

Debt restructurings and bankruptcy: Accounting, tax and FAS 109 considerations



Current market conditions have precipitated efforts by companies, across industries and markets, to reduce or restructure their debt obligations. Lenders also are experiencing difficulties, which creates pressure on the ability to negotiate debt covenant waivers or modify obligations. In the most troubled circumstances companies may plan for a bankruptcy filing.

The transactions and events occurring in these settings can have significant and sometimes unique financial reporting consequences. At the same time, efforts by the U.S. government to provide economic stimulus and foster liquidity include a number of federal tax law changes and proposals affecting these types of transactions.

This paper provides an overview of these transactions and events from both a financial reporting and income tax perspective.

Debt restructurings

Companies often consider a variety of potential transactions with creditors or security holders to either deleverage or otherwise enhance liquidity. The transactions may involve cash settlement, an issuance of equity for debt, an exchange of debt or modification of debt terms. Most transactions occur outside of bankruptcy, either through negotiation, open market transactions or tender offer.

From both an accounting and income tax perspective, a significant variable is whether the restructuring creates income (or loss) at the time of the transaction.

Key accounting principles

Extinguishing debt generally results in an accounting gain (or loss). A debt extinguishment may result from a payment or exchange of assets, an issuance of stock or from a contemporaneous exchange of debt instruments that have "substantially different terms" (as defined in EITF Issue No. 96-19 *Debtor's Accounting for a Modification or Exchange of Debt Instruments*). Depending on the circumstances, an extinguishment of debt may be full or partial.

In the case of an exchange of debt instruments, the debtor must first determine whether certain criteria are met for the exchange to be considered a "troubled debt restructuring." If those criteria are met, then an extinguishment gain generally is recognized but only to the extent that the gross cash flows of the new debt instrument are less than the carrying amount of the old debt instrument. Otherwise, the "gain" is carried over as part of the principal balance of the new debt instrument.

If an exchange of instruments is not a troubled debt restructuring, the old debt instrument may still be considered extinguished if the old and new debt instruments have substantially different terms. Otherwise, the exchange is considered a modification of debt the effects of which generally are reported prospectively. Under modification accounting, a new effective interest rate is determined based on the carrying amount of the original debt and the revised cash flows. Interest expense is recognized using the new effective interest rate.

Convertible debt instruments are also considered extinguished when the debt instrument is converted into shares of the company's stock. Upon conversion, the issuer will generally reclassify the carrying value of the convertible debt instrument to equity with no gain or loss recorded. However, if the issuer of a convertible debt instrument induces conversion by temporarily offering additional securities or other consideration (i.e., a "sweetener"), the issuer may need to expense the cost of the sweetener in accordance with FASB Statement No. 84, *Induced Conversions of Convertible Debt, an amendment of APB Opinion No. 26*.

Induced conversion accounting differs from extinguishment accounting, and can result in an expense when one might expect a gain. For example, assume a debt instrument with a carrying amount of \$100 allows the issuer to satisfy the entire obligation by issuing ten shares of common stock, per its original terms. Assume the issuer offers an inducement of five additional shares to convert the debt into equity for a limited period of time. If the market value of the shares is \$6, the issuer would expense \$30 (5 additional shares x \$6), even though the company settled the debt for \$90 (15 shares x \$6) which is less than the \$100 carrying value.

Tax considerations

For U.S. tax purposes, settlement of debt at a discount (whether for cash, other assets or issuance of stock or debt) normally creates debt cancellation income. The treatment of debt modifications or exchanges depends upon whether the debt is publicly traded and the significance of the modifications. Exchanges or significant modifications of publicly traded debt instruments usually create income for the difference between the fair value and the tax basis of the debt. Generally, a sweetener provided to induce conversion of debt to equity would reduce debt cancellation income but would not be deductible to the extent it results in a retirement premium. In most cases, modifications or exchanges involving private debt obligations do not result in a taxable income (or loss), but prospectively adjust interest deductions.

The American Recovery and Reinvestment Act of 2009 ("the 2009 Act") allows a debtor that is neither insolvent (as defined in the tax law) nor in bankruptcy to defer recognizing debt cancellation income for the years 2009 and 2010. The debtor may elect to defer the income for four or five years depending on the year of the restructuring and then recognize it ratably over the following five year period, subject to certain criteria.

A taxable modification or exchange of debt typically results in an original issue discount (OID) on the modified or new debt. OID is amortized over the remaining term of the debt. If the remaining term exceeds five years, the applicable high yield discount obligation (AHYDO) rules can cause a portion of the deductions to be permanently disallowed. Transactions that create both taxable income and OID which is permanently disallowed can cause an increase in taxable income without equivalent offsetting future deductions. The 2009 Act, however, suspended the AHYDO rules related to certain OID deductions for a limited time. Under the Act, the rules do not apply to debt that is issued between September 1, 2008 and December 31, 2009 in exchange for pre-existing debt as long as the interest deductions on the pre-existing debt were not already limited under the AHYDO rules.

