

**Where's My Cash Windfall?
Tax Planning Opportunities from Recent Legislation**

**Joseph P. Dawson
Dawson & Gerbic, LLP, Seattle, WA**

21st Annual Winter Leadership Conference

The purpose of this presentation is the identification of a series of tactical steps which will permit a financially troubled, but potentially viable, business entity to maximize the benefits of its various tax attributes both during, and after, its turnaround period.

The speakers won't focus on the computational intricacies of the familiar and long-standing tax attributes that we discuss. That could not be done in an hour and a half presentation, particularly by an all-attorney panel, and while that minutia is of intense concern to my associates in their income tax return preparation and tax compliance activities, most of this audience is probably much more interested in how you can use the attributes than in how we compute them. At the risk of boring you to distraction, we will provide somewhat greater detail on newer attributes and the tools for their use created by 2008 and 2009 legislation; again, however, the purpose is limited to ensuring that you have the necessary information to recognize opportunities for their use.

To a large extent the utilization of tax attributes involves the application of tax accounting rules. Not accounting in the financial recording of transactions sense, but accounting in the law school timing of recognition sense. Our presentation includes a series of Exhibits, included at the end of this material as Appendix A, which illustrate many of the effects of the normal attribute timing rules and of various permissible timing modifications and elections which can often improve the results. All statutory references in these summary materials are to the Internal Revenue Code.

Everything else being equal (which admittedly is never the real world situation), a solvent taxpayer would probably opt for the tax attribute usage pattern that appears to provide the

highest total benefits over time, on a discounted present value basis. On the other hand, a troubled business might instead opt for an immediate cash benefit, preferably as an immediate refund of prior taxes or, failing that, a reduction of otherwise required current tax payments, even if that means absorption of attributes at less than the maximum marginal tax rate. Therefore, this presentation attempts to show the results of both approaches where there are clear alternatives.

Tax Attribute Utilization:

The attributes mostly likely to produce an immediate cash benefit are already-recognized losses, the most common of which are capital losses and net operating losses.

Exhibit 1 presents a fact pattern where a C corporation reporting on the calendar year recognizes both types of loss during 2009, and Exhibit 2 shows the utilization of those losses under the applicable carryback and carryforward rules.

C corporations are permitted a three-year carryback of an unused capital loss after it is offset against current year capital gains, but solely against prior years' capital gains and subject to the restriction that the carryback can neither cause nor increase a net operating loss in those years. Any unused capital losses can be carried forward for five years, subject to the same restriction. Thus, \$100 of the 2009 capital loss will be carried to each of the corporation's three preceding taxable years, permitting a full recovery of the tax paid on the prior year capital gains, and the final \$100 will be carried forward to avoid 2010 tax on that year's installment contract gain.

With very narrow exceptions, C corporations are also permitted a two-year net operating loss carryback and a 20-year net operating loss carryforward. The net operating loss is applied first

21st Annual Winter Leadership Conference

against prior year ordinary income and then against prior year net capital gain, on a year-by-year basis beginning with the earliest year. Net capital gain for this purpose is computed after any capital loss carryback or carryforward to that year. Therefore, \$50 of the \$150 2009 operating loss can be carried back to offset the 2007 ordinary income and \$100 will be carried forward. That carryforward will offset the 2010 and 2011 ordinary income of \$75, and the remaining \$25 will be applied against the 2011 installment sale contract capital gain.

Exhibit 3 presents a fact pattern similar to Exhibit 1, but for an individual taxpayer and including the entire installment contract collection period, and Exhibit 4 shows the effects of the somewhat different individual loss utilization rules. Individuals are not permitted a capital loss carryback; instead, they are granted a lifetime capital loss carryforward, subject to the same application limitations and ordering rules, and the net operating loss creation or increase restriction, as corporate taxpayers. Therefore, the \$400 2009 net capital loss will offset the 2010 through 2013 installment sale capital gain, but no portion of the pre-2009 capital gains.

The individual net operating loss deduction application and timing rules are nearly identical to the corporate ones. Therefore, the 2009 \$150 net operating loss is carried to 2007, where it first offsets the \$50 of ordinary income. Because the 2009 capital loss cannot be carried back to offset prior year capital gain, however, under the year-by-year application rule the remaining \$100 of net operating loss is then absorbed against the 2007 capital gain. And while the use of net operating loss against capital gain in the Exhibit 2 fact pattern did not present a significant issue because corporations pay the same tax rate on both capital gain and ordinary income, that is not true for individuals; their tax rate on long-term capital gains is currently less than half the rate on ordinary income.

