Chapter 14

Tax Considerations When Deciding on a Pathway

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Scope

Other chapters of this treatise are intended to help you determine what legal path you should steer your (or your client's) company down as a means to help it deal with its financial troubles. One important topic the other chapters give short shrift to is taxes. Thus, it is critical that this chapter be read and understood before you choose your path. The tax impact of each legal option can touch not just the company, but also its principals, creditors, and any buyer.

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§ 14:1 The basic options

As discussed in other chapters, companies that are insolvent or are approaching insolvency have a number of options. For example, a troubled company can:

1. File a bankruptcy petition in federal court
2. Make an assignment for the benefit of creditors
3. Liquidate the business without a formal process
4. Negotiate with individual creditors separately
5. Sell off assets piece-meal

Each of these choices has different tax ramifications. The straight liquidation of a company with excessive debt, for example, can have very different tax outcomes if it is done in a bankruptcy case or in a less formal process. Depending on the path chosen, there could be different tax outcomes to the owners of the entity depending on what type of entity it is and how much was invested in the assets before they were liquidated. Having the secured lender do a friendly foreclosure may have a good tax impact or a bad tax impact, again depending on facts and circumstances such as whether the debt is recourse debt or non-recourse debt.

This chapter deals with these and other issues, such as personal liability for unpaid business taxes, cancellation of debt income, dischargeability and non-dischargeability of taxes, different results for different types of entities, the interplay between the Internal Revenue Code and the Bankruptcy Code, the IRS' collection process, and other administrative matters.

§ 14:2 The backdrop

The United States prides itself on having a "voluntary" tax system. The word "voluntary," as used in IRS publications, refers to our system of allowing taxpayers initially to determine the correct amount of tax they owe and complete the appropriate returns, rather than have the government determine tax for them from the outset.

The requirement to file an income tax return is not voluntary and is clearly set forth in I.R.C. §§ 6011(a), 6012(a) et seq., and 6072(a). Insolvency is not a defense for not filing, not paying, or not adhering to the complex rules of taxation passed down from both the federal and state governments. Whichever solution a company chooses to deal with its financial trouble, there will most likely be tax consequences.

This chapter is a general guideline of tax factors to consider. It is not authoritative and should not be used as tax advice for purposes of (i) avoiding penalties imposed under the United States Internal Revenue Code or (ii) promoting, marketing or recommending to another person any tax related matter. It is not a how-to, and as such will not give filing guidelines, form numbers, etc. Many of the tax elections required to be made to take advantage of tax savings come with deadlines that must be adhered to.

Tax laws and regulations change constantly, especially in the current economic and political environment. For example, certain rules related to Cancellation of Debt Income (COD income) were adopted for 2009 and 2010 only. These rules had both benefits and traps for distressed taxpayers and were instituted as part of the American Recovery and Reinvestment Act of 2009, the purpose of which was to deal with the nation's economic crisis. In today's constantly changing political and economic environment, it is important to always check the latest tax rules and regulations before making final decisions.

This chapter uses words like "generally" to a considerable extent. The reason is because tax issues surrounding insolvency are highly dependent on specific facts and circumstances. As you will find in this chapter, the tax code is not always consistent, and the results are not always what many would consider fair or logical.

The tax code deals with many situations, but it cannot possibly deal with all situations that arise in the world of insolvency. If you are in doubt as to potential tax treatment of your client's situation and the amount involved is significant, consult an expert.

Developing a strategy depends on a number of factors, including COD income, Trust Fund taxes owed, what other types of taxes are owed, and what type of entity is facing insolvency. What follows are tax issues to consider as you work through your strategies for dealing with insolvency.

§ 14:3 A word about the Tax Code

The tax code is primarily written to determine and acquire the government's share of its citizenry's income and wealth, and insolvency is dealt with in scattered portions of the code as if it were an afterthought. Many of the provisions related to insolvency seem to exist more to close apparent loopholes and keep tax dollars flowing into government coffers than as an intelligent, comprehensive approach to dealing with the problems of insolvency and lack of resources that businesses often face.

Bankruptcy judges have the power to determine what is fair, equitable, and rational. Never forget that the tax code serves different purposes than bankruptcy does. The tax code is fashioned by political debate and written by congressional authors who take polls and consult with lobbyists and find out what they think "fair," "equitable," and "rational" mean, and then write tax laws accordingly. It is written to favor the government over the taxpayer and is subject to change as frequently as there are elections.

§ 14:4 The non-escapability of taxes

Outside of bankruptcy, you have few defenses from the tax collector. Unless you can dispute the validity of the tax (for example, disagreeing with a sales tax audit assessment or a property tax assessment), you have to pay it, plus penalties and interest for late payment. Penalties are often negotiable, the amount of the tax owed is sometimes negotiable, payment terms may be negotiable, and interest tends to hardly ever be negotiable.

From a practical standpoint, both the IRS and most state revenue departments will work with you in a situation where aggressive collection for non-egregious lapses in payment would jeopardize the health of the business to the point where it could cost innocent employees their jobs. It is very bad publicity for a tax collecting agency to put employees out on the street over unpaid taxes (and bad economics to then have to pay them unemployment compensation).

On the other hand, if the business has already ceased operating and there are no employees remaining to serve as human shields, the tax collecting agencies will often come after non-payers very aggressively. In fact, upon closure of a business, it is common for every jurisdiction in which the

business has ever filed to request an audit so they can fight over whatever scraps are left.

