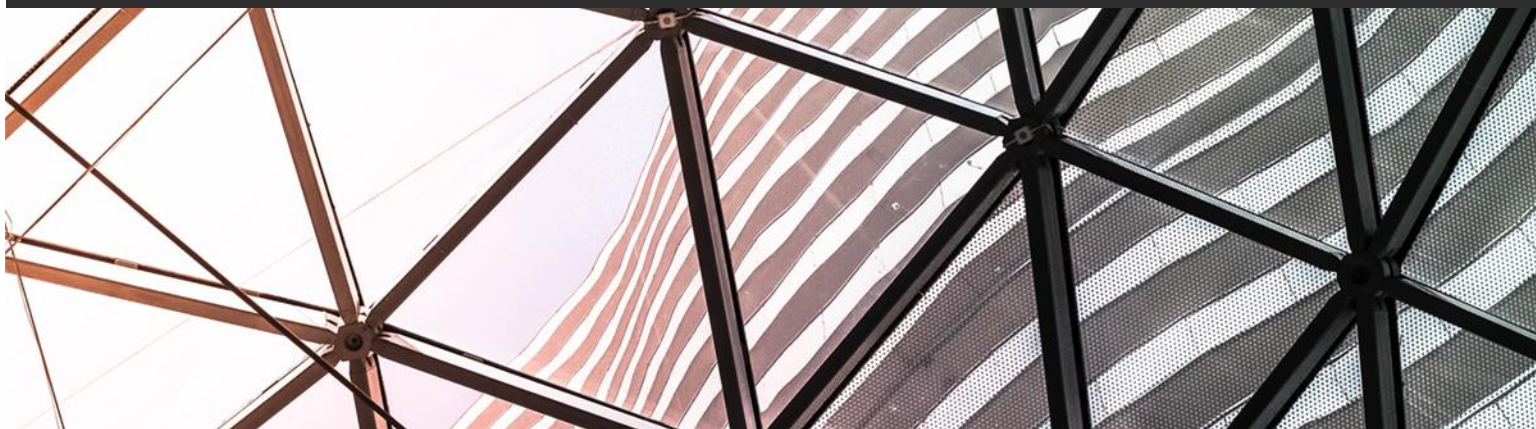


## **Alert** | Restructuring & Bankruptcy



June 2018

### **Tax Relief Under Tax Cuts & Jobs Act? Not for Debtors.**

In December 2017, Congress passed and President Trump signed the Tax Cuts and Job Act of 2017 (TCJA). Effective as of Jan. 1, 2018, the TCJA is a wide-ranging change to the Internal Revenue Code of 1986 (the Tax Code) affecting individual, corporate, and international taxation.

Lost amongst the many commentaries are two changes that have a negative impact on business debtors under the Bankruptcy Code: (1) reduction of the corporate tax rates and (2) elimination of the ability to carry back net operating losses.

First, the reduction in corporate tax rates from 35 percent to 21 percent reduces the value of a corporation's net operating loss (NOL), which is listed on a debtor's balance sheet as a deferred tax asset. Before the TCJA, this deferred tax asset would be valued at 35 percent of the amount of the NOL (based on the then-corporate tax rate), but now must be valued at 21 percent (the new corporate tax rate). So, for a debtor that had a \$100,000,000 NOL in 2017, that would equate to a deferred tax asset valued at \$35,000,000. After the TCJA, that same asset – a \$100,000,000 NOL – is now worth only \$21,000,000. Thus, the TCJA rate change has decreased the value of NOLs by 14 percent. In a chapter 11 case, this difference could affect the solvency of the estate and the ability of a chapter 11 debtor to satisfy the feasibility requirements to confirm a chapter 11 plan under Section 1129 of the Bankruptcy Code and emerge from bankruptcy.

Secondly, TCJA amended Section 172 of the Tax Code to prohibit carrybacks of NOLs (with exceptions for farming business and non-life insurance companies). The NOLs can now only be carried forward (indefinitely) and applied against 80 percent of taxable income.

The problem is that although farmers and non-life insurance companies may need an NOL carryback to generate a tax refund, one can argue that few entities need the quick refund provided by an NOL carryback more than an insolvent entity in bankruptcy. While the exception for farmers and non-life insurance companies would suggest that those industry groups had some influence over this provision of the TCJA, any input on this issue from the insolvency community appears to have been overlooked or disregarded.

Truly insolvent chapter 11 bankruptcy estates frequently are able to survive and start anew only with the funds supplied by federal and state/local tax refunds claimed by carrying back NOLs and applying for prompt refunds generated by application of those NOLs to their prior tax years. Similarly, in a corporate chapter 7 case, a tax refund resulting from an NOL carryback may determine whether there are even funds available for distribution to creditors. The failure to include insolvent corporate debtors within the exception provided for farmers and non-life insurance companies is an area that arguably should be addressed in any technical corrections bill. The exception allowing for carryback of NOLs can be expanded to include insolvent corporate debtors (both in chapter 7 and chapter 11). Solvent companies that choose to seek bankruptcy protection for other reasons may not need to seek expedited refunds; but those companies whose very existence may depend upon a rapid infusion of cash provided by an NOL carryback may benefit from the same consideration afforded to farmers and casualty insurers.

The conversion of the NOL into a cash refund does not change a debtor's balance sheet, insofar as one asset – an illiquid deferred tax asset – is reduced dollar-for-dollar by every dollar realized from application of the carryback. As the dollars are then used to satisfy liabilities, the cash asset is reduced by the same amount that the liability is reduced by – the cash payment. There is no accounting magic here, just the conversion of a long-term (and illiquid) deferred tax asset to the receipt of an immediate (and liquid) asset – cash; in a word, a source of liquidity that after TCJA does not exist.

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