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ATTRIBUTE REDUCTION RULES FOR SEPARATE COMPANIES AND FOR CONSOLIDATED RETURN GROUPS

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Distressed debt workouts and restructurings have dramatically increased during the current economic downturn. To the extent a debtor is insolvent or a debt discharge occurs in a title 11 bankruptcy, such cancellation of debt ("COD") income is not taxable to the debtor.¹ However, section 108(b) provides that the excluded COD income shall be applied to reduce tax attributes.

The first part of this article reviews the general attribute reduction rules for stand-alone C corporations. The second part of the article provides an overview discussing how these rules are applied to federal consolidated return groups under regulation section 1.1502-28.

Part I: Application of Attribute Reduction Rules for Separate Company C Corporations

Section 108 – General Rules

Section 61(a)(12) of the Internal Revenue Code provides that gross income includes income from the discharge of indebtedness, except as provided by law. Section 108(a) provides that gross income of a C corporation does not include any amount that would otherwise be includible in gross income by reason of the discharge, in whole or in part, of indebtedness of the taxpayer if the discharge occurs in a title 11 case (section 108(a)(1)(A)), the discharge occurs when the taxpayer is insolvent, but only to the extent of the insolvency (section 108(a)(1)(B)), or the indebtedness discharged is qualified farm indebtedness (section 108(a)(1)(C)).

Although section 108 does not require certain taxpayers to include discharge of indebtedness income in gross income, it does require the reduction of tax attributes. Section 108(b)(1) provides that if a taxpayer excludes an amount from gross income under section 108(a)(1)(A), (B), or (C), the taxpayer must reduce its tax attributes by the amount excluded. Absent an election under section 108(b)(5) (described below), pursuant to section 108(b)(2), tax attributes are reduced in the following order:

- (A) *Net Operating Loss (NOL)* — Any net operating loss for the taxable year of the discharge, and any net operating loss carryover to such taxable year.
- (B) *General business credit* — Any carryover to or from the taxable year of a discharge of an amount for purposes for determining the amount allowable

as a credit under section 38 (relating to general business credit).²

- (C) *Minimum tax credit* — The amount of the minimum tax credit available under section 53(b) as of the beginning of the taxable year immediately following the taxable year of the discharge.
- (D) *Capital loss carryovers* — Any net capital loss for the taxable year of the discharge, and any capital loss carryover to such taxable year under section 1212.
- (E) *Basis reduction* —
 - (i) *In general* — The basis of the property of the taxpayer.
 - (ii) *Cross reference* — For provisions for making the reduction described in clause (i), see section 1017.
- (F) *Passive activity loss and credit carryovers* — Any passive activity loss or credit carryover of the taxpayer under section 469(b) from the taxable year of the discharge.
- (G) *Foreign tax credit carryovers* — Any carryover to or from the taxable year of the discharge for purposes of determining the amount of the credit allowable under section 27.

Any amount of debt discharge that remains after attribute reduction is not includible in income.³ These provisions are designed to "preserve the debtor's 'fresh start' after bankruptcy."⁴ In addition, they are intended to "carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge."⁵ By making attributes unavailable to offset income in later years, the provisions offer the debtor a temporary, rather than a permanent, deferral of tax.⁶

For example, a debtor that is insolvent by \$90 realizes \$100 of COD income. \$10 of the COD income is taxable under section 61(a)(12). The remaining \$90 of COD income is excluded from income under section 108(a)

² Note that Section 163(j) carryforwards are subject to section 382 limitations but are not subject to attribute reduction under section 108.

³ See H.R. Rep. 96-833 at 11 (1980); S. Rep. No. 96-1035 at 12 (1980).

⁴ H.R. Rep. 96-833 at 9 (1980); see S. Rep. No. 96-1035 at 10 (1980).

⁵ *Id.*

⁶ Section 108 discussion is adapted from the Preamble to the Temporary Regulation Section 1.1502-28T, FR DOC #03-22453, Page 52488.

¹ Section 108(a)(1),(2).

