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Restructuring? Beware of the Book Minimum Tax Regulations

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The corporate landscape is riddled with uncertainties: fluctuating interest rates, unpredictable tariffs, tax reform and the application of the "book minimum tax" (BMT). In effect since 2023, this tax could blindside companies with an unexpected bill, significantly impacting restructuring plans.

The Treasury's recently released proposed regulations for the BMT[1] addressed certain concerns raised and adopted some recommended suggestions in a previous article.[2] However, there are still many potential pitfalls. This article will arm the restructuring community with updated insights on how the BMT could affect emergence structuring and valuation analysis, helping you navigate these changes more effectively.

Triggering BMT Liability

The previous article[3] explored the BMT, which was designed to ensure that "applicable corporations" pay their fair share of taxes. To briefly recap, the BMT requires these corporations to pay the higher of their regular tax liability or 15 percent of their adjusted financial statement income (AFSI), minus certain credits. This tax primarily targets corporations with significant book profits but low taxable income, which in part is due to various "book-tax" differences, including timing. Basic BMT concepts include:

- *Applicable Corporation Criteria:* A corporation is an applicable corporation if its three-year average annual AFSI exceeds $1 billion, or if it is part of a non-U.S.-parented group meeting specific thresholds. Once designated, a corporation remains subject to the BMT rules indefinitely unless certain conditions are met.
- *AFSI:* The calculation of AFSI involves several adjustments to book income reported on an applicable financial statement (AFS), including the incorporation of a book net operating loss (FSNOL) concept and the replacement of book depreciation with tax deductions for depreciable property.
- *AFS:* The proposed regulations provide a priority of financial statements: (1) GAAP statements that are audited and certified, such as those filed with the Securities and Exchange Commission or used for significant non-tax purposes; (2) IFRS statements that meet similar criteria as the GAAP statements; (3) financial statements prepared according to other generally accepted accounting standards; (4) financial statements filed with a government or agency or a self-regulatory organization; and (5) if a corporation does not have any of the above financial statements, then the federal income tax or information return filed with the Internal Revenue Service.

The COD Income Conundrum Continues

Unfortunately for tax and tax-averse restructuring practitioners, complexities regarding cancellation of indebtedness (COD) income continue as part of overall restructurings and because of the BMT. COD income generally occurs when a lender forgives or cancels a portion of indebtedness. The first question practitioners need to address is whether an item is "indebtedness." While this might seem straightforward, what is considered indebtedness for financial statement purposes, such as convertible

1 89 *Fed. Reg.* 75062 (Sept. 13, 2024); 89 *Fed. Reg.* 104909 (Dec. 23, 2024).
2 Kevin M. Jacobs, Anthony V. Sexton & Andrey Ulyanenko, "Companies' Debt-Restructuring Plans Could Trigger Minimum Tax," XLII *ABI Journal* 1, 54-55, 95-96, January 2023, abi.org/abi-journal/companies%E2%80%99-debt-restructuring-plans-could-trigger-minimum-tax.
3 *Id.*

debt, might be equity for federal income tax (FIT) purposes. Further, the rules governing when COD income is recognized and how it is calculated for financial statements could be different from those governing FIT.

FIT rules provide exclusions for COD income for insolvency and bankruptcy,[4] which require a reduction in available tax attributes such as net operating losses (NOLs), certain tax credits and tax basis of assets. These exclusions are not included in the financial statement rules. In this regard, the proposed regulations provide an AFSI exclusion, which is not provided in the statute. Financial statement COD income is excluded if the debt[5] is forgiven in bankruptcy, either by a court or pursuant to a bankruptcy plan, or if the corporation is insolvent for FIT purposes.

While this exclusion is a welcome provision, it presents a potential pitfall. Companies may need to adjust the carrying value of their liabilities for financial statement purposes upon the occurrence of certain events, including, in some situations, the filing of a bankruptcy petition. As such, the resulting COD income would not qualify for the bankruptcy exclusion, so it would need to qualify for the insolvency exclusion to avoid being subject to the BMT. However, the insolvency exclusion is limited to the extent of FIT insolvency, which might be different than financial statement insolvency. This difference might be due to a multitude of factors, including the amount of debt for both purposes and the use of fair value for financial statement purposes vs. fair market value for FIT purposes. As a result, the insolvency exclusion might be less than it would have been if it were calculated based on financial statement insolvency and could be insufficient to shield all of the COD income.

