Portfolio Media. Inc. | 111 West 19th Street, 5th Floor | New York, NY 10011 | www.law360.com
Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Tax Reform, Hollywood And The Media: Part 2

By **Michele Alexander and Ryan Davis** (April 17, 2018, 2:51 PM EDT)

This article is part two of a series in which Bracewell LLP attorneys Michele Alexander and Ryan Davis examine different aspects of tax reform's impact on the media industry.

Michele Alexander

Ryan Davis

As noted in our previous article, tax reform will impact the media industry in many ways, including those in the industry responsible for reporting on the widespread effects of these sweeping changes to existing tax law. In this installment, we will explore new limitations which will specifically impact media companies' restructuring, acquisition and disposition strategies.

The Tax Cuts and Jobs Act, P.L. 115-97, contains new limits on a corporation's ability to take advantage of its net operating losses, or NOLs, which may disproportionately harm traditional media companies operating as corporations. As a result of TCJA, corporations generally will be able to utilize NOL carryovers against only 80 percent of their taxable income in future years, and carrybacks are eliminated. Notably, this change affects losses arising in 2018, so NOL carryforwards from 2017 and earlier are not subject to the 80 percent limit — or carryback repeal — and this may accelerate business transactions that originally were contemplated to occur further down the road for media companies than 2018. While we already expect to see more mergers and acquisitions activity in this sector due to the 40 percent decrease in the corporate tax rate, target media companies with large NOLs may be considered less attractive due to the limited opportunity to use prior losses in future years. Of course, taxpayers already are subject to limits in their ability to traffic in losses by purchasing such "loss companies" — namely, Internal Revenue Code Section 382 limits the ability of a corporation, following an "ownership change" — a defined term, but one that includes most M&A activity — to use "pre-change" losses against "post-change" income. Because the limitation is the value of the corporation at the time of the change multiplied by a prescribed rate, there may be circumstances where it is not a material impediment — i.e., where the value of the enterprise is high. However, even there, and certainly where the Code Section 382 limit already is severe, this new NOL limit further devalues the tax benefit. As a result, 2018 may be a banner year for media acquisitions.

The new NOL limitation also may have a large impact on strategic decisions media companies must make on whether to restructure their debt. Generally, when debt is forgiven or reduced, borrowers are taxed on the amount of debt from which they are, or are deemed to be, relieved — their cancellation of indebtedness, or COD, income. A company looking to restructure its debt and facing the possibility of COD income could rely on: (1) large NOL carryovers to shield taxable COD income and (2) an exclusion of COD income from taxable income for a debtor who is in a bankruptcy case or insolvent — but, in the latter case, only to the extent the debtor's liabilities exceed its assets. Where the COD income is excluded, such exclusion is at the cost of reducing certain attributes of the debtor, notably NOLs and depreciable tax basis. The new NOL limitation is a new headache for a taxpayer that cannot exclude COD income — in whole or in part. If the taxpayer has noncash taxable income from cancellation of debt and insufficient current year losses to shield such income, it could have tax for the year of the restructuring as a result of no longer having a full NOL carryover — and no related cash with which to pay it.

Again, given that the 80 percent limit and carryback repeal applies to losses arising in taxable years beginning in 2018, more restructurings in 2018 may be expected. Of course, many restructurings will continue to result in excluded COD income. Though not specifically addressed in the new law, we would expect the entire NOL — not limited to 80 percent of current taxable income — to be available for reduction against such excluded COD income. Considering that insolvent media companies not in bankruptcy only can exclude COD income — and reduce their tax assets — to the extent of insolvency, following 2018 we may see more media workouts in bankruptcy to avoid the direct impact of the 80 percent limitation.

The new interest deduction limits also could be an issue for media companies. Under TCJA, interest on indebtedness generally may be deducted only up to an amount equal to the sum of business interest income and 30 percent of adjusted gross income — the interest deduction limit. The disallowed interest may be carried forward indefinitely to succeeding taxable years and also may impact media companies' restructuring decisions. As media companies do not typically function as lenders or invest in debt, the new limit effectively is 30 percent of adjusted gross income — and, beginning in 2021, without deduction for depreciation, amortization or depletion. As media companies do not usually depend on interest income, the new provisions may act as a 30 percent taxable income limit — with no interest income buffer. However, media companies incur debt and, whereas the new NOL limits may impact future restructurings, the interest deduction limit may alter the manner in which media companies borrow and restructure existing debt. Generally, there is no COD income recognized to the extent the payment of a liability would have given rise to a deduction. Under prior law, this meant that interest generally was not included as COD income if it was deductible. It may be this exception could be read to apply only to the extent that the interest is deductible in the year after the interest deduction limitation is applied. On the other hand, the indefinite carryover could be interpreted to mean that the interest will be deductible at some point — assuming no other limits apply — thus any unpaid interest should continue to be excluded from COD income. To the extent this issue remains unclear, it could impact the ability of media companies to restructure.

We may see more companies looking to preferred equity investment — rather than debt — as a result of the interest deduction limitation — and the NOL limits, to the extent otherwise deductible interest creates or increases NOLs that now may be viewed as less valuable. Going forward, we may see both debt for preferred equity exchanges as well as new placements of preferred equity. Given to whom this type of investment typically is attractive, the media industry may be well positioned to be an exciting new area for private equity investment.

Finally, the repeal of like-kind exchange treatment other than for real estate also stands to disproportionately affect media transactions. Prior to TCJA, Code Section 1031 allowed for tax-free treatment where property held for use in a trade or business or for investment was exchanged for like-kind property — also held for use in a trade or business or for investment. Television and radio station owners historically switched stations among themselves in order to take better advantage of broadcast areas which provided them with more conducive audiences, often in three way transactions. This became especially attractive after 2000 once the IRS began ruling — albeit privately — that FCC licenses — even television and radio licenses — were like kind, a point that had been greatly debated due to the differing range, geography and demographics each station could provide.[1] However, new Code Section 1031(a)(1) limits like-kind exchanges to real property, leaving owners of personal property, such as FCC licenses, out in the cold. Moreover, as FCC licenses are not tangible personal property, they will not be eligible for the new immediate expensing provisions of Code Section 168(k) which would have offset the loss of like-kind exchange treatment. This repeal will likely have a chilling effect on such transactions, generally seen as beneficial and promoting efficiency the industry.

Michele J. Alexander is a partner and Ryan Davis is an associate in the New York office of Bracewell LLP.

[1] See TAM 200035005.