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Companies' Debt-Restructuring Plans Could Trigger Minimum Tax

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The unprecedented lull in restructuring activity that began suddenly after the COVID-19 wave appears to have come to an abrupt end. As companies navigate insolvency and restructuring plans, they may be surprised to learn that they could be hit with an unexpected tax bill under the new "book minimum tax" regime (BMT) that was passed as part of the Inflation Reduction Act of 2022 and came into effect at the beginning of this year.[2]

The BMT was promulgated to make large profitable companies pay their fair share of taxes. While it is clear that financially distressed companies were *not* what Congress had in mind, this article explores how it could impact distressed companies and some "fixes" that the Treasury should consider in regulatory guidance to come. This article provides the broader restructuring community details on these tax issues that could significantly affect emergence structuring, valuation analysis and the like.

Triggering BMT Liability

The BMT causes "applicable corporations" to owe the greater of (1) their regular tax liability (including any base erosion and anti-abuse tax liability); and (2) 15 percent of their adjusted financial statement income (AFSI), less BMT foreign tax credits, reduced by certain general business credits (including the research and development credit) subject to a cap.[3] Differences between book income and taxable income that could trigger the BMT include the following: (1) the timing differences for recognizing income and losses; (2) the differences between fresh start/purchase accounting and the tax treatment of transactions; and (3) policy-driven determinations that certain items (*e.g.*, cancellation of indebtedness (COD) income) should be excluded from taxable income although included in book income.

The bottom line is that *all* these differences are attributable to congressional decisions about how federal income tax should work to drive behavior and be administrable. Nevertheless, corporations with significant book profits and low taxes are easy targets for revenue-raising that do not draw much sympathy.

Further complicating matters is that the calculation of AFSI reflects several adjustments to Generally Accepted Accounting Principles (GAAP) book income, two of which are relevant to this discussion. First, a book net-operating-loss (NOL) concept is included in calculating the tax owed but not in determining whether a corporation is an applicable corporation,[4] creating another tax attribute to track and fight over. The second relevant adjustment is the replacement of book depreciation with tax deductions allowed for certain property (depreciable property).[5]

A corporation, with some limited exceptions, becomes an applicable corporation if (1) its three-year average annual AFSI (AAAFSI) is more than $1 billion (applying an aggregation rule), or (2) it is part of a non-U.S.-parented group and (a) the group as a whole exceeds the same $1 billion threshold, and (b) the U.S. entities and subsidiaries have a three-year AAAFSI of at least $100 million for the same period.[6] Once a corporation becomes an "applicable corporation," it is subject to these rules forever, unless the Treasury determines that it no longer is an applicable corporation because either it had a "change in ownership" (which is undefined) or its AAAFSI has been below the required threshold for a yet-to-be-determined period of time.[7] If a company's AAAFSI never implicates the tax, they still incur significant compliance costs forever.

The COD Income Conundrum

How can a tax law aimed at gazillion-dollar companies matter to the restructuring community? One of the primary answers is the same issue that tax people have long been dealing with (and torturing the readers of this article about): COD income.

Even tax-averse restructuring practitioners know that (1) restructurings give rise to COD income; (2) fact-based rules allow the exclusion of such income for insolvent companies; and (3) COD income is almost always excluded when a corpora-

1 The views, opinions, statements, analysis and information in this article are solely the authors' and do not necessarily reflect the views of their firms. This article (1) is not legal or tax advice or written advice subject to the requirement of § 10.37(a)(2) of Circular 230; (2) does not form the basis of an attorney/client or consultant/client relationship; and (3) should not be relied on without seeking specific legal or tax advice with respect to the particular facts, and state of the current law, with respect to any situation where legal or tax advice is required.

2 Pub. L. No. 117-169.

3 I.R.C. §§ 55(a) and (b)(2), and 38(a) and (c)(6)(E).

4 I.R.C. §§ 56A(d) and 59(k)(1)(B).

5 I.R.C. § 56A(c)(13). It is currently unclear whether book or tax is relevant for purposes of determining gain or loss on the disposition of depreciable property.

6 I.R.C. § 59(k). It is currently unclear to what extent the aggregation rule described in (1) applies in the case of a non-U.S.-parented group.

