LOCKE LORD
LEGAL ISSUE Q&A
Series

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Ken Simon practices tax and corporate law and is the Managing Partner of the Firm's Houston office. Mr. Simon has experience representing purchasers, sellers, issuers, and investors in connection with acquisitions, mergers, joint ventures and dispositions, and public offering and private placement of debt and equity securities. He focuses on the representation of entrepreneurs and private equity, and the use of limited partnerships, master limited partnerships, joint ventures, limited liability companies, and other business entities. Mr. Simon also represents individuals and business enterprises in federal, state, and local tax planning for a variety of complex transactions and financings. He holds leadership positions at Locke Lord and in the Houston community.

Distressed Energy Sector Creates Need for Thoughtful Tax Planning

Editor's Note: This is one in a continuing series of Q&As with Locke Lord lawyers on key legal issues confronting companies engaged in industries that have national and global impact.

How do tax issues change for energy companies in a distressed environment?

KS: Companies in a distressed environment often generate substantial losses which may need to be funded with additional debt or equity capital. If the company is structured as a partnership for tax purposes, the company needs to consider how the losses will be allocated and if any limitations on deductibility will be applicable. If the company is structured as a corporation for tax purposes, consideration needs to be given to how the losses can best be utilized, including the possibility of carrying back the losses, carrying the losses forward and the limitations that could be applicable. Furthermore, companies will need to consider how to structure any new financing in order to maximize tax efficiencies. If additional equity is contributed to a partnership, the company should analyze the potential capital account adjustments that will result from the valuation used for the equity contribution in order to ensure consistency with the terms of the business deal.

Is there anything companies can do now on the tax front, with lower oil prices and a weakening energy sector, to prepare for the anticipated recovery?

KS: Companies should re-evaluate their incentive compensation arrangements to ensure that they still have the desired effect. If the milestones are no longer appropriate in the current environment, executives may not have the appropriate incentives to achieve the company's goals. In the worst situations, there may be difficulty retaining key executives who might believe that they can have a fresh start for their incentive compensation arrangements with a new company. For closely held companies, the lower valuations may present certain estate planning opportunities. If there is a desire to transition value to a younger generation, this is a very opportune time to be talking to an estate planning attorney.

What role do taxes play when someone is looking to do deals in a distressed environment? Are there deal breakers on the tax side of a proposed transaction, and, if so, how can those deal breakers be avoided?

KS: Two key issues when doing deals in a distressed environment are to ensure that any losses that result from a sale are available to be used as efficiently as possible and to avoid any cancellation of debt income or other gains for which there is no cash. With respect to losses, often the character of any losses that are generated from sale are capital, resulting in substantial limitations on their deductibility. To the extent losses can be ordinary in nature, there can be substantial benefits derived. Foreclosures or debt restructurings can often result in cancellation of debt income or gains at a time when there is little or no cash available to pay the resulting tax liability. These transactions should be structured so as to take advantage of any planning opportunities that may be available to reduce the tax impact. One other issue for corporations relates to the possibility of preserving any available net operating loss carryforwards. The net operating losses can have considerable value if they are able to be preserved without the application of certain limitations that are often applicable in sale transactions.