If the business has reached its terminal stage, it is especially helpful to have professionals who have experience dealing with tax agencies and audit techniques, either CPAs or attorneys, to negotiate in behalf of the debtor. The first objective is to make sure an audit never happens, which can be as simple as reminding an auditor from Arkansas how brutal Chicago winters are or as complex as teaching the revenue authority why the audit would not be cost effective for them. If the audit does occur, it is critical to understand and be involved in the entire audit process. Auditors will draw small samples and make large inferences from them. Their methodologies are often flawed or biased, and hence challengeable. Do not let overly aggressive auditing turn into a final determination of liability.

Being inside of bankruptcy does not, by itself, do much to resolve existingtax problems. The government will stop sending you those threatening "intent to levy" letters, and agents with guns and badges won't show up at your door, but you still owe the money.

§ 14:5 Dischargeability of income taxes in bankruptcy

The Bankruptcy Code attempts to walk a fine line between accomplishing two often contradictory goals: (1) require everybody to pay taxes owed; and (2) provide insolvent debtors a fresh start. A debtor's ability to discharge tax debt is based upon the classification of that particular tax debt. For the purposes of the Bankruptcy Code, a tax claim can be characterized in various ways as a trust fund tax, a secured claim, an administrative tax claim, a priority tax claim, a general unsecured claim, or a penalty claim. Other than "trust fund tax," these classifications are dictated by the Bankruptcy Code, not the Internal Revenue Code or regulations.

The general rule is that taxes are not dischargeable in bankruptcy. The Bankruptcy Code does not specify which taxes are dischargeable, but does specify which taxes are "excepted from discharge." Income taxes excepted from discharge are primarily addressed in Bankruptcy Code sections 507(a)(7)(A), 523(a)(1)(B) and 523 (a)(1)(C). Income taxes may be dischargeable when all of the following apply:

- 1. the income tax return has been filed by the due date as extended, not to exceed six months (an IRS "substitute for return" does not count);
- 2. the return due date was more than three years before the date the bankruptcy petition is filed;
- 3. if the return was filed late, it was filed more than two years before filing of the bankruptcy petition;
- 4. the tax was "assessed" more than 240 days prior to filing of the bankruptcy petition (this applies where there is a later assessment after the return is filed, e.g., through an audit);
- 5. there is no fraud involved in filing the return; and
- 6. some other minor conditions.

In other words, if the Company timely filed all its returns and did everything else required to pay its taxes (short of actually paying them), and the government dropped the ball and pursued no collection activity for at least three years (a fact pattern that is seldom seen in the real world), then the Company may be able to discharge some of that income tax debt.

§ 14:6 Status and dischargeability of taxes other than income taxes

Most taxes other than income taxes, such as sales taxes, employment taxes (forms 940 and 941), and the trust fund recovery penalty (personal liability of persons in charge for an entity's failure to pay employment taxes—more on this below), cannot be discharged in bankruptcy. Tax penalties on non-dischargeable priority tax claims are also generally non-dischargeable to the extent they are punitive in nature.

Priority tax claim status is granted to certain "allowed unsecured claims of governmental units" under Bankruptcy Code section 507(a)(8). The Code is detailed and should be consulted for specific questions. In general, taxes levied on income or gross receipts, certain employment taxes, and certain excise taxes are granted priority status in bankruptcy. Prepetition interest on priority taxes is also granted priority status and is non-dischargeable. Post-petition interest is a general unsecured claim, is not entitled to priority, and is subject to discharge.

Tax claims are considered secured if the taxing authority

filed a valid lien pre-petition. The claim is secured to the extent of the value of the property securing the claim. If the value of the property securing the lien is less than the amount of the lien, then the remaining balance of the tax claim would either be a general unsecured claim or a priority tax claim, depending on how it would be treated in the Bankruptcy Code had a lien not been filed. Federal tax liens are not discharged even if the underlying taxes are discharged. Thus, secured taxes essentially are nondischargeable, although personal liability may not be asserted.

Administrative tax claims consist of taxes that have accrued during the pendency of the bankruptcy. Again, the status of the claim is determined by the Bankruptcy Code (particularly sections 507(a)(8), 507(a)(8), and 503(b)(1)), and the Code should always be consulted to determine the bankruptcy precedence of a specific claim.

Tax claims that do not qualify as secured, administrative, or priority are treated as general unsecured claims that could be discharged. Typically these are old claims that the taxing authority has not aggressively pursued. However, if the debtor filed a fraudulent return or willfully attempted to evade or defeat taxes, the taxes are nondischargeable. Submitting false withholding statements and failing to report embezzlement income are examples of acts that have been determined to be acts of fraud making the related taxes nondischargeable. Willful attempts to evade or defeat tax liabilities also include actions such as concealing assets and failing to either file returns or to pay taxes over an extended period.

Debts incurred to pay taxes

Conniving debtors have tried to avoid the non-discharge of tax rules by borrowing from non-government sources in order to pay down tax debts, and then seeking to discharge that borrowing in bankruptcy. This ploy fails, however, because debts incurred to pay non-dischargeable taxes are themselves non-discharageable.

§ 14:7 Trust fund taxes

Less conniving but still troubled debtors often "borrow" money that they are holding in trust. This money was withheld from employees' wages (income tax, social security, and

Medicare taxes) by an employer and held in trust until paid to the Treasury, or collected from customers (sales taxes required to be collected at the point of sale and remitted to state governments) and held in trust until remitted to the states.

