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Impact of Tax Reform on Financially Distressed Companies: Operating and Restructuring Challenges

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Impact of Tax Reform on Financially Distressed Companies: Operating and Restructuring Challenges

January 22, 2019

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Agenda

1. Revised Rules on NOL Carryforwards and Carrybacks
2. New Limitations on Deductions of Interest Expense
3. “Expensing” Provisions
4. Modifications to Rules Regarding Foreign Collateral Packages
5. Relevant Developments in International Taxation

NOL Carryforwards and Carrybacks

1. NOL Carryforwards and Carrybacks

- Old Law: 2-year carryback and 20-year carryforward for NOLs.
  - Company that was profitable and paid taxes in years 1 and 2 but became distressed in year 3 could use losses generated in year 3 to seek a refund of taxes paid in years 1 and 2.
  - Sometimes a *critical* source of liquidity for company facing sudden financial distress/shift in market conditions (generally less important for "slow death" situations).
  - 20-year limitation on carryforward typically not meaningful.
    - NPV of tax benefit realized in 20 years? Basically zero.

1. NOL Carryforwards and Carrybacks (cont'd)

- New Law: **No** carryback, indefinite carryforward (for NOLs generated in 2018 and later).
  - In no world does an indefinite carryforward "pay" for the loss of NOL carrybacks.
  - There is no real "planning" or "fix" to this issue, it's simply a source of potential liquidity that has evaporated.
  - Historically, Congress has made changes to NOL Carryback rules to liberalize them when the economy goes south, but changes come **too late** to save companies that are most in need.
  - Current turmoil in markets (especially O&G) + rising interest rates – will history repeat?

1. NOL Carryforwards and Carrybacks (cont'd)

- Old Law: NOL carryforwards could offset 100% of taxable income, subject to 2% floor under alternative minimum tax.
- New Law:
  - NOL carryforwards for NOLs generated *before* 2018 subject to no limitation.
  - NOL carryforwards for NOLs generated in 2018 or later can only offset 80% of taxable income in any year.
  - Net effect for post-2018 NOLs is that the "minimum tax" increases from 2% to 4.2% (21% FIT * 20% unshielded income).
  - But just a timing issue if company is consistently profitable.

1. NOL Carryforwards and Carrybacks (cont'd)

- Change mean pre-2018 NOLs are more valuable.
- Impact on restructuring transactions:
  - Asset sales and taxable restructuring transactions designed to obtain a tax basis step-up ("Bruno's" transactions) may be tax-free if there are sufficient pre-2018 NOLs.
  - Potentially greater emphasis on restructuring transactions that preserve ability to use NOLs without limitation, i.e., plans that qualify under Section 382(l)(5) of the IRC.
    - Eligibility can be tough and post-deal trading limitations still present real limitations.

Limits on Interest Deductibility

2. Limitations on Interest Deductions

- Old Law:
  - Subject to certain limitations (e.g., related party issues, Applicable High Yield Debt Obligation Rules), 100% of interest expense typically deductible.
  - Result: Debt was typically more efficient than equity in a capital structure, if strictly evaluated from a tax perspective.
  - Different from many non-U.S. jurisdictions that had “thin capitalization” rules and similar limitations that put limits on interest deductibility.

2. Limitations on Interest Deductions

- New Law: Section 163(j), *plus* most of the old rules.
  - For most businesses, "interest" deductibility limited to 30% of "adjusted taxable income" plus business interest.*
    - Real estate businesses and certain regulated businesses can elect out.
  - "Adjusted taxable income" is *roughly* EBITDA until 2022 and EBIT thereafter, subject to certain significant caveats.
  - Proposed regulations have defined "interest" very broadly.
  - *No grandfathering* for pre-2018 debt.
  - Result: Financial distress will not necessarily cause expected reduction in tax liability.

*"Floor plan financing" interest is also added but only relevant to a small number of industries.

2. Limitations on Interest Deductions (cont'd)

- What is "Interest"? Extremely broad.