(1)(B).⁷ Debtor has \$40 of NOLs and \$70 of tax basis in section 197 intangibles with a 5-year remaining life. Debtor does not elect under section 108(b)(5) to first reduce basis in depreciable assets. Of the \$90 of COD that is excluded, the \$40 NOL is reduced to \$0 and \$70 of tax basis in section 197 intangibles are reduced to \$20. As such, \$90 of tax attributes have been reduced (\$40 of NOLs and \$50 of section 197 intangibles). If the debtor were profitable in a future year, the \$40 of NOLs would not be available to offset taxable income.⁸ Moreover, the taxpayer would lose \$50 of amortization deductions over the following 5 years.

Alternatively, assume the debtor's only tax attributes were the \$40 of NOLs. Such attributes would be reduced to zero, and \$50 of the excluded COD would thus not reduce any attributes. As stated above, any amount of debt discharge that remains after attribute reduction is not includible in income. Excluded COD that does not reduce attributes is colloquially referred to as "black hole" COD.

Section 108 – Amount of Reduction and Ordering Rules

- The reductions for general business credits, minimum tax credits,⁹ and foreign tax credits shall be 33 1/3rd cents for each dollar excluded by subsection (a).¹⁰ All other reductions shall be one dollar for each dollar excluded by subsection (a).¹¹ For example, \$300 of excluded COD income would reduce \$100 of general business credits, but would otherwise reduce \$300 of NOLs.
- The reductions shall be made after the determination of tax for the taxable year of discharge.¹² In other words, the tax return for the year is first tentatively prepared before attribute reduction and then attribute reduction is applied. As such, any carrybacks to prior years are taken before attribute reduction. For CARES Act NOL carrybacks, this can be very taxpayer friendly. For example, an insolvent taxpayer carries back a \$100 NOL from 2020 to 2016. The taxpayer would receive a \$35 refund (as 2016 had a 35% corporate tax rate). In the alternative, the NOL may be been reduced to zero in attribute reduction if it had not been carried back.

- The reductions to NOLs and capital loss carryovers shall be made first in the loss for the taxable year of the discharge, and then in the carryovers to such taxable year in the order of the taxable years from which each such carryover arose.¹³
- The reductions to general business credits and foreign tax credits shall be made in the order in which carryovers are taken into account for the taxable year of the discharge.¹⁴

Section 108 – Election to Apply Reduction First Against Depreciable Property

The taxpayer may elect to apply any portion of attribute reduction to the reduction in section 1017 of the basis of depreciable property of the debtor.¹⁵ The amount to which such an election applies shall not exceed the aggregate adjusted bases of the depreciable property held by the taxpayer as of the beginning of the taxable year following the taxable year in which the discharge occurs.¹⁶ For affiliated and consolidated return groups, tax basis in subsidiary stock is treated as depreciable property only to the extent that the subsidiary consents to a corresponding reduction in the basis of its depreciable property.¹⁷

In the case of a discharge in bankruptcy, or to the extent the taxpayer is insolvent, reduction in tax basis of assets cannot exceed the excess of the aggregate bases of the property held by the taxpayer immediately after the discharge, over the aggregate liabilities of the taxpayer immediately after the discharge.¹⁸ However, this "liability floor" limitation does not apply to any reduction in basis by reason of an election under 108(b)(5) to first reduce basis in depreciable assets.¹⁹

For example, a taxpayer has \$100 of excluded COD and does not make an election under section 108(b)(5). The corporation has \$20 of NOLs, \$100 of tax basis in depreciable assets, and will have \$70 liabilities immediately after the discharge. In this case, the \$20 of NOLs will be reduced. As the reduction in tax basis in depreciable assets cannot exceed the liabilities remaining, only \$30 of tax basis in assets will be reduced. As only \$50 of attribute reduction occurred, there will be \$50 of "black hole" COD that will not reduce any attributes.