Businesses that dip into their tax trust fund money almost always expect to pay the money back within days; being the optimistic type that entrepreneurs typically are, they are certain that whatever short-term difficulties they are having are just about to reverse, and cash will come flowing in again. It can seem like a good idea for several reasons. Interest rates on the late payments are lower than banks or credit cards. It takes months for anyone in government to notice that you haven't paid. And when it does notice, the government sends you a series of computer-generated letters, rather than those uncomfortable debt collection calls that more aggressive lenders make.

These monies that are in transit between employees or customers and the government are called "trust fund taxes," and any person who has custody or control over them is considered a trustee. In the words of the IRS; "Postponing paying [trust fund taxes] is not the same as making a late payment on your phone bill or to a supplier. Congress has established large penalties for delays in turning over your employment taxes to the Treasury. The longer it takes to pay that money, the more it will cost you." They sound serious. They are. The IRS seems to pursue unpaid trust fund taxes more vigorously than any other tax collection effort.

According to IRS Publication 15, Employers Tax Guide, the penalty rates are as follows for amounts not properly or timely deposited:

2% - Deposits made one to five days late.
5% - Deposits made six to 15 days late.
10% - Deposits made 16 or more days late. Also applies to amounts paid within 10 days of the date of the first notice the IRS sent asking for the tax due.

10%	-	Deposits paid directly to the IRS, or paid with your tax return (as opposed to remitting them electronically or through a bank)
15%	-	Amounts still unpaid more than 10 days after the date of the first notice the IRS sent asking for the tax due or the day on which you received notice and demand for immediate payment, whichever is earlier.

Late deposit penalty amounts are determined using calendar days, starting from the due date of the liability.

If federal income, social security, and Medicare taxes that must be withheld are not withheld or are not deposited or paid to the United States Treasury, the trust fund recovery penalty may apply. The penalty is the full amount of the unpaid trust fund tax. This is often called the "100%" penalty. If these unpaid taxes cannot be immediately collected from the employer or business, the IRS will pursue them from the "responsible" individuals.

A "responsible person" can be an officer or employee of a corporation, a partner or employee of a partnership, an accountant, a volunteer director/trustee, or an employee of a sole proprietorship. A responsible person also may include one who signs checks for the business or otherwise has authority to cause the spending of business funds. The trust fund recovery penalty may be imposed on all persons who are determined by the IRS to be responsible for collecting, accounting for, and paying over these taxes, and who acted willfully in not doing so. State governments treat sales and payroll tax trust funds in a similar manner, except that some states omit the word "willfully" from their statutes.

The liability shield of corporations or other limited liability entities does not protect a person deemed to be a "responsible" person from the 100% trust fund tax. The moral of the story here is do not hinder, delay, or otherwise cause trust fund taxes to be late or unpaid unless you are willing to pay them all with your own assets.

Some states actually make it difficult to pay trust fund taxes. Sales taxes are typically remitted monthly after a two- to three-week period where the retailer is allowed to calculate the amount due. This is not, however, a defense or

excuse for non-payment. Having your cash frozen in a bankruptcy proceeding, foreclosure, or levy is also not a defense or excuse. Taxes became trust fund obligations the moment they were received from the customer or withheld from the employee. Responsible parties in a company on the verge of insolvency will often try to remit their sales taxes before they are officially due to avoid the 100% penalty. These efforts are often hindered by state systems that do not competently accept advance payments. Two ways to work around this are to significantly over-pay on some of your scheduled/allowed payment dates, or to obtain a certified check payable to the state (which safely takes the cash out of the company on the day it is created) and hold it to remit at the appropriate time.

When employment tax withholdings are not remitted to the Treasury, the IRS requires the employees to pay that money in to satisfy their accounts, even if they have W-2 forms indicating that it was previously withheld. In addition to making employees pay this tax a second time (first via withholding and second via IRS demand), the IRS also pursues collection from the employer and if unsuccessful from responsible persons via the 100% penalty. Theoretically the IRS can collect the 100% penalty from every person deemed to be "responsible," there are no limits on how many times they can get paid for each transgression. In practice, they tend to stop collecting once the penalty has been paid by somebody.

Using trust fund money for anything other than its intended purpose is a bad idea. This statementmerits repeating because it is done so often by companies in distress. Using trust fund money for operations is no different than the gambler betting his family's dinner money on that last race to win everything back. The difference here is that one is betting against the government, and the government is undoubtedly going to come and collect. They may seem slow and plodding, and friendlier than the bank work-out department or hysterical vendors constantly demanding payment, but they are also unrelenting and have unlimited resources to devote to getting their money. They will not hesitate to padlock buildings, levy bank accounts, and seize other assets. Unpaid trust fund taxes are never dischargeable. If the business is in so much distress that it can only survive by using its employees' withheld payroll taxes, it needs to either stop

operating or make use of other solutions discussed in this book.

In bankruptcy, unpaid trust fund taxes have priority status under Bankruptcy Code section 507(a)(8)(C).

§ 14:8 Cancellation of Debt (COD) income

Being so insolvent that your creditor forgives all or part of your debt is actually, in many circumstances, a taxable event. I.R.C. § 62(a)(12) says that gross income includes all income derived from the cancellation of debt unless the cancellation meets certain qualifications, which will be discussed below. COD income arises from any action that satisfies a debt for less than the full amount owed.

More than most other provisions of the tax code, this one seems to generate a huge amount of anger and resentment in taxpayers. Why should someone be taxed for going broke? The reasoning is the closure of potential loopholes. The receipt of a loan does not generate taxable income for the recipient. If that loan is subsequently cancelled, and COD income is not assessed, than an entire avenue would be open for transferring money from one party to another without the government getting its share. Fred “loans” Joe a car and Joe “loans” Fred some money and ultimately they both forgive each other’s loans. The possibility of tax avoidance through forgiven “loans” would be ripe without the imposition of tax on COD income.