Rules	Examples
❶ Amounts paid, received or accrued for the use or forbearance of money and amounts treated as interest under other Code provisions	OID, qualified stated interest, acquisition discount, market discount bonds, repurchase premium, amounts treated as interest under 467, 988, 7872, etc.
❷ Specifically enumerated items not falling within general rule	Swaps with non-periodic payments, contingent payment debt instruments, substitute interest payments, yield adjustments, commitment fees, debt issuance costs, guaranteed payments, factoring income, etc.
❸ Any expense or loss that is predominantly incurred in consideration of the time value of money	Guarantee fees? Other examples?

— Appears to be limited to section 163(j) purposes only
— Applies to both interest income and interest expense

2. Limitations on Interest Deductions (cont'd)

- EBITDA until 2022? Not so fast…
  - Proposed regulations provide that items that are required to be capitalized pursuant to Section 263A are not "added back" to ATI.
    - E.g.: $100 of gross income and $20 of depreciation. Prior to 2022, ATI = $100 and 163(j) limitation = $30. But if capitalization under 263A is required for the $20 that would otherwise be depreciation expense, ATI = $80 and 163(j) limitation = $24.
  - Section 263A is a complex area of tax law, but it generally applies to companies that are in the business of manufacturing/selling inventory (including, e.g., energy).
  - Huge issue for manufacturing companies – arguably already living in a post-2022 world.

2. Limitations on Interest Deductions (cont'd)

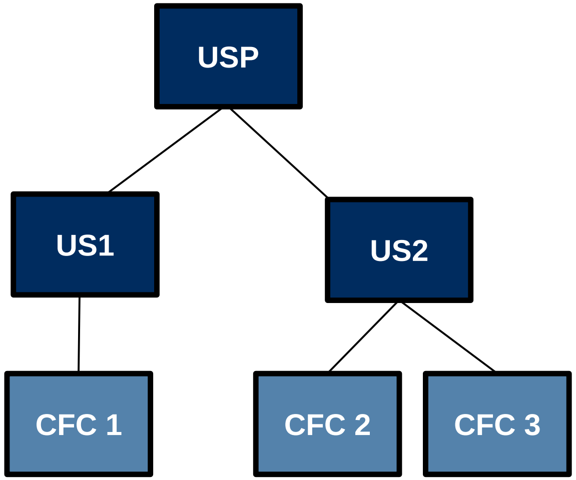
- Depreciation "claw-back"
  - Proposed regulations provide that if depreciation/amortization deductions claimed prior to 2022 increase the 163(j) limitation, and the property is sold in the future, then the amount of gain that would otherwise factor into ATI in the year of the sale is reduced by the *lesser of* (a) amount of depreciation or (b) the amount of gain.
    - Example: In year 1 (2019), gross income of $100, depreciation of $20, for taxable income of $80. Because depreciation is added back, ATI = $100. In year 2, asset is sold for a gain of $20, attributable to the depreciation claimed in year 1. The $20 of gain is **not** included in ATI in year 2.
  - Technical issue: The "gain cap" does **not** apply to sales of stock, so stock vs. asset sale must be careful scrutinized.

2. Limitations on Interest Deductions (cont'd)

- Application of §163(j) to CFCs

Default Method	CFC Group Method
General rules — CFC-level section 163(j) limitation determined on a CFC-by-CFC basis — Netting of inter-CFC interest income and expense is <u>disallowed</u> in determining 163(j) limitation — U.S. shareholder ATI determined <u>without regard to</u> Subpart F income, GILTI, and section 78 income net of section 250 deduction related to excluded GILTI **Initial impressions** — GILTI double counting trap persists because netting of intra-group business interest expense and business interest income not allowed — Excess limitation can be trapped at CFC level because no adjustment to parent-level ATI permitted	**General rules under Prop. Reg. § 1.163-7** — Elective method available for certain highly related CFCs to apply group method approach to determine CFC-level 163(j) limitation and U.S. shareholder ATI adjustments for certain CFC inclusions — Netting of intragroup business interest expense and income <u>allowed</u> — Upper-tier CFC-level ATI <u>increased by</u> lower-tier CFC excess taxable income — USSH ATI decreased by Subpart F, GILTI, S. 78 inclusions (like Default Method) but excess taxable income ("ECI") remaining at highest-tier CFC may be added back to U.S. shareholder ATI in an amount measured by reference to GILTI/Sub F inclusions at CFC(s) with ETI (determined based on complex computation) — Election is irrevocable until CFC Group terminates **Initial impressions** — CFC group method almost always preferable to default method — May still requires CFC-by-CFC calculations so not easier to calculate than default method

