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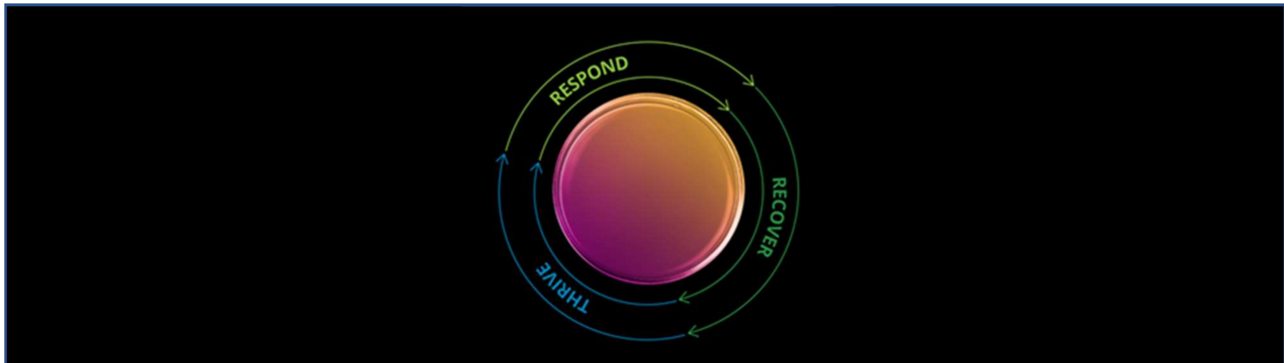
Transaction & Integration Services

Structuring Alternatives to Unlock Value

Uncovering Potential Opportunities in Response to COVID-19



The political, social, and regulatory global responses to COVID-19 have created unprecedented operational challenges for businesses across all industries. Companies have scrambled to ensure the people, processes, and technologies currently in place align to address new issues created by this current economic climate. Tax departments must also re-prioritize their agendas to provide value to the organization as pivotal business decisions are evolving daily.

Significant tax law changes have also been enacted to help taxpayers navigate the challenges of the pandemic. The Coronavirus Aid, Relief, and Economic Security ("CARES") Act modifies certain provisions of the 2017 Tax Cuts & Jobs Act ("TCJA") and creates new mechanisms to assist the cash position of businesses in response to COVID-19. Under these modifications, net operating losses ("NOLs") generated in 2018, 2019, and 2020 can now be carried back five years and eliminate up to 100% of the taxable income (excluding any mandatory repatriation income). Carrybacks to tax years prior to 2018 also benefit from refunds at a higher corporate tax rate of 35%, when compared to the current 21% rate[1].

Although many companies are currently analyzing tax accounting periods and methods considerations to better utilize tax NOLs for this 5-year carryback opportunity, there are a number of structuring alternatives that organizations may consider in order to enhance and potentially accelerate the tax benefits being offered under the CARES Act.

Worthless Stock Deductions – Monetizing Business Losses

Current economic conditions will likely increase pressure on many companies and business lines. As a result of the increasing economic pressures, companies may find that it is no longer viable to operate an acquired business segment or subsidiary. However, certain conditions may allow the company to realize a valuable tax benefit on this lost investment that could translate into current cash.

[1] Please note that the US House of Representatives has proposed legislation that would limit the carryback of NOLs to years after the enactment of the TCJA, which may limit the opportunity to recover losses at the higher 35% tax rate. While this does not represent enacted law, companies should continue to monitor legislative developments.

Many large companies acquire and operate separate business lines within separate corporate subsidiaries. In situations where the stock of a corporate subsidiary becomes "worthless", the parent corporation may benefit from a tax deduction resulting from the subsidiary's liquidation or other disposition. Worthlessness can be evidenced by a number of factors, including insolvency of the entity, bankruptcy, operational shutdown or disposition of business assets, or other indicators demonstrating that the company has no current or future value. Under these circumstances, the parent corporation can take a loss attributable to this "worthless" stock. This loss may be ordinary in nature, provided certain ownership requirements and gross receipts tests are satisfied. In situations where it may not be possible to liquidate the worthless subsidiary due to regulatory or other considerations, the loss can also be triggered through an entity conversion to a limited liability company or a tax election to change the tax characterization of an entity.

