Valuation Analyst Guidelines Related to Bankruptcy Expert Reports and Expert Testimony

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Valuation analysts are often called upon to value debtor corporation assets, properties, and business interests during a bankruptcy proceeding. Valuation-related issues often arise with respect to: (1) the solvency of the debtor corporation at various points in time, (2) the value of creditors' security interests, (3) the protection of creditors and other parties, (4) the fairness of proposed DIP sale or purchase transactions, (5) the collateral for DIP financing, (6) the reasonableness of a proposed plan of reorganization, and (7) many other reasons. In these instances, the valuation analyst is typically asked to prepare an expert report and is often asked to offer expert testimony. Now, the valuation analyst is not an attorney, of course. However, the valuation analyst cannot serve the information interests of the client—or the judge or other finder of fact—if his or her expert testimony is not admitted. Therefore, the valuation analyst who practices in the bankruptcy discipline should have a basic understanding of the judicial rules related to the admissibility of expert reports and expert witness testimony.

Introduction

Disputes regarding the value of assets (tangible and intangible) and securities (debt and equity) are commonplace among the parties to a bankruptcy proceeding. Therefore, valuation analysts are often asked to provide valuation expert reports and offer valuation expert testimony within the bankruptcy environment.

For example, a valuation dispute may involve an avoidance action regarding allegations that the debtor corporation received less than reasonably equivalent value in exchange for a transferred property.

A valuation dispute may involve the allegation that the debtor corporation was insolvent at the time of a property transfer, or an expense payment, or a dividend distribution.

A valuation dispute may involve an allegation regarding:

1. the allowed amount of a creditor's claim or
2. whether a secured creditor has adequate protection for its position.

A valuation dispute may relate to whether (and on what terms) the debtor corporation may buy or sell property, abandon a property, or reject a lease.

A valuation dispute may involve whether the debtor corporation can enter into an intellectual property license (or other commercialization) agreement.

And, a valuation dispute may involve whether a proposed plan of reorganization should be confirmed.

A valuation dispute may relate to an action to revoke the confirmed plan of reorganization for the failure to disclose material information regarding the debtor corporation value.

This discussion is directed to the valuation analyst who practices in the bankruptcy discipline. This discussion summarizes what the analyst should

know about the standards that govern the admissibility of expert testimony in bankruptcy court.

The valuation analyst is not a lawyer, of course. And, the valuation analyst should rely on legal advice from legal counsel related to expert testimony.

Nonetheless, the valuation analyst who practices in the bankruptcy discipline should be generally aware of the bankruptcy court guidelines related to expert reports and expert witness testimony.

Judicial Precedent and Administrative Rulings

The admissibility of all expert testimony is governed by the principles of the Federal Rule of Evidence (FRE) Rule 104(a). Under Rule 104(a), the party that offers the evidence has the burden of establishing, by a preponderance of the evidence, that the expert testimony is admissible.

FRE Rule 702 provides the standards for the admissibility of expert (including valuation) opinion evidence in the bankruptcy court (as well as in other courts).

The valuation analyst who is engaged to testify in the bankruptcy court should be aware of the following Rule 702 expert testimony guidelines:

> If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if
>
> (1) the testimony is based upon sufficient facts or data,
>
> (2) the testimony is the product of reliable principles and methods, and
>
> (3) the witness has applied the principles and methods reliably to the facts of the case.

Rule 702 was enacted in 1973 as part of the Federal Rules of Evidence. However, it was not until about 20 years later that the U.S. Supreme Court confirmed that Rule 702 governs the admissibility of expert testimony in the federal courts.

Prior to the adoption of Rule 702, the admissibility of expert testimony was generally governed by the standards developed by a 1920s federal appellate court decision, *Frye v. United States*.[1]

In the *Frye* decision, the defendant in a murder case wanted to admit testimony. The testimony related to the fact that he had passed a lie detector test that proved his innocence.

The Appeals court affirmed the trial court decision to refuse to admit the lie detector test, as such tests had not yet gained sufficient scientific standing.

The *Frye* decision established the judicial standard for the proponents of scientific evidence for the next 70 years. That standard concluded that the theory on which the expert opinion was based should be sufficiently established to have gained "general acceptance" in the particular scientific field.

In *Daubert v. Merrell Dow Pharmaceuticals, Inc.*,[2] the U.S. Supreme Court held that the so-called *Frye* standard no longer governed expert testimony admissibility in federal court.

The *Daubert* decision concluded that whether the expert's theory or methodology was "generally accepted" was just one of the factors that the trial court should consider in determining whether to admit expert testimony evidence.

In *Daubert*, parents sued the manufacturer of antinausea drugs that were alleged to cause birth defects. The defendant pharmaceutical company moved for summary judgment based on the affidavit of a credentialed expert.

The defendant's submitted peer-reviewed studies were based on human patients who had taken the drug. The studies concluded that there was no link between the drug and birth defects.

The plaintiffs responded with affidavits from experts who relied on (1) animal studies and (2) a re-analysis of the epidemiological studies on which the defendant's expert had relied.

The trial court ruled the plaintiffs' tests to be inadmissible under the *Frye* standard. The trial court concluded these tests were not "generally accepted."

The Supreme Court reversed the trial court decision, concluding that FRE 702 (not the *Frye* decision) governed expert testimony admission. The Supreme Court decided that the *Frye* standard was at odds with the more liberal FRE.

In *Daubert*, the Supreme Court established three expert testimony principles:

1. The trial judge has the task of ensuring that the expert testimony both rests on a reliable foundation and is relevant. This is the judge's "gatekeeping role."
2. Faced with a proffer of expert scientific testimony, the trial judge should make a preliminary assessment of whether the expert's underlying reasoning or methodology is scientifically valid and can be properly applied to the facts at issue. This inquiry is a flexible one, and its focus should be solely on principles and methodology, not on the expert's conclusions.
3. The expert's conclusions should be properly challenged through cross-examination, presentation of contrary evidence, and judicial instruction on the burden of proof.

The *Daubert* decision established a nonexclusive checklist for federal courts to determine the admissibility of expert opinions. Accordingly, the valuation analyst should select valuation methodology, perform valuation analyses, and prepare a valuation report that will pass this *Daubert* admissibility checklist.

The *Daubert* Tests for Admissibility of Expert Testimony

The valuation analyst who is engaged to testify in the bankruptcy court should be familiar with these five "*Daubert* tests":

1. whether the expert's technique or theory can be or has been tested—that is, whether the expert's theory can be challenged in some objective sense, or whether it is simply a subjective, conclusory approach that cannot be reasonably assessed for reliability
2. whether the expert's technique or theory has been subjected to peer review and publication
3. the known or potential rate of error of the expert's technique or theory when applied
4. the existence and maintenance of standards and controls
5. whether the expert's technique or theory has been generally accepted in the scientific community.[3]

Also, according to FRE 702, the expert testimony must "assist the trier of fact to understand the evidence or to determine a fact in issue."

In the *Kumho Tire Co. v. Carmichael* decision,[4] the Supreme Court extended these principles to technical, nonscientific expert testimony. In the *Kumho* decision, the Supreme Court held that the trial court properly excluded testimony by an expert on tire failure because the expert's methodology was unreliable.

The *Kumho* decision established three additional admissibility of expert testimony criteria:

1. *Daubert's* "gatekeeping" function (requiring an inquiry into both relevance and reliability) applies not only to scientific testimony, but to all expert testimony.
2. The *Daubert* framework was intended to be flexible, and not all of the factors listed in the *Daubert* checklist apply to every form of testimony.
3. The trial court's review of expert testimony should focus on both the expert's methodology and the expert's conclusions.

The valuation analyst should understand that in the bankruptcy court, whether valuation expert testimony is admissible is governed by FRE 702, as interpreted by *Daubert* and *Kumho*. State courts, however, may employ different expert testimony admissibility tests. Some state courts still rely on the old *Frye* test.

The valuation analyst should also understand that an important factor the judge will consider is whether the expert is qualified to perform the subject valuation.

According to the U.S. Court of Appeals: "For an expert's testimony to be admissible under [FRE 702] . . . it must be directed to matters within the witness' specific, technical, or specialized knowledge and not to lay matters which a jury is capable of understanding and deciding without the expert's help."[5]

Valuation training and professional valuation credentials are important factors that the court will

certainly consider. However, valuation experience is probably the most important factor that the judge will consider. This is because courts seem to give a great deal of weight to the opinion of valuation experts who have valued similar assets or securities in the past.

In addition, in order to be admissible, the valuation expert's testimony should be based on a reliable methodology and on generally accepted procedures—and not simply presented for client advocacy purposes.

