Stopping MCI's Attempted Tax Scam

Why the fraudulent phone company should not get a multi-billion-dollar tax cancellation

MCI, the notorious telecommunications company whose managers committed the nation's largest accounting fraud to date, is trying to milk the public even more, by creating an enormous tax loophole.[1] MCI's fraudulent activities have bankrupted the company and cost MCI's shareholders and creditors hundreds of billions of dollars. Now, MCI is trying to force America's taxpayers to pay the company billions of dollars more over the next several years.

Specifically, MCI wants to pervert the purpose of a federal tax law that lets companies coming out of bankruptcy temporarily postpone certain tax payments. MCI hopes to convert this limited tax benefit into a complete forgiveness of its postponed taxes.[2]

MCI's argument is inconsistent with the legislative history of the tax law, a recent related Supreme Court decision and good tax policy. Because the text of the statute is not entirely clear, however, legislation should be enacted to protect honest taxpayers by assuring that MCI's position is not sustained.

I. MCI's Attempted Tax Scam: A Brief Statement of the Issue

As part of its bankruptcy reorganization, MCI will be allowed to repudiate substantial debt, "upwards of $19 billion or more" according to one of its bankruptcy filings and as much as $27 billion based on another filing.[3] Under longstanding tax law, such debt forgiveness normally generates taxable income to the borrower. In MCI's case, that entails a potential tax liability of $6.7 billion to $9.5 billion. Section 108 of the Internal

---

[1]MCI was renamed WorldCom when it was acquired by its now discredited managers. As part of its bankruptcy reorganization, the company will be renamed MCI.

[2]MCI is no stranger to tax avoidance. From 1996 to 2000, for example, while it reported $16 billion in pretax U.S. profits to its shareholders, it paid only $0.3 billion in federal income taxes, a tax rate of only 1.9 percent. Showing substantial chutzpah, MCI is now separately arguing that in light of its financial restatements, it should get a refund of even those paltry tax payments.

[3]"Debtors' Disclosure Statement Pursuant to Section 1125 of the Bankruptcy Code," p.105; "Debtors' Joint Plan of Reorganization under Chapter 11 of the Bankruptcy Code," pp. D-2, D-5; *In re: WorldCom, Inc. et al.*, Chapter 11 Case No. 02-13533, U.S. Bankruptcy Court, Southern District of New York (2003).

Revenue Code (IRC), however, allows bankrupt corporations to postpone payment of the taxes they owe on debt cancellation to give them time to get back on their feet.

MCI is attempting to use financial sleight of hand to turn this temporary postponement of taxes into a complete exemption, thereby saving the company billions of dollars in taxes. There is little doubt that MCI's argument makes a mockery of the tax law, but the statutory language of IRC Sec. 108 is not completely dispositive. Thus, legislation is pending in the Senate and House to clarify section 108 and assure that MCI cannot pervert the purpose of the law at the expense of ordinary taxpayers. That legislation should be enacted.

II. Why Debt Forgiveness is a Taxable Event

The tax laws have long provided that when a debt is cancelled, the amount of the forgiven debt is generally taxable income to the borrower.[4] This rule is not only required by basic income tax theory.[5] It's also necessary if we are to have an income tax at all. For example:

- Employers could pay their workers with "loans" rather than wages, and then immediately forgive the loans. If debt forgiveness were not taxable, then wages would become tax-exempt.
- Customers could buy goods and services with "loans" rather than payments, and then forgive the debt. Without a tax on forgiven debt, sellers would never have any gross income and thus, no taxable profits.
- Companies paying dividends could "lend" their shareholders the money, and then forgive the debt. Without a tax on such debt forgiveness, all dividends would be tax-free.

In fact, it's hard to think of any kind of income—wages, sales, dividends, interest, capital gains, rents or whatever—that could not be easily converted into a loan. So without a usual tax on debt forgiveness, the income tax would collapse.

---

[4]IRC Sec. 61(a)(12). *See also United States* v. *Kirby Lumber Co.*, 284 U.S. 1 (1931).

[5]The basic tax policy principle is that borrowed money is excluded from taxable income only because it has to be paid back. But a borrower obviously enjoys an increase in wealth if he later pays back less than (or none of) the amount borrowed.

III. Bankruptcy Postpones Taxes; It Doesn't Cancel Them

There are a few exceptions to the usual rule that debt forgiveness generates taxable income. For example, if parents forgive a child's debt as a gift, rather than as a business transaction, no income is recognized by the child.

In the case of businesses that reorganize through a Chapter 11 bankruptcy, such as MCI, the exception is much more limited. To make it easier for companies to get a fresh start out of bankruptcy, companies emerging from bankruptcy do not recognize taxable income immediately on washed-out debt. Instead, they are taxed on the income from their cancelled debt gradually, by losing future deductions. Technically, this is accomplished by reducing the company's "net operating losses" (i.e., its accumulated tax losses carried forward from past years), the "basis" of its depreciable assets and other items that would otherwise generate future tax write-offs—"tax attributes" in the jargon of the tax code. IRC Sec. 108(b). However, if the amount of debt cancelled in bankruptcy exceeds the sum of all of those "tax attributes," then the excess is permanently tax-exempt.