If the taxpayer had elected under section 108(b)(5) to first reduce basis in depreciable assets, the liability floor limitation would not apply. As such, all \$100 of excluded COD would reduce the tax basis in its depreciable assets

⁷ The amount excluded under Section 108(1)(B) shall not exceed the amount by which the taxpayer is insolvent. Section 108(a)(3).

⁸ However, the NOLs may have been subject to Section 382 limitation(s) and/or the 80% Section 172(a) limitation for losses that arise in tax years after 2017.

⁹ It is unlikely a taxpayer would still have minimum tax credits remaining as they became fully refundable in 2018 or 2019. See Section 53(e)(5) for election to take 100% refundable credit amount in 2018 – per CARES Act Section 2305(b).

¹⁰ Section 108(a)(3)(B).

¹¹ Section 108(a)(3)(A).

¹² Section 108(a)(4)(A).

¹³ Section 108(4)(B).

¹⁴ Section 108(4)(C).

¹⁵ Section 108(b)(5)(A).

¹⁶ Section 108(b)(5)(B).

¹⁷ Section 1017(b)(3)(D).

¹⁸ Section 1017(b)(2).

¹⁹ Section 1017(b)(2)(B).

to zero. The corporation would still have \$20 of NOLs after attribute reduction.

Part II – Application of Attribute Reduction Rules to U.S. Federal Consolidated Return Groups

Consolidated Return Groups – Separate or Consolidated Approach?

Prior to the issuance of the section 1.1502-28T regulations in 2003, it was not settled whether attribute reduction would only occur to the debtor(s) in the group (separate) or to the group as a whole (consolidated).

In the early 1990's the Treasury took the view that consolidated return groups should apply separate company attribute reduction.²⁰ However, by the late 90's, the Treasury had reconsidered and decided that consolidated attribution should apply,²¹ though the issue remained unsettled.

This issue dramatically presented itself when WorldCom, Inc. ("WorldCom") filed for bankruptcy in 2002 after an \$11 billion accounting scandal.²² It was the largest bankruptcy ever in the United States when it filed.²³

WorldCom was formed in 1993 and had acquired many communications companies, such as the former MCI, Inc. telecom with which it had previously merged with in 1997.²⁴ As MCI, Inc. had a less tarnished name than WorldCom, WorldCom renamed itself MCI, Inc. (MCI) in 2003²⁵ (further use of the name "MCI" in this article refers to the renamed WorldCom).

Virtually all of the subsidiaries of MCI had NOLs. The subsidiaries paid a management commission to the parent. As such, the parent had no NOLs but had incurred most of the third-party debt. If separate entity attribution reduction occurred, MCI would have no separate company NOLs to reduce, and would only reduce its basis in its first-tier subsidiaries, after recognizing approximately \$35 billion of excluded COD income in the bankruptcy. Under consolidated attribute reduction, MCI would instead lose virtually all of its NOLs.²⁶

MCI had generated great antipathy with its competitors. William Barr, then Verizon's general counsel, "helped orchestrate objections to the reorganization plan (in order to force MCI to liquidate rather than reorganize in bankruptcy). . . Mr. Barr contends the (fraud) turned the phone company into a 'criminal enterprise' and that 'bankruptcy is not a mechanism for laundering stolen goods.'"²⁷

Besides trying to force MCI liquidate, its competitors lobbied Congress to enact legislation that would force consolidated groups to apply consolidated attribute reduction such that the reorganized MCI would not have billions of NOLs to shield future taxable income. "In the summer of 2003, Senator Santorum introduced legislation to resolve this issue (but) the Senate Judiciary Committee took no action of the Santorum proposal."²⁸

Preamble to the Section 1.1502-28T Regulations – Consolidated Approach

After Congress failed to enact legislation, the Treasury issued the 1.1502-28T regulations with an effective date of August 29, 2003. The preamble to the temporary regulations state that:

The IRS and Treasury Department have considered a separate entity approach and various consolidated approaches to the application of the attribute reduction rules of section 108(b) in the consolidated group context. As explained below, *these regulations adopt a consolidated approach that reduces all attributes that are available to the debtor* (emphasis added).

