



# Downturn planning: general US tax points

This briefing discusses key issues US corporations should consider as they manage their US tax positions in the face of the current financial crisis. Topics include ways to reduce tax liability for 2009, carry-over of tax losses to other years, limitations on use of losses after ownership changes, potential liability for unpaid taxes of affiliates and tax aspects of restructurings.

This briefing provides only general information, not advice on which you can rely to avoid US tax penalties.

## Introduction

The ongoing financial crisis and the resulting general economic downturn present many challenges to corporations worldwide. At the same time, new opportunities for corporations arise, including to buy back debt trading in the markets at a significant discount or to benefit from new tax incentives aimed at encouraging green and other advanced technologies. In a period of uncertainty conserving cash is critical, so that controlling the amount of taxes owed becomes even more important than in more stable times.

## Reducing taxes owed for 2009

US corporations may wish to reduce their federal income tax liability for 2009 by:

- triggering losses through the disposition of built-in loss assets, including through structures that enable retention of some control and economic exposure and thus possibly avoid financial accounting losses;
- considering other techniques that may permit the current recognition of losses, such as a 'mixed straddle account' election available with respect to certain positions in actively traded personal property. Generally, such an election must be made by the due date of the taxpayer's return for the preceding tax year (without considering extensions);
- claiming additional first-year depreciation deductions equal to 50 per cent of the basis of qualified property placed in service in 2009 or by electing refundable

research or alternative minimum tax credits in lieu of this bonus depreciation; and

- considering the availability of various 'green' tax credits for placing certain energy generation facilities in service, installing equipment producing or using solar or geothermal energy, installing clean-fuel vehicle refueling property or acquiring plug-in electric motor vehicles.

US corporations also should consider the possibility of:

- claiming deductions for wholly or partially worthless loans or other debt obligations that are not in the form of debt securities. Proving the existence and time of (partial) worthlessness can be fact-intensive. Worthlessness is presumed, however, when a bank or other regulated corporation writes off a debt under orders of, or a policy established by, a supervising authority. Losses on worthless debts that are not in the form of debt securities are ordinary losses that may offset operating income; and
- claiming deductions for worthless stock, debt securities or rights to acquire stock. A loss cannot be taken merely because of a decline in market value, but a taxpayer may claim a loss if it abandons the asset. Losses on worthless stock, rights to acquire stock and debt securities (other than the amount of accrued interest) are generally capital losses. Losses on worthless bonds and other debt securities are ordinary in the hands of banks.

In considering any of the foregoing options to reduce this year's federal income tax liability, a corporation

needs to determine if it expects to realise positive income for 2009 and to evaluate its ability to carry back or carry forward net-operating and capital losses and to utilise tax credits. If these options would result in a net loss for 2009, a corporation must consider the extent to which the associated future tax benefit will be reflected as an asset in its financial statements.

## **Tax losses**

Net operating losses (NOLs) of corporations generally can be carried back two years and carried forward 20 years to offset taxable income in those years. A special rule permits small corporations with average annual gross receipts (measured over a three-year period) that do not exceed \$15m to elect to carry back NOLs up to five years. NOL carry-forwards cannot offset more than 90 per cent of a corporation's income for purposes of the alternative minimum tax.

Capital losses of corporations can only be used to offset capital gains. Capital losses can generally be carried back three years and carried forward five years.

In a consolidated group, losses of one group member can offset current, past or future income of another group member, subject to specified limitations. Losses generated in a year in which a corporation was not a group member may only offset future income of that group member, and consolidated losses may be carried back or forward to a separate return only of the member generating the losses.

Corporations with significant NOLs may wish to consider certain transactions that effectively permit the transfer of tax benefits associated with the NOLs to another related or unrelated US taxpayer. Such strategies are particularly attractive if the corporation or any consolidated group of which it is a member does not expect to be able to utilise its NOLs in the foreseeable future and does not show a corresponding asset on its financial statements.

Tax loss carry-forwards as well as built-in loss and deduction items are valuable assets of a corporation. In planning restructurings and other transactions that may result in a change of control, it is important to consider special rules limiting future utilisation of loss items. Subject to special rules for corporations involved in a title 11 or similar bankruptcy case, if ownership of more

than 50 per cent of a loss corporation's shares changes within a rolling three-year period, the corporation's ability to offset future taxable income by pre-change loss carry-forwards or a recognised loss or deduction that was 'built-in' on the change date, is limited to an amount equal to the fair market value of the corporation's stock on the change date multiplied by the long-term tax-exempt rate (published monthly by the Treasury) applicable to the change date (plus any recognised built-in gain). The limitation is reduced to zero if the corporation fails to continue its historic business for at least two years after the ownership change. Therefore, a change of control can diminish greatly the future value of loss carry-forwards and other loss or deduction items and requires careful planning.