Common Fact Pattern

A common fact pattern involves a corporate subsidiary (or subsidiary group) that was acquired by a corporate parent in a taxable stock acquisition sometime in the past. Under these circumstances, the enhanced value or goodwill associated with the acquisition is translated into a high cost-basis in the acquired subsidiary's stock. If the entity becomes insolvent due to increasing operational leverage (intercompany or third party), or other circumstances occur establishing that the assets of the acquired subsidiary have no net positive value, the facts may provide the parent corporation with a taxable loss on the subsidiary investment. This opportunity may exist in both domestic consolidated subsidiaries and foreign subsidiaries owned by U.S. parent corporations.

Timing Considerations

The worthless stock deduction must be taken in the year that the stock becomes worthless and not in an earlier (or later) year. Establishing the timing of the deduction can be crucial, particularly if the corporate subsidiary has a long ownership history. Often, acquired subsidiaries will decline over time, and a subsidiary may be deemed as worthless in an earlier year, even though the opportunity to monetize the deduction is discovered in the current year. In some circumstances, establishing worthlessness in an earlier year is advantageous — for example, to better utilize a 2018 or 2019 loss under the 5-year carryback. In other situations, however, the IRS may argue that the worthless event occurred in an earlier year that is barred under statute of limitations.

An extended 7-year statute may apply to alleviate some concerns, but taxpayers should carefully document the year of worthlessness to substantiate the deduction. Under tax regulations, a worthless stock loss generally cannot be claimed prior to a liquidation or disposition event for a U.S. consolidated subsidiary, but the same guidance does not apply to non-U.S. subsidiaries or non-consolidated U.S. subsidiaries. Varying fact patterns may provide both opportunities and challenges on the timing of worthless events.

Bankruptcies and Non-Corporate Owners

Worthless stock losses can also be claimed with respect to minority stock ownership and on stock held by non-corporate shareholders; however, this loss is generally capital (rather than ordinary) in nature. A common example is stock of a portfolio company owned by a private equity fund ("PEI") or other group of non-corporate investors. If the stock is established as worthless, the fund may benefit from a capital loss that flows through to the fund investors to be utilized currently or potentially carried back. In the current downturn, this fact pattern may manifest through a Chapter 11 bankruptcy proceeding of a PEI's portfolio company, and bankruptcies provide unique issues with regard to timing and establishment of worthlessness in a bankruptcy proceeding.

For example, the market may see a significant increase in bankruptcy filings during Q3 and Q4 of 2020 as companies continue in decline, but these bankruptcy proceedings may not be completed until sometime in 2021. Under this fact pattern, when is the company considered "worthless"? Can the common shareholders claim a worthless stock in 2019, and before the bankruptcy liquidation in order to enhance potential opportunities to utilize the capital loss? Timing considerations become more complex for a series of events that span more than one tax year and establishing worthlessness in a year prior to completion of the bankruptcy proceeding requires a careful analysis of the facts.

Bad Debt Deductions

It is likely that the market will see a decline in credit ratings, and the outstanding debt of distressed companies may become impaired. Under these circumstances, it may be possible for taxpayers to claim an ordinary loss from the worthlessness of a debt that is business-related.

Establishing a Bad Debt

The worthlessness of a debt is a question of fact. The debt must first be established as a bona fide debt that arises from a debtor-creditor relationship based upon a valid and enforceable obligation. Establishing the debt can be easier when the obligation is evidenced by a formal note or enforceable instrument but may require a more complex analysis if documentation is not formalized, or the debtor and creditor are related parties.

Worthlessness of the debt may result from specific identifiable events, and all pertinent evidence should be considered, including the value of any collateral and the financial condition of the debtor. Generally, the creditor should establish that any enforceable action to collect on the debt would be useless.

Partial Worthlessness

A business bad debt can be either partially or totally worthless. Before the taxpayer can deduct a partially worthless business debt, it must be able to show that partial worthlessness has occurred, as well as, the amount of partial worthlessness that has been charged off on the books of the business. The taxpayer may choose among certain options concerning how to handle the debt for tax purposes. Once the amount of the debt that can treated as worthless is established, the taxpayer can use the NOL provisions discussed in the previous sections to carryback any resulting losses.