The IRS and Treasury Department have rejected a separate entity approach. Such an approach would reduce only the attributes attributable to the member with excluded discharge of indebtedness income. The IRS and Treasury Department have rejected this approach because it fails to take into account the fact that consolidated attributes that are attributable to other members will be available to offset income of the debtor member as long as the debtor is a member of the group. A separate entity approach could result in the permanent exclusion of discharge of indebtedness income when there are other attributes available to the debtor member.²⁹

²⁰ See PLR 9121017 (Feb. 21, 1991).

²¹ See FSA 199912007 (Dec. 14, 1998); CCA 200149008 (Aug. 10, 2001).

²² WorldCom, Inc. Form 10-K for the fiscal year ended December 31, 2002. <https://www.sec.gov/Archives/edgar/data/723527/000119312504039709/d10k.htm>

²³ "WorldCom Files for Largest Bankruptcy in U.S. History." PBS News Hour, July 12, 2003. https://www.pbs.org/newshour/economy/business-july-dec02-worldcom_07-2

²⁴ "Justice Department Clears WorldCom /MCI Merger after MCI Agrees to Sell its Internet Business." United States Department of Justice, July 15 1998. https://web.archive.org/web/20090601034716/http://www.usdoj.gov/atr/public/press_releases/1998/1829.htm

²⁵ WorldCom, Inc. Form 10-K for the fiscal year ended December 31, 2002. <https://www.sec.gov/Archives/edgar/data/723527/000119312504039709/d10k.htm>

²⁶ "Tax Consequences from Discharging Debt," Norton Rose Fulbright, October 1, 2003. <https://www.projectfinance.law/publications/tax-consequences-from-discharging-debt>

²⁷ "Verizon to MCI: Drop Dead; Campaign Is on for Liquidation," Wall Street Journal, May 15, 2003. The article noted that MCI would reduce its debt from \$41 billion to \$6 billion post-emergence, while Verizon had debt of about the \$54 billion at the time.

²⁸ "Recent Developments in Bankruptcy Tax." Jones Day Commentaries, October 2003. <https://www.jonesday.com/files/Publication/87de9563-4fc6-435f-a3d7-e48ce4bbfe86/Presentation/PublicationAttachment/a1d3359a-799c-45c3-ad79-94aeddac1005/Recent%20Developments.pdf>

²⁹ 68 FR 52487, Page 52488. <https://www.federalregister.gov/documents/2003/09/04/03-22453/guidance-under-section-1502-application-of-section-108-to-members-of-a-consolidated-group>

Overview of Section 1.1502-28 Regulations

The section 1.1502-28 regulations were issued in finalized form on March 21, 2005. While the Treasury stated the regulations take a "consolidated" approach, in actuality the regulations adopt a hybrid approach. For example, the first section of the regulation, 1.1502-28(a)(1), states that section 108(a)(1)(A) and (B) is applied separately to each member that realizes excluded COD income, and insolvency is tested based on the assets and liabilities of only the member that realized excluded COD income.

The "consolidated" provisions of the regulation are contained in a subsequent three-part analysis: -28(a)(2) debtor attribute reduction; -28(a)(3) look-through (or 'push down') rules and -28(a)(4) "fan out." These three steps are described below:

- 1) *Section 1.1502-28(a)(2) – Reduction of tax attributes attributable to the debtor* – With respect to a member that realizes excluded COD income in a taxable year, the tax attributes attributable to that member shall be reduced as provided in sections 108 and 1017 and this section. Basis of subsidiary stock, however, shall not be reduced below zero pursuant to paragraph (a)(2) of this section.
- 2) *Section 1.1502-28(a)(3) – Look-through ("push down") rules* – To the extent the stock basis of a lower-tier member is reduced in -28(a)(2), that subsidiary is treated as having recognized excluded COD in amount equal to such basis reduction.
- 3) *Section 1.1502-28(a)(4) – Reduction of certain tax attributes attributable to other members ("fan out")* – To the extent that, pursuant to paragraph (a)(2) of this section, the excluded COD income is not applied to reduce the tax attributes attributable to the member that realizes the excluded COD income, after the application of paragraph (a)(3) of this section, such amount shall be applied to reduce the remaining consolidated tax attributes of the group, as provided in section 108 and this section.