For example, in *United Phosphorus, Ltd. v. Midland Fumigant, Inc.*,[6] the U.S. District Court ruled that both (1) valuation testimony by an economics expert that a trade name had no value and (2) the expert's analysis regarding trademark valuation failed to satisfy the "evidentiary reliability" standard for expert testimony.

Accordingly, that economics expert testimony was not admissible.

The *United Phosphorus* court noted that:

1. the expert's valuation analysis was prepared solely for litigation purposes and
2. the expert used a valuation methodology that was developed solely for that litigation.

The District Court concluded that:

1. the valuation expert's opinions and analysis had not been subjected to peer review and
2. there was no objective, verifiable evidence to indicate that the valuation methodology was accepted by any other economist.

Other Valuation Analyst Considerations Related to Bankruptcy Court Expert Testimony

The valuation analyst should be aware of the elements of the *Daubert* standard with respect to any proposed expert testimony in bankruptcy court. And, while he or she is not an attorney, the valuation analyst should generally be aware of the legal framework for valuation testimony provided by judicial precedent, the Bankruptcy Code, and the Bankruptcy Rules.

For example, as a general guideline for bankruptcy purposes, valuations are performed as of the date of the transaction or property transfer, and not with the hindsight benefit of subsequent events.

In addition, generally accepted accounting principles (GAAP) or other accounting principles may be informative to the valuation analyst. However, GAAP account balances typically do not reflect the current value of an asset for bankruptcy purposes.

Moreover, whether the valuation involves a single asset or an entire going-concern business, the courts often conclude that an actual arm's-length sales price is generally the best indication of value.

It is usually important for the valuation analyst to generally understand the disputed issue and the legal rules that will be applied to decide that issue. As articulated by the bankruptcy court in the *Brandt v. nVidia Corp.* decision, "the question to be answered is value to whom and for what purpose."[7]

Accordingly, in a bankruptcy assignment, the valuation analyst should clearly understand:

1. the purpose and objective of the valuation,
2. an adequate description of the valuation subject and
3. the appropriate valuation date, standard of value, and premise of value.

The above-mentioned *Brandt v. nVidia Corp.* decision[8] illustrates the importance of considering the purpose of the valuation in the context of a fraudulent conveyance claim.

In *nVidia Corp.*, the subject dispute was whether an entity that purchased substantially all of the debtor corporation assets had paid a reasonably equivalent value for the debtor assets. The trustee attempted to prove that the purchaser paid too little, while the purchaser defended the amount paid as being reasonable.

The *nVidia Corp.* case involved several complex valuation issues, such as: the value of a settlement of patent litigation, the value of a highly skilled assembled workforce, and the value of trademarks.

In his expert testimony, the trustee's valuation analyst offered a buyside valuation analysis. The valuation analysis was based entirely on the purchaser's internal documents regarding the debtor corporation value.

The bankruptcy court rejected that expert's methodology. This is because it provided no objective evidence of the market value of the debtor's business at the time of the transaction.

The bankruptcy court concluded that the purchaser's analysis of the debtor corporation value, based on expected strategic synergies, was not relevant—given that the market had already indicated a much lower value.

The *nVidia Corp.* decision reflects an important principle in fraudulent conveyance claims: whether "reasonably equivalent value" is given is to be

determined from the standpoint of the creditors at the time of the property transfer.

That is, the relevant question is: whether the subject transaction "deplete[d] the debtor's estate of valuable assets without bringing in property of similar value from which creditors' claims might be satisfied."[9]

Additional Valuation Analyst Expert Testimony Guidelines

The above-mentioned guidelines relate to valuation testimony before the bankruptcy court. However, there are also general guidelines that the valuation analyst should consider in every expert testimony situation.

Some of these valuation analyst guidelines relate to potential vulnerabilities that the opposing legal counsel may attack in the valuation expert's opinion.

The first thing that opposing legal counsel typically does is investigate the valuation expert's résumé or curriculum vitae. Therefore, the valuation analyst should check (and double check) his or her résumé. The valuation analyst should ensure that the résumé is current and that it does not contain any misstatements.

Another thing that opposing legal counsel typically does is review the valuation analyst's prior testimony and any published writings. The valuation analyst should anticipate questions concerning any prior statements that appear to be inconsistent with the current valuation opinion.

The valuation analyst should determine whether he or she was ever contacted by the adverse party in connection with the subject bankruptcy case. The valuation analyst should ensure that:

1. he or she has no confidential relationship with the adverse party and
2. he or she did not receive privileged information.

The valuation analyst should be knowledgeable about the facts related to the valuation subject asset or security. Courts find the opinions of even a highly qualified expert to be unpersuasive when the expert is not sufficiently familiar with the specific facts of the case.

The valuation analyst should be prepared to testify as to all of his or her opinions at the time of the deposition. The valuation analyst should be prepared for the following deposition questions:

1. Have you reached any opinions or conclusions not contained in your expert report?
2. Have you been asked to form any other opinions?
3. Do you plan to offer any other opinions?
4. What additional work, if any, do you plan to perform related to this case? Expert testimony may be excluded if the adverse party can show that the valuation analyst was not prepared to state his or her opinion at the time of the deposition.

The valuation analyst should generally understand:

1. the requirements for the expert report contents and format and
2. the schedule for when the expert report should be completed.

Federal Rule of Civil Procedure 26(a)(2) has specific requirements for expert report contents and for when the expert report should be submitted to the other side. The valuation expert's report may be excluded if these rules are not followed.

The valuation analyst should understand (1) the valuation analysis (both data selection and methodology) and (2) how to perform the calculations in that valuation analysis. The valuation analyst should be prepared for the following deposition questions:

1. Did you write the entire expert report yourself?
2. Did anyone assist you in the valuation?
3. Does the expert report include any text that was written by your assistants?
4. Does the expert report include any analysis that was performed by your assistants?

The valuation analyst should have sufficient knowledge about what information was relevant to be included in (or excluded from) the expert report. The expert report should include a list of all of the documents and testimony that the expert reviewed.

The valuation analyst should be prepared to explain why he or she selected the information that formed the basis of the expert opinion.

The valuation analyst should learn everything he or she can about the opposing valuation expert's position. The valuation analyst will typically have access to the opposing expert's report.

In addition, the valuation analyst should ask for the valuation workpapers that support the opposing expert's position.

The valuation analyst should consider whether the expert opinion would make sense to a layperson.

Even if the subject valuation analysis is 100 percent correct, it may not be persuasive to a finder of fact if it is not understandable to a layperson.

Additional Valuation Analyst Expert Report Guidelines

There are numerous objectives of the bankruptcy-related asset or security valuation report.

Of course, the valuation analyst wants to persuade the valuation report reader (whether the reader is a party to the bankruptcy proceeding, legal counsel to the parties, or the judicial finder of fact). And, the valuation analyst wants to defend the subject asset, security, or business value conclusion.

In order to accomplish these objectives, the content and the format of the valuation report should demonstrate that the valuation analyst:

1. understood the specific bankruptcy valuation assignment;
2. understood the subject asset, property, or business interest;
3. collected sufficient debtor entity financial and operational data;
4. collected sufficient industry, market, and competitive data;
5. documented the specific economic attributes of the subject asset, property, or business interest;
6. performed adequate due diligence procedures related to all available data;
7. selected and applied all applicable income approach, market approach, and cost approach valuation methods; and
8. reconciled all value indications into a final value related to the subject asset, property, or business interest conclusion.

The final (and arguably most important) procedure in the entire bankruptcy valuation analysis is for the valuation analyst to defend the value conclusion in a replicable and well-documented expert report.

Whether defending the value of a tangible or intangible asset, a debt or equity security, or a business enterprise, the written valuation report should:

- explain the subject bankruptcy valuation assignment;
- describe the subject asset, property, or business interest and the subject bundle of legal rights;
- explain the selection or rejection of all generally accepted valuation approaches and methods;
- explain the selection and application of all specific analysis procedures;
- describe the analyst's data gathering and due diligence procedures;
- list all of the documents and data considered by the valuation analyst;
- include copies of all documents that were specifically relied on by the valuation analyst;
- summarize all of the qualitative valuation analyses performed;
- include schedules and exhibits documenting all of the quantitative valuation analyses performed;
- avoid any unexplained or unsourced valuation variables or analysis assumptions; and
- allow the expert reader to be able to replicate all of the valuation analyses performed.

"The final . . . procedure in the entire bankruptcy valuation analysis is for the valuation analyst to defend the value conclusion in a replicable and well-documented expert report."

In order to encourage the reader's acceptance of the written report conclusion:

- the expert report should be clear, convincing, and cogent;
- the expert report should be well-organized, well-written, and well-presented; and
- the expert report should be free of grammatical, punctuation, spelling, and mathematical errors.