An election is available that avoids the Exhibit 4 net operating loss absorption against 2007 capital gain. Exhibit 5 shows the effect on the Exhibit 4 fact pattern of an election under sec. 172(b)(3) to waive the entire net operating loss carryback period. Under that election the entire 2009 net operating loss would remain available to carry forward against potential future, higher rate ordinary income, but at the cost of any recovery of 2007 tax.

No new taxable entity is created when a C corporation files for bankruptcy, so the loss carryback and carryforward rules discussed above are essentially unchanged by such a filing. That is not the case in individual business filings, however. Under sec. 1398 an individual Chapter 7 or Chapter 11 case creates a separate debtor's taxable estate and, with it, significant tax computation complexities but also numerous additional opportunities for constructive tax attribute utilization planning.

Exhibits 6 and 7 modify the fact pattern of the previous individual taxpayer Exhibits by adding \$200 of ordinary income in 2008 and assuming a Chapter 11 filing at April 30, 2009, with all of the 2009 income and losses falling in the post-petition period.

IRC sec. 1398(d)(2) permits a debtor in a Chapter 7 or Chapter 11 case to treat the taxable year which includes the case commencement date as two taxable years; one ending on the on the day before the commencement date, and the second beginning on the commencement date. Secs. 1398(g) and 1398(j)(2) transfer a group of tax attributes, including the debtor's tax history, from the debtor to his bankruptcy estate as of the first day of the debtor's taxable year in which the case commences.

Thus, if the debtor does not make the sec. 1398(d)(2) election, he includes the entire case commencement calendar year in his individual income tax return for that year and no portion of that year is included in the bankruptcy estate's taxable history. If, on the other hand, the debtor makes the

21st Annual Winter Leadership Conference

sec. 1398(d)(2) election, that election's first taxable year becomes a pre-petition taxable year of the bankruptcy estate.

Exhibit 6 assumes no debtor sec. 1398(d)(2) election. In that scenario the two-year carryback of the bankruptcy estate's \$150 2009 net operating loss is completely absorbed in 2007, to a large extent against capital gain. Exhibit 7, on the other hand, assumes that an IRC sec. 1398(d)(2) election is made. In that case the debtor's April 30, 2009 year becomes the estate's first pre-petition year, and the net operating loss is carried back to 2008, where it offsets only presumably higher tax rate ordinary income.

Exhibits 8 and 9 modify the previous individual taxpayer fact pattern again, this time to subdivide the 2009 operating loss into \$150 of income during the debtor's April 30, 2009 short year and a \$300 operating loss from a flow-through entity, which is taken into the bankruptcy estate's taxable income at the flow-through entity's year-end.

While the Internal Revenue Code severely restricts the ability of individuals and most business entities to utilize fiscal (non-calendar) taxable years, C corporations and estates, including bankruptcy estates created under sec. 1398, are free to elect a fiscal year. Exhibit 8 shows the utilization of the \$300 flow-through loss if the bankruptcy estate does not select an initial fiscal year ending prior to December 31, 2009, and Exhibit 9 contrasts the situation after an August 31 fiscal year election.

Without the fiscal year election, calendar 2008 is the second preceding taxable year for application of the December 31, 2009 net operating loss, and \$100 of that loss is utilized against the 2008 capital gain; with the election none of the net operating loss offsets capital gain, but at the cost of an indeterminate delay in utilization of the resulting net operating loss carryforward.

Just as sec. 1398(g) transfers most of an individual debtor's tax attributes to his bankruptcy estate at the commencement of his bankruptcy case, sec. 1398(i) transfers most remaining attributes of the estate, including the losses discussed above, back to the debtor at the termination of the case.

Bankruptcy cases often create tax attributes, other than the losses discussed above, with additional utilization issues. One common example of such an attribute is the administrative expenses arising during the case. Sec. 1398(h) makes these expenses deductible and, if there is insufficient taxable income to absorb such expenses during the year they are incurred, that subsection allows a three-year carryback and a seven-year carryforward of the unused portion, subject to two principal limitations: (1) net operating loss carrybacks and carryforwards to each year are deducted first; and (2) administrative expense deductions are permitted only in bankruptcy estate taxable years, with no transfer back to the debtor of unused deduction amounts under sec. 1398(i).