2. Limitations on Interest Deductions (cont'd)



	CFC1	CFC2	CFC3
3rd Party Interest Expense	(90)	--	--
Intercompany Interest Income	100	--	--
Intercompany Interest Expense	--	(50)	(50)
ATI	100	100	100

- Example Prop. Reg. § 1.163-7:
  - CFC1, CFC2 and CFC3 are a CFC group
  - Assuming a CFC group election is made:
  - <u>Applicable net business interest expense of the group</u>
    - (90) + 50 + 50 + (100) = 90
  - <u>Net business interest expense of each member</u>
    - CFC 1 = 0 (10 excess interest income)
    - CFC 2 = 50/(50+50) * 90 = 45
    - CFC 3 = 50/(50+50) * 90= 45
  - <u>163(j) limitation of each member</u>
    - CFC 2 = 100 * 30% =30
      - Disallowed interest expense = 15
    - Same result for CFC 3
  - <u>Total interest subject to limitation</u>
    - CFC 2 = 50 – 35 (increase of 5 for excess interest income)
    - Same result for CFC 3
  - <u>If no CFC group election is made</u>
    - CFC 2 has 20 of disallowed interest expense
    - Same result for CFC 3

2. Limitations on Interest Deductions - CODI

- Impact on Cancellation of Debt Income.
  - Generally, when a company that is in bankruptcy or is insolvent has cancellation of debt income (“CODI”), there is no taxable income, but tax attributes are reduced to offset the CODI.
  - Historically, it is generally most tax-advantageous to a debtor to deduct all interest, including post-petition interest (even if unlikely to be paid).
    - Additional deductions would “net” with additional CODI from accrued interest and give debtor flexibility.
  - Section 163(j) changes the analysis.

2. Limitations on Interest Deductions – CODI (cont’d)

- Example:
  - Company has $100 of debt at a 10% interest rate and $60 of NOL.
  - In Year 1, Company has EBITDA (and ATI) of $0, so no interest can be deducted and $10 163(j) carryforward is created.
  - In Year 2, Company declares bankruptcy, and creditors receive equity of Company, which is worth $50.
  - Does Company have $50 of CODI, or does the accrued interest result in there being $60 of CODI despite Company only receiving a 163(j) carryforward of potentially limited value.
  - If $60 of CODI, are all of Company’s NOLs eliminated, basically trading $10 of NOL for $10 of less valuable 163(j) carryforward?

2. Limitations on Interest Deductions - CODI (cont'd)

- Potential arguments (all with significant weaknesses):
  - Company does not have CODI with respect to interest under "tax benefit" principles, because no real tax benefit was obtained.
  - Section 108(e)(2) generally provides there is no CODI if the liability would have given rise to a deduction when paid. Does it apply here?
    - Much harder to make if interest is actually paid, of course.
    - Most plans of reorganization provide that recoveries are principal-first, notwithstanding certain regulations to the contrary.
  - Can the CODI attributable to interest be viewed as interest expense, which would "unlock" limited interest deduction?
  - Reduce 163(j) carryforward instead of, or pro rata with, NOLs?

2. Limitations on Interest Deductions - CODI (cont'd)

- Can Company forego deducting the interest in year 1?
  - IRS historically argued that debtors could not deduct interest if the interest was unlikely to be paid.
  - IRS changed position in early 2000s after adverse court ruling, at least for pre-effective date years.
  - IRS has maintained position that interest in year of plan effective date cannot be deducted.
  - Potential argument that Company could take the position that the interest should not be accrued, even for pre-effective date years, so no CODI should arise.

