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IRS Changes Rules for COD Income

On September 4, 2003, just in time for a scheduled confirmation hearing on MCI's bankruptcy reorganization plan, the Treasury Department has published temporary regulations that will significantly (and adversely) affect the tax profile of many debtors emerging from bankruptcy. In particular, the new temporary regulations address the method of tax attribute reduction that results from cancellation of indebtedness ("COD") income incurred by a member of a consolidated group in a title 11 case. Prior to the issuance of these rules, it was not clear whether a member of a consolidated group that incurred COD income while in bankruptcy was required to reduce only the tax attributes of the debtor itself (the "separate company basis") or, alternatively, whether the tax attributes of the entire consolidated group were subject to such reduction (the "consolidated group basis"). When advising clients on this issue in the past, we (and most other advisors) have generally indicated that, although there was no clear authority on the issue, it was appropriate to take the position that attribute reduction in these cases should occur on a separate company basis. The new temporary regulations, however, have made it clear (subject to ordering rules described below) that attribute reduction will occur on a consolidated group basis. The temporary regulations apply to discharges of indebtedness that occur after August 29, 2003.

BACKGROUND

When a debtor is relieved of indebtedness, it is generally required to recognize the economic benefit of such relief by including the forgiven amount in its gross income. COD income is, however, excluded from gross income under §108 of the Internal Revenue Code of 1986 (the "Code"), to the extent that a debtor is insolvent (as defined in the Code) or if the debtor is in a title 11 case. As a trade-off for the exclusion of COD income, §108 requires the debtor to reduce its tax attributes (which are valuable because they could otherwise be used by the debtor to reduce taxable income – assuming the debtor actually generates taxable income – in future taxable years) by an amount equivalent to the excluded COD income.¹ If COD income exceeds the tax attributes that are available for reduction, the COD income has no further tax impact.

¹ Subject to certain elections that can be made, a debtor that has COD income excluded from its taxable income under §108 is required to reduce its tax attributes in the following order: (i) net operating losses; (ii) general business credits; (iii) minimum tax credits; (iv) capital loss carryovers; (v) tax basis in assets of the debtor; (vi) passive activity loss and credit carryovers; and (vii) foreign tax credit carryovers.

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While the application of these rules is usually uncontroversial, it has not been clear how these rules applied to a debtor that was part of a consolidated group. For example, if a debtor has COD income and its subsidiary has a net operating loss (“NOL”) carryover, it was not certain whether the parent’s COD income could cause the subsidiary’s NOL to be reduced. On the basis of the available authorities, many debtors that were members of consolidated group took the position that they would reduce tax attributes only on a separate company basis. This position allowed the tax attributes of members of the consolidated group other than the actual debtor to emerge from bankruptcy unscathed.

THE NEW TEMPORARY REGULATIONS

Under the new regulations, the tax attributes attributable to other members of a consolidated group are exposed to the effects of §108. This exposure is mitigated, however, by certain ordering rules, as explained below.

The new rules provide that, when a member of a consolidated group realizes COD income while in chapter 11, so that the COD income is not included in taxable income, tax attributes will be reduced in the following sequence: (1) tax attributes attributable to the debtor member (including the portion of consolidated net operating losses attributable to that member and the tax basis of property held by the debtor member); then (2) to the extent that the excluded COD income exceeds the amount of the tax attributes listed in (1), such excess will be applied to reduce the remaining consolidated tax attributes of the other members of the group in the order provided in §108 of the Code (note, however, that the tax basis in assets held by other members of the consolidated group is not subject to reduction under this rule). In order to prevent “double-counting” of certain tax attributes, the new regulations also impose a look-through rule which provides that, to the extent a debtor member reduces its basis in stock of a consolidated subsidiary, solely for purposes of these rules, the subsidiary is treated as itself realizing excluded COD income in an amount equal to such basis reduction. A subsidiary that is deemed to realize excluded COD income in this way must reduce its attributes (including both NOLs and tax basis in its assets) as outlined in (1) above. Any deemed COD income in excess of this amount will not be applied to reduce the tax attributes attributable to any other member of the group.

THE AFTERMATH

As noted above, these new rules are effective for discharges of indebtedness that occur after August 29, 2003. Although the discussion above summarizes the main effects of the new rules, there are also a number of technical and complex collateral effects of these new provisions that must be taken into account to determine their full effect in each particular case. In particular, other special rules apply where (i) tax attributes are reduced as a result of insolvency (rather than bankruptcy), (ii) there are multiple debtors in the consolidated group that realize excluded COD income, and (iii) a debtor makes certain elections.

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If you have any questions concerning these new regulations, please contact Rick Bronstein 212-373-3744 or Peter Rothenberg 212-373-3154.

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