Example 1 – Parent of a consolidated return group (P) directly owns 100% of S1 and S2. P has no other attributes. P has a basis of \$100 in S1 and a basis of \$0 in S2. P has no NOLs. S1 and S2 each have \$60 of NOLs, assets with a tax basis of \$0, and no other attributes. P recognizes \$150 of excluded COD.

Step 1 – Under -28(a)(2), P would reduce its basis in S1 by \$100. P cannot reduce S2's basis below zero.

Step 2 – Under -28(a)(3), S1 would be treated as having recognized \$100 of excluded COD (equal to the amount that P reduced its basis in the stock of S1). S1 would then reduce its \$60 NOL to zero.

Step 3 – Under -28(a)(4), P had \$150 of excluded COD but only reduced \$100 of attributes in -28(a)(2). As such, P would have to reduce up to \$50 of remaining consolidated tax attributes (\$150 less

\$100). In this case, the only other consolidated tax attribute is the \$60 NOL at S2. Thus, under -28(a)(4), S2 would reduce its \$60 NOL by \$50.

Example 2 – P owns 100% of S. P recognizes \$150 of excluded COD. P has no assets except for a \$120 tax basis in the stock of S and has liabilities after the discharge of \$70. S has \$60 of NOLs, tax basis in assets of \$0 and no liabilities after the discharge.

Step 1 – Under -28(a)(2), P would reduce its basis in S1 by \$50 as it is limited by the section 1017(b)(2) liability floor. In other words, P cannot reduce basis in assets below the \$70 of liabilities remaining after discharge. In this case, P will have a \$70 basis in the stock of S after attribute reduction, and \$70 of liabilities – resulting in net assets of \$0. The section 1017(b)(2) liability floor is designed to prevent the creation of negative net liabilities after attribute reduction.

Step 2 – Under -28(a)(3), S would be treated as having recognized \$50 of excluded COD (equal to the amount that P reduced its basis in the stock of S). S1 would then reduce its \$60 NOL to \$10.

Step 3 – Under -28(a)(4), P had \$150 of excluded COD but only reduced \$50 of attributes in -28(a)(2), but there are no more attributes left to reduce in the group.

Other Regulation Section 1.1502-28 Provisions

Section 1.1502-28(a)(3) limitation – To the extent that the excluded COD income realized by the lower-tier member pursuant to this paragraph (a)(3) does not reduce a tax attribute attributable to the lower-tier member, such excluded COD income shall not be applied to reduce tax attributes attributable to any member under paragraph (a)(4) of this section and shall not cause an excess loss account³⁰ to be taken into account under regulation § 1.1502-19(b)(1) and (c)(1)(iii) (B).

For example, P reduces tax basis in S stock by \$100. S only has \$60 of tax attributes to reduce. The remaining \$40 would not be applied to reduce tax attributes of other members under -28(a)(4).

Multiple Debtors – If in a single taxable year multiple members realize excluded COD income, paragraphs (a)(2) and (3) of this section shall apply with respect to the excluded COD income of each such member before the application of paragraph (a)(4) of this section.³¹

Election under section 108(b)(5) – The group may make the election described in section 108(b)(5) for any member that realizes excluded COD income. The election is made separately for each member. Therefore, an election may be made for one member that realizes

³⁰ An excess loss account is essentially negative tax basis in the stock of a subsidiary of a consolidated return group. See regulation section 1.1502-32(a)(3)(ii).

