Income Tax Newsletter

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TAX ISSUES IN BANKRUPTCY AND INSOLVENCY

By Sean H. Cook

For the past several months and in the upcoming months, transactions and projects involving insolvent taxpayers are and will become much more common. The Butzel Long Income Tax Group has already received several inquiries regarding the tax implications of such transactions. Common questions include: (a) Analysis of whether taxable income is generated, (b) the impact on net operating loss carryovers and (c) the discharge of tax obligations in a bankruptcy. Given the likelihood of additional situations that our clients encountered, we thought it would be helpful to provide some guidance on the issues that may be involved. Of course this short article will not cover all possible topics as they would be too numerous.

Real Estate Foreclosures

When a creditor seeks to foreclose on a property or otherwise receive a transfer in lieu of a foreclosure, several preliminary questions need to be answered to evaluate the tax implications. First, is the debt recourse or non-recourse? The character of the transaction and the type of income will depend on the answer to this question along with the answer to the next question. What is the fair market value of, tax basis of and amount of debt secured by the property? Also, what type of entity holds the property? If property is held by an LLC, for example, a bankruptcy proceeding of the entity will not prevent taxation of the owners unless the owners themselves have submitted themselves to bankruptcy protection.

A transfer of troubled property that produces a gain or income upon disposition will often reflect the tax deductions which exceeded income in previous years due to depreciation deductions. Sometimes, owners may have unused losses to offset the gain or income. If the losses were used against other income, then the taxpayer is merely repaying the tax benefits of the losses however this is little solace when a taxpayer is faced with a tax bill without any cash proceeds.

If any of the gain is classified as cancellation of indebtedness income, then this income could be non-taxable under one of the exemptions for such income. Cancellation of indebtedness income is exempt when occurring in a Title 11 bankruptcy, when the taxpayer is insolvent, or when the real estate is used in an active business. The difficulty with applying the Title 11 and insolvency exemptions to real estate holding companies is that these exemptions will apply to the entity and owner level because most real estate holding companies as partnerships for tax purposes. Also, the leasing of real estate has been held to not be an active trade or business. In short, the exemptions to cancellation of indebtedness income usually do not provide protection for real estate holding companies.

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Net Operating Losses

Many entities that are filing for bankruptcy protection have net operating loss carryovers. A net operating loss in a particular year can be carried back to the 2 prior years and then forward 20 years. A net operating loss can be a valuable tax attribute of the entity however there are many restrictions put in place to prevent the trafficking of net operating losses. These anti-trafficking laws affect taxpayers that have a change of ownership of more than 50% or an applicable equity shift. Companies that are being reorganized in a bankruptcy may experience a restriction on its net operating loss that could result in a loss of this tax attribute as a result of the ownership change. The rules do allow for certain pre-bankruptcy creditors to be part of the ownership change without counting against the reorganized entity.

Continuity of Interest

Outside of the bankruptcy context, troubled companies may be looking to enter into mergers and other reorganization transactions that will involve their creditors. In order for a merger or other reorganization transaction to be treated as tax free, several requirements must be met. One of those requirements is the continuity of interest doctrine. Simply stated, the continuity of interest doctrine requires a meaningful amount of ownership by the historic shareholders in the reorganized entity. Although there is no safe harbor for the amount of continued ownership that will be meaningful, the regulations specify at least a 50% continued ownership by the historic shareholders as a group.

Troubled companies may include creditors in the merger or reorganization transactions which presents a hurdle to meet the continuity of interest test because creditors are not ordinarily part of the historic shareholder group. However, the U.S. Treasury recently issued regulations which allow for qualified creditors to be considered as part of the historic shareholder group. These regulations will provide a better environment for reorganizing entities to maintain tax free treatment of the transactions.

Unpaid Michigan taxes create personal tax exposure

The discharge of taxes in a bankruptcy or insolvency proceeding is an issue for our bankruptcy group to address. However, when it comes to Michigan taxes including property, transfer, sales, use, withholding or business tax, the Michigan Department of Treasury can and will assess unpaid company taxes against responsible persons. The responsible persons can include the officers, managers, partners and members. Typically, Treasury will have a shot gun approach and then sort out who are truly the responsible persons when the assessments are challenged. Each person caught in the dragnet should seek their own counsel as conflict issues are inherent when determining which party or parties are truly responsible for a debt.