If a debtor is either insolvent or in bankruptcy, debt cancellation income is eligible for deferral and in some circumstances eliminated. For insolvent debtors the deferral or elimination of income is available to the extent of insolvency (excess of liabilities over the fair value of assets prior to the transaction). If the income exceeds the calculated amount of insolvency, it is currently taxable to the debtor. For debtors in bankruptcy, there is no limitation on the amount of income eligible for deferral or elimination. Generally, the deferral of income requires a respective reduction of the debtor's tax basis in assets and/or other tax attributes such as loss or credit carryforwards. Elimination of income occurs to the extent the income exceeds the available basis and attributes.

For example, assume a company that is not a member of a consolidated tax return group has debt cancellation income of \$120 but only \$90 of tax basis in assets and other attributes. The following table compares the deferral and elimination of the debt cancellation income by a company that is insolvent (by \$10) with one that is in bankruptcy.

	Insolvent	In bankruptcy
Debt cancellation income	\$120	\$120
Debt cancellation income excluded from gross income	(10)	(120)
Debt cancellation income included in gross income	110	-
Reduction in basis in assets and other tax attributes	(10)	(90)
Permanent elimination of debt cancellation income	n/a	30

The basis and/or attribute reduction is subject to specific ordering rules and can include the basis of stock of a subsidiary. If the basis in the stock of a subsidiary is reduced and the debtor and subsidiary are members of a U.S. consolidated tax return group, then the subsidiary must respectively reduce the basis of its assets and/or other tax attributes. Special rules can also require a reduction in the tax attributes of other members of a consolidated return group.

Income tax accounting

If the accounting and tax treatments of a transaction diverge there can be temporary differences resulting in deferred tax impacts under FASB Statement No. 109, *Accounting for Income Taxes* (FAS 109). Typically, temporary differences result from a post-restructuring difference between the liability's book carrying amount and the tax basis. Transactions resulting in a permanent tax benefit or permanent loss of benefits would impact the effective tax rate either when the transaction is consummated, in subsequent periods or both.

In addition to deferred tax impacts for temporary differences in the basis of the liability, deferred taxes generally will be recorded for the effects of a tax deferral that causes a reduction in the tax basis of assets. Similarly, a reduction of tax attributes would result in a write-off of any related deferred tax assets. If a valuation allowance exists against the assets, it would be released, thereby offsetting the income and balance sheet effects.

If debt cancellation income is deferred by decreasing the tax basis of the debtor's investment in the stock of a

subsidiary, the income tax accounting effects may vary depending on whether the debtor and the subsidiary file a U.S. consolidated tax return. If the subsidiary is not a member of the consolidated tax return group, there would be no respective reduction in the tax basis of the subsidiary's assets and/or other tax attributes. In addition, a deferred tax liability typically is not recorded on the basis difference for an investment in a domestic subsidiary because there is often a way of recovering the investment in a tax-free manner (e.g., a tax-free merger or liquidation).

The deferred tax impact of a change in the tax basis of an investment in a foreign subsidiary depends on whether the parent is making an Accounting Principles Board Opinion No. 23 *Accounting for Income Taxes—Special Areas* (APB 23) assertion. That is, whether the parent expects the basis difference to remain indefinitely and therefore is not recording a deferred tax liability on the investment. In that circumstance the change in tax basis will not impact deferred taxes. If an APB 23 assertion is not being made, the change in tax basis generally would result in a deferred tax impact.

Income tax accounting for changes in ownership—tax attribute limitation

Additional consequences can arise from debt restructurings that are accompanied by changes in the debtor's stock ownership, whether through an issuance of stock to a creditor or related equity transactions. Certain changes in ownership can cause an annual limitation on the future use of a company's unrealized loss and tax attribute carryforwards. The limitation can restrict the timing of tax attribute utilization, and possibly cause tax attributes to eventually expire unused.

The impacts of a change of ownership on a company's tax attributes may be lessened by special tax rules available for companies in bankruptcy. Recent legislative changes and proposals, for example, with respect to Troubled Asset Relief Program (TARP) or other governmental funding program participants, also may lessen the impact of attribute limitation for certain taxpayers.