³¹ Regulation section 1.1502-28(b)(1).

excluded COD income (either actually or pursuant to paragraph (a)(3) of this section) while another election, or no election, may be made for another member that realizes excluded COD income (either actually or pursuant to paragraph (a)(3) of this section). For purposes of applying section 108(b)(5)(B), the basis of stock of a subsidiary that has an excess loss account shall be treated as zero.³²

Application of section 1017 –

(i) *Timing of basis reduction* – Basis of property shall be subject to reduction pursuant to the rules of sections 108 and 1017 and this section after the determination of the tax imposed by chapter 1 of the Internal Revenue Code for the taxable year during which the member realizes excluded COD income and any prior years and coincident with the reduction of other attributes pursuant to section 108 and this section. However, only the basis of property held as of the beginning of the taxable year following the taxable year during which the excluded COD income is realized is subject to reduction pursuant to sections 108 and 1017 and this section.

(ii) *Limitation of section 1017(b)(2)* – The limitation of section 1017(b)(2) on the reduction in basis of property shall be applied by reference to the aggregate of the basis of the property held by the member that realizes excluded COD income, not the aggregate of the basis of the property held by all of the members of the group, and the liabilities of such member, not the aggregate liabilities of all of the members of the group.

(iii) *Treatment of shares with an excess loss account* – For purposes of applying section 1017(b)(2) and § 1.1017-1, the basis of stock of a subsidiary that has an excess loss account shall be treated as zero.³³

Summary

As described above, section 108 is designed to preserve the debtor's 'fresh start' after bankruptcy. In addition, section 108 is intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge. By making attributes unavailable to offset income in later years, the provisions offer the debtor a temporary, rather than a permanent, deferral of tax.

The liability floor in section 1017(b)(2) is designed to prevent the creation of negative net assets after attribute reduction. In a consolidated return context, an excess loss account, or negative tax basis in subsidiary stock cannot be created in attribute reduction.³⁴

While the regulation section 1.1502-28 rules are designed to "reduce all attributes that are attributable to debtor," the mechanics of the regulations, in combination with the section 1017(b)(2) liability floor, may result in certain attributes remaining after attribute reduction.

In a consolidated return group setting, determining where the post emergence debt should reside (between parent and/or subsidiaries) can have a large impact on asset attribute reduction due to the liability floor, depending on the group's facts and circumstances.

MCI – Post Note

MCI emerged from bankruptcy on April 20, 2004, shedding \$35 billion of debt. If it had been allowed to apply separate company attribute reduction, it would have reduced tax basis in first-tier subsidiaries and retained all other tax attributes, including its NOLs. However, the section 1.1502-28T regulations were written to prevent that outcome. MCI thus emerged bankruptcy shorn of substantial tax attributes.³⁵

On July 13, 2005, Bernie Ebbers, the co-founder and CEO of MCI, was sentenced to 25 years in prison for securities fraud and conspiracy charges.³⁶

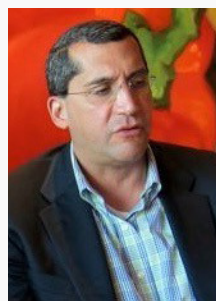
On January 6, 2006, Verizon, who had previously tried to force MCI into liquidation, merged with MCI. The business unit was renamed "Verizon Business."³⁷

³⁵ "Following the application of the attribute reduction rules, (MCI) estimates all of its federal NOL, capital loss and credit carryforwards and the majority of its state NOL and credit carryforwards (totaling approximately \$15.5 billion) will be eliminated and will not be available for use in future periods." MCI Form 10-K for the fiscal year ending December 31, 2004. <http://getfilings.com/o0001193125-05-052451.html>

³⁶ *United States v. Bernard Ebbers*, 458 F.3d 110, (2006).

³⁷ "Verizon and MCI close merger creating stronger competitor for advanced communications services," (January 6, 2006). <https://www.verizon.com/about/news/verizon-and-mci-close-merger-creating-stronger-competitor-advanced-communications-services>

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³² Regulation section 1.1502-28(b)(2).

³³ Regulation section 1.1502-28(b)(3).

³⁴ Regulation section 1.1502-28(a)(2)(i).