Many bankruptcy cases are concluded within two taxable years and incur the bulk of their potentially deductible payments near the conclusion of the case, creating both net operating loss and administrative expense carrybacks. In that situation, if the estate has insufficient taxable income during its existence to absorb the full loss amounts, the net operating loss which would otherwise transfer to the debtor for potential carryforward may be used in full while a portion of the administrative expenses can never be deducted. Exhibit 10 illustrates such a situation. There both a \$150 net operating loss and a \$100 administrative expense from the estate's final year would be carried back to the estate's two preceding taxable years, leaving \$50 of administrative expenses nondeductible.

There is yet another taxable year election available to individual debtors, however, and it can potentially provide a solution to this problem. Sec. 1398(j)(1) permits an individual bankruptcy estate to change its taxable year one time without Treasury approval. Exhibit 11 illustrates the effect of such an election in

21st Annual Winter Leadership Conference

the Exhibit 10 factual situation. There, the election of a two-month short year ended October 31, 2009, changes the chronological positions of the estate's taxable income years from first and second years back to second the third. The three-year carryback permitted for the estate's administrative expenses therefore allows it to reach, and partially offset, the estate's \$150 August 31, 2009 income, while the net operating loss two-year carryback limitation allows it to reach back only to the August 31, 2010 year. The total carrybacks in Exhibit 11 are \$50 lower than in Exhibit 10, but the debtor acquires a \$100 net operating loss carryforward.

Discharge of Indebtedness and Tax Attribute Reduction:

Most bankruptcy cases result in some reduction in outstanding debt, and that reduction is often classified as discharge of indebtedness income (COD) for tax purposes. COD is taxed as ordinary income if it is taxed, but it is not always taxed. Subject to numerous technical rules and limitations, sec. 108(a) excludes COD from taxable gross income in five situations:

- (A) discharge in a title 11 [bankruptcy] case;
- (B) discharge while insolvent, to the extent of the insolvency;
- (C) discharge of qualified farm indebtedness;
- (D) discharge of qualified real property business indebtedness [except C corporation debtors];
- (E) discharge of qualified principal residence indebtedness.

In an attempt to prevent a double benefit from its COD gross income exclusion, sec. 108 extracts a price in some situations. Sec. 108(b) requires reduction of many tax attribute carryforwards if they remain unused through the end of the COD exclusion year. Double benefit is a highly-prized taxpayer goal,

however, and it can still sometimes be achieved in sec. 108(a) situations by careful planning despite sec. 108(b).

Exhibit 12 once more changes the individual taxpayer's fact pattern under consideration. The bankruptcy case still terminates at November 30, 2010, but it reports on a calendar year rather than on fiscal years for its earlier periods. Furthermore, the December 31, 2009 operating loss is moved to the November 30, 2010 final bankruptcy year and is deemed to be caused entirely by "bonus depreciation" under sec. 168(k), \$250 of COD is added in that final bankruptcy year, and total asset basis before the bonus depreciation is deemed to be substantially less than the debt remaining after the COD.

Sec. 108(b) works much like Cinderella's royal ball curfew; at midnight on November 30 it would turn many unused attributes into the equivalent of vermin and pumpkins, so the first step to minimize its impact is acceleration of the use of attributes against any income that is reasonably certain to be recognized in the future, if that can be accomplished and does not create significant additional costs.

Exhibit 13 shows a possible example of such acceleration. Outside of bankruptcy situations installment contracts are not frequently pledged as collateral for their holder's debts, because such a pledge is treated as a payment for tax purposes and accelerates a proportionate part of the contract's deferred gain. Here, however, acceleration of future installment gain by an encumbrance on the installment contract is offset by utilization of the \$400 December 31, 2009 unused capital loss which might not otherwise remain available. This step simultaneously shields the capital loss from sec. 108(b) and probably assists in obtaining creditor consent to plan confirmation.

The Cinderella analogy can be carried even further. Sec. 108(b) does not completely eliminate all tax attributes of debtors benefiting from sec. 108(a). Just as one of Cinderella's glass shoes survived past the witching hour, and proved to be of significant future value to her, so too some tax attributes can

21st Annual Winter Leadership Conference

survive for future use, either because sec. 108(b)'s application is limited by another IRC provision or because the attribute is not included in the sec. 108(b) hit list at all.

Among the tax attributes targeted by sec. 108(b), the most significant limitation probably applies against the sec. 108(b)(2)(E) asset basis reduction. Unless the debtor sacrifices its protection by an affirmative election, sec. 1017(b)(2) prohibits basis reduction below the amount of debt remaining after the excluded COD.