In summary, the effective (i.e., persuasive) bankruptcy valuation report should tell a narrative story that:

1. defines the valuation analyst's assignment;
2. describes the valuation analyst's data gathering and due diligence procedures;
3. justifies the valuation analyst's selection of the generally accepted valuation approaches, methods, and procedures;
4. explains how the valuation analyst performed the valuation synthesis and reached the final value conclusion; and

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Income Tax Considerations Related to Debtor Company Debt Restructuring

Robert F. Reilly, CPA

Many debtor companies are organized as partnerships or limited liability companies (taxed as partnerships) for income tax purposes. This statement is particularly true for many commercial real estate property owners. In the current economic environment, many of these companies have to renegotiate or restructure their commercial debt. This debt restructuring presents unique income tax consequences (and tax planning opportunities) to these debtor companies—and to their individual partners. This discussion summarizes these income tax challenges—and opportunities. The debtor companies, the individual partners, and their legal counsel and tax advisers should carefully consider these issues when planning for any debt restructurings.

Introduction

The current economic environment has affected most companies in most industries. This statement is true regardless of the subject company legal structure or income tax status (i.e., C corporation, S corporation, partnership, or limited liability company (LLC)).

The effects of the economic environment on debtor companies are twofold. First, debtor companies face the continued sluggish economy and increased competition from other industry participants. Second, debtor companies face the effects of severe contractions in both the credit markets and the equity markets.

In the credit markets, in particular, banks continue to be unwilling to lend to any company other than the most creditworthy borrowers. Accordingly, the current low interest rates have little positive impact on most debtor companies, if they cannot arrange for debt financing.

In the current unfavorable economic conditions, it is not uncommon for debtor companies (particularly real estate property owners) to renegotiate or restructure the terms of their existing commercial debt. For federal income tax purposes, however, such a debt restructuring often results in cancellation of debt (COD) income.

This situation is particularly relevant to many debtor companies in the commercial real estate industry.

Currently, many commercial real estate companies are facing either:

1. default as their real estate debt comes due or
2. substantial restructuring of their mortgage debt (with the associated COD income recognition).

The most common COD income exclusion provisions are provided by Internal Revenue Code Sections 108(a)(1) and (2) (i.e., the bankruptcy exception and the insolvency exception).

These Section 108(a) exclusions allow a debtor corporation that recognizes COD income resulting from debt restructuring to defer or to exclude the COD income at the taxpayer entity level. This COD income deferral or exclusion is achieved with minimal income tax consequences to the debtor corporation shareholders.

However, the Internal Revenue Code treats the COD income of a debtor partnership (or of an LLC taxed as a partnership) very differently than the COD income of a C corporation (or, for that matter, an S corporation).

For that reason, partners in a debtor partnership or members in a debtor LLC taxed as a partnership may be subject to unexpected income tax consequences related to the business debt restructuring.

This discussion summarizes the partner/member income tax consequences related to the debt restructuring of a debtor partnership or LLC.

Debtor Company COD Income Recognition: the General Rules

Generally, under the Section 61(a)(12) provisions, COD income constitutes ordinary income. And, COD income is subject to federal income taxation at the time of the debt discharge.

However, provisions do exist to defer this income tax impact by either:

1. electing to defer the recognition of the COD income or
2. excluding the COD income at the cost of reducing certain of the taxpayer's income tax attributes.

Under the following circumstances, Section 108(a) provides for exceptions to the COD income general recognition rule:

1. The debtor company has filed a Title 11 bankruptcy proceeding.
2. The debtor company is insolvent; however, the COD income exclusion applies only to the extent of the insolvency amount.
3. The cancelled debt is qualified farm debt incurred in operating a farm.
4. The cancelled debt is qualified real property business indebtedness of a non-C-corporation taxpayer.

The "cost" of excluding the COD income under one of the above-listed statutory exceptions is the Section 108(b)(2) reduction in the debtor company income tax attributes.

The reduction in such debtor company income tax attributes may include a reduction in:

1. net operating loss carryovers,
2. income tax credits,
3. capital loss carryovers,
4. the tax basis of property owned by the debtor company,
5. passive loss carryovers, and
6. any foreign tax credit carryovers.

Under Section 705(a)(1)(A) and (B), the adjusted basis of a partner's interest in the debtor partnership business is increased by the amount of COD income allocated to the individual partner. This statement is true regardless of whether or not the partner is personally able to exclude the COD income.

However, the decrease in the partnership liabilities as a result of the debt discharge will result in a decrease in the partner's individual share of the partnership liabilities.

Under Section 752, any decrease in the partner's share of the debtor business liabilities is considered to be a deemed cash distribution to the partner.

Therefore, a partner may recognize gain under Section 731—to the extent that the deemed cash distributions exceeds the partner's adjusted basis in the partner's interest in the debtor partnership.

The recognition of gain under Section 731 will likely result in situations where the amount of the COD income allocated to the partner is less than the amount of the debt that the partner is deemed to be relieved of.

A debtor partnership may allocate COD income to the partner in accordance with:

1. the minimum gain chargeback rules under Regulations Section 1.704-2,
2. the substantial economic effect rules under Regulations Section 1.704-1(b)(2), or

3. the partner's individual interest in the debtor partnership.

Accordingly, the tax matters partner should carefully review the partnership agreement so as to determine the proper allocation of:

1. the COD income and
2. the partnership liabilities.

The Bankruptcy COD Income Recognition Exception

The bankruptcy COD income recognition exclusion has limited application to an individual partner. This is because, under Section 108(d)(6), the bankruptcy exception will only apply at the individual partner level—and not at the debtor partnership level.

That is, in order for the bankruptcy COD income exception to apply, the debtor partnership must be discharged of its liabilities in the bankruptcy proceeding.

In addition, the individual partner:

1. must also be a debtor in the bankruptcy proceeding or
2. must be granted a debt discharge under an individual bankruptcy filing.

Let's consider the scenario where:

1. the individual partner files for bankruptcy, but the debtor partnership does not file for bankruptcy, and
2. the partner's share of the partnership liabilities is discharged, but the debtor partnership remains liable for the debt.

In that case, the individual partner is deemed to have received a cash distribution from the partnership in the amount of the individual partner's discharged debt.

Also in that case, the remaining partners are deemed to have provided a cash contribution to the debtor partnership. That contribution is considered to be made through an increase in their share of the debtor partnership's liabilities.

Therefore, the individual partner will recognize taxable gain to the extent that the deemed cash distribution is in excess of the partner's partnership basis.

The Insolvency COD Income Recognition Exception

Like the bankruptcy COD income exception, the insolvency COD income recognition exception also applies at the partner level. Therefore, the insolvency COD income exception only applies to the extent that the individual partner—and not the debtor partnership—is insolvent.

> **"Like the bankruptcy COD income exception, the insolvency COD income recognition exception also applies at the partner level."**

In addition, the exclusion of COD income recognition is limited to the amount of the debtor partner's insolvency.

Under Section 108(d)(3), insolvency is measured by determining the excess of the debtor liabilities over the fair market value of the debtor assets—immediately before the debt discharge.

The individual partner may include his or her partnership interests in calculating personal insolvency.

Nonetheless, there is some uncertainty as to the impact that the partnership's nonrecourse liabilities may have on the insolvency calculation.

In Revenue Ruling 92-53, the Internal Revenue Service (the "Service") took the position that nonrecourse debt in excess of the fair market value of the property that secured the debt is treated as debt for purposes of determining insolvency—but only to the extent that such debt is discharged.

Accordingly, the nonrecourse debt of an insolvent partnership may have little or no effect on the individual partner's determination of insolvency.

A solvent partner may incur income tax on his or her allocation of the COD income. In contrast, an insolvent partner may have little or no income tax impact related to the COD income. In that case, the debtor partnership may consider a special allocation of COD income to the insolvent partner.

However, for such a special allocation to be accepted by the Service, the allocation must have "substantial economic effect."

In Revenue Ruling 99-43, the Service ruled that a last minute amendment of a partnership agreement would not be accepted. The Service concluded

that the Revenue Ruling 99-43 special allocation of the COD income to that insolvent partner lacked substantiality.

The Qualified Indebtedness COD Income Recognition Exception

Under Section 108(a)(2), the qualified indebtedness exception does not apply:

1. if the debt discharge of a farmer or real property indebtedness occurs in bankruptcy or
2. to the extent that the debtor taxpayer is insolvent.

Whether an indebtedness constitutes qualified farm or real property business indebtedness is determined at the debtor partnership level. In contrast, the election to exclude the COD income is made at the individual partner level.

Section 108(c)(3) defines qualified real property indebtedness as indebtedness that:

1. was incurred in connection with real property used in a trade or business,
2. is secured by such real property,
3. is qualified acquisition indebtedness or was assumed before January 1, 1993, and
4. is the subject of an election by the taxpayer to have the qualified real property business indebtedness provision apply.

