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ETS Tax Intelligence: Bankruptcy "Free and Clear" Provisions

Situation

For state unemployment insurance ("SUI") tax purposes, employers engaged in merger and acquisition ("M&A") transactions must adhere to the SUI tax provisions in each taxing jurisdiction (50 states, DC, PR, and VI), based on each unique set of facts and circumstances. An M&A transaction can broadly be defined as a transaction involving the transfer of workforce from one legal entity to another. When one of the legal entities involved in an M&A transaction is emerging from bankruptcy, unique opportunities may be presented.

The most impactful of the SUI tax provisions relates to the transfer of unemployment experience, often referred to as the "successor employer" provisions. Jurisdictions can require, prohibit, or allow (i.e., optional at the discretion of employers) a transfer of unemployment rating experience (i.e., the "customary" successor employer provisions). However, there can be exceptions to these customary provisions when an employer emerges from bankruptcy. The reason that successor employer status is so important to acquiring employers is that financially distressed companies often have a need to lay off employees (a lack of work claim), which in turn increases SUI tax rates that could carry over to the acquiring employer. The qualification as a successor employer versus a newly liable employer upon bankruptcy emergence may have a significant tax cost impact for an employer looking for a "fresh start."

Solution

When an employer emerges from bankruptcy, whether under the same legal entity or by having some or substantially all of its assets (including workforce) acquired by another legal entity, special transfer of experience provisions may apply, often benefiting the acquiring employer. The following summarizes the different successor employer provisions that could apply to an employer emerging from bankruptcy:

- Customary M&A Provisions: In certain jurisdictions, the bankruptcy is disregarded and the jurisdiction follows the customary successor employer provisions (i.e., the jurisdictions SUI tax laws, regulations, and/or rules).
- Provisions are Unclear: When SUI tax provisions are unclear in a jurisdiction, employers should obtain guidance from the jurisdiction on how the specific set of facts and circumstances will be treated for successor employer purposes. An employer may take the opportunity to negotiate or petition the state workforce agency that "successorship" is inappropriate based on the facts and circumstances or is inconsistent with the intent of the relevant SUI tax provisions.
- Specific Bankruptcy Provisions: In certain jurisdictions, specific SUI tax provisions apply in the determination of successorship in bankruptcy. For example, Section 96-11.7(a) of the North Carolina statutes provide: *"This mandatory transfer does not apply when there is no common ownership between the predecessor and the successor and the successor acquired the assets of the predecessor in a sale in bankruptcy. In this circumstance, the successor's contribution rate is determined without regard to the predecessor's contribution rate."*
- "Free and Clear" Provisions: Many jurisdictions refer back to the bankruptcy court order in making a determination of "successor employer" status. These jurisdictions often base their determination on the existence of a "free and clear" provision within the bankruptcy sale order. The order may state something to the effect of: "the acquired assets are free and clear of all liens, claims, encumbrances, and interests pursuant to Section 363(f) of the Bankruptcy Code." The SUI tax court decisions benefiting acquiring employers include such arguments as: 1) the workforce agency's interest in the employer's property was extinguished pursuant to the sale order; 2) the "free and clear" order is broad and sufficiently elastic to consider SUI experience an "interest" in property to prevent its transfer; and 3) if the sale had not been "free and clear," the purchasers presumably would have paid less for the assets. However, other SUI tax case decisions take a contrary position requiring the application of the customary successor employer provisions.

When attempting to apply the above successor employer provisions to each unique set of facts and circumstances, employers must also be mindful of each jurisdiction's annual taxable wage base. In many jurisdictions, without the determination of "successor employer" status, the acquiring employer is not permitted to consider the wages paid by the selling employer in determining the annual taxable wage base limits (i.e., the taxable wage bases must be restarted). This can create significant additional SUI tax costs for transactions that occur mid-year. Therefore, when analyzing the above provisions, the taxable wage base limits must also be contemplated.

Value

When employers emerge from bankruptcy, use of the special SUI tax provisions, including "free and clear" provisions within bankruptcy court orders, may prevent assignment of elevated SUI tax rates and assist formerly financially distressed employers in getting a fresh start. For more information, please contact Tom Towson at thomas.towson@equifax.com. You can also visit our corporate blog at http://insight.equifax.com/ for information on other employment tax matters that might impact your organization.

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