Exhibit 14 demonstrates a two-step procedure whereby an individual's bankruptcy estate can take advantage of sec. 1017(b)(2) in the fact pattern under discussion. The November 30, 2010 unused \$150 operating loss is subject to reduction under sec. 108(b)(2)(A). Because that loss is entirely due to bonus depreciation, however, it is not necessary to recognize most of the loss. Bonus depreciation, which will be covered in some depth during our presentation, is automatic for qualified property, but an election out is available under sec. 168(k)(2)(D)(iii). Such an election replaces the asset basis reduced by the depreciation, and since total asset basis after that replacement remains less than remaining debt, sec. 1017(b)(2) bars a sec. 108(b) basis reduction.

Bonus depreciation is not the only asset expensing tool augmented in the recent stimulus legislation. Sec. 179, which will also be covered in our presentation, takes a different approach, with different qualification requirements, both for eligible property and taxpayers, and dramatically lower deduction limits. Perhaps the most relevant constraint on sec. 179 for purposes of our presentation appears in sec. 179(d)(4), which prohibits the section's use by estates, almost certainly including individual bankruptcy estates. C corporations can use the sec. 179 expensing provisions, however, so Exhibit 15 resurrects the earlier C corporation data to demonstrate the use of sec. 179 in avoiding sec. 108(b). And where it is available, the mechanics of its application can make sec. 179 very effective for that purpose.

Unlike bonus depreciation, asset expensing under sec. 179 is elective, subject to various dollar limitations. While the amount subject to the sec. 179 election can be higher, however, under sec. 179(b)(3) the actual deduction in any year cannot exceed that year's trade or business income. Any elected expense amount in excess of the trade or business income limitation becomes a carryforward loss subject to that same limitation in future periods. That loss, however, is not one of the tax attributes enumerated in sec. 108(b), so it is not subject to reduction due to the a sec. 108(a) COD exclusion. As Exhibit 15 demonstrates, for eligible taxpayers a currently non-deductible sec. 179 election, combined with an election out of bonus depreciation, can replace a net operating loss carryforward which is subject to sec. 108(b) reduction with a sec. 179 carryforward which is not.

Sec. 108(i) COD Deferral

The American Recovery and Reinvestment Act of 2009 provided a highly taxpayer-friendly new tool for sec. 108 tax planning. While the examples discussed in this presentation summary that dealt with COD focused on situations where the taxpayer was able to exclude COD from gross income due to a Title 11 case, debt cancellation can occur in situations where none of the sec. 108(a) exclusions from gross income will completely shield the COD from taxation. Furthermore, it is not always possible to identify techniques for shielding tax attributes for future use when sec. 108(a) exclusions have been utilized.

New sec. 108(i) permits an election to defer calendar year 2009 and 2010 COD from trade or business debt instrument reacquisition or cancellation until 2014, on an instrument-by-instrument basis, and to then take that COD into income ratably over a five-year period. The election is irrevocable, but its benefits are not necessarily guaranteed. For example, events constituting a cessation of business, including death, can result in acceleration of the deferred COD. And the election has a potentially significant price; under sec. 108(i)(5)(C) none of the exclusions from gross income under sec. 108(a)

21st Annual Winter Leadership Conference

will apply to the COD covered by the election, no matter when it is taken into income. On the other hand, however, no attribute reduction under sec. 108(b) will occur in connection with that COD.

Appendix A

Exhibit 1

	2006		2007		2008		2009		2010		2011	
	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.
Installment contract gain		100		100		100		100		100		100
Capital (loss)								(500)				
Operating income/(loss)	100		50				(150)		50		25	

Exhibit 2

	2006		2007		2008		2009		2010		2011	
	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.
Installment contract gain		100		100		100		100		100		100
Capital (loss)								(500)				
Operating income/(loss)	100		50				(150)		50		25	
Attribute utilization:												
Capital loss		(100)		(100)		(100)		400		(100)		
Net operating loss			(50)				150				(25)	(25)

Exhibit 3

	2006		2007		2008		2009		2010		2011		2012		2013	
	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.
Installment contract gain		100		100		100		100		100		100		100		100
Capital (loss)								(500)								
Operating income/(loss)	100		50				(150)		50		25					

21st Annual Winter Leadership Conference

Appendix A

Exhibit 4

	2006		2007		2008		2009		2010		2011		2012		2013	
	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.
Installment contract gain	100		100		100		100		100		100		100		100	
Capital (loss)							(500)									
Operating income/(loss)	100		50				(150)		50		25					
Attribute utilization:																
Capital loss							400		(100)		(100)		(100)		(100)	
Net operating loss			(50)	(100)			150									

