

Distressed S Corporations: Tax Issues Involved in Restructuring

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The recent economic downturn, coupled with the tightening of the credit market, is affecting all types of businesses, including S corporations. A financially distressed S corporation may have to work with its creditors to restructure debt or satisfy indebtedness in various creative ways in order to ease its financial difficulties. These transactions may include subordinating shareholder debt to a third-party loan, issuing stock to creditors, or soliciting additional capital contributions. This article highlights tax issues and planning opportunities that may arise relative to a distressed S corporation, its shareholders, and its creditors.

Cancellation of Debt

The general rule of income tax law is that if a taxpayer is relieved of or forgiven indebtedness, it will give rise to ordinary taxable income.¹ However, Sec. 108 lays out exceptions to this rule, such as cases in which the taxpayer is bankrupt under title 11, is insolvent,² or has qualified real estate indebtedness. The trade-off for this exclusion from income recognition is that certain taxpayer tax attributes such as net operating losses (NOLs), general

business credits (GBCs), minimum tax credits (MTCs), or capital losses (C/Ls) must be reduced. Alternatively, the taxpayer may elect to reduce basis in depreciable assets. Note that the creditor is allowed a tax deduction for the loss even though the debtor may not recognize income.

Reorganizations

Another tax provision that often comes into play in debt restructuring is the E reorganization under Sec. 368(a)(1)(E). This rule allows an entity and its creditors and shareholders to restructure the liabilities and equity section of the balance sheet. Some common applications of an E reorganization are converting debt to equity to avoid violating loan covenants or moving shareholder debt from senior to junior status to raise cash. These transactions may be done without triggering recognized gain.

Another application of the E reorganization is to take advantage of a bad situation. For example, if a C corporation's asset values are close to their adjusted basis, the taxpayer might make an S election with minimal Sec. 1374 built-in

gain exposure. If an S election is made, a recapitalization might be necessary to eliminate preferred stock or class B common stock, because an S corporation is allowed only one class of stock. Neither the shareholder nor the corporation will incur a recognized gain. An E reorganization (recapitalization) is preferable to redeeming the prohibited stock, where shareholder gain recognition would likely be triggered.

Assuming a good business purpose, converting brother-sister S corporations into a parent-QSub group may increase basis for loss and allow the profitable company's profits to offset the loss company's losses. This may be effected by a D reorganization under Sec. 368(a)(1)(D). Note that the gain rules of Sec. 357(c) are turned off for an acquisitive D reorganization. Generally, one would want the profitable company to be the parent and the loss company (if solvent) to be the QSub because it will provide better asset and liability protection.

A G reorganization under Sec. 368(a)(1)(G) may also be used to allow a bankrupt debtor S corporation to transfer its assets in satisfaction of its liabilities. The

Authors' note: The authors wish to thank Laura Howell-Smith and Laura Berard, members of the Distressed S Corporation Task Force, for their contributions to this article.

1 Sec. 61 and Regs. Sec. 1.61-12.

2 Insolvency is the condition of the entity immediately before the forgiveness where liabilities exceed the fair market value of the assets (Sec. 108(d)(3)). Note: It is tested at the S corporation entity level.

S corporation may cease to exist as a separate entity if all of its assets are utilized, or the S corporation may continue as a separate entity if only some of its assets are transferred.

Debt Restructuring

One of the initial tactics an S corporation may undertake to ease financial distress is to modify and restructure the terms of its debt. When attempting to modify the terms of debt, however, the distressed S corporation and its shareholders need to be mindful of the significant modification of debt rules of Regs. Sec. 1.1001-3, which may require the recognition of income.

Modification of loan terms may include reducing the interest rate, deferring interest payment, extending the maturity date, modifying conversion privileges, or reducing the principal amount of the debt. As a general rule, any significant modification will be material unless the Service or the regulations have specifically exempted the modification as immaterial. For example, a change in yield of more than one-quarter of 1% would be a significant modification;³ extending the maturity date beyond the lesser of five years or 50% of the original loan term is also a significant modification.⁴ The substitution of a new obligor on a recourse debt will be a significant modification, but not on a nonrecourse debt.⁵

However, changes in the debt instrument embedded in the agreement would not be a modification. If stock is issued in exchange for third-party debt, care must also be taken to avoid creating a second class of stock. Also, if a deep-pocket shareholder takes on recourse liability for a formerly nonrecourse debt or pays the guarantee that all the shareholders were potentially liable for, the possibility of a disguised gift must be considered, especially if related parties are involved in the transaction.

