is at least \$500 and at least 10% of the expected tax liability. The Form must be filed within 2½ months after the end of the tax year and before the corporation files its Federal income tax return. The IRS is required to act upon the application within 45 days of the date of filing.

INVESTMENT TAX CREDIT PLANNING

A corporation which purchases business equipment is eligible to claim investment tax credit. If the use of the investment tax credit results in a net operating loss, it must be determined whether the corporation is profitable enough to fully utilize the net operating loss. Unlike investment tax credit, which can only be carried back, net operating losses may be carried forward 15 years.³³ If the investment tax credit carries back or forward does not produce a tax saving, it is worthless to claim the credit. An alternative involves leasing the

³³ See, § 172 of the IRC.

equipment rather than purchasing it. Since a lessee has the option of leaving the investment tax credit with the lessor, the corporation may be able to take the savings in the form of a lower rent payment which can be matched, for tax purposes, with the net operating loss carryovers. In addition, beginning in 1983, the ACRS rules³⁴ require the basis of property to be reduced by $\frac{1}{2}$ of the investment tax credit claimed. Accordingly, the corporation should consider not claiming investment tax credit in order to retain a higher asset basis.

AVOIDING THE CAPITAL GAINS TRAP

A corporation which realizes a capital gain is required to compute the tax on the gain under the alternative tax method. If the corporation has a net operating loss carryover, part of the net operating loss benefit will be lost because the alternative tax rate is lower than the corporations regular tax rate.³⁵ As an alternative, a corporation which anticipates a large capital gain should consider an installment sale in the year of a net operating loss or should seek to minimize deductions or accelerate income so as to prevent the loss of a net operating loss. Often, this can be accomplished by electing to carry the net operating loss forward only.

FOREIGN TAX CREDITS

Since foreign tax credits are based upon dividends as a percentage of earnings and profits in the foreign jurisdiction, a corporation may maximize its foreign tax credit benefits by paying careful attention to the method of accounting used. For example, if a foreign subsidiary operates in a country with a higher tax rate thus producing excess foreign tax credit, the subsidiary can change its depreciation method to straight line. This will have the effect of increasing earnings and profits thus decreasing the foreign tax credit.³⁷ If the U.S. parent could benefit from an increase in the foreign tax credit, the subsidiary could switch its inventory method to LIFO thus reducing earnings and profits and increasing foreign tax credit.

PARENT-SUBSIDIARY PLANNING

Section 108 does not require a parent corporation whose debts are forgiven to reduce its basis in the stock of a subsidiary if no consolidated return is filed and the parent corporation is insolvent. As a result, the subsidiary retains its asset bases. Even if the basis of the subsidiary's assets is reduced, its net operating losses remain intact. In the event

³⁴ § 168 of the IRC.

³⁵ See, § 1201(a) of the IRC.

³⁶ Id.

³⁷ See generally, regulations under §§ 964 and 902 of the Income Tax Regulations.

of a solvent parent and an insolvent subsidiary, any cancellation of the subsidiary's debt increases the earnings and profits of the subsidiary. Assuming no basis or net operating loss adjustments, the effect of the increase in the subsidiary's earnings and profits increases the parent's basis in the stock of the subsidiary thus enabling the parent corporation to take a larger worthless stock deduction.³⁸ Often there is a market for a seemingly worthless subsidiary.

EMPLOYMENT TAX SAVINGS

The amount of State unemployment taxes which a corporation must pay are based upon the state's experience rate as well as the state's unemployment experience. A corporate employer may be able to obtain a one time benefit by shifting operations to a state which has a lower unemployment experience. This may be attractive to a corporation with expiring net operating loss carryovers since those carryovers can be used to offset the increased Federal tax resulting from the decrease in the corporation's state unemployment tax burden.

MISCELLANEOUS TAX SAVINGS STRATEGIES FOR CORPORATIONS

- A financially strapped corporation may be able to obtain from IRS a waiver of its pension plan's minimum funding requirements.
- Gifts of excessive inventory to charities are not subject to the limits on charitable contribution deductions.
- Current cash flow expenditures can be reduced by instituting a stock option plan whereby employees can receive stock options or other property in lieu of salary increases.³⁹
- Certain worthless intangible assets, such as purchased customer lists or patents, may be written off as worthless.
- Since the maximum personal income tax rate is only 4% higher than the maximum corporate rate, a subchapter S election⁴⁰ should be considered. Since gains and losses of a subchapter S corporation pass through to the shareholders, the shareholders may take advantage of losses to offset income from other sources. In the event that a gain is anticipated at the corporate level, the subchapter S status may be cancelled.
- The 1981 Supreme Court holding that the value of free meals and lodging provided to an employee for the employer's benefit do not constitute wages for income or FICA purposes,⁴¹ may entitle an employer to a refund of its portion of FICA taxes paid with respect to free meals and lodging.

³⁸ § 165(g).

³⁹ Under § 83 the employee may elect to be taxed currently on the value of the other property.

⁴⁰ See, § 1372 of the IRC.

⁴¹ 81-1 U.S.T.C. 9479.

- Corporations which normally employ persons who qualify as economically disadvantaged, may be eligible for significant tax savings by taking advantage of the targeted jobs tax credit.⁴² The credit, which may be as high as \$6000 per employee per year, need not require any change in hiring practices.
- Family businesses may save social security taxes when a spouse and children are employed in the business.⁴³

CONCLUSION

There has been many recent changes in the tax law which were designed to significantly reduce corporate taxes and improve cash flow. Many of these changes were designed to assist financially disadvantaged corporations to survive their financial crisis. Examples are the enormous liberalization of the bankruptcy rules under Chapter 11 as well as the enactment of the Type G reorganization. These significant changes, combined with the refinements of prior law provide a wide array of opportunities for disadvantaged corporations.

BIBLIOGRAPHY

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⁴² See, § 44B of the IRC.

⁴³ § 3121(a)(17) of the IRC.