2. Limitations on Interest Deductions - CODI (cont'd)

- Practical steps:
  - "Adequate protection" orders often leave open whether payments are principal or interest. If possible to do so without effecting economics, characterize as principal payments?
  - Don't claim deduction and take position that no interest was accrued, subject to meaningful risk?
  - Would "self-help" language in a plan of reorganization, or a court ruling that interest was always highly unlikely to be paid, help the situation?
- IRS **actively considering** CODI/163(j) interaction—PLR likely not possible at this time. Closing agreement?

“Expensing” Provisions

3. Expensing

- Old law: Taxpayers could take an immediate deduction for 50% of the price of certain types of *new* property placed in service.
  - Property purchased from others was ineligible.
- New law: Through 2022, 100% deduction for *newly acquired* property, with a 20%-per-year phase-out from 2023-2026.
  - Includes property purchased from someone else.
  - Subject to certain anti-abuse exceptions and applies only to property with a depreciation period of 20 years or less (*i.e.*, most real property excluded).
  - Bottom line: Opportunity to claim immediate deduction for M&A activity.

3. Expensing (cont'd)

- In restructuring, often a choice between a "tax-free" reorganization and a "taxable" reorganization (from the debtor's perspective).
  - Tax-free: Preserve existing tax attributes, subject to potential limitations on the ability to use those attributes under Section 382 of the IRC.
  - Taxable: Assets transferred in a way that results in a "reset" of their tax basis to FMV.
  - Taxable is often a better structure if (a) CODI rules will result in elimination of attributes; (b) Section 382 will largely eliminate ability to use attributes; (c) there is a large basis "step-up"; and (d) sufficient attributes to shield any taxable gain.

3. Expensing (cont'd)

- Expensing provisions add another planning opportunity: When assets transferred pursuant to a taxable transaction, the acquisition may be eligible for expensing and give the reorganized company an immediate "jolt" of deductions.
- **But beware not to "overshoot"** and create large NOL carryforwards that will be subject to 80% NOL limitation in the future.
- **Also beware:** "Claw-back" of depreciation for Section 163(j) purposes if assets sold.

Foreign Collateral Packages

4. Rules on Foreign Collateral Packages

- Old law:
  - Company owns foreign subsidiary (“CFC 1”), and CFC 1 owns CFC 2.
  - To avoid negative tax consequences (“deemed repatriation”) under Section 956 of the IRC: (a) stock pledges typically limited to 65% of voting stock of CFC 1; (b) no guarantees by or pledges of any of the assets of CFC 1 or CFC 2, including any of the stock of CFC 2.
  - Overwhelmingly market position in “healthy” company deals.
  - Occasionally practice not followed in bankruptcy “debtor-in-possession” financing contexts.
  - Occasionally, when tax lawyers not consulted, “adequate protection” liens given to prepetition creditors would cause problems as well.

4. Rules on Foreign Collateral Packages (cont'd)

- New law:
  - Statute changed nothing about this issue, other than potentially reducing exposure because of operation of other tax rules.
  - Even though statute made *actual* repatriation tax-free under many circumstances, *deemed* repatriation was (insanely) not.
  - Proposed regulations have fixed this issue and, in situations where an actual repatriation would be tax-free under new law, the "deemed" repatriation is also tax-free.

4. Rules on Foreign Collateral Packages (cont'd)

- Not so fast…
  - Starting to become a common talking point for non-tax lawyers to claim foreign pledges/guarantees ok without consulting with tax colleagues—it's not that easy.
  - For 100% stock pledge of CFC 1 to be ok for US tax purposes, must ensure eligibility under the tax-free repatriation rules, which require, among other things, a one-year holding period of the CFC stock.
  - 100% pledge of CFC 1 stock may not be problematic for US tax purposes, but a guarantee by CFC 1/CFC 2, or a pledge of any assets, may create *significant* local-law tax and non-tax problems.
  -

Changes in International Taxation

5. New International Tax Rules

- Common talking point of new rules was that it would move US to “territorial system” that did not tax overseas income as much.
- Despite implementation of tax-free repatriation, **nothing could be further from the truth**.
- In general, the **majority** of overseas operations will be **immediately taxable** under the new “GILTI” regime.
- Certain historic methods of limiting US taxable income by entering into arrangements with foreign affiliates are subject to significant limitations under “BEAT” regime.
- One bright spot: Certain foreign-derived income subject to new, favorable rules under FDII regime.
- Comprehensive discussion beyond the scope of this presentation.

