

Insight

March 2009

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Tax Considerations During Troubled Economic Times

As the economic downturn continues, many companies are facing bankruptcy and reorganization situations. Others are dealing with such circumstances as worthless stock. This issue of *Insight* will focus on tax considerations pertaining to these unique situations.

CANCELLATION OF DEBT INCOME

Under Section 108 of the Internal Revenue Code if a company repurchases its debt at a discount, the company is required to recognize cancellation of debt (COD) income in the amount of the discount. Under the American Recovery and Reinvestment Act of 2009, at the taxpayer's election, COD income realized in 2009 or 2010 may be deferred up to five years and included in income ratably over a five year period.

Generally, when a taxpayer is relieved of debt obligation, COD income must be recognized unless one of the following exclusions apply:

- Chapter 11 bankruptcy
- The taxpayer is insolvent
- Indebtedness discharged is qualified farm indebtedness
- In the case of a taxpayer other than a C corporation, the indebtedness discharged is qualified real property business indebtedness
- Indebtedness discharged is qualified principal residence indebtedness which is discharged before January 1, 2010

The two most common exclusions are bankruptcy and insolvency exceptions. A Chapter 11 bankruptcy is a reorganization under the Bankruptcy Code. The Chapter 11 reorganization is presided over by the bankruptcy judge. Either the debtor referred to as a debtor in-possession (the “DIP”) or trustee, a representative of the creditors, will remain in control of the business and assets. Creditors in a Chapter 11 reorganization look to the future earnings of the debtor to satisfy their claims.

COD income is not recognized to the extent that the taxpayer is insolvent, i.e. that there is an excess of liabilities over the fair market value of assets. The term “indebtedness of the taxpayer” means any indebtedness 1) for which the taxpayer is personally liable, or 2) subject to which the taxpayer holds property. For companies who have not filed for bankruptcy, the insolvency exception is critical. These companies will need to value their liabilities as well as consider any asset impairment. The following case study illustrates the role of valuation in an insolvency situation.

CASE STUDY

ABC Corporation is engaged in the manufacture of automobile parts in the Midwest. It acquired property and built a new plant in 2005. Since that time, ABC has been struggling and has determined that it will be unable to fund its debt obligations. ABC's balance sheet reflects a book basis of assets of \$275MM and debt of \$325MM. After lengthy discussions with their creditor, ABC was able to come

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to an agreement whereby their creditor agreed to cancel the debt in exchange for ABC stock worth \$250MM. Accordingly, outstanding debt has been satisfied to the extent of \$250MM while \$75MM of debt has been forgiven.

In order to determine the extent to which the \$75MM of debt forgiveness will be taxable as COD income, ABC engages VRC to provide a valuation to determine the extent of insolvency. VRC values the assets and determines, due to the current depressed property values, that ABC's assets are only worth \$250MM. Accordingly, the company was insolvent to the extent of \$75MM, as supported by the valuation prepared by VRC. Since the amount of debt forgiveness does not exceed the amount of insolvency, no COD income is required to be recognized as taxable income.

“Obtaining a valuation from an independent valuation provider is essential to the first requirement.”

WORTHLESS STOCK DEDUCTION

The general rule under IRC Section 165(g)(3) provides that if a security becomes worthless during a taxable year, the resulting loss will be treated as a sale or exchange of a capital asset, resulting in a capital loss equal to the taxpayer's basis in that asset. IRC Section 165(g)(3) goes on to provide that the loss resulting from a worthless stock deduction may be characterized as an ordinary loss provided the subsidiary is a qualified corporation affiliated with the taxpayer. Meeting the affiliation test requires that the taxpayer own 80% of the vote and value of the subsidiary. In addition, in order to be a “qualified corporation,” more than 90% of the subsidiary's gross receipts historically must have been from other than passive-type income such as royalties, rents, interest, dividends, etc. Assuming that the subsidiary meets the requirements as a qualified affiliated corporation, in order to claim a worthless stock deduction under IRC Section 165(g)(3), the taxpayer has the burden of proving that the security became worthless in the year of deduction and that the security had tax basis. Meeting these requirements is heavily dependent on a taxpayer's circumstances.

In order to support that the stock is worthless, a taxpayer must generally prove that 1) the security has no liquidating value and 2) there is a complete lack of future potential value, which is sometimes supported by the occurrence of an identifiable event occurring during the year of worthlessness. An identifiable event would include, but is not limited to, a cessation of business or a sale of substantially all of the assets. As noted above, a key component of support for this deduction is proving that the security has no liquidating value. Obtaining a valuation from an independent valuation provider is essential to the first requirement.

RELY ON THE EXPERTS

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