If the discharged debt meets the above four statutory requirements, then the resulting COD income may be excluded by a partner (other than a C corporation partner).

The COD income amount excluded may not exceed:

1. the outstanding principal amount of the business liabilities immediately before the debt discharge less
2. the business real property fair market value immediately before the debt discharge (i.e., the value limit).

The COD income amount excluded also may not exceed the aggregate adjusted basis of the partner's real property held immediately before the debt discharge (i.e., the tax basis limit).

In accordance with Regulations Section 1.1017-1(g)(2), a partner making the COD income exclusion election and including his or her share of the partnership's depreciable property within the election may be required to request and obtain the consent of the debtor partnership.

Let's assume that the COD income exclusion election is made to include the partnership's depreciable property. In that case, the debtor partnership must reduce the electing partner's tax basis in the applicable depreciable partnership property.

In addition, under Section 1017(d), the debtor partnership must treat the tax basis reduction as accelerated depreciation. Given this depreciation recapture provision, the election may be of little or no benefit to an individual partner. This is the case if, shortly after the debt discharge occurs, the property is either:

1. foreclosed on or
2. sold as part of the debt discharge.

The Election to Defer COD Income Recognition Under Section 108(i)

Section 108(i) was enacted as part of the American Recovery and Reinvestment Act of 2009. Unlike the above-mentioned COD income exclusions, this tax provision permits the individual partner to retain his or her income tax attributes for future use—while significantly deferring the partner's recognition of the COD income.

In accordance with Section 108(i), the individual partner is permitted to make an election to defer COD income arising from a cancellation, reacquisition, or modification of a business debt occurring after December 31, 2008, and before January 1, 2011.

In addition, the individual partner is permitted to include the COD income in taxable income ratably over a five-year period beginning in 2014.

However, the deferred COD income will be accelerated and recognized as income in the tax year in which:

1. the partner dies or the partnership liquidates or
2. the partnership sells substantially all of its assets (including in a Title 11 or similar bankruptcy proceeding), ceases to do business, or in similar circumstances.

In the case of a debtor partnership, the COD income will also be accelerated in the case of:

1. a sale or exchange or
2. a redemption of an interest in the partnership.

These transactions must be initiated by a partner or other person holding an ownership interest in the debtor partnership.

Under Section 108(i)(5)(B), the election is made on a debt instrument-by-instrument basis. And, in the case of a debtor partnership, the election must be made by the partnership.

In addition, Section 108(i)(5)(C) provides that if the debtor elects to defer the COD income under the Section 108(i) provision, then the debtor cannot take advantage of the above-listed Section 108(a) COD income exclusions.

Because the debtor partnership makes the election, no COD income is recognized by the individual partners. However, any deferred COD income will be allocated to the individual partners immediately before the debt discharge.

The deferred COD income will be allocated in the manner that those amounts would have been included in the partners' distributive shares under Section 704.

In addition, the decrease in the partnership liabilities as a result of the debt discharge is not taken into account for purposes of Section 852. This statement is true to the extent that the decrease of the partnership liabilities would cause a partner to recognize gain under Section 731.

Summary and Conclusion

In the current economic climate, many debtor companies have to renegotiate or restructure their long-term debt. This statement is true regardless of the legal structure or tax status of the debtor company. And, this statement is true regardless of whether or not the debtor company has actually filed for bankruptcy protection.

This debt restructuring scenario is relevant to debtor companies in any industry. These debtor companies face the dual effects of a prolonged economic downturn and continued inactivity in the credit (and equity) markets.

This debt restructuring scenario is particularly relevant to debtor companies in the commercial real estate industry. Many of these companies face balloon payments on their real estate debt in 2011.

Therefore, these debtor companies may have to decide between:

1. defaulting on the commercial real estate debt or
2. restructuring the real estate mortgage debt (and accepting the COD income consequences).

When the debtor company is a partnership or an LLC taxed as a partnership, the debtor company owners should carefully consider the Section 108 income tax effects. In the case of a corporation, the COD income recognition exclusion—and the costs of any income tax attribute reduction—are applied at the debtor corporation level.

However, the Section 108(a) insolvency and bankruptcy COD income exclusion provisions, along with the statutory income tax attribute reduction provisions, are not applied at the debtor partnership level. Rather, they are applied at the individual partner level.

Accordingly, first, COD income passes through to an individual partner. And, second, the individual partner generally cannot exclude the COD income unless that individual partner is insolvent or in bankruptcy.

In this situation, the COD income presents income tax problems to a partner who is not in bankruptcy or who is solvent.

In the case of the Section 108(i) provision, the Section 108(i) deferral election is made at the debtor partnership level, thereby binding all of the partners.

In that situation, the COD income deferral election is mostly beneficial to a solvent partner—that is, a partner who is unable to use the insolvency or the bankruptcy exceptions.

This situation may cause a dilemma to a debtor partnership that has both (1) solvent partners and (2) insolvent partners.

In summary, it is important for debtor company owners (and for their professional advisers) to be aware of the income tax consequences of—and to consider all alternatives related to—any partnership (or LLC) debt restructuring.

Such pre-debt restructuring planning may allow the debtor partnership partners to avoid the unexpected result of recognizing COD income and of paying the associated income tax.

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Income Tax Issues Related to S Corporation Debt Restructuring

Robert F. Reilly, CPA

In the current economic environment, a financially troubled S corporation may have to restructure or renegotiate the terms of its corporate debt. Alternatively, the S corporation may have to implement creative capital structure procedures (such as converting debt to equity or subordinating equity to debt). In all capital restructuring cases, careful planning should be considered by the S corporation, its shareholders, and its professional advisers. This is because these restructuring procedures can have undesirable income tax consequences to the corporation and/or the shareholders. This discussion summarizes some of the income tax issues that the financially troubled S corporation management and owners should consider with respect to the debt restructuring or renegotiation.

Introduction

Like any other type of debtor entity, a financially distressed S corporation may have to restructure its debt obligations in the current economic environment. Unlike many types of debtor entities, there are specific S corporation income tax ramifications associated with some of the common S corporation debt restructuring procedures.

Both the current economic downturn and the unfavorable credit markets have affected S corporations in many industries. In the current environment, the financially distressed S corporation may have to use creative debt restructuring procedures.

These procedures may include the following:

1. subordinating shareholder debt to third-party creditor debt
2. issuing stock (or some other type of equity instrument) to creditors
3. obtaining new capital contributions from equity investors

This discussion summarizes some of the income tax considerations—and the tax planning opportunities—that relate to the typical debt restructuring procedures available to a financially distressed S corporation. The financially troubled S corporation—and its shareholders—should consult with legal counsel and tax advisers before finalizing the corporate debt renegotiation process.

Cancellation of Debt Income Tax Provisions

A general principle of federal income taxation is that a taxpayer (whether a corporation or an individual) will recognize ordinary taxable income if the taxpayer is relieved of (i.e., is forgiven) a debt obligation.

This taxable income is often referred to as cancellation of debt (COD) income. However, Internal Revenue Code Section 108 provides certain exceptions to this general income recognition principle.

These Section 108 statutory exceptions include situations where the taxpayer debtor corporation:

1. is in bankruptcy under title 11 of the U.S. Bankruptcy Code,
2. is insolvent, or
3. has qualified real estate indebtedness.

The trade-off for this statutory exclusion from COD income recognition is that the taxpayer corporation will have to reduce certain favorable tax attributes. Some of these favorable tax attributes include: net operating losses (NOLs), general business credits (GBCs), minimum tax credits (MTCs), or capital losses (C/Ls).

When claiming a statutory exclusion from COD income recognition, the taxpayer corporation may alternatively elect to reduce its tax basis in its depreciable assets.

It is noteworthy that the creditor is allowed an income tax deduction for its loss related to the COD event even though the debtor corporation may not recognize taxable income (due to one of the Section 108 statutory exclusions).

The S Corporation Reorganization

Another income tax provision that may come into play in a financially troubled corporation debt restructuring is the E-type reorganization. This reorganization structure is allowed under Section 368(a)(1)(E). This Section allows (1) the taxpayer corporation and (2) its creditors and shareholders to restructure the liabilities and equity section of the taxpayer debtor corporation balance sheet.

Some of the common applications of an E-type reorganization include:

1. converting debt to equity in order to avoid violating a loan covenant or
2. moving shareholder debt from a senior debt class to a junior debt class.

Under an E-type reorganization structure, such transactions may be completed without the taxpayer debtor corporation recognizing a taxable gain.

Another application of the E-type reorganization is to allow the taxpayer corporation to take advantage of other Internal Revenue Code provisions. For example, if the fair market values of corporation assets are close to their adjusted tax basis, then the C corporation may make an S election with a minimum amount of Section 1374 built-in gain (BIG) tax exposure.