A legitimate dispute of the amount owed, and an arm’s-length compromise agreement that adjusts the amount of the debt to settle the dispute, is generally not COD. It must be proven, however, that a valid dispute existed and was settled at arm’s length.

COD income can only be attributed to the obligor of the debt. Guarantors of cancelled debt do not owe tax on the amount cancelled.

The expiration of the statute of limitations on collecting a debt generally creates COD income on the part of the debtor. The expiration of the statute does not extinguish the debt, it just makes it much more defensible not to pay it back. An identifiable event that makes a debt forever uncollectible is the trigger for realizing COD income.

Debts can be modified without generating COD income.

Examples of modifications include changes to the interest rate, maturity date, or payment schedule. A new debt that substitutes for the original debt, on the other hand, could generate COD income. A change in principal amount is generally considered a taxable event. Treas. Reg. § 1.1001-1(a) states that the conversion of any property into cash, or the exchange of property differing materially, either in kind or extent, is treated as income or loss. If new debt is swapped for old debt, the new debt must be valued to determine the tax treatment of the transaction.

The IRS has various tests as to what constitutes a significant enough modification of a debt to generate COD income and what does not. Changes in yield, timing, or amount of payment could generate COD income if they are material in relationship to the original agreement. Substitutions of obligors, changes in security, changes in the nature of the instrument (rights, currencies, fixed-rate vs. variable), exchanges of debt for equity, and exchanges for property are all events that will most likely be considered significant enough to generate the possibility of COD income.

Shareholders in distressed corporations need to be particularly careful if their corporation owes them money. Contributions of capital, stock for debt transactions, and acquisitions of debt by related parties are all transactions that could be deemed to generate COD income.

In a partnership, if the modification of debt alters the allocation of the debt between partners, gain may be recognized by some partners at the individual level, even if the modification was not significant enough to generate COD income at the partnership level.

The sale of an asset secured by debt, whether or not it was a foreclosure sale, can also generate COD income if the creditor is not paid in full and writes off a part of the debt as a result of the transaction. This is discussed further below in the Asset Sales section.

§ 14:9 COD income in bankruptcy

The first defense to the taxability of COD income is the discharge of the debt in bankruptcy. This is set forth in I.R.C. § 108(a).

The bankruptcy exception is not a free-ride: I.R.C. § 108(b)(1) provides that if cancellation of debt in bankruptcy

is not recognized as income, the debtor is required to reduce certain tax attributes such as Net Operating Losses, credit carryovers, capital loss carryovers, suspended passive losses, and the basis of property. In essence the debtor may recognize cancellation of debt income in the form of increased future tax liabilities arising due to the loss of other favorable treatments available in the tax code.

The bankruptcy exclusion of COD income from gross income may steer debtors who are distressed but not yet insolvent into bankruptcy court.

§ 14:10 COD income in insolvency, but not bankruptcy

The second main defense to the taxability of COD income is insolvency. The amount of COD income excluded from taxable income because of the insolvency provisions (COD income is not taxable to the extent the taxpayer is insolvent.) cannot exceed the amount by which the debtor is insolvent. Thus, in an out-of-court settlement where the debt outstanding is $8 million, the fair market value of the assets of the debtor is $6 million, and $3 million of debt is discharged, $2 million would fall under the insolvent debtor provision and $1 million of the debt cancellation would be COD income. Note that this applies to a debt discharge, not a transfer. If the asset was transferred, either ordinary income or capital gain income may then exist, regardless of the solvency, insolvency, or bankruptcy status of the debtor.

It is not always easy to determine whether a company was solvent, and there are different tests for determining that solvency. One is the ability of the debtor to pay its debts as they come due. Another is whether or not the business has adequate capitalization to properly conduct its business.

A third test for solvency requires a valuation of the fair market value of the debtor's assets and the ascertainment of the amounts of all liabilities. This is often contentious and subject to the methods and assumptions used by the person determining the company's solvency. The value of many assets, especially intangibles such as goodwill, intellectual property, leasehold interests, patents, etc., can be and are often the subject matter of courtroom dispute. Some liabilities may be interminable, contingent, or disputed. Examples of these could include warranty obligations,

environmental damage, or even tax claims. Business valuation is a topic outside the scope of this chapter, but nevertheless one that is extremely relevant to the determination of solvency or insolvency.

Determination of solvency (or insolvency) can differ depending on which solvency tests are applied. Solvency under any single test does not imply solvency under the others, and it is frequently seen where a company passes one test but fails another. Talented cash-flow managers, for example, are sometimes adept at keeping creditors satisfied with their payment streams during extended periods of time where the liabilities of the business far exceed the fair market value of its assets. The different solvency tests measure different things and the indications they give of solvency or insolvency don't always agree with each other.

Interesting questions have arisen in the determination of solvency. For example, should non-recourse debt that exceeds the fair market value of the asset pledged as security for the debt be included in the solvency calculation? Rev. Rul. 92-53, 1992-2 C.B. 48, adopts the position that non-recourse debt which exceeds the fair market value of the property which it secures is included in the insolvency computation only to the extent that such non-recourse debt is itself the subject of the discharge being tested.

Use of the insolvency exception for the assessment of COD income is clearly a logical choice when dealing with a distressed debtor. It may not always be an easy choice to implement.