Distinction for Registered Securities

The classification of a debt as a "registered security" under tax guidance can require a complex analysis for some instruments. Although worthless business bad debts generally result in ordinary deductions, the creditor taxpayer must generally claim a capital loss (rather than an ordinary deduction) if the debt instrument is a registered security of an unaffiliated entity. As another limiting factor, it is not possible to claim a partially worthless bad debt from impairment of a registered security. The taxpayer must instead establish that the debt is completely worthless with no hope of recovery in order to claim a worthless securities deduction.

Abandoned Transaction Costs

In the current economic climate, certain synergies and efficiencies that may have driven an M&A deal prior to the pandemic may no longer be obtainable. As a result, some businesses may choose to cancel transactions that were expected to close in 2020 or beyond.

Costs that are facilitative of a capital transaction, including acquisitions or dispositions of a trade or business, mergers, spin-offs, initial public offerings (IPOs) and other similar transaction related costs are generally required to be capitalized. In a case where the transaction is "abandoned", the taxpayer may be allowed a deduction for these costs in the tax year that the abandonment is established.

Establishing Abandonment

Loss treatment for transaction costs is only appropriate in cases where the transaction is conclusively abandoned. Establishing abandonment is a facts and circumstances-based analysis. The IRS will typically look to the identifiable events of a taxpayer to demonstrate affirmative action to fully and completely abandon the proposed transaction. A mere delay or postponement of a transaction is not enough to establish abandonment.

Since maintaining appropriate documentation and understanding the factors considered by the IRS when determining abandonment are key to successfully claiming a loss on abandoned transaction costs, taxpayers should consult with a competent advisor on whether the actions taken with respect to an abandoned transaction support the loss.

Other Considerations under the CARES Act

In addition to the potential opportunities regarding NOLs discussed above, a tax department should consider other CARES Act provisions which may provide additional planning considerations, including favorable modifications applicable for 2019 and 2020 to the TCJA interest deduction limitation, employee retention credits, payroll tax deferral, technical corrections to TCJA regarding Qualified Income Property, and the acceleration of corporate AMT credit refunds. These changes provide businesses with potential opportunities to improve their current cash position.

Furthermore, companies can identify various other planning considerations to provide current liquidity, including review of equity and deferred compensation plans, credits and incentives initiatives, and effective tax rate arbitrage as supply chains are disrupted.

Workforce Disruption

As governments move to contain the spread of the virus, companies must work to address how to manage their employees while continuing business operations as seamlessly as possible. Business operating models should incorporate an expectation that at least a partially mobile workforce will continue in the near to mid-term. Domestic and international considerations to address while maintaining a more mobile workforce include payroll and withholding tax considerations, additional social security and income tax exposures, credits and incentives reviews, and risks of permanent establishment.

Tax and Technology Operating Model

Current social distancing models and office closures have created a dynamic change to the operating model for many businesses. Many organizations must adapt and develop a revised operating model that continues to capture operational synergies and streamlines the structure of an organization and its tax department. Revised operating models can impact many areas of a business, including global supply chain and other business process changes that will require updates to existing tax operations. In addition, it is important for an organization to address the challenges associated with workforce reduction and operational considerations due to lowered headcount. A review of the existing business and tax processes can identify potential opportunities and provide a streamlined end-state that eliminates inefficiencies, takes into account tax benefits and/or attributes, and re-aligns tax processes and resources with the company's go-forward strategy.

Streamlined Entity Structure

The current environment offers businesses the incentive to revisit synergy opportunities and strategically position themselves to "power up" as the economy moves forward. Many companies will need to strategize on how to reduce current SG&A costs and become leaner as they look to the future. Many companies may benefit by reviewing current operating structures to identify candidates for legal entity rationalization in order to reduce redundant or duplicative entities in various regions or establish value chain alignment.

Final Thoughts

Recent events have been unprecedented in both severity and the speed at which the resulting economic downturn has impacted taxpayers. In many cases, economic survival requires companies to quickly respond to this impact, develop a plan of recovery, and position the business to thrive as the market improves. The CARES Act provides tools to help companies prevail in the current environment, and a focus towards monetizing distressed investments can help companies enhance the effectiveness of these tools. Now may also be the right time for some companies to focus on operational realignment and streamlined entity structure to better position for the future. Our approach and extensive experience can assist tax departments in executing on the critical tax tasks that deliver value as companies reposition for the future.

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