7 I.R.C. § 59(k)(1)(C).

tion is in bankruptcy. However, the exclusions result in a reduction to available tax attributes,[8] which involves a complex analysis and detailed modeling. For book purposes, however, COD income is generally included.[9] As a result, if the Treasury does not issue guidance that would reduce the AFSI to reflect the COD income that is excluded from taxable income, a debtor that is an applicable corporation could be subject to the BMT on the COD income, or if the debtor is not an applicable corporation, the COD income could cause the corporation to become one, thereby subjecting it to BMT forever. In addition, to the extent that the corporation reduced its tax basis in its depreciable property as part of the attribute reduction, it would have less depreciation deductions to use in calculating its AFSI, thereby causing the corporation to pay for the COD income twice.

For example, Company X, a domestic corporation with break-even financial results for 2020 and 2021, filed for bankruptcy in 2022. Under a court-approved reorganization plan, its debt of $6 billion was fully discharged in 2022 in exchange for stock in the emerging entity. Based on the statute, Company X's three-year AAAFSI is $2 billion ($6 billion total book net income for the three-year period divided by three), making it an applicable corporation in 2023, unless the restructuring falls under the change-in-ownership exception. Alternatively, if Company X was already an applicable corporation and the COD income occurred in 2023, its AFSI for purposes of calculating its potential BMT liability is $6 billion — probably resulting in a company-killing administrative tax liability.

This is not a merely hypothetical issue, and some of the authors have examined public and nonpublic information that indicates that these rules could have put certain companies into the BMT. This is a problem that obviously must be fixed; the book COD income excluded for tax purposes[10] must not be included as a current-year AFSI item. That said, exclusions from COD income are generally (but not always) timing adjustments, and the elimination of tax attributes will generally cause more income tax to be paid in the future. That result should, to the extent practicable, be mirrored in the context of AFSI: AFSI book attributes (*e.g.*, book NOLs and basis) should be reduced and taken into account in future-year AFSI calculations.[11] Of course, this introduces yet more complexity into an already unbelievably complex area, as fees abound!

Getting a "Fresh Start" and Preserving Tax-Free Transactions

Similar to COD income, there is currently no adjustment to the AFSI calculation to exclude the gain or loss reported on financial statements associated with tax-free reorganizations, which would also include the fresh-start accounting.[12] Therefore, any gain from a distressed company's tax-free exchange of substantially all its assets, along with the fresh-start-accounting adjustments, could increase the AFSI and trigger the BMT rules, potentially turning a tax-free transaction into a taxable one.

Fresh start essentially requires that a company's book assets be reset to the then-current fair market value and applies in most restructurings, even where, from a tax perspective, there is no reset to fair market value (whether that is because the transaction is an equitization around the existing structure or a tax-free reorganization, such as a "G" reorganization[13]). Fresh-start accounting could create several distortions between AFSI and taxable income, some of which are taxpayer-favorable, some of which are not, and none of which are appropriate for determining a tax liability. Key implications include the following:

- Recognition of significant book income in the year of the restructuring (*e.g.*, an asset has been significantly depreciated for book purposes), which could inappropriately cause a corporation to become an applicable corporation or result in BMT;
- Recognition of book losses in the year of restructuring (*e.g.*, an asset with a built-in loss) that could inappropriately cause a corporation to not become an applicable corporation, reduce the amount of its BMT or generate a book NOL; and
- In both cases, the step-up or step-down in basis in depreciable property, which only occurs for book purposes, will not be factored into the company's AFSI in future years, as only tax depreciation is relevant.

The Treasury should address these disconnects, as well as similar disconnects that apply because of purchase accounting that applies in both taxable and tax-free mergers and acquisitions in healthy company contexts. For example, if fresh-start adjustments are excluded from AFSI, the emerged company should calculate its book-basis-recovery deductions on nondepreciable property (*i.e.*, amortization and depletion) based on the basis that the company had in its assets before the application of fresh start for AFSI purposes only. In addition, because of the different treatment of certain bankruptcy expenses, any associated nondeductible expenses should also be excluded from the calculation of AFSI. However, if the government chooses not to adjust AFSI for tax-free reorganizations,[14] guidance would still be needed on whether book or tax basis should be used for determining AFSI gain on the disposition of depreciable property.

Disconnects in Taxable Transactions

Restructuring lawyers know this common refrain: "We need to determine whether to do this transaction as a restruc-

8 I.R.C. § 108(a)(1)(A) and (B). While the bankruptcy exception applies to all COD income generated by a debt discharge that occurs in a title 11 case, the insolvency exception is limited to the extent the taxpayer is insolvent for tax purposes. I.R.C. § 108(a)(3).