§ 14:11 COD income involving qualified real estate indebtedness

The third main defense to the taxability of COD income is if the debt secures "qualified real estate." Debtors can elect to exclude canceled qualified real property business indebtedness from income. Qualified real property business indebtedness is debt that meets all of the following conditions:

1. It was incurred or assumed in connection with real property used in a trade or business.
2. It is secured by that real property.
3. It was incurred or assumed:
   a. Before 1993, or
   b. After 1992, if the debt is either (i) qualified acquisi-

tion indebtedness (defined next), or (ii) debt incurred to refinance qualified real property business debt incurred or assumed before 1993 (but only to the extent the amount of such debt does not exceed the amount of debt being refinanced).

4. It is debt to which the debtor elects to apply these rules.

This exclusion does not apply to a cancellation of debt in a bankruptcy case or to the extent the debtor was insolvent immediately before the cancellation. If qualified real property business debt is canceled in a bankruptcy case, the debtor must apply the bankruptcy exclusion rather than the exclusion for canceled qualified real property business debt. If the debtor was insolvent immediately before the cancellation of qualified real property business debt, the debtor must apply the insolvency exclusion before applying the exclusion for canceled qualified real property business debt. The order in which the exclusions apply is important for planning purposes, as each exclusion may have a different impact on the debtor or debtor's shareholders and/or partners.

There are exclusions and limitations on the amount that can be excluded from income that are based on the principal amount of the debt, the fair market value of the property securing the debt, and the basis at which the property is carried on the debtor's books.

§ 14:12 Qualified farm indebtedness

There are many special tax laws, including laws related to the discharge of "qualified" farm indebtedness, that are peculiar to the farming industry. Practitioners working with farming clients should be aware that these special rules exist and need to be considered.

§ 14:13 Satisfying debt with the issuance of equity

I.R.C. § 108(e) deals with a shareholder's or partner's conversion of debt to equity and when a corporation or partnership transfers ownership to creditors to satisfy its debts. Whether or not there is COD income depends on facts and circumstances—the fair market value of the stock or partnership basis, the shareholder's basis in the stock, etc.

When a shareholder-creditor's debt is cancelled or modified, the shareholder is treated as having made a contribution of debt to capital to the extent of the shareholder's basis

in the debt. Thus, if the shareholder's basis in the debt is less than the amount of the debt, the corporation can incur COD income, subject to the bankruptcy exception.

When stock is issued to satisfy debt, there is no cancellation of debt income to the extent of the fair market value of the stock transferred. Although issuance of stock may completely avoid the COD income, the resulting change in corporate ownership may affect the corporation's future ability to use net operating losses, capital loss carryovers, and other credit carryovers.

In the case of any partnership, any COD income recognized under I.R.C. 108(e) shall be included in the distributive shares of taxpayers which were the partners in the partnership immediately before such discharge.

§ 14:14 Asset sales

The sale of assets, whether in or outside of bankruptcy, is potentially a taxable transaction. If you sell the asset for more than its basis (generally the value of consideration you paid for it, less depreciation), the gain (excess of sales proceeds over basis) is taxable. For tax purposes, a foreclosure or deed-in-lieu-of-foreclosure is a taxable disposition. Important factors when considering the sale of an asset are: sales price; fair market value; tax basis of the asset; amount of secured debt; and tax characterization of the asset as ordinary or capital.

The sale of an asset secured by debt, primarily an asset that is not worth as much as the debt that secures it, can result in COD income to the extent the debt exceeds the fair market value of the asset (if the creditor is not paid in full). The sale of this asset can also generate taxable income to the extent the sales price of the asset exceeds its tax basis. The sale of the asset can therefore generate two different income tax liabilities—first on the sale of the asset, assuming it is sold for more than it is carried on the books for, and second on the COD income, assuming that the creditor who secured the asset was not paid in full. Note that this applies whether the asset is voluntarily sold or involuntarily foreclosed on and sold.

Whether the debt is recourse or non-recourse could have a bearing on the tax treatment of a transfer of assets in satisfaction of the debt.

When property secured by non-recourse debt is transferred in satisfaction of that debt, the transfer is treated as a sale or exchange for tax purposes, and gain or loss will be recognized by the debtor based on the difference between the amount of the obligation satisfied and the basis of the property. The true fair market value of the property taken to satisfy the debt is irrelevant—the sale is deemed to have occurred for the full amount of the debt, and there is no COD income.

Unlike with non-recourse debt, the fair market value of the property being transferred does matter if it is transferred to satisfy recourse debt. With recourse debt, the deemed sales price is the fair market value of the property, not the face amount of the debt. This applies whether or not the debtor is relieved of his personal liability or any remaining balances unpaid. If the sales proceeds of the property are less than the full amount of the debt, and the creditor does not receive payment in full, the debtor may be taxed on COD income.

Generally, if the debt is non-recourse than the property that secures it is the only refuge of the creditor, and the borrower is not also personally liable.

The IRC generally provides that a transfer of property between a debtor and a bankruptcy estate at the beginning and at the conclusion of the bankruptcy case, other than by sale or exchange, is not treated as a sale, and therefore there are no tax consequences.

§ 14:15 Different outcomes for different entity types

Business in the United States is generally conducted inside one of five different legal structures: C corporations; S-corporations; partnerships; limited liability companies; and sole proprietorships. Sole proprietorships are the most common form of business operation, but are not legally separate and distinct from their individual owners.

In a general partnership each partner is jointly and severally personally liable for business debts, torts, and other liabilities. The partnership does not pay income taxes (although it does pay income or "replacement" taxes in some states). The income or loss of a partnership flows through the partnership to the tax returns of the individual partners.