If an S election is made, then a recapitalization may be necessary—in order to eliminate any taxpayer corporation preferred stock or class B common stock. Such a stock class elimination is necessary for the S election. This is because an S corporation is only allowed to have one class of stock.

Under an E-type reorganization, neither the shareholder nor the taxpayer corporation would recognize a gain in the stock class elimination transaction. An E-type reorganization (i.e., a recapitalization) structure is preferable to redeeming the prohibited class of taxpayer corporation stock. This is because, in a stock redemption, any shareholder gain would likely be recognized.

Assuming that there is a valid business purpose, converting brother-sister S corporations into a parent-QSub group may:

1. increase the amount of the debtor corporation basis for loss recognition purposes and
2. allow the profitable company's profits to offset the loss company's losses.

These taxation objectives may be achieved by a D-type reorganization structure. This type of reorganization is allowed under Section 368(a)(1)(D).

It is noteworthy that the gain provisions of Section 357(c) do not apply to an acquisitive D-type reorganization. Generally, the debtor corporation would want the profitable company to be the parent corporation and the loss company (if solvent) to be the QSub. This corporate structure is preferred, because it will provide better asset and liability protection.

A G-type reorganization is allowed under Section 368(a)(1)(G). A G-type reorganization structure may be used to allow a bankrupt debtor S corporation to transfer its assets in satisfaction of its liabilities. The bankrupt taxpayer S corporation may cease to exist as a separate entity if all of its assets are used in the G-type reorganization.

Alternatively, the bankrupt taxpayer S corporation may continue as a financially separate entity if only some of its assets are transferred in the G-type reorganization.

The S Corporation Debt Restructuring

One of the primary procedures that a debtor S corporation may use to ease its financial distress is to modify and restructure the terms of its outstanding debt.

When attempting to modify the debt terms of its outstanding debt, however, the financially distressed S corporation (and its shareholders) should consider the significant modification of debt provisions of Regulations Section 1.1001-3. These provisions may require the recognition of S corporation income.

The typical modifications of the S corporation loan terms may include the following:

1. reducing the debt interest rate
2. deferring an interest payment
3. extending the debt maturity date
4. modifying any debt/equity conversion privileges
5. reducing the principal amount of the debt

As a general rule, any significant modification of the S corporation debt terms will be material unless the Internal Revenue Service or the regulations have specifically exempted the modification as immaterial. For example, under the regulations, a change in the debt yield of more than one-quarter of one percent would be considered a significant modification.

Also under the regulations, the substitution of a new obligor on a recourse debt instrument will be considered a significant modification. However, such a substitution on a nonrecourse debt is not considered to be a significant modification.

However, changes in the debt instrument embedded in the agreement would not be a modification. If stock is issued in exchange for third-party debt, then the debtor S corporation should be careful to avoid creating a second class of stock.

Also, if a deep-pocket shareholder takes on a recourse liability for a formerly nonrecourse debt or pays the loan guarantee that all the shareholders were potentially liable for, then the Service may raise the possibility of a disguised gift. This consideration is especially important if related parties are involved in the debtor S corporation transaction.

The Second Class of Stock Issues

To induce creditors to lend it money, the debtor S corporation may issue stock warrants or stock rights. In some situations, this issuance may lead to the unintentional creation of a second class of stock. A second class of S corporation stock is prohibited under Section 1361(b)(1)(D). A violation of the single class of stock requirement could terminate the debtor corporation S election.

In order to maintain one class of stock, all outstanding shares of the S corporation stock should confer identical rights to distributions and to liquidation proceeds. In addition, the S corporation should not have issued any instrument or obligation, or entered into any arrangement, that is treated as a second class of stock.

For example, the issuance of preferred stock by a community bank to acquire federal funds, the issuance of new stock in exchange for debt to existing shareholders or creditors, and shareholder debt that does not meet the straight debt safe-harbor requirements of Section 1361(c)(5) are all situations that could cause problems for an S corporation.

For example, any of these procedures could either:

1. lead to the creation of a second class of S corporation stock or
2. result in disqualified S corporation shareholders.

Change in the S Corporation Ownership

If the debtor S corporation accepts additional funds in exchange for the debtor corporation stock, it may create a change of ownership as defined in Section 382(g).

If the S corporation (1) had previously been a C corporation and (2) has recognized a built-in gain for the current year, then the provisions of Sections 382 and 383 may limit the utilization of entity-level tax attributes. These tax attributes may include: net operating losses, carryover losses, general business credits, or miscellaneous tax credits.

Such tax attributes may be used to offset the net recognized built-in gain (or the associated tax liability) as provided by Section 1374(b)(2) and (3). If Sections 382 and 393 apply to the financially troubled S corporation due to a change in ownership, some tax-planning strategies may still apply.

For example, some of the following taxation-related issues—and tax planning ideas—should be considered:

1. The debtor corporation should ensure to continue the S corporation historical business or to use the corporation historical assets for the next two years. Otherwise, Section 382(c) will cause the Section 382 limitation to be zero.
2. If a shareholder contributes assets to the S corporation, the debtor corporation should be aware that Section 382(l)(1) and (4) may limit the benefits under Section 382.

Let's consider the Section 1374 built-in gain exposure when the debtor corporation converts from C corporation status to S corporation status.

Related to this C corporation to S corporation conversion, some of the following taxation-related issues—and tax planning ideas—should also be considered:

1. Limit the entity-level taxable income.
2. Defer any current gain recognition through a Section 1031 like-kind exchange beyond the 10-year recognition period.
3. Lease—rather than sell—any built-in gain asset.

Other Debtor S Corporation Considerations

The debtor S corporation should consider and comply with the provisions of Section 1366(d) to make the best of a bad situation and to allow the shareholder to benefit from losses generated at the S corporation level.

The debtor S corporation may do this by structuring the addition of funds as a back-to-back loan—as opposed to either:

1. a guarantee of the S corporation debt or
2. a co-borrowing.

This is because neither of these investment structures will generate a tax basis for future S corporation loss recognition purposes.

Shareholders who borrow from a third party and then lend the funds to the debtor S corporation will generally produce shareholder debt basis. Of course, this conclusion assumes that the form and substance requirements of the shareholder to S corporation loan transaction are complied with.

When the third-party lender is a related party, the Internal Revenue Service may question the shareholder to S corporation loan transaction.

Let's consider the substitution of the shareholder debt (i.e., the process of subrogation) for S corporation debt to a third-party lender. This subrogation may be a valid way to increase the shareholder's basis for S corporation loss recognition purposes under Section 1366(d).

Obviously, a capital contribution will increase the shareholder's basis for S corporation loss recognition purposes. If the debtor S corporation was formerly a C corporation and still has accumulated earnings and profits, then a "leapfrog election" may be made along with a deemed dividend election.

This tax structure will increase the shareholder's basis for loss recognition purposes at a 35 percent tax deduction (presumably) for the cost of a 15 percent qualified dividend tax liability.

It is noteworthy that all of the S corporation shareholders must approve these elections. And, a statement affirming the shareholder approval of the elections must be attached to the S corporation Form 1120S.

Another way to help a debtor S corporation would be to attract foreign investors. However, these foreign investors may want stock ownership. Of course, such foreign investors would be prohibited S corporation shareholders.

The following transaction structure should permit foreign investors to indirectly provide capital to the distressed S corporation. The structure of forming a partnership owned by both parties, with the S corporation contributing operating assets and the foreign investor contributing cash, has been approved by the Internal Revenue Service.

It is noteworthy that whether the S corporation is forced into bankruptcy or voluntarily goes into bankruptcy, a bankruptcy estate is a permissible shareholder under Section 1361(c)(3). By itself, the bankruptcy estate shareholder will not terminate the S corporation's tax status.

Summary and Conclusion

In the current economic environment, a debtor S corporation may have to work with its creditors to restructure its debt obligations. Such a debt restructuring may or may not involve a bankruptcy proceeding.

Some of the debt restructuring procedures that the S corporation may consider include: cancellation of debt, reorganizations, debt terms restructuring, additional equity investments, and other procedures. The debtor S corporation (and its shareholders) should carefully consider the income tax implications of each of these debtor S corporation restructuring alternatives.

The debtor S corporation (and its shareholders) should seek the advice of legal counsel and tax advisers before restructuring or renegotiating the corporation's debt.

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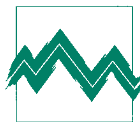

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Income Tax Planning for Commercial Real Estate Debt Restructuring

Robert F. Reilly, CPA

Many industry observers forecast a continued downturn in the commercial real estate market over the next few years. In particular, many industry analysts forecast distress in the commercial real estate market in 2011 as many short-term commercial loans come due—while property values continue to decrease. Therefore, many commercial real estate property owners may have to restructure or renegotiate the commercial mortgages related to their property. These property owners (and their legal counsel and tax advisers) should carefully plan for the income tax consequences related to such a debt restructuring. These tax consequences are influenced both by the type of debt (i.e., recourse, nonrecourse, or partially recourse) and by the property owner's tax attributes.