Similar to FIT rules, if an exclusion applies for BMT purposes, then the corporation needs to reduce its BMT attributes (*e.g.*, basis in property, FSNOLs and BMT foreign credits). However, the order for attribute reduction differs, and without a tracking mechanism in the proposed regulations to address timing differences in recognizing COD income, traps for the wary emerge.

For example, Company X has financial statement COD income of $100x in Year 1 and FIT COD income of $100x in Year 2, both associated with Loan D. At the end of Year 1, Company X has a FSNOL of $500x. To determine whether Company X's AFSI includes the $100x of financial statement COD income, it must assess its insolvency in Year 1 using FIT principles. If Company X is insolvent, its AFSI will not include the $100x of COD income, but it will need to reduce its BMT attributes (*e.g.*, its FSNOL). If it remains insolvent in Year 2, Company X will need to reduce its FIT attributes. If it reduces the basis in its depreciable property, this reduction will impact its AFSI calculations on an ongoing basis, as AFSI uses FIT depreciation instead of financial statement depreciation. Therefore, the same $100x COD income would impact Company X's BMT calculation twice (once with a reduction of its FSNOL and another time with decreased depreciation deductions).[6]

The proposed regulations provide for another exclusion that, if applicable, does not require a reduction of BMT attributes, similar to the FIT exclusion: COD income to the extent that the payment of the liability would have given rise to a direct reduction in AFSI. However, unlike the FIT rules, the proposed regulations do not provide any special rules to address typical troubled company transactions, including debt-for-debt or debt-for-equity exchanges and debt contributed to capital.

Ongoing Tax Challenged in Bankruptcy

For companies entering bankruptcy, taxes are always a concern due to their priority[7] and administrative claim[8] status. This is illustrated by the fact that a tax motion is generally included as part of "first-day motions." Unfortunately, the BMT has the potential to wreak havoc, as it could have adverse consequences throughout the pendency of the bankruptcy.

When a company files for bankruptcy, it might need to adjust the carrying value of its liabilities on its books, which could result in COD income. In addition, if not all members of the consolidated financial group file for bankruptcy, the bankruptcy filing might cause a financial statement deconsolidation, which could cause a corporation to recognize financial statement income that might be included in AFSI, even if the company that files for bankruptcy subsequently rejoins the consolidated financial statement group.[9]

Furthermore, the BMT continues to apply during the pendency of the bankruptcy. The corporation must determine what constitutes its AFS. Corporations sometimes transition from the financial statements that they ordinarily used to preparing monthly operating reports (MORs). However, MORs are generally not prepared in accordance with any generally accepted accounting standard, GAAP or otherwise, and there is uncertainty about whether the bankruptcy court constitutes the "Federal Government" or how to address situations in which portions of the year are covered by different priority statements (*e.g.*, the year of entering or emerging from bankruptcy). As such, many believe that in those instances, one should rely on a corporation's tax return as its AFS, which could result in havoc due to book-tax timing differences.

For example, a corporation may recognize an impairment loss associated with a distressed subsidiary for financial statement purposes[10] in a year in which it has to rely on its tax return as its AFS, then subsequently recognize the loss with respect to its consolidated subsidiary for income tax purposes[11] in a year in which its AFS reverts to a traditional financial statement. Fortunately, the proposed regulations provide that if a corporation changes to a different-priority AFS, it generally takes into account differences in the asso-

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

5 There is some uncertainty as to whether the COD exclusion applies to all financial statement indebtedness or only indebtedness that is such for both financial statement and FIT purposes.

6 This double detriment is resolved if/when Company X sells the depreciable asset. However, when that occurs, if ever, is uncertain.

7 11 U.S.C. § 507(a)(8).

8 11 U.S.C. § 503(b)(1)(B).

9 As a result, careful planning should be made on which of the eligible entities join in the filing of the bankruptcy petition.

10 *See* A.S.C. 360-10-35.

11 Treas. Reg. §§ 1.1502-80(c), 1.1502-19(c)(iii).

ciated retained earnings over a four-year period. However, in addition to questions about how this adjustment is calculated,[12] there are timing concerns because the adjustment is over a four-year period, even if it is favorable, which could cause a corporation to have a BMT cash tax liability, only to have a subsequent FSNOL in a later year that cannot be carried back to generate a refund.