Corporations are defined and governed under state law,

but their status as a C-corporation or an S-corporation is a construct of federal tax law. Taxation of C-corporations leads to "double taxation," since the corporation pays tax on its income and then the shareholders pay tax a second time when the corporation distributes its post-tax money or property to them. S-corporations were created in tax law to allow some of the tax benefits of a partnership but the liability protection of a corporation, and are subject to rigid ownership provisions. The income of an S-corporation flows through to its individual shareholders and is taxed at the shareholder level and not at the corporate level. Unlike general partnerships, all corporations have limited liability for shareholders.

Limited liability companies (LLC's) were designed to combine even more of the tax advantages of a partnership (such as less rigid ownership restrictions and more flexibility in allocating pass-through income) with the liability protection of a corporation. Members of an LLC can elect to be taxed as either a partnership or S corporation. LLC's are usually treated as a partnership for federal tax purposes, meaning that income, losses, deductions, and tax credits flow through the LLC to the individual members, who report this on their individual income tax returns.

Conceptually, the tax code treats a corporation as a separate and distinct entity, while a partnership is treated as an agglomeration of individuals. The treatment of an LLC is determined by which entity it elected to be treated as, set forth in its operating agreement. It is important to note that even though income can flow through to the owners of both corporations and partnerships, the tax distinctions between them can create very different results when determining the taxability of the entity's activity.

§ 14:16 Partnerships (and LLC's that are taxed as partnerships) and COD income

Partnerships act as pass-through entities for tax purposes. Based upon I.R.C. § 702(a), items of income, loss and deduction flow through to the partners, and any tax consequences from those items are recognized at the partner level. However, partners can deduct partnership losses only to the extent of their basis in their partnership interest.

Each partner's basis in its partnership interest is increased

under I.R.C. § 705(a) by the amount of any income which passes through to the partner. On the other hand, I.R.C. § 752(b) treats any reduction in a partner's share of partnership debt as a distribution of money, and I.R.C. § 733 requires a partnership interest basis reduction for such distributions.

Debt discharge is an item of partnership income which passes through to the partners under I.R.C. § 702(a)(8). Under the terms of I.R.C. § 108(d)(6), each partner's eligibility for the I.R.C. § 108(a)(1)(B) insolvency exclusion of its share of debt discharge income depends upon that partner's individual solvency status, rather than that of the partnership. Partners of insolvent entities, therefore, may still be assessed with the COD income of their partnerships on their personal tax returns.

Individual partner recognition of COD income passed through the partnership occurs even if the partnership is in bankruptcy. Unless the partner himself is also insolvent or in bankruptcy, the obligation to recognize COD income will pass through to him personally. Unless special allocation rules have been agreed upon by the partners prior to the insolvency, investors in a partnership can receive unexpected tax consequences from the partnership's bankruptcy.

In applying these rules to partnerships, it should be noted that, under Sec. 703(a), a partnership is treated as an entity for purposes of computing its taxable income. Although COD income resulting from the discharge or modification of a partnership liability is recognized at the partnership level, the nonrealization rules may apply at either the partnership or partner level. The exclusion of any COD income recognized by the partnership is determined at the partner level, as is the cost of the exclusion. This means that the individual partner's fate is not in his own hands.

In connection with partnerships, COD income generated by a partnership flows through to its partners on the last day of the year (not on the date of cancellation), although the determination of partner insolvency (for purposes of the exclusion rules discussed later) should be made as of the date of the forgiveness.

A partnership, or an LLC taxed as a partnership, contemplating debt restructuring should carefully consider the tax effects. In the case of a corporation, the exclusion of recogniz-

ing COD income and the cost of tax attribute reduction are applied at the entity level. In a partnership, the exclusions and attribute reductions are not applied at the partnership level but are instead applied at the partner level (i.e. to each individual partner). COD income, therefore presents issues to a partner not in bankruptcy or who is solvent that are quite different from issues faced by a shareholder in an insolvent corporation.

§ 14:17 S Corporations and COD income

Like partnerships, S-corporations also act as conduits for tax purposes in most instances. I.R.C. § 1366(a) includes pass-through provisions which are quite similar to those for partnerships under normal circumstances. And, like partnerships, owners of S-corporations can deduct losses only to the extent of their basis in the corporation.

There are significant differences between the rules related to partnerships and to S-corporations for I.R.C. § 108 purposes. I.R.C. § 108(d)(7) requires determination of eligibility for the insolvency exclusion of debt discharge income at the corporate level rather than at the shareholder level. Therefore, the I.R.C. § 108(b) attribute reduction rules are also applied at the corporate level, and I.R.C. § 1366(d)(1) characterizes losses suspended for lack of shareholder basis as corporate net operating losses potentially subject to reduction under I.R.C. § 108(b)(2)(A). An S-corporation shareholder can potentially lose his suspended losses in exchange for the corporation excluding COD income.

The I.R.C. § 108 rules for S corporations also differ from those for C-corporations in one significant respect. As discussed above, I.R.C. § 108(e)(6) normally requires corporate recognition of debt discharge income when corporate debt with a reduced basis in a shareholder's hands is contributed to the capital of the corporation. However, I.R.C. § 108(d)(7)(C) adds back S corporation basis reductions due to net operating losses previously passed through to the shareholder under I.R.C. § 1367 for purposes of the I.R.C. § 108(e)(6) computation.