An annual limitation on utilizing tax attributes may trigger the need for a valuation allowance against deferred tax assets. Assessing whether and how much of a valuation allowance is needed may require detailed scheduling of the reversal pattern of existing temporary differences. In cases where the limitation mathematically will preclude the use of a portion of the tax attribute, it generally is appropriate

to derecognize the gross deferred tax asset as opposed to recording a valuation allowance since it will never provide a tax deduction or benefit.

Under the guidance in EITF Issue No. 94-10 *Accounting by a Company for the Income Tax Effects of Transactions among or with Its Shareholders under FASB Statement No. 109*, the impact of a tax attribute limitation generally is reported in earnings, rather than in equity, even though it arises as a result of a transaction among or with shareholders. The impact is considered a change in expectations with respect to the realization of deferred tax assets.

Bankruptcy

The financial statements for periods before a company enters bankruptcy likely will differ from those during the bankruptcy period and post-emergence. Accounting during the bankruptcy period, upon emergence from bankruptcy and in related respects thereafter primarily is based on the guidance of AICPA Statement of Position 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code*. That guidance applies both to public and private companies.

If the company that files for Chapter 11 bankruptcy is a subsidiary of a company that is not in bankruptcy, the subsidiary typically is deconsolidated for financial reporting purposes. Deconsolidation occurs because the parent no longer controls the subsidiary. The company that emerges from bankruptcy typically is a new reporting entity. Therefore, financial statements are presented for the "predecessor" company during the bankruptcy period and for the "successor" company from the emergence date onward. The predecessor and successor financial statements are labeled as such and are usually separated by a vertical "black line."

Bankruptcy period accounting

The needs of financial statement users change when a company is in bankruptcy. An objective of financial statements issued by an entity in Chapter 11 is to reflect its financial evolution during the proceeding. For that purpose, the financial statements should distinguish transactions and events that are directly associated with the reorganization from the ongoing operations of the business.

The balance sheet for companies in Chapter 11 distinguishes pre-petition liabilities subject to compromise (i.e., may be settled at a lesser amount), those that are not subject to compromise (e.g., fully secured claims not

expected to be compromised), and post-petition liabilities. Pre-petition liabilities and claims generally are reported at the full dollar amount of the claim, not at a "cents on the dollar" amount, even though the company might not expect to pay the full amount of the claim. Interest, on the other hand, should only be accrued to the extent it will be paid during the proceeding or it is probable that it will be an allowed claim.

The income statement separately portrays the results of ongoing operations from the activities related to reorganizing and restructuring the business. Gains or losses resulting from adjustments to the carrying amounts of pre-petition liabilities, the effects of restructuring or extinguishing debt, adjustments resulting from "fresh start" accounting, and other costs related directly to the bankruptcy proceedings are classified separately as reorganization items. Fresh start accounting adjustments generally are reported in the final statements for the bankruptcy period (i.e., in the predecessor financial statements).

In a typical bankruptcy proceeding, the equity-based compensation awards are cancelled by the courts and not accompanied by the concurrent grant of a replacement award. Under FASB Statement No. 123(R) *Share-Based Payment*, the awards are accounted for as a repurchase of the awards for zero consideration. Accordingly, the predecessor company records any remaining unrecognized compensation expense related to the cancelled awards.

Fresh start accounting

Not all companies that emerge from bankruptcy qualify for fresh start accounting. Certain requirements must be met. A company would apply fresh start accounting when the reorganization value of the emerging entity immediately before the confirmation date is less than the total of all allowed claims and post-petition liabilities and the existing common shareholders do not retain a greater than 50% interest in the reorganized company. The loss of control by the existing shareholders must be substantive and not temporary. That is, the new controlling interest must not revert to the shareholders existing immediately before the plan was filed or confirmed. Fresh start accounting provides the company with just that—a fresh start with no beginning retained earnings or deficit.

A key element in applying fresh start accounting is the reorganization value, which is a highly judgmental and often complex determination that is made in the bankruptcy confirmation process. Reorganization value generally

approximates fair value of the entity before considering liabilities and approximates the amount a willing buyer would pay for the assets of the entity immediately after the restructuring. The reorganization value and the terms of the plan are determined after extensive arm's-length negotiations or litigation between the interested parties and should include tax considerations. The reorganization value typically should give effect, for example, to limitations on the use of tax attributes resulting from the bankruptcy process.

Fresh start accounting is largely based on acquisition accounting set forth in FASB Statement No. 141(R), *Business Combinations*. However, since the reorganization value of the entity is essentially a fixed amount based on the value of the entity's assets, the offset to a liability or contingency recorded in fresh start accounting is to equity. Reorganization value in excess of the fair value of the entity's identifiable assets is recorded as goodwill.