Introduction

The continuing credit crisis has negatively affected the market value of most industrial and commercial real estate. This statement is true for corporate owner/operators of industrial and commercial real estate. And, this statement is particularly true for developers of—and investors in—multi-family residential property, hotel and other hospitality property, and office rental property.

This discussion collectively refers to such commercial real estate developers, institutional and commercial real estate investors, and industrial real estate owner/operators as "property owners."

For many such property owners, the current fair market value of their industrial, commercial, or residential properties has decreased below the mortgage debt amount on these properties.

Many such properties owners (whether or not they are currently in bankruptcy protection) may have to renegotiate the terms of their commercial mortgage debt.

The objective of such a commercial mortgage renegotiation process is that the property owner:

1. will be able to retain ownership of the commercial real estate and
2. will presumably be able to service the restructured mortgage debt payments on a going-forward basis.

The downside of such a commercial debt restructuring is that the property owner may recognize cancellation of debt (COD) income for income tax purposes. Of course, without the debt restructuring, the property owner may face both foreclosure and phantom income from debt relief.

With both foreclosure and commercial debt restructuring common in the current credit environment, the property owner (and the owner's valuation and other financial advisers) should be generally aware of the COD income tax rules.

And, the property owner (and the owner's professional advisers) should carefully plan for the income tax effects of any commercial debt restructuring transactions.

COD Income Tax Implications of Commercial Mortgage Restructuring

The American Recovery and Reinvestment Act (ARRA) of 2009 added Internal Revenue Code

Section 108(i). Section 108(i) allows certain taxpayers who realized COD income in 2009 or 2010 to defer that income and to recognize it ratably over a five-year period, beginning in 2014.

For a property owner that deferred COD income under this tax provision, the other COD income exclusion provisions will not be available.

Therefore, the property owner (and the property owner's tax adviser) should carefully consider whether other COD income exclusion tax provisions provide a greater immediate benefit.

Section 108(i) defers the COD income recognition only for a limited period of time. Accordingly, the previous COD income exclusion provisions may be more beneficial for providing income tax benefits to the property owner.

For example, bankrupt or insolvent property owners may be able to escape the recognition of COD income entirely, depending on their specific circumstances. And, COD income from the renegotiation of qualified real property indebtedness may also be excluded, depending on the property owner's specific circumstances.

The COD income recognition rules vary depending on whether the commercial debt related to the real estate being foreclosed is subject to (1) recourse debt, (2) nonrecourse debt, or (3) partially recourse and partially nonrecourse financing.

COD Income Recognition Provisions Related to Recourse Debt

For income tax purposes, when the mortgage holder forecloses on real estate in satisfaction of a recourse debt, the foreclosure is considered to be a property sale. The property sale proceeds are treated as being equal to either:

1. the amount of the debt or
2. the fair market value of the real estate, whichever is less.

For income tax purposes, the difference between (1) the deemed property sale proceeds and (2) the property cost basis is equal to (3) the gain or loss on the property sale.

To the extent that the recourse debt exceeds the amount of the real estate fair market value, the property owner is deemed to have COD income. This means that, when the commercial real estate has recourse debt, the debt restructuring transaction is considered to be two transactions for income tax purposes:

1. a property sale transaction
2. a COD income transaction

Since a property foreclosure is treated as a sale or exchange of the commercial real estate, the character of any tax gain or loss is determined in accordance with the Section 1221 and Section 1231 requirements. As a result, the property owner may have held the commercial real estate:

1. as a capital asset under Section 1221 or
2. for use in the taxpayer's trade or business under Section 1231.

In that case, then any gain may be a capital gain or a Section 1231 gain.

In the case of Section 1231 real estate, the gain is also subject to the Section 1250 depreciation recapture rules.

Alternatively, if the commercial real estate was held by the property owner primarily for sale to customers in the ordinary course of business (under Section 1221(a)(1)), then the property owner would recognize ordinary income or loss from the deemed sale transaction.

To the extent that the recourse debt is greater than the real estate fair market value, then the deemed property sale proceeds are considered to be equal to that fair market value amount. For income tax purposes:

	the recourse debt
–	the deemed property sale proceeds
=	the property owner's COD income.

The property owner should also plan for any gain or loss on the mortgage foreclosure in addition to the COD income. For income tax purposes:

the deemed property sale proceeds (i.e., the real estate fair market value)

– the property cost basis

= the gain or loss.

This gain or loss calculation is made just as if the commercial real estate was actually sold.

Depending on the character of the commercial real estate in the property owner's hands, the deemed sale transaction gain or loss may be (1) capital, (2) Section 1231, or (3) ordinary.

Let's assume that both the recourse debt and the cost basis are greater than the commercial real estate fair market value. In that case, the property owner will have both:

1. COD income (i.e., the debt minus real estate market value) and
2. a Section 1231, ordinary, or capital loss (i.e., the real estate market value minus the property basis).

This scenario is known as a bifurcation.

The income tax implications are more straightforward if the amount of the recourse debt is less than the commercial real estate fair market value. In this scenario, the deemed property sale proceeds are equal to the amount of the recourse debt. And, in this scenario, the property owner will not recognize COD income.

However, the property owner will have a gain or loss on the deemed property sale (which may be capital, ordinary, or Section 1231).

COD Income Recognition Provisions Related to Nonrecourse Debt

For income tax purposes, the mortgage holder's foreclosure in satisfaction of nonrecourse debt, including the foreclosure of qualified nonrecourse debt, is treated as a deemed property sale. For income tax purposes, the deemed sale transaction proceeds are considered to be equal to the amount of the nonrecourse debt.

In this scenario, the amount of the commercial real estate fair market value is irrelevant for income tax purposes. Also, in this scenario, there is no COD income recognized by the property owner.

The income tax implications are based on:

1. the amount of the nonrecourse debt and
2. the tax basis of the commercial real estate.

If the amount of the discharged debt is greater than the commercial real estate cost basis, then the property owner will recognize income (whether capital, ordinary, or Section 1231) on the debt foreclosure. However, the gain is not treated as COD income to the property owner.

As a result, none of the Section 108 COD income exclusion discussed below are available. This statement is true even if the property owner is bankrupt or insolvent.

The gain in this scenario is includible in the property owner's gross income for the year. This taxpayer-unfriendly result is the major difference between foreclosures involving (1) recourse debt and (2) nonrecourse debt.

Alternatively, if the nonrecourse debt is less than the real estate cost basis, then the property owner will have a capital, Section 1231, or ordinary loss—depending on the nature of the commercial real estate.

COD Income Recognition Provisions Related to Partial Recourse Debt

If the mortgage is a partial recourse debt (e.g., due to a partial guarantee by a partner or an LLC member), then the income tax consequences of the debt restructuring will vary. The income tax consequences will depend on how the deemed sale transaction proceeds are allocated to satisfy the partial recourse debt.

The deemed sale transaction proceeds allocation options are:

1. the sale proceeds are first allocated to the recourse portion of the debt,

2. the sale proceeds are first allocated to the nonrecourse portion of the debt, or
3. the sale proceeds are allocated pro rata between the two components of the debt.

Unfortunately, there is little professional guidance available regarding this sale proceeds allocation issue.

Section 108 COD Income Recognition Exclusions Available

Under Section 61(a)(12), gross income includes income related to the discharge of indebtedness. However, Section 108 provides the property owner with several exceptions to this COD income recognition rule. The Section 108 exceptions to the COD income rule are as follows:

1. The debt discharge occurs as part of a Title 11 bankruptcy proceeding.
2. The debt discharge occurs when the taxpayer is insolvent.
3. The forgiven debt is qualified farm indebtedness.
4. The forgiven debt is qualified real property indebtedness.

The property owner in bankruptcy can exclude all of the COD income from gross income. The insolvent property owner can exclude COD income to the extent of the taxpayer's amount of the insolvency.

However, it is important to consider what type of entity qualifies as the taxpayer for these purposes. That is, these various Section 108 COD income recognition exceptions are applied differently for partnerships and for corporations.

Any COD income that a property owner excludes from gross income is applied dollar for dollar to reduce the amount of the income tax attributes of the subject taxpayer.

Let's assume that the property owner reduces all of its income tax attributes to zero but some excluded COD income still remains. Then, the balance of the COD income goes away.

According to Section 108(b)(2), the property owner's income tax attributes are reduced in the following order:

1. net operating losses (NOL) for the tax year of the debt discharge and any NOL carryforwards to that tax year
2. general business tax credits under Section 38
3. the minimum tax credits under Section 53
4. capital loss carryovers for the tax year of the debt discharge and any capital loss carryovers to that tax year
5. income tax basis reduction
6. passive activity loss and credit carryovers under Section 469(b)
7. foreign tax credit carryovers under Section 27

With regard to the income tax base reduction, the property owner may make an election under Section 108(b)(5) to reduce the tax basis of depreciable property first—before reducing any other income tax attributes.