§ 14:18 C Corporations and COD income

An advantage of C-corporations, unlike S-corporations or partnerships, is that they can directly make use of net

operating loss carry-backs and carry-forwards. In pass-through entities, these pass through to the shareholders or partners.

Many corporations have accumulated substantial net operating losses (NOLs) that may possess significant value if the corporation can offset them against future income. A corporation that undergoes an "ownership change" will be greatly limited in its use of those NOLs, and in some cases the NOLs can be lost entirely.

In general, if there is a "significant change" of a company's ownership within a three-year period, the carry-forward of certain losses, credits, and favorable tax attributes is limited. A significant change is defined as a shareholder owning 5% or more of the company increasing his ownership interest by 50% or more. If a shareholder owning 6% of a company increased his ownership to 9%, that would be considered a significant change that would limit the use of the tax benefits the distressed company had previously generated.

Basically, the purpose of these limitations are to prevent the sale of tax benefits in the guise of a troubled company, although their effect is also to take away one of the few potential items of value (the accumulated tax benefit generated by consistent losses) that troubled companies often have. The limitations are inversely proportional to the company's value immediately before the ownership change. Since the value of a distressed company is often close to zero, the limitations are usually severe.

There are special rules written to define and determine what exactly constitutes a "change in ownership." They are too complex to be summarized or repeated here. What you need to know is that they were written harshly to discourage the transfer of tax benefits and are very unfavorable to distressed companies. It may make a difference whether the ownership change occurs inside or outside a formal proceeding (bankruptcy, receivership, foreclosure) in a federal or state court. Any changes in the ownership structure or capitalization of a distressed company should be vetted against these rules and the future plans for the business to ensure that there is not a detrimental tax impact. I.R.C. §§ 382 and 269 are the places to start your research here.

From a planning perspective, it can be very difficult to avoid an ownership change under Section 382. If a corpora-

tion needs new equity to survive, the new investors will most likely be in a strong enough position to negotiate a significant enough position to trigger the change in ownership provisions. Ownership change can also occur if the debtor has a strong enough position to force creditors into converting their debt into equity. If preserving the usage of the NOLs is critical to the company's survival plan, issuing preferred non-convertible non-voting stock may help escape triggering a Section 382 ownership change. Given the current economic environment where providers of capital definitely have the upper hand in any negotiation, bringing in new capital in exchange for corporate securities with relatively little security and no upside participation is likely a hard sell.

§ 14:19 Administrative matters

When a business enters into a bankruptcy proceeding or an assignment for the benefit of creditors, a separate estate is created for bankruptcy or fiduciary purposes. Bankruptcy and other alternative solutions, by themselves, have no tax impact. Treas. Reg. 1.641(b)-2(b) provide that the estate is not considered a new entity or a separate entity. The corporation or partnership continues as the taxable entity even if a trustee or receiver has been appointed.

Insolvent entities, whether operating as DIPs, assignments, or struggling businesses, continue to have a duty to file all tax returns using the same identification number, reflecting both pre and post-petition income and deductions. The entity's tax year does not change. Pre-petition tax attributes (NOLs, tax credit carryovers, asset values, etc.) do not change simply as a result of the initiation of a bankruptcy case. Most post-petition costs allowed by the courts or post-assignment costs paid by the trustee are deductible as ordinary and necessary business expenses.

Pass-through entities (S-corporations and partnerships) continue to file their returns as they did before the bankruptcy or assignment. The amount and nature of income continues to "pass through" to the stockholders or partners, who are taxed individually. S-corporations can lose their status if the bankruptcy plan distributes ownership of the company to too many or to disqualified owners.

If a bankruptcy case is dismissed, for tax purposes it is

deemed never to have existed (1398(b)(1)). Also, conversion of a case from Chapter 11 to Chapter 7 has no tax consequence. For federal tax purposes, a partnership is not terminated until all operations cease and all assets have been disposed of. State law, however, may terminate the partnership upon the bankruptcy filing.

Trustees are required to file any tax return required by law to have been filed by the debtor, and furnish, without personal liability, all information required by government rules and regulations. Of course, distressed debtors do not always have books and records in pristine condition, and the trustee is only required to provide what is available. Failure to file returns can result in the dismissal or conversion of the case.

It is not uncommon for an insolvent entity to realize substantial taxable income from the sale or liquidation of assets, rental income, royalty payments, dividends, and interest during the administration of the case. The person who has control of the assets of a debtor in any bankruptcy proceeding is required to give notice to the IRS within 10 days of the date of appointment or authorization to act. Failure to pay tax obligations that arose during the pendency of the case can attach personal liability to the fiduciary that should have made those tax payments.

Section 505 of the Bankruptcy Code covers all taxing authorities, not just the IRS, and all types of taxes including income taxes, excise taxes, sales tax, unemployment compensation taxes, etc. It also deals with interest, fines, penalties, or other additions to taxes. Sec. 505(a) authorizes the court to determine the liabilities. The court's jurisdiction does not apply to non-debtors such as partners, spouses, and officers. Under Sec. 505(b) the governmental units must determine the tax liabilities within a specified time period. Once this time period has expired, the returns cannot be audited or changed.

Under Bankruptcy Code section 507(a)(8)(A) taxes for income, gross receipts, property, employers taxes, excise taxes (including sales taxes), duties, withholding taxes, prepetition interest, and certain fines are granted eighth priority, after Administrative Expenses, wages, benefit plans, and deposits. If the case becomes administratively insolvent, it is likely that tax obligations will not be satisfied. Note that the lower priority does not excuse non-debtors such as

guarantors or responsible persons who may also be liable from having to pay.