## **Liability for unpaid taxes of others**

In the current economic environment, some corporations will likely become unable to meet their tax obligations. As a result, certain other persons may become liable for the unpaid taxes of the defaulting corporations. In a consolidated group, each member is severally liable for the group's entire US federal income tax liability. The US tax authorities may assess a tax deficiency against a subsidiary even if it has left the consolidated group. Members of a consolidated group cannot enter into intercompany agreements to reduce this liability. While indemnities against this tax liability from the former group of an acquired subsidiary are customary, those indemnities may be of limited or no value if the selling group experiences financial difficulties or becomes insolvent.

The US tax authorities may also seek to assess a tax deficiency against a shareholder of an insolvent or liquidated corporation based on the theory that, in the hands of the shareholders, the assets of a corporation constitute a trust fund for the corporation's creditors. Shareholders have been held severally liable as transferees in numerous situations, including redemptions of stock and corporate distributions or liquidations of assets, in each case to the extent of assets received. This transferee liability applies to all existing debts – including taxes – regardless of whether or not such debts were determined or known at the time the assets were distributed or transferred. As a general rule, the US tax authorities

have the same rights as other creditors. Thus, except for special rules making members of a consolidated group severally liable for the group's taxes, the tax authorities' rights are generally determined under creditor's rights law rather than the tax law.

## Restructurings

Financially distressed companies may wish, or be forced, to restructure their debt or business operations. Debt restructurings and asset sales (including sales of corporate subsidiaries) often have significant tax consequences and require careful planning.

In the credit crisis, the terms of many debt instruments have been modified to reflect deteriorations in the credit quality of the obligor or its affiliates or in general market conditions. Other companies (or their shareholders) have taken advantage of the opportunity presented by the current crisis to restructure by retiring their own debt through repurchases in the market at depressed valuations. In the current environment, a corporation may also wish to replace its outstanding debt with preferred stock if it already has large NOLs and thus can no longer benefit from interest deductions. These types of restructurings can be expected to continue until the economy recovers and the credit crisis abates.

Profits realised by a corporation in repurchasing its own debt at a discount or resulting from a purchase of low-trading debt by an affiliate – as well as outright debt forgiveness by a creditor – generally give rise to cancellation of debt (COD) income. Debt-for-debt exchanges, including deemed exchanges resulting from certain significant modifications of existing debt instruments and debt-for-equity exchanges can also give rise to COD income. COD income of a corporation subject to bankruptcy proceedings or of an insolvent corporation (but only to the extent of its insolvency) is not taxed currently but the corporation is required to reduce its tax attributes (including NOLs, tax credits, capital loss carryovers and asset bases).

Recently enacted legislation permits a corporation irrevocably to elect to defer COD income recognised as a result of repurchases of its own debt, actual or deemed debt-for-debt exchanges, debt-for-equity exchanges, contributions of debt to the corporation's capital or

forgiveness of debt, in each case occurring during 2009 and 2010. Deferred amounts must be included ratably over five taxable years beginning in the taxpayer's 2014 taxable year. Deferred income will generally be accelerated if the electing taxpayer liquidates or sells substantially all of its assets (including in bankruptcy) or ceases to do business. If a taxpayer elects to apply this deferral provision, it will not be permitted to apply the bankruptcy or insolvency exception with respect to the same debt instrument for the year of realisation or any later taxable year.

Gain or loss recognised on the sale of a subsidiary will be capital, except in the case of a sale of a foreign subsidiary with untaxed earnings and profits. A sale of a subsidiary at a gain would permit a corporation to utilise existing capital losses, unless it is such a foreign subsidiary. A sale of a subsidiary at a loss, on the other hand, would result in a capital loss that may be of limited use to the corporation. If a loss is expected, it should be considered if a transaction might be structured as an asset sale giving rise, at least partially, to ordinary losses.

## Possible legislative changes

In connection with developing the US federal government's budget for the fiscal year 2010, the Administration as well as the Senate and the House of Representatives have released proposals and preliminary budget plans. These plans contemplate various tax relief measures to benefit US corporations including:

- tax incentives to encourage research and development, (re)training of workers, development of alternative fuel and automobile technologies and continued production of other advanced technologies and the infrastructure to support them;
- expansion of NOL carry-backs; and
- extension of various expiring and expired tax relief provisions.

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