Second Class of Stock Issues

To induce creditors to lend it money, a distressed S corporation may issue stock warrants or stock rights. In some situations this may lead to the unintentional creation of a second class of stock, prohibited under Sec. 1361(b)(1)(D), which would terminate the S election. In order to maintain one class of stock, all outstanding shares of S corporation stock must confer identical rights to distribution and liquidation proceeds, and the corporation must not have issued any instrument or obligation, or entered into any arrangement, that is treated as a second class of stock. Issuance of preferred stock by a community bank to acquire federal funds,⁶ issuance of new stock in exchange for debt to existing shareholders or creditors, and shareholder debt that does not meet the straight debt safe-harbor requirements of Sec. 1361(c)(5) are all situations that could lead to the creation of a second class of stock or result in disqualified shareholders.

Change in Ownership

If the troubled S corporation accepts additional funds in exchange for company stock, it may engender a change of ownership as defined in Sec. 382(g). If the S corporation had previously been a C corporation and has recognized built-in gain for the current year, the rules of Secs. 382 and 383 may limit the utilization of entity-level tax attributes such as NOLs, C/Ls, GBCs, or MTCs from offsetting the net recognized built-in gain or its tax liability as normally allowed by Secs. 1374(b)(2) and (3).

Caution: The IRS has never issued guidance providing that Sec. 382 applies to S corporations, and some practitioners do not agree that it does apply.

If Secs. 382 and 383 apply due to a change in ownership, some of the following issues and planning ideas should be considered:

- Make sure to continue the entity's historic business or use its historic assets for the next two years or else Sec. 382(c) will cause the Sec. 382 limitation to be zero;
- If one contributes assets to the company, be aware that Secs. 382(l)(1) and (4) may limit the benefits under Sec. 382.

As to Sec. 1374 exposure when converting from C to S status, some of the following issues and planning ideas should be considered:

- Limit entity-level taxable income;
- Defer current gain recognition through a Sec. 1031 like-kind exchange beyond the 10-year recognition period; or
- Lease rather than sell a built-in gain asset.⁷

Other Considerations

The tax adviser and the taxpayer should consider and comply with the rules of Sec. 1366(d) to make the best of a bad situation and allow the shareholder to benefit from losses generated at the S level. A taxpayer may do this by structuring the addition of funds as back-to-back loans⁸ as opposed to guarantees of S corporation debt or co-borrowing, neither of which will generate basis for loss.

Shareholders borrowing from a third party and then lending to the distressed S corporation will generally produce shareholder debt basis, assuming the form and substance of the transaction are complied with. When the third-party lender is related, the IRS may question the transaction, although some courts have held such lending to still produce debt basis.⁹ Substituting shareholder debt (subrogation) for corporate debt to a third-party lender has been held to be a valid way to increase basis for loss under Sec. 1366(d).¹⁰

Obviously, a capital contribution will increase basis for loss. If the distressed S corporation was formerly a C corporation and still has accumulated earnings and

3 Regs. Sec. 1.1001-3(e)(2)(ii)(A).

4 Regs. Sec. 1.1001-3(e)(3)(ii).

5 Regs. Sec. 1.1001-3(e)(4).

6 Note that in January 2009, Treasury promulgated a rule allowing S corporation banks to issue debt for federal Troubled Asset Relief Program funds to avoid violation of the second class of stock criteria (Treasury Dep't, "TARP Capital Purchase Program (Subchapter S Corporations) Senior Securities: Summary of Terms" (January 14, 2009), www.treas.gov/initiatives/eesa/docs/scorp-term-sheet.pdf).

7 Caution: Watch out for the passive income tax application to rental income, especially in a triple net lease arrangement (i.e., where the lessee pays for taxes, insurance, and property maintenance in addition to rent).

8 See *Ruckriegel*, T.C. Memo. 2006-78; *Miller*, T.C. Memo. 2006-125; Rev. Rul. 75-144.

9 See, e.g., *Culnen*, T.C. Memo. 2000-139; *Yates*, T.C. Memo. 2001-280.

10 *Gilday*, T.C. Memo. 1982-242; Rev. Rul. 75-144.

profits, a leapfrog election¹¹ may be made along with a deemed dividend election¹² to increase the basis for loss at presumably a 35% tax deduction for the cost of a 15% qualified dividend tax liability. Note that all shareholders for the tax year must approve these elections, and a statement affirming that should be attached to the Form 1120S, U.S. Income Tax Return for an S Corporation.

Another potential way to help a distressed S corporation would be to attract foreign investors. Often these investors want stock ownership, which is prohibited under Sec. 1361(b)(1)(C). Forming a partnership owned by both parties, with the S corporation contributing operating assets and the foreign persons contributing cash, has been approved by the government.¹³

Note that if the S corporation is forced or voluntarily goes into bankruptcy, under Sec. 1361(c)(3) a bankruptcy estate is a permissible shareholder and by itself will not end the S corporation's status.

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EditorNotes

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¹¹ See Sec. 1368(e)(3).

¹² See Regs. Sec. 1.1368-1(f)(3).

¹³ See Rev. Rul. 94-34, 1994-2 C.B. 198, revoking Rev. Rul. 77-220, 1977-1 C.B. 263.