Exhibit 5

	2006		2007		2008		2009		2010		2011		2012		2013	
	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.
Installment contract gain		100		100		100		100		100		100		100		100
Capital (loss)							(500)									
Operating income/(loss)	100		50				(150)		50		25					
Attribute utilization:																
Capital loss							400		(100)		(100)		(100)		(100)	
Net operating loss							75		(50)		(25)					

Exhibit 6

	2007		2008		5/1/09-12/31/09		2010		2011		2012		2013	
	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.
Installment contract gain		100		100		100		100		100		100		100
Capital (loss)						(500)								
Operating income/(loss)	50		200		(150)		50		25					
Attribute utilization:														
Capital loss						400		(100)		(100)		(100)		(100)
Net operating loss	50	100			150									

AMERICAN BANKRUPTCY INSTITUTE

Appendix A

Exhibit 7

	2007		2008		5/1/09-12/31/09		2010		2011		2012		2013		2015	
	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.
Installment contract gain		100		100		100		100		100		100		100		
Capital (loss)						(500)										
Operating income/(loss)	50		200		(150)		50		25							
Attribute utilization:																
Capital loss						400		(100)		(100)		(100)		(100)		
Net operating loss			(150)		150											

Exhibit 8

	2008		4/30/2009		12/31/2009		2010		2011		2012		2013	
	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.
Installment contract gain		100				100		100		100		100		100
Capital (loss)						(500)								
Operating income/(loss)			150		(300)									
Attribute utilization:														
Capital loss						400		(100)		(100)		(100)		(100)
Net operating loss		(100)	(50)		150									

Exhibit 9

	4/30/2009		5/31/09-8/31/09		8/31/2010		8/31/2011		8/31/2012		8/31/2013		8/31/2014	
	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.
Installment contract gain						100		100		100		100		100
Capital (loss)				(500)										
Operating income/(loss)	150				(300)		50		25					
Attribute utilization:														
Capital loss						(100)		(100)		(100)		(100)		(100)
Net operating loss	(150)				(150)									

21st Annual Winter Leadership Conference

Appendix A

Exhibit 10

	8/31/2009		8/31/2010		11/30/2010	
	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.
Operating income/(loss)	150		50		(150)	
Administration expenses					(100)	
Attribute utilization:						
Capital loss						
Net operating loss	(150)				150	
Administration Expenses			(50)		50	

Exhibit 11

	8/31/2009		8/31/2010		10/31/2010		11/30/2010	
	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.
Operating income/(loss)	150		50				(150)	
Administration expenses							(100)	
Attribute utilization:								
Capital loss								
Net operating loss			(50)				50	
Administration Expenses	(100)						100	

Exhibit 12

	5/1/09-12/31/09		11/30/2010		12/31/2010		2011		2012		2013	
	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.
Installment contract gain		100				100		100		100		100
Capital (loss)		(500)										
Operating income/(loss)	(150)											
Discharge of indebtedness			250									
IRC sec. 108(a) exclusion			(250)									
Attribute utilization installment contract acceleration		400				(100)		(100)		(100)		(100)

AMERICAN BANKRUPTCY INSTITUTE

Appendix A

Exhibit 13

	5/1/09-12/31/09		11/30/2010		12/31/2010		2011		2012		2013	
	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.
Installment contract gain		100				100		100		100		100
Capital (loss)		(500)										
Operating income/(loss)	(150)											
Discharge of indebtedness			250									
IRC sec. 108(a) exclusion			(250)									
Attribute utilization												
Installment contract acceleration		400			(100)		(100)		(100)		(100)	
Attribute transformation												

Exhibit 14

	5/1/09-12/31/09		11/30/2010		12/31/2010		2011		2012		2013		2014	
	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.
Installment contract gain		100				100		100		100		100		
Capital (loss)		(500)												
Operating income/(loss)	(150)													
Discharge of indebtedness			250											
IRC sec. 108(a) exclusion			(250)											
Attribute utilization														
Installment contract acceleration		400			(100)		(100)		(100)		(100)			
Attribute transformation														
Election out of bonus depreciation	120		(48)				(28)		(18)		(18)		(8)	

Exhibit 15

	5/1/09-12/31/09		11/30/2010		12/31/2010		2011		2012		2013	
	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.	Ord.	Cap.
Installment contract gain		100				100		100		100		100
Capital (loss)		(500)										
Operating income/(loss)	(150)											
Discharge of indebtedness			250									
IRC sec. 108(a) exclusion			(250)									
Attribute utilization												
Installment contract acceleration		400			(100)		(100)		(100)		(100)	
Attribute transformation												
Election out of bonus depreciation	150											
Sec. 179 expense election	(150)											