PUBLICATION

# Spotlight on Tennessee: Department of Revenue Issues Guidance for Financially Troubled Companies

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Very recently, the Tennessee Department of Revenue (TDR) published Letter Ruling #11-44 addressing many issues surrounding income or gain that may arise from the discharge of indebtedness (DOI), as well as the ancillary effects such a discharge or cancellation may have on other tax attributes.

## Discharge of Indebtedness Income

Generally, the Internal Revenue Code (IRC) includes in income an amount equal to any debt owed by a taxpayer that is in any way discharged or cancelled. However, there are exceptions to this general rule of inclusion in income that typically apply to financially troubled taxpayers. Such exceptions may allow for the exclusion of DOI from income to the extent that a taxpayer is insolvent, or if the amounts were discharged in bankruptcy. Although the DOI income may initially escape taxation, the IRC does also require that several tax attributes of the taxpayer, such as net operating losses (NOLs), be reduced. The IRC also allows a taxpayer to elect to take a reduction in the basis of depreciable property by the amount of excluded DOI income, though such a reduction may also be required after all other tax attributes have been exhausted. These reductions represent an attempt by Congress to eliminate a double tax benefit.

Although Tennessee's franchise and excise tax law generally conforms to the IRC, there have apparently been questions as to whether or not such conformity extends to situations involving DOI.

## Letter Ruling #11-44

This Letter Ruling first addresses whether Tennessee excludes debt discharged in bankruptcy from net earnings for purposes of the Tennessee excise tax. For purposes of the Tennessee excise tax, "net earnings" is generally federal taxable income with some specific statutory exceptions. According to the ruling, an amount otherwise excludable from income under the IRC due its discharge in bankruptcy should not be included in net earnings. The ruling concludes that state law does not require that the discharged amount otherwise be added back to income as determined for federal tax purposes.

The ruling next addresses whether a taxpayer must reduce an NOL for the year in which a DOI via a bankruptcy proceeding occurred. The IRC requires that when reducing NOLs for DOI income that is excluded from taxable income, a taxpayer should first reduce a NOL for the current year and only after that loss is exhausted should they begin reducing the NOL for prior years. However, for purposes of the Tennessee excise tax, the ruling states that DOI income is not included in net earnings (as discussed above), and the Tennessee NOL is defined independently from the IRC as the excess of deductions over net earnings. Thus, according to the ruling, DOI income simply cannot, in absence of specific provision such as that in the IRC, reduce the current year NOL. The ruling also states that no reduction is required to be made for the amount of prior year NOLs.

As discussed above, a taxpayer may elect for federal income tax purposes to reduce the basis in certain assets by the amount of DOI income excluded instead of reducing certain tax attributes, though the basis in these assets may also be reduced should all other tax attributes be exhausted or nonexistent. In addressing the basis reduction, the ruling simply states that since no specific state law requires a reduction in the basis of depreciable assets for excludable DOI income, none is required. This reasoning is consistent with the TDR's position on reductions to NOLs discussed in the previous paragraph.

Finally, the ruling addresses the limitation on the use of NOLs under Section 382 of the IRC. Section 382 is designed to prevent the trafficking of tax attributes such as NOLs, and therefore imposes limitations on the use of such losses when more than 50 percent of a taxpayer's stock has changed ownership within a three year period. The ruling states that the Tennessee excise tax law contains no limitation on the use of NOLs upon a mere change in stock ownership when the entity that generated the losses remains in existence as a separate entity.

**Conclusion**

It is important to note that Letter Ruling #11-44, like most such rulings, is binding only on the taxpayer that requested it and cannot be relied upon as official guidance. Nevertheless, it is useful to corporations and other limited liability taxpayers as an indication of the TDR's likely positions on a number of important issues involving DOI. To further discuss the potential effects that this ruling, or the TDR's possible positions on similar issues, please feel free to contact any of the attorneys within the Firm's Tax Department.