5. GILTI and FDII

- “Global Intangible Low Taxed Income” = GILTI
  - A tax on any income in excess of a permitted rate of return on foreign tangible assets.
- “Foreign-derived intangible income” = FDII
  - *Favorable* tax treatment for income derived outside of the US.
  - Again, not linked to intangibles. Any return in excess of a specified return on tangible assets it assumed to relate to intangibles for this purpose.

5. GILTI and FDII (cont'd)

- GILTI and FDII income are each eligible for deductions that reduce the relevant rate for these kinds of income, and a deemed-paid foreign tax credit is also associated with GILTI income.
- Unfortunately, taxpayers with NOLs are forced to use those NOLs **before** being permitted to receive the benefit of the GILTI/FDII deductions.

5. GILTI and FDII (cont'd)

- U.S. company with no income other than $100 GILTI inclusion and $50 of FDII income.
  - If no NOLs, 50% GILTI deduction (through 2025), 37.5% FDII deduction = $81.25 of taxable income (subject to increase by the Sec. 78 gross-up and offset by deemed-paid FTCs with respect to the GILTI inclusion).
  - If $50 of NOLs, before taking into account any Sec. 78 gross-up, there is a 50 "excess" amount, applied *pro rata* to the GILTI and FDII income, so deduction is disallowed for ~33.3 of the GILTI amount and ~16.7 of the FDII amount.
  - May also effectively limit the benefit of a portion of the deemed-paid GILTI FTCs (which cannot be carried forward), even though the full Sec. 78 gross-up will apply in any case.

5. BEAT and NOLs

- The “base erosion anti-abuse tax,” or “BEAT,” essentially undoes certain tax benefits that might otherwise be obtained by having a U.S. company make payments to a foreign affiliate to shift income from the U.S. to the foreign affiliate.
- Compare “modified taxable income” to regular tax liability. “Modified taxable income” ignores “base erosion tax benefits” *and* a portion of a company’s NOLs based on a “rough justice” approach that compares base erosion tax benefits to deductions and assumes that such ratio applies to any NOLs.
- Proposed BEAT regulations do provide that (a) the relevant limitation on NOLs used in subsequent years is determined by reference to the percentage in the year the NOL was generated, not the current year; and (b) the relevant percentage for pre-2018 NOLs is zero (yet another reason pre-2018 NOLs are more valuable).

5. BEAT and NOLs (cont'd)

- Current Year Loss and Pre-2018 NOLs:

US1

US1's Items of Income and Expense (TY 2020)	Amount
Gross Income	$100
Gross BETBs	$70
Other non-BETB CY deductions	$80
NOL carryforward (2016)	$400

- Example Prop. Reg. § 1.59A-4(c):
- *Modified Taxable Income ("MTI") = Taxable Income ("TI") + Base Erosion Tax Benefits ("BETBs") + Base Erosion % of NOLs*
- <u>Step 1: Determine TI starting point</u>
  - Pre-NOL TI = $100 (gross income) less $150 (gross deductions) = ($50)
    - Because US1's 2020 pre-NOL TI does not exceed $0, US1 excludes its NOL carryforward amount for purposes of determining TI
    - US1's TI starting point = ($50)
- <u>Step 2: Determine Base Erosion % of NOLs</u>
    - Because no portion of the NOL was taken into account in Step 1, there's no NOL "add back" in determining MTI
    - Note: Even if NOL was taken into account in Step 1, the BE% of the NOL would be 0 because the NOL arose pre-2018
- <u>Step 3: Add-back Gross BETBs and Base Erosion % of NOLs</u>
    - MTI = ($50) (TI starting point) + $70 (BETBs) + $0 (BE % of NOLs) = $20
- Note: Although not addressed above, US1's Base Erosion Minimum Tax Amount in 2020 is $2 (10% * $20 – ($0))