The current rules for postponing tax on corporate debt forgiveness in bankruptcy were established by statute in 1980, in a bill designed to close inadvertent loopholes in prior law and bring the tax code into conformity with 1978 revisions to the bankruptcy laws. The purpose of section 108(b) is spelled out clearly in the Senate report on the 1980 bill: **"to effectuate the Congressional intent of deferring, but eventually collecting tax on, ordinary income realized from debt discharge."** [6]

As the 1980 Senate report explains in more detail:

> "The rules of the bill concerning income tax treatment of debt discharge in bankruptcy are intended to accommodate bankruptcy policy and tax policy. To preserve the debtor's 'fresh start' after bankruptcy, the bill provides that no income is recognized by reason of debt discharge in bankruptcy, so that a debtor coming out of bankruptcy . . . is not burdened with an immediate tax liability. The bill provides that the debt discharge

[6] Sen. Rpt. No. 96-1035; 96 Cong. 2d Sess. (Dec. 1980).

> amount thus excluded from income is applied to reduce the taxpayer's net operating losses and certain other tax attributes . . . . Accordingly, **the rules of the bill are intended to carry out the Congressional intent of deferring, but eventually collecting within a reasonable period, tax on ordinary income realized from debt discharge.**"

IV. MCI's Smoke & Mirrors Explained

MCI has numerous subsidiaries. Like other big companies, MCI files a "consolidated" income tax return reflecting the combined income and losses of all of these parts of the company. The postponement of recognizing income from debt cancellation in bankruptcy benefits the entire company, not any particular part. So by any normal logic or policy, the net operating losses, depreciable basis and so forth of the entire MCI company should be reduced by the amount of debt cancelled in bankruptcy.

But MCI is apparently taking the position that through financial sleight of hand, it is entitled to keep all of its future tax write-offs and permanently avoid tax on its entire $19-27 billion in potential cancellation-of-debt income. The key to MCI's argument is that nominally separate parts of the company should be treated as unrelated entities for purposes of section 108(b). Specifically, MCI argues:

- One part of MCI — finance — incurred the debt that is being cancelled, albeit on behalf of the entire company. This part of MCI has cancellation-of-debt income, but no "tax attributes."
- Another part of MCI — operations — holds the company's tax-loss carryforwards, depreciable property and so forth. This part of MCI has "tax attributes," but no cancellation-of-debt income.
- By treating these parts of the company separately, says MCI, its cancellation-of-debt income should be totally wiped out for tax purposes, rather than reducing MCI's future tax write-offs.

Needless to say, if MCI's position is sustained, then section 108(b) will be rendered meaningless. If a company's borrowing can be treated as unrelated to the operations it financed, then no tax would ever be collected on debt cancellation in bankruptcy.

V. Congress Must Clarify the Law

Although common sense, good tax policy and the purpose of section 108(b) make it clear that MCI's position should not be sustained, the language of section 108(b) does not specifically address the issue of whether debt-cancellation-income and tax attributes must be calculated on a consolidated, net basis.

Fortunately, a recent Supreme Court decision, *United Dominion Industries, Inc.* v. *United States*, 532 U.S. 822 (2001), tends to undermine MCI's position. That decision held that the concept of separate, rather than consolidated corporate loss carryforwards "simply does not exist" in the tax code. But while quite relevant, that case was dealing with loss carryforwards outside of the bankruptcy context, so it is arguably not completely on point.

Thus, to address this problem, bipartisan legislation is pending in both the House and Senate. This legislation would clarify section 108(b) to require that all tax attributes and debt cancellation be netted at the consolidated corporate level.[7] The bill should be quickly enacted to stop MCI's attempted raid on the U.S. Treasury.

---

[7] S. 1331 was introduced in the Senate on June 25, 2003 by Senators Rick Santorum (R-Pa.), Kent Conrad (D-ND) and John Breaux (D-La.), and is currently also co-sponsored by Senators Tom Daschle (D-SD), Orrin Hatch (R-Utah), Mark Pryor (D-Ark.), Jim Bunning R-Ky.), Arlen Spector (R-Pa.) and Michael Crapo (R-Idaho). An identical bill, H.R. 2706 was introduced in the House on July 10, 2003 by Representatives Jim McCrery (R-La.), Bob Matsui (D-Ca.) and Scott McInnis (R-Co.), and currently has 24 additional House co-sponsors. The bill reads:

> "(a) IN GENERAL— Section 108(b) of the Internal Revenue Code of 1986 (relating to reduction of tax attributes) is amended by adding at the end the following new paragraph:
>
> > " '(6) AFFILIATED GROUPS— If the taxpayer is a member of an affiliated group of corporations which files a consolidated return under section 1501, the tax attributes described in paragraph (1) shall be the aggregate tax attributes of such group. The Secretary shall prescribe such regulations as may be necessary under section 1502 to carry out the purposes of this paragraph.'."