2010 BANKRUPTCY TAX ISSUES

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TRIGGERING EVENTS FOR DEBT EXCHANGES

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- **Discounted repayment.**
- **Significant modifications.**
- **Other deemed repayments.**

IS THERE A DEEMED EXCHANGE OF DEBT?

If restructuring significantly modifies existing debt, new debt/equity is deemed exchanged for old debt.

General test is whether modification is economically significant based on all facts and circumstances.

Specific Rules

- **Change in yield**
- **Change in timing**
- **Change of obligors**
- **Change in security**
- **Change in nature of debt instrument**

DEBT EXCHANGES UNDER SECTION 1001

Bright line test applies to deemed debt exchanges with potential tax consequences for holders and issuers.

- **Deemed exchanges are easy to trigger, hard to avoid.**
- **Two key questions when debt modification: whether the modifications are significant, and if so, is the resulting deemed exchange a recapitalization?**
- **Recap treatment is not available for partnership debt or short term corporate debt.**

EXCEPTIONS TO MODIFICATIONS

Changes pursuant to an instrument's original terms are not modifications, except:

- **Changes in obligor or recourse nature of instrument.**
- **Changes transforming debt into equity (other than pre-wired conversions).**

Exercises of unilateral options are not modifications, but unilateral options do not exist in workouts.

ADDITIONAL EXCEPTIONS

Issuer's non-performance alone is not a modification when it occurs.

- **Waiver of default rights for up to 2 years will not trigger modification. Longer waivers can occur in bankruptcy or during good faith negotiations.**
  - **No modification occurs in connection with a restructuring until parties agree to new terms and either satisfy closing conditions or bankruptcy proceedings conclude.**

WHAT IS A SIGNIFICANT MODIFICATION?

A modification is significant, triggering a deemed exchange, if it changes legal rights or obligations of parties in an economically significant manner – addition/deletion of puts, calls, exchange and conversion rights, changes between fixed and contingent interest rates, and yield changes.

- **Collective approach: When testing significance of particular modification, assume all other simultaneous modifications have occurred.**
  - **Significant modification can occur even without an economic change – *e.g.*, when a borrower simultaneously reduces collateral and adds a guarantor.**

CHANGE IN PAYMENT EXPECTATIONS

A change in payment expectations occurs upon substantial enhancement or impairment of obligor's capacity to meet its payment obligations under the instrument from speculative to adequate or vice versa.

- **Capacity considers all sources for payment, including collateral, guarantees, or other credit enhancements.**
- **Are rating agency determinations still relevant to adequate vs. speculative repayment capacity?**
- **Change from investment grade to junk may constitute substantial impairment – limited relevance to issuers of high-yield debt.**

SIGNIFICANT MODIFICATIONS IF PAYMENT EXPECTATIONS CHANGE

- Addition or deletion of co-obligor.
- Addition, deletion, or change to guarantee or credit enhancement.
- Change in priority of instrument.
- Release, substitution, or addition of collateral on recourse debt.

CHANGES IN OBLIGOR

Changing the obligor on recourse debt is generally a significant modification <u>except</u> in connection with certain transfers of substantially all of the original obligor's assets in which payment expectations do not change and transfer does not otherwise trigger a deemed exchange.

- **Typical qualifying transactions are section 381 transactions and acquisitions with section 338 elections.**
- **Note, this exception would not apply when issuer contributes "substantially all" of its assets to two or more commonly controlled subsidiaries, one of which assumes the debt.**
- **Should COBE "qualified group" concept in section 368 apply? Compare result on transfers to disregarded LLCs.**

CHANGES IN OBLIGOR

Does obligor change when corporate issuer of recourse debt converts to single member disregarded LLC?

- **No change in obligor for state law purposes.**
- **IRS ruled that conversion does not produce change in obligor or recourse nature of debt. PLR 200315001. Subsequent rulings treated conversion as not triggering a significant modification. *See* PLRs 200709013; 200630002.**
- **Is conversion a transfer of substantially all of the obligor's assets to new obligor?**
- **Change in payment expectations?**
  - **Recourse or nonrecourse debt of LLC's sole member?**

CHANGES IN SECURITY AND PRIORITY

For recourse debt, changes in security or priority will be significant modifications only if change in payment expectations results.

For nonrecourse debt, changes in security will be significant modifications unless collateral is fungible or credit support is commercially available.

Change in priority, *e.g.*, subordination, is a significant modification only if it changes payment expectations.

CHANGES IN YIELD

No more than the greater of 25 bps or 5% of annual yield of old debt (*i.e.*, 60 bps if the interest rate is 12%).

- **Original yield = adjusted issue price of instrument immediately prior to modification.**
- **Take into account consent and other fees, but not certain prepayment penalties.**
- **Reducing principal changes yield.**
- **Capitalizing interest changes yield unless the capitalized interest itself bears interest.**

CHANGES IN TIMING OF PAYMENTS

Significant modification occurs if payments are materially deferred, based on all facts and circumstances.

- **Deferring $1 of payments is an extension.**
- **Safe harbor for payments deferred for shorter of 50% of instrument's original term or 5 years.**
- **Multiple deferrals within original safe harbor period are permitted.**

MORE ON TIMING EXTENSIONS

If capitalizing interest, debt must mature within safe harbor deferral period.

- **Also need to test change in yield due to capitalization.**

Even if no deemed exchange, debt is treated as reissued at original debt's adjusted issue price for OID purposes.

- **Reissuance may convert non-OID debt to OID debt if new debt is not current cash pay.**

CHANGES IN DEBT COVENANTS

Addition, deletion, or alteration of customary accounting or financial covenants generally does not produce significant modification.

Could a deemed exchange result, based on the theory that some covenants are non-customary?

- **Treatment of holder consent fees?**
  - **Additional payments on debt? Fee income? Does answer depend on whether only tendering holders receive fee?**

RETESTING DEBT AS EQUITY

Significant modification occurs if resulting instrument is equity.

- **Note that although debt is transformed into equity of the borrower, the transformation may cause liquidation of partnerships if all equity is deemed acquired.**

Debate regarding scope of debt-equity retesting under preamble and regulations.

- **Broad view - deterioration in financial condition of issuer may be disregarded for purposes of all regulatory tests if no change in obligor or co-obligor.**
  - **Query why change of obligor on nonrecourse debt should trigger retesting.**

1001–3 TEST

Preamble:

A number of commentators raised questions regarding the circumstances under which the modification of a debt instrument will require a determination of whether the modified instrument is debt or equity. Many expressed concern that a deterioration in the financial condition of the issuer between the date of original issuance and the date of the modification could lead to a determination that the modified instrument is not debt for tax purposes. The final regulