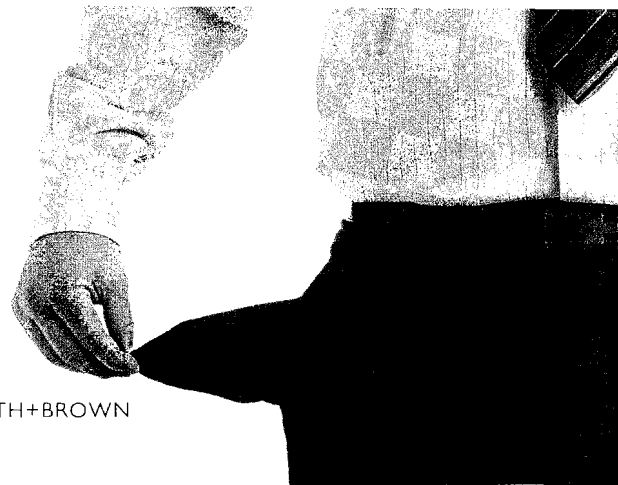


# Restructuring Obligations Outside of Bankruptcy

BY KENNETH J. DEGRAW, CPA, AND DAVID POILLUCCI, CPA, WITHUMSMITH+BROWN



A debtor looking to restructure its obligations outside of bankruptcy has a daunting task, not only in seeking agreement from creditors but, once successful, navigating the tax compliance complexities associated with the restructured debt and equity structure of the company.

Each transaction needs to be analyzed on its unique fact pattern. However, three code sections will likely have the most significant impact on your analysis: Internal Revenue Codes (IRC) §108 and §1017 dealing with the discharge of indebtedness (DOI) and attribute reductions, and IRC §382 related to attribute limitations resulting from capital changes.

Any obligation restructured from its original terms may give rise to DOI income. As an example, assume a debtor owes \$10,000. The creditor agrees to accept \$7,500 in full settlement of the obligation. The debtor has incurred \$2,500 of DOI income. While this example may be overly simplistic, there are several instances where DOI is far less obvious: consider the scenario where a debtor exchanges stock for debt. DOI will occur to the extent that the value of the debt exchanged is greater than fair value of the stock received. Similarly, DOI cannot be avoided by having a related party acquire the debt from the creditor at a discount.

The most complicated situation occurs when new debt is issued or exchanged for debt. This is particularly troublesome in instances where the debt instrument has been modified from its original terms. The issue here is whether the change in terms can be considered a significant modification. The regulations identify several specific

instances where the DOI rules will apply, including changes in yield, timing of payments, a change in the obligor or security, and a change in the nature of the instrument.

Once the existence of forgiveness has been determined, consider if an available exclusion exists, which would allow the debtor to avoid, in whole or in part, the inclusion of the DOI in income. The debtor's status as solvent, insolvent or operating within a bankruptcy proceeding on the date of the discharge will determine the analysis to be undertaken. Furthermore, there are also exclusions specific to farmers and owners of business real estate.

Solvency is defined as the excess of the fair value of the debtor's assets over the debtor's liabilities. It is important to note that contingent liabilities are not considered in this analysis. Non-recourse liabilities — liabilities secured only by the underlying property — need to be separately considered to determine the amount of debt to be included in the calculation, since the debtor may not be liable for any shortfall should the property's fair value be less than the related obligation.

A debtor can exclude DOI entirely when operating within a bankruptcy proceeding. DOI is entirely includable in income if the debtor is solvent, and it is excludable to the extent of insolvency in instances where the debtor is considered insolvent.

There is no free lunch under any of the situations where DOI has been excluded in whole or in part. The price to be paid is in the form of tax attribute reduction. The IRC contains a seven-tier list of attributes that

are reduced in order; any excluded DOI remaining is then completely excluded from income with no further ramifications. The rules require debtors to offset the excluded income first against their available net operating losses, then against various other available tax credit and loss carryovers and the basis of assets. The debtor is allowed one exception to the ordering rules: it may elect to reduce the basis of depreciable assets first. IRS Form 982 is filed with the relevant tax return to disclose how the exclusion was handled by the taxpayer.

Debt restructuring involving the use of the debtor's stock can result in the application of the loss limitation rules. The purpose of these rules is to limit a corporation's use of losses that existed before the change in stock ownership occurred. A change of ownership occurs when one or more 5-percent owners have increased their ownership by greater than 50 percent during a three-year look-back period. These rules are applied before any attribute reductions related to DOI.

Once there is a change in ownership that triggers the loss limitation rules, the restructured corporation's ability to shelter post-change income with pre-change losses becomes restricted. In a turnaround situation, where a restructured company becomes profitable, this limitation can result in unexpected tax liabilities.

The use of a loss carry-forward is limited to a predetermined annual amount. This annual amount is computed by multiplying the stock value of the entire corporation immediately before the ownership change by the federal long-term tax exempt interest rate. Once initially

computed, the annual limitation remains fixed and is applied every succeeding year until the loss carry-forward has been fully utilized.

The corporation must maintain its pre-change line of business during the two years following the ownership change (the continuity test). Failure to do so will cause the limitation to be zero for all post-change years. In other words, the corporation will lose its ability to deduct any of the pre-change carry-forward losses.

A practitioner facing a turnaround or workout situation needs to consider not only the operational impact of the decisions being made, but the ramifications to the entity's tax status as well. The above provides some of the general rules applicable to debtors. Additional issues will result based on the type of entity involved (corporation, S corporation, partnership or individual) as well as instances of tiered-entity structures and reorganizations. ❏

---

*Kenneth J. DeGraw, CPA, CFP, Cr.FA, is a partner with WithumSmith+Brown. He is a member of the New Jersey Society of CPAs Valuation and Litigation Services Resource Group and is chair of the Insolvency and Reorganization Interest Group. David Poillucci, CPA, is also with WithumSmith+Brown. He is a member of the NJSCPA Tax and Young CPAs resource groups. The authors can be reached at 908-526-6363.*

## FOR SALE – CHESTER TOWNSHIP



- 25,698 Square Feet
- Office, Medical, Banking & School Zoning
- \$3,850,000

Contact Exclusive Agent:  
James J. Medenbach  
(908) 771-0400

 **STAUBACH**  
A World of Real Estate Knowledge

## FORENSIC & LITIGATION SERVICES DIRECTORY

  
**NJCPA**  
New Jersey Society of  
Certified Public Accountants

## NOW ACCEPTING APPLICATIONS

The New Jersey Society of CPAs *Forensic & Litigation Services Directory* is designed to inform legal professionals about the diversity of CPA services.

The directory, which will be distributed to judges and attorneys throughout New Jersey, showcases the broad-based value of CPAs, promotes CPAs who provide forensic and litigation support, and is a resource for the judicial process.

For a fee of \$375, each CPA listing includes two areas of expertise and four county listings. Space for a brief description of your qualifications and experience also is included. Additional counties and areas of expertise may be purchased for \$60 each.

Applications are due by Monday, December 10. Apply online at [www.njscpa.org/forensic](http://www.njscpa.org/forensic). Questions? Contact David Plaskow at 973-226-4494, ext. 228, or [dplaskow@njscpa.org](mailto:dplaskow@njscpa.org).

## 2008-09 Forensic & Litigation Services Directory