A property owner making this election should follow a separate set of ordering rules for the tax basis reduction under Section 1017. The amount of the tax basis reduction will not exceed the total adjusted tax basis of all of the taxpayer's depreciable property as of the beginning of the tax year following the year of the debt discharge.

In the case of a partnership property owner, (1) the COD income exclusion from gross income under Section 108(a), (2) the reduction of the income tax attributes under Section 108(b), and (3) the discharge of qualified real property indebtedness under Section 108(c) are all applied at the partner level.

The bankruptcy or the insolvency of the property owner partnership—rather than of the individual partner—is not directly relevant.

Each individual partner will make his or her own determination as to whether to exclude the COD income under Section 108. And, each individual partner will then make his or her own corresponding income tax attribute and/or tax basis reductions.

In the case of a corporation property owner, the provisions of Section 108 are applied at the corporation level. For purposes of the tax basis reduction rules, losses of an S corporation may be:

1. disallowed at the shareholder level (for either tax basis or at-risk investment reasons) and
2. carried forward.

Such disallowed losses are then treated as an NOL of the corporation for purposes of the income tax attribute reduction.

If the property owner is neither bankrupt nor insolvent, then the property owner may still be able to exclude COD income if the debt is qualified real

property indebtedness (QRPI). QRPI is debt that was incurred or assumed by the property owner in connection with real estate used in a trade or business.

The QRPI must be secured by such real estate and must be incurred or assumed before January 1, 1993. Or, if incurred or assumed on or after that date, the QRPI must be qualified acquisition indebtedness. See Section 108(c)(3).

Qualified acquisition indebtedness is debt incurred or assumed to acquire, construct, reconstruct, or substantially improve such real estate.

The amount of the COD income excluded under Section 108(c)(2)(A) cannot exceed the excess of (1) the restructured debt principal amount over (2) the commercial real estate fair market value.

Further, the amount of COD income excluded cannot exceed the property owner's aggregate adjusted tax basis of the depreciable property. The amount of excluded COD income is applied so as to reduce the property owner's tax basis in the commercial real estate.

Rental real estate qualifies for the qualified real property indebtedness exclusion. However, any debt secured by land held for investment purposes would not qualify for the COD income exclusion. This is because such land is not held for use in a trade or business.

In order to take advantage of predevelopment appreciation at capital gain tax rates, the property owner may classify the newly acquired land as held for investment before the property owner decides on its ultimate use.

A property owner should carefully consider classifying land in this manner against (1) the potential of a troubled debt restructuring and (2) the opportunity to use this COD income exception under such a scenario.

Debtor Taxpayer Planning for the Tax Attribute Reduction Implications

In addition to finding the greatest deferral alternative for the property owner, careful planning should involve an analysis of the property owner's tax attributes that may be lost due to the excluded COD income. The amount of any NOL and capital loss carryforwards are reduced as of the first day of the next tax year.

Therefore, the property owner that is facing this tax attribute reduction should attempt to accelerate any income or gains where possible—in order to make use of these tax attributes before they are lost.

If a property owner facing any tax attribute reduction has a significant NOL carryforward and partnership interests with negative capital accounts, then the property owner may consider triggering the gain on those negative capital accounts. In that way, the property owner could use the NOL before it is lost to the tax attribute reduction provisions.

For example, the property owner could:

1. form a wholly owned S corporation and
2. transfer the partnership(s) interest(s) to that S corporation.

Since the liabilities covering the negative capital would no longer flow through to the property owner, the transfer transaction would be considered a constructive distribution—resulting in gain recognition.

Summary and Conclusion

Most industry analysts forecast that the commercial real estate market will continue to deteriorate for the next few years. This forecast is applicable for all types of industrial, commercial, multi-family residential, and mixed use property types.

Therefore, the market value of more commercial real estate projects is expected to decrease below the corresponding project indebtedness. Accordingly, many commercial property owners are expected to renegotiate/restructure the terms of their commercial property mortgages.

Such commercial property owners—whether or not in bankruptcy—will have to plan for the income tax consequences of such a commercial mortgage renegotiation/restructuring.

There are several planning alternatives available for property owners to minimize the current recognition of COD income. Many of these planning alternatives may be more beneficial than the Section 108(i) election provided for in the 2009 ARRA tax legislation.

The careful planning prior to the commercial mortgage renegotiation should include an examination of:

1. the property owner's solvency situation and
2. the property owners tax attributes.

The objective of such an examination is to produce the most favorable possible COD income exclusion or deferral consequences.

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Income Tax Planning Opportunities Related to COD Income and Debt Restructuring

Robert F. Reilly, CPA

Tax planning opportunities exist for debtor corporations that have to recognize COD income as a result of debt restructuring. Tax planning opportunities also exist for debtor corporations that have issued new debt (at a discount) in exchange for the outstanding old debt. This discussion summarizes some of the income tax planning considerations related to the debtor corporation restructuring of commercial debt.

Introduction

The American Recovery and Reinvestment Act of 2009, P.L. 111-5, provided corporation and partnership debtors with a cancellation of debt (COD) income deferral election.

For purposes of this discussion, let's assume that the debtor entity is a corporation. This debtor corporation election is available under Internal Revenue Code Section 108(i).

This election relates to the reacquisition of applicable debt instruments by the debtor corporation or by certain related parties. Under this Section 108(i) election provision, the debt instruments have to be reacquired after December 31, 2008, and before January 1, 2011.

The electing debtor corporation will recognize deferred COD income ratably over a five-tax-year period beginning in 2014. The debtor corporation must also defer original issue discount (OID) deductions related to certain COD income deferrals.

The COD income deferral relates to certain actual and deemed debt modifications and exchanges. Such an exchange would include the scenario where the debtor corporation uses the proceeds of a new debt issuance to pay off an existing debt obligation.

The electing debtor corporation would forgo the potential tax benefits of the insolvency exception and the bankruptcy exception under Section 108(a)(1) for the COD income deferral. However, the electing debtor corporation would also avoid the negative effects of any tax attribute reduction under Section 108(b).

Therefore, for the debtor corporation that realizes COD income, the debtor management and the debtor professional advisers should analyze both the costs and the benefits of making the COD income deferral election.

These income tax implications are particularly important to the debtor corporation that is insolvent or in bankruptcy. Given the impact of the current economic conditions on many debtor corporations, tax planning related to COD income should be of significant interest to the debtor corporation management.

COD Income Exclusion Implications and Related Income Tax Attributes Reduction

When a debtor corporation purchases its own debt for less than that debt's adjusted issue price (AIP), the debtor corporation generally realizes COD income under Section 61(a)(12). The amount of the COD income is equal to the difference between:

1. the debt price and
2. the debt AIP.

Debtor Corporation Purchases its Own Debt at a Discount

For example, let's assume that Debtor Corporation purchases its own debt for $3 million when the debt has an AIP of $5 million. In this case, the Debtor Corporation will realize $2 million of COD income.

Let's consider what happens if a party related to the Debtor Corporation (as defined in Section 108(e)(4)) acquires the debt.

First, the Debtor Corporation is considered to have acquired the debt instrument (with potential COD income).

Second, the Debtor Corporation is considered to have reissued the debt instrument with an issue price equal to the amount that the related party paid for the debt instrument.

COD Income Recognition Exclusion Rules

Either a solvent debtor corporation or a debtor corporation outside of bankruptcy must generally recognize COD income unless:

1. the debtor corporation specifically makes a COD deferral election or
2. another COD income relief provision applies.

However, under Section 108(a), a bankrupt debtor or an insolvent debtor does not generally recognize COD income. Rather, such a debtor corporation is subject to a required reduction of certain tax attributes.

Such a bankrupt or insolvent debtor corporation may first elect to reduce the income tax basis of its depreciable property. Otherwise, the bankrupt or insolvent debtor corporation:

1. reduces its net operating loss (NOL) (after an absorption against its current-year income) and
2. reduces its various other income tax attributes.

It is noteworthy that the NOL limited by Section 283 is available in full for the income tax attributes reduction. Also, there are complex additional rules that apply for partnership and consolidated group tax attribute reduction purposes.[1]

In a bankruptcy, Section 108 permanently excludes the recognition of COD income (even COD income in excess of the debtor corporation's tax attribute reduction). However, Section 108(a)(2)(B) limits an insolvent corporation's COD income exclusion to the extent of the debtor corporation's insolvency.