Another concern is that a corporation not previously subject to the BMT might become liable for it, or a corporation already subject to the BMT might face additional liabilities. For example, a § 363 sale[13] of some of a corporation's assets to satisfy its debt might give rise to sufficient AFSI to cause the corporation to either become an applicable corporation or have a cash tax liability as a result of the BMT.[14]

Finally, exiting bankruptcy poses additional challenges. Although most corporations that emerge from bankruptcy generally experience a significant reduction in their assets, an applicable corporation does not generally automatically shed such status.[15] The proposed regulations instead permit any corporation to shed its applicable corporation status once it has not satisfied the applicable corporation criteria described herein for three consecutive tax years. In addition, the proposed regulations exclude from AFSI any gain or loss that is solely a result of the entity's emergence from bankruptcy, including from fresh-start accounting.[16] While this exclusion is generally favorable, it comes at a significant cost: All corresponding basis adjustments are ignored for BMT purposes.

As a result, notwithstanding that the BMT is supposedly based on an AFS and the proposed regulations provide for a priority listing of financial statements, a company that emerges from bankruptcy will need to create a faux financial statement that backs out the effects of all the basis adjustments. Many corporations might consider incurring the additional cost of maintaining a separate set of BMT books for administrative simplicity, although many companies — particularly those emerging from bankruptcy — are looking to shed costs and often have significantly smaller administrative staff to perform such tasks.

An Additional Limitation to Worry About

Even the most tax-averse restructuring practitioners are aware that there is the potential Internal Revenue Code § 382 limitation on a troubled company's tax attributes upon a change of control.[17] The proposed regulations implement a new system modeled after the separate return limitation year (SRLY) rules, which are infrequently applied in real life because they only apply when there is no § 382 ownership change. The proposed system introduces a more-granular SRLY approach, operating on a business (but not entity) level, and applies in various circumstances, including when a corporation is acquired in an asset (as opposed to stock) reorganization, when it was a member but not the parent of a consolidated group before its acquisition, or when it joins a new tax consolidated group.

> **It is prudent for companies and their tax advisers to carefully assess the potential tax implications ... of liability-management transactions and bankruptcy restructurings.**

If applicable, the proposed regime limits the ability to use FSNOLs, as well as certain built-in losses, on a business-level basis. This will require corporations to separately track their activities on a business-level basis, irrespective of how the AFS tracks the corporation's activities. Practitioners need to be aware that this could lead to significant administrative burdens and potential mismatches between tax and financial reporting.

Conclusion

The proposed regulations attempt to address troubled company situations in a manner that is generally more advantageous than the statute. To that end, troubled companies are given the option to rely on only certain aspects of the proposed regulations, including the COD income exclusions. However, significant gaps remain, which, when coupled with some of the proposed rules, create potential traps for the unwary.

It would be helpful if the Treasury provided further relief, even before finalizing the regulations. It is prudent for companies and their tax advisers to carefully assess the potential tax implications (both regular tax and BMT) of liability-management transactions and bankruptcy restructurings. It is possible that the BMT could significantly impact a company's liquidity planning. abi

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12 An example of such a question is that the adjustment is based on a comparison of "retained earnings," and it is unclear how to make such an adjustment when the AFS (which is generally viewed as merely an income statement) does not contain retained earnings or when the AFS is a tax return.

13 11 U.S.C. § 363.

14 Similar to post-2017 regular tax NOLs, FSNOLs are only allowed to offset 80 percent of a corporation's AFSI. Companies could also only start accruing FSNOLs beginning with their taxable year ending after Dec. 31, 2019. As a result, the magnitude of regular tax NOLs and FSNOLs could vary drastically, which could give rise to a cash tax BMT liability.

15 If a subsidiary of a consolidated FIT group emerges as separate from its parent, the subsidiary can shed its applicable corporation status and is retested to determine whether it becomes an applicable corporation.

16 A.S.C. 852-10-45-19 through 45-25 (Fresh Start Reporting). Fresh-start reporting essentially requires that a company's assets be reset to fair value and applies in most restructurings, even where, from a tax perspective, there is no reset to fair market value.

17 As part of a bankruptcy emergence, practitioners frequently discuss whether the emergence transaction can qualify under I.R.C. § 382(l)(5), which, if applied, would not subject the corporation's tax attributes to a change-of-control limitation, but would subject them to a strict subsequent emergence ownership change limitation.