9 A.S.C. 470-60-35.

10 For example, if the tax exclusion for an insolvent corporation is 40 percent of its tax COD income, AFSI should be reduced by 40 percent of its book COD income.

11 For this purpose, the amount of book attribute reduction should be reduced by the amount of the reduction of depreciable property tax basis so that a company is not paying for the exclusion twice (once with reduced book NOLs or other attributes and another time with reduced depreciation deductions).

12 A.S.C. 852-10-45-19 through 45-25 (Fresh Start Reporting).

13 Described in § 368(a)(1)(G) of the Internal Revenue Code of 1986, as amended, a G reorganization occurs when a debtor corporation transfers all or part of its assets to a new corporation in a title 11 case and the stock or securities of the new corporation are distributed to the former stock and securityholders.

14 Similar to COD income, under this scenario a troubled company may have to "pay" twice as a result of a tax-free reorganization to the extent the corporation recognized fresh-start income associated with its depreciable property, but it will determine its depreciation deductions based on tax basis in calculating its AFSI.

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turing in place or as a taxable transaction." This is often a time-consuming modeling exercise. Unfortunately, the BMT will only make things more complicated, because book income recognized in a transaction could be greater than the taxable income that a company would recognize in a taxable transaction. For example, tax NOLs may exceed book NOLs, tax basis may exceed book basis, and there may be items that are triggered in the year of restructuring for tax but not for book purposes. Any of these items could cause an otherwise-attractive taxable transaction — such as selling assets under § 363 of the Bankruptcy Code and using the funds to pay creditors or transferring the business to creditors in exchange for their debt in a taxable restructuring, commonly referred to as "Bruno's transaction" — to become an unattractive option due to the BMT.

In addition, it is unclear whether the new company would be a successor entity for BMT purposes such that it inherits the BMT history of the original company. This could cause the anticipated tax profile of the new company to be less favorable than otherwise anticipated. A taxable transaction is typically consummated because the go-forward tax profile of the new company is expected to be superior to a restructuring in place, which is normally attributable to the anticipated go-forward tax depreciation and amortization profile. However, the transaction and the amortization could be dramatically different, and less beneficial, for book purposes, which could deprive the debtor of some anticipated benefits. Unfortunately, because the BMT provision does not provide grandfathering rules, these issues — which require guidance — may influence ongoing restructuring determinations and affect the tax profile of recently restructured companies that made decisions based on the laws in place at the time.

The Ask

Congress provided the Treasury with broad regulatory authority to determine necessary adjustments to financial statement income to carry out the purposes of the corporate BMT, including reflecting the principles that guide corporate liquidations, organizations and reorganizations.[15] Guidance to address distressed companies' concerns include the following:

- A corporation that undergoes a tax-free debt-for-equity restructuring and satisfies a specified ownership change test is excluded under the BMT rules;
- In determining AFSI, proportionately eliminate the COD income that is included for book purposes based on the percentage of COD income that is excluded for tax purposes, combined with a book attribute reduction regime;
- In determining AFSI, exclude any book adjustments, including those for fresh-start accounting, associated with tax-free transactions;
- Use tax basis of depreciable property for all purposes, including determining the book gain or loss on the sale of the property; and
- Address other transaction-related issues (*e.g.*, providing grandfathering rules and clarifying successor entity rules).

Lastly, the Treasury should elaborate on when an applicable corporation ceases to be considered one.

Conclusion

Financially distressed companies undergoing debt-restructuring or emerging from bankruptcy could suffer undue consequences under the BMT rules, including an immediate cash tax liability. Despite the uncertainty and much-needed guidance, debtors may want to consider planning opportunities now, because 2022 financial results (still under preparation, despite the fact that we are now in 2023) could affect whether a corporation will be subject to the BMT next year. For example, impairments or other book adjustments that can be made this year could generate book NOLs that could be crucial in either determining applicable corporation status or mitigating future minimum tax liability, especially when book tax differences produce unfavorable results upon restructuring. Further, management and its tax advisers may want to reassess debt-restructuring tax-planning, because the specific approach and timing of certain transactions could influence BMT in future tax years. abi

15 I.R.C. § 56A(c)(15).