In bankruptcy, the debtor needs permission to make any payments, including the payment of any trust fund taxes it is holding. In a contentious case angry creditors may try to block approval for payments of pre-petition trust fund amounts, hoping that the 100% penalty will be assessed on responsible parties that they seek revenge on. Entities with trust fund exposure may want to avoid bankruptcy, as other alternative solutions allow them to maintain more control over their disbursements.

§ 14:20 Collection methods

Taxing authorities generally move at the speed of government. What they may lack in speed, however, they more than make up for in tenacity and ability. Troubled companies will almost always hear from their trade creditors and bank long before the tax man calls. The initial contact from the IRS will almost always be in the appearance of computer-generated form-letters asking the taxpayer for more information or reminding of a payment due (plus penalty and interest). These letters become successively more demanding as time goes on. Eventually the IRS will collect the money owed, either voluntarily or involuntarily. The myth of the IRS padlocking the doors of a business is not a myth—I've seen it first-hand.

The Internal Revenue Manual (IRM), which is the operating handbook for the IRS, is posted online. The section detailing collection matters is at http://www.irs.gov/irm/part5/. Once a taxpayer is in the collection process they can expect the following sequence of notices:

1. Notice CP 501 is the notice required by IRC 6303 demanding payment. It is sent within 60 days of assessment. The letter will clearly state "Reminder—pay in 10 days—we can file liens." If this is the only notice received by the taxpayer they can usually count on having adequate time to prepare to fully explore and plan for resolution of the matter.
2. Notice CP 503 is not a required notice. It states "Important. Immediate Action . . ."—"pay or we'll take steps." The IRS can skip it and sometimes does.
3. Notice CP 504 states "Urgent. We intend to levy"—"take

state refunds." Under I.R.C. § 6330(f) the levy of state refunds is an event that requires no advance 30-day notice, and the IRS will often attach any state and federal refunds due the taxpayer at this point.

4. Notices such as LT 11, Letter 1058, Notice CP 90 or Notice CP 297 contain the same language. These notices can also be computer-generated or can be more personalized from the agent assigned to the case. When this notice arrives it is the last stop before the IRS will commence taking assets. Bank accounts are the first asset to be taken as they are the easiest for the IRS to find and grab. This notice provides the required "Notice of Intent to Levy and Notice of Your Right to a Hearing." This notice starts the final 30-day clock before levies are put in place. Even if the taxpayer is actively working with the IRS Collections department to resolve the case during that final period, absolutely NOTHING will suspend the expiration of the 30-day period. Delinquent taxpayers are well advised to make some sort of peace with the IRS before they issue an Intent to Levy notice.

The IRM indicates that the IRS will not conduct seizures that subject a taxpayer to "hardship." The definition of "hardship" is being unable to meet "necessary" living expenses. There are IRS tables that determine how much money is "necessary" to live on, and they most likely define "living" much more harshly than most Americans do. To obtain hardship status a taxpayer must disclose all income and living expenses and a full valuation of all assets and liabilites. The taxpayer also must have no cashflow in order to qualify for a harship. You may think you have a zero budget; the IRS may feel differently. Economic hardship is considered a temporary condition, and the debt is only suspended, not eliminated. It also does not forgive penalties and interest, which continue accruing and double the amount owed roughly every five years.

The IRM states that seizures will not be conducted on taxpayers who "will pay" or "can't pay." These categories include taxpayers who:

1. do not agree with the assessment and are working with the Service to properly adjust their account;
2. willfully pay their liability within a reasonable time frame;

3. require a reasonable period of time to sell an asset or secure a loan;
4. qualify for and submit an offer in compromise;
5. have no ability to make payments and have no distrainable assets (currently not collectible); and
6. request and qualify for an installment agreement.

Taxpayers who are unable to pay what they owe should contact the IRS as soon as possible. There are a number of payment solutions the IRS may be able to offer to the taxpayer including:

1. Extension of Time to Pay—Taxpayers may be eligible for a short extension of time to pay of up to 120 days. Taxpayers should request an extension if they would be able to pay their taxes in full within the extended timeframe.
2. Installment Agreement—Installment agreements paid by direct deposit from a bank account or payroll deduction from wages will help avoid agreement default by ensuring timely payments and will reduce the burden of mailing payments and save postage costs.
3. Delaying Collection—If the IRS determines that a taxpayer is unable to pay, it may delay collection until the taxpayer's financial condition improves. In this case it will often attach a levy to any identified but untakeable assets (such as retirement accounts protected under state law) and simply wait until the asset is liquidated.
4. Offer in Compromise—Some taxpayers are able to settle their tax bill for less than the amount they owe by submitting an Offer in Compromise. However, the IRS states that the criteria for accepting an offer are strict and relatively few offers are accepted each year.

During the collection process, even if a taxpayer works out a payment solution with the IRS, the IRS may have to file a Notice of Federal Tax Lien to secure the government's interest. The lien is required by law to establish priority as a creditor in competition with other creditors in certain situations, such as bankruptcy proceedings or sales of real estate.

§ 14:21 Conclusion

Tax issues may or may not be a factor in the resolution of a distressed company's problems. In many cases the company

has been in so much trouble for so long that as long as the trust fund taxes are all currently paid, tax issues are nothing but a distant memory of better times when taxable income was more than just something to wish for. In some situations good planning opportunities may be available, but, more often, cognizance of tax traps and pitfalls mainly will aid in damage control. Either way, advisors to distressed companies are well advised to consider the main issues outlined here and research them further if they apply to the case at hand.