Section 1017(b)(2) limits the reduction in the tax basis of depreciable property for an insolvent corporation or a bankrupt corporation. This provision limits the tax basis reduction to:

1. the post-discharge excess of the depreciable property aggregate tax basis less
2. the corporation liabilities.

Only depreciable property held by the debtor corporation at the beginning of the tax year following discharge will be subject to the tax basis reduction. Various tax planning opportunities, such as disposing of certain debtor corporation property in the year of the COD income realization (e.g., a sale to a creditor or to a third party), may be available to a debtor corporation.

Such a tax planning opportunity would allow the debtor corporation to:

1. utilize its NOL or
2. avoid the property basis reduction.

DIP Corporation Illustrative Example

Let's consider an example of such a tax planning opportunity. Let's assume that DIP Corporation is a calendar-year C corporation.

In 2010, let's assume that DIP Corporation was in bankruptcy. And, DIP Corporation realized $10 million of COD income based on the cash repurchase of its own debt.

Also in 2010, DIP Corporation generated $5 million of income (excluding the COD income). Prior to this income, DIP Corporation had an NOL carry forward of $6 million (limited only by Section 172).

Let's assume that the DIP Corporation tax basis in its depreciable assets immediately after the debt discharge was $6 million. And, DIP Corporation had $5.5 million of post-discharge liabilities.

DIP Corporation did not elect the COD income deferral. At the beginning of 2011, DIP Corporation held depreciable property with a tax basis of $50 million.

Applying the tax attribute reduction provisions of Section 108(b), DIP Corporation first reduced its remaining NOL (i.e., $6 million – $5 million) by $1 million to $0. In the beginning of 2011, DIP Corporation reduced the tax basis of its depreciable property by $.5 million (according to Sections 1017(b)(2) and (a)(2)).

Accordingly, in this example, the entire $10 million of the DIP Corporation COD income escaped recognition at a cost to the debtor corporation of only $1.5 million in total tax attribute reduction.

This example is illustrated in Table 1.

The COD Income Deferral Election

The debtor corporation may make the Section 108(i) irrevocable COD income deferral election on a debt instrument-by-instrument basis. And, the debtor corporation recognizes the deferred COD income ratably over the five-tax-year period beginning in 2014.

The Section 108(i) election can be applied to any COD income realized on the repurchase of debt instruments after December 31, 2008, and before January 1, 2011 (as defined in Section 108(i)(4)).

Let's assume that a solvent debtor corporation (that is not in bankruptcy) purchased its debt for $7.5 million in 2010 when the debt had an AIP of $10 million. In that case, the debtor corporation realized $2.5 million of COD income in 2010.

The debtor corporation elected:

1. to defer recognition of the $2.5 million of COD income and
2. to recognize the COD income ratably (i.e., $.5 million per year) over the tax years of 2014–2018 inclusive.

Table 1
DIP Corporation
Illustrative Example
Avoidance of COD Income Recognition

	2010 COD income	$10,000,000
	NOL carryforward	$6,000,000
–	2010 taxable income (excluding COD income)	5,000,000
	Remaining NOL carryforward (excluding COD income)	1,000,000
	Reduction of NOL carryforward due to COD income	1,000,000
	Remaining NOL carryforward (after COD income)	$ 0
	2011 beginning depreciable property tax basis	$50,000,000
	Post-debt discharge depreciable assets	6,000,000
	Post-debt discharge liabilities	5,000,000
	Reduction in depreciable property tax basis	$ 500,000
	Total DIP Corporation tax attributes used to shelter $10,000,000 of 2010 COD income	
	Reduction of NOL carryforward due to COD income	$ 1,000,000
	Reduction of depreciable property tax basis	500,000
	Total tax attributes used to avoid COD income	$ 1,500,000

Certain events, such as the liquidation or sale of all the debtor corporation assets (including an asset sale in bankruptcy), will terminate the COD deferral.

Additional COD deferral rules apply to debtor partnerships.[2]

Exchange of Old Debt for New Debt

Under Section 108(e)(10), the debtor corporation will recognize COD income if:

1. a debtor corporation retires its old debt obligation with a new debt obligation or
2. a debtor corporation significantly modifies an outstanding debt instrument.[3]

The amount of COD income that the debtor corporation will recognize is equal to the difference between the AIP of the old debt and the issue price of the new debt.

If either the old debt or the new debt qualifies as publicly traded (as defined in Regulation section 1.1273-2(f)), then the issue price of the new debt is its fair market value. Otherwise, generally, the issue price of the new debt is its face value—that is, the principal amount of the debt provided that the debt includes a stated interest rate (per Section 1274).

Let's consider the example of Public Debt Corporation. Public Debt Corporation realized $7 million of COD income based on the exchange of (1) its publicly traded debt with an AIP of $10 million and a fair market value of $3 million for (2) its new debt.

Let's assume that the new debt has a face value of $10 million.

If Public Debt Corporation elected to defer the COD income, then Public Debt Corporation would recognize the deferred COD income ratably over the tax years 2014–2018 inclusive.

However, Public Debt Corporation must also defer the portion of the $7 million of accrued OID deductions while the corresponding COD income is deferred.

Under the tax provisions, no OID income deferral is available for a creditor. A related tax relief provision suspends the

applicable high-yield discount obligation interest deferral and disallowance rules for certain debt exchanges between September 1, 2008, and December 31, 2009 (per Section 163(e)(5)).

Debtor Corporation COD Income Election Deferral Consideration

An insolvent corporation, a bankrupt corporation, or a corporation with NOL carryforwards (expiring or potentially limited) should carefully consider the costs and benefits of the COD income deferral—versus a current COD income recognition or a COD income exclusion.

For instance, it would not make sense for the above-described DIP Corporation to have made the COD income deferral election. This is because the bankruptcy exception provided DIP Corporation with $10 million of COD income exclusion—while the COD income deferral election would only defer such income.

In addition, an insolvent corporation or a bankrupt corporation (with an NOL that is limited by IRC Section 382) could forgo the COD income deferral in order to apply its tax attribute reduction to otherwise unusable NOLs.

In addition, a debtor partnership could make the COD income deferral election at the partnership level. In contrast, the bankruptcy and the insolvency COD exceptions are tested at the individual partner level.

Therefore, partners with differing tax attributes or differing solvency statuses may disagree as to whether the debtor partnership should make the COD deferral election.

Summary and Conclusion

Tax planning opportunities may exist for a debtor corporation (or a debtor partnership) realizing COD income. The management of a debtor corporation that has renegotiated or restructured its commercial debt should carefully consider all of the benefits and costs of the COD income deferral election.

These benefits and costs should be considered as part of the debtor corporation overall income tax planning.

In the current economic environment, the tax planning cost/benefit implications of the COD income considerations should be important to the managements of (and the professional advisers to) debtor corporations that have to renegotiate or restructure corporate debt.

Notes:

1. See, for example, Section 108(d)(6) and Regulation section 1.1502-28, respectively.
2. See Section 108(k)(5)(D).
3. See Regulation section 1.1001-3.

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Guidelines Related to Reports and Testimony

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5. defends the analyst's asset, property, or business interest value conclusion.

Summary and Conclusion

A well-prepared and articulate valuation analyst can provide an important service to a party in a bankruptcy dispute. Such a valuation analyst can also assist the client's legal counsel to (1) present the valuation aspects of the case in chief and (2) prepare to cross-examine the opposing valuation analyst.

Valuation analysts are not lawyers. And, they should not attempt to "practice law without a license." Accordingly, the valuation analyst should always seek and rely on legal instructions from the client's legal counsel.

However, the valuation analyst who practices in the valuation discipline should be generally aware of the rules regarding the content and format of expert witness reports. And, the valuation analyst should be prepared to present valuation testimony that meets the judicial requirements for expert testimony.

However, before the valuation analyst can help anyone, the analyst's expert testimony must be admitted. The valuation analyst should consider the factors that the court will consider and then should analyze his or her expected testimony against those factors.

With this consideration, the valuation analyst should be able to tailor his or her valuation report and valuation testimony to ensure that the expert testimony admissibility thresholds are met.

Notes:

1. *Frye v. United States*, 293 F. 1013 (D.C. Cir. 1923).
2. *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993).
3. See the FRE 702 comment citing *Daubert*, 509 U.S. at 593-94.
4. *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999).
5. *Andrews v. Metro North Computer Railroad Co.*, 882 F.2d 705, 708 (2nd Cir. 1989).
6. *United Phosphorus, Ltd. v. Midland Fumigant, Inc.*, 173 F.R.D. 675, 686-87 (D. Kan. 1997).
7. *Brandt v. nVidia Corp.*, 389 B.R. 842, 883 (Bankr. N.D. Cal. 2008).
8. Ibid.
9. See *Rubin v. Manufacturers Hanover Trust Co.*, 661 F.2d 979, 988 (2d Cir. 1981).

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