LOWENSTEIN SANDLER PC CLIENT ALERT

BANKRUPTCY, FINANCIAL REORGANIZATION & CREDITORS' RIGHTS DEPARTMENT

POTENTIAL BENEFIT TO UNSECURED CREDITORS FROM THE WORKER, HOMEOWNERSHIP, AND BUSINESS ASSISTANCE ACT OF 2009

By John L. Berger, Esq., Sharon L. Levine, Esq. and Cassandra M. Porter, Esq.

December 28, 2009

There is something for everyone in the suitably named Worker, Homeownership, and Business Assistance Act of 2009–including potential recoveries for unsecured creditors of a debtor reorganizing or liquidating pursuant to the United States Bankruptcy Code.

Background

Two significant laws were enacted in 2009 that impact how taxpayers utilize net operating losses for federal income tax purposes. A net operating loss ("NOL") arises when a company's deductible expenses exceed its gross income in any given tax year. The first law is the American Recovery and Reinvestment Act of 2009, which extended the time an eligible small business (defined generally as a business with average gross receipts of $15 million or less) could elect to carry back net operating losses. The second is the Worker, Homeownership, and Business Assistance Act of 2009, which provided a similar NOL carry back election to businesses of every size.

Application

Prior to enactment of the new laws, an NOL could only be carried back two years (an NOL could also be carried forward 20 years). Under the new laws, at the taxpayer's election an NOL incurred in a tax year beginning or ending in 2008 or 2009 may be carried back three, four or five years (the 20-year carry forward period remains intact, as does the two-year carry back period if no election is made). This means a taxpayer now may be eligible to collect a tax refund for years that previously were off limit.

> Example: Assume a taxpayer had taxable income of $20 million in 2005, $40 million in 2006, broke even in 2007 and 2008, and lost $80 million in 2009. Under prior law, the $80 million NOL would not have generated a tax refund, since it only could have been carried back two years (to 2007 and 2008), years in which no tax was paid (the $80 million NOL could have been carried forward to offset income from future years). Under the new laws, the 2009 NOL can be carried back to 2005 and 2006, thus generating a refund of the tax paid in those years.

The potential value for taxpayers under the new laws is significant. The Joint Committee on Taxation ("JCT") estimates that the new carry back provisions will benefit businesses by nearly $34 billion in 2010 alone. Also, a taxpayer who elects to carry back an NOL to a prior profitable year may be able to obtain a "quick refund," speeding the recovery of its tax refund. To offset lost revenue, the new laws increased certain penalties for not filing tax returns on time.

Potential Benefit to Creditors

For creditors of a reorganizing or liquidating company, the new laws have the potential to generate cash to pay claims that previously was not available. Under the new law, a debtor that previously was not eligible to receive a tax refund now may be eligible to collect several years' worth of refunds. In the example above, literally tens of millions of dollars may be recovered from the IRS. The potential increase in a debtor's available cash will significantly assist reorganizing debtors with paying their debts going forward, and thereby avoid potential conversion to a case under Chapter 7 (liquidation) under the Bankruptcy Code. Alternatively, a debtor already participating in Chapter 11 with a plan of liquidation will have more funds available to pay its debts through the plan. Moreover, the speed in processing refunds will significantly benefit debtors who are in a cash-crunch situation.

Because the extended carry back period under the new law requires a taxpayer election, there may be situations in which the interests of creditors and debtors diverge. For example, a reorganizing debtor may prefer not to carry back NOLs, thereby preserving them to offset future earnings. On the other hand, a creditor with no continuing interest in the reorganized debtor would greatly prefer that the debtor elect to carry back its NOLs, thereby securing additional funds to pay claims. Thus, it becomes critically important for creditors to negotiate whether the debtor will make the carry back election.

Caveats

There are some limitations to be aware of under the new laws. For example, a taxpayer generally may elect to carry back an NOL more than two years for losses incurred either in 2008 or in 2009, but not both years. Also, if a company elects to carry back an NOL five years, the NOL generally can only be used to offset 50% of the taxable income earned in that fifth preceding year; any unused NOL then would be carried forward to other years, beginning with the fourth preceding year. Also of note is that any refund exceeding $2 million automatically is reviewed by the JCT. The review potentially could slow down the taxpayer's receipt of its refund. In addition, certain companies that participated in the Troubled Asset Relief Program are prohibited from participating in the NOL carry back program. Finally, not every state and local government follows federal tax law. Therefore, before deciding whether to carry back NOLs under the new laws, a company should consider the impact of that decision on its state and local tax liability.

John L. Berger, is a Member of the Firm in Lowenstein Sandler's Business Tax Counseling & Structuring Group, Sharon L. Levine is a Member of the Firm in the Bankruptcy, Financial Reorganization & Creditors' Rights Department and Cassandra M. Porter is an Associate in the Bankruptcy, Financial Reorganization & Creditors' Rights Department. They may be reached by calling 973 597 2500 or via email at jberger@lowenstein.com, slevine@lowenstein.com and cporter@lowenstein.com.

www.lowenstein.com

New York
1251 Avenue of the Americas
New York, NY 10020
212 262 6700

Palo Alto
590 Forest Avenue
Palo Alto, CA 94301
650 433 5800

Roseland
65 Livingston Avenue
Roseland, NJ 07068
973 597 2500

Lowenstein Sandler
ATTORNEYS AT LAW