Fair value measurements of particular assets and liabilities should reflect tax impacts on cash flows that may be the basis of the valuation approach employed. This would include tax amortization or depreciation benefits, as well as other tax consequences that would be expected from the viewpoint of a neutral "market participant". Whether the particular owner is a tax paying entity or has other tax attributes is disregarded. The tax impacts used in measuring the fair value of the assets and liabilities, however, should reflect the tax laws of the jurisdiction(s) that apply to the assets and liabilities. Thus, if no tax benefits are possible (in any circumstance), the discounted cash flows or income-based valuation should not reflect tax benefits.

Tax considerations

When a company files for bankruptcy, creditors typically seek an injunction preventing the shareholders and creditors from engaging in sales of stock or creditor claims and other actions that would limit the use of losses or tax attribute carryforwards. By preserving those potential tax benefits during the bankruptcy period, the debtor may avail itself of favorable special rules for utilizing such benefits in the transactions resulting from the approved bankruptcy plan and thereafter.

If the parent of a U.S. consolidated tax return group files for bankruptcy, the filing in itself does not cause the group to terminate; the debtor continues filing a consolidated return with its includible subsidiaries. Similarly, if a subsidiary in a consolidated tax return group files for bankruptcy, it nonetheless remains a member of the group.

An emergence from bankruptcy in itself generally has no specific impact on a company's tax basis in assets and liabilities. However, the emergence typically will involve transactions that have tax consequences (e.g., debt cancellation and/or ownership changes that may limit the use of tax attributes). In addition, bankruptcy costs (i.e., costs for administering the bankruptcy) may be permanently nondeductible.

Income tax accounting

There are a number of differences between financial reporting and tax reporting during the bankruptcy period that may give rise to deferred taxes. For example, there may be adjustments to the carrying amount of assets and liabilities during the bankruptcy period. For financial reporting, the company may cease accruing interest on debt but the interest might continue to be tax deductible. Additionally, the effective tax rate generally will be impacted by bankruptcy costs that are nondeductible. If separate financial statements are required for a subsidiary in bankruptcy, then income taxes will need to be allocated to the subsidiary in a manner consistent with the broad principles of FAS 109.

Even before entering bankruptcy, companies facing financial difficulties might find that they are no longer able to sustain an APB 23 assertion. That assertion is generally based upon the company's ability and intent to indefinitely reinvest the earnings of a foreign subsidiary. If a company is having liquidity issues, it may be difficult to support such an assertion. Once the company files for bankruptcy, and control of the company is moved from management to the bankruptcy court, it may be difficult to continue such an assertion.

If nonqualified stock options are cancelled, the company will generally record a deferred tax asset for the additional book compensation recognized, which may be accompanied by an increase in valuation allowance. The company will then account for the resulting "shortfall" from cancelling the awards. A shortfall results because the tax deduction (zero) is less than the book compensation expense. The deferred tax asset write-offs (net of any valuation allowance) are first charged to equity to the extent of the company's "windfall pool" and then to the income statement.

If fresh start accounting is applied, deferred taxes are recorded for the difference between the fair value and the tax bases of the assets and liabilities. Income tax assets and liabilities are not recorded at fair value. In the unusual circumstance that tax-deductible goodwill exceeds reorganization value (i.e., book goodwill), a deferred tax asset is recorded for the difference. However, if book goodwill exceeds tax-deductible goodwill, no deferred tax liability is recorded.

A valuation allowance is recorded against deferred tax assets if it is more likely than not that the tax benefits will not be realized. In determining whether a valuation allowance should be recognized, past results of the company should not be ignored. However, the analysis should focus on the post-reorganization outlook of the company. Similarly, FASB Interpretation No. 48, *Accounting for Uncertainty in Income Taxes* (FIN 48) applies to income tax uncertainties and any necessary FIN 48 liabilities are recorded in fresh start accounting.

A subsequent release of a valuation allowance established in fresh start accounting is recorded in earnings (subject to FAS 109 "intra-period allocation" principles) rather than as an adjustment to goodwill. Likewise, subsequent FIN 48 adjustments adjust tax expense rather than goodwill. The effective tax rate may, as a result, be more volatile in periods following an emergence from bankruptcy.

In conclusion

Debt restructurings and bankruptcy present unique financial reporting and income tax considerations. Effective management of these issues is best accomplished through close coordination among those responsible for financial reporting and income taxes. The issues are multi-disciplinary, often necessitating additional coordination with attorneys, and appraisal and valuation experts. Companies that are considering a debt restructuring or the possibility of a bankruptcy should be sure to include all appropriate subject matter experts on their project teams.

Contacts

The paper is intended not just to inform but to raise questions. Clients of PricewaterhouseCoopers may want to open a dialogue with their PwC engagement partner or the primary authors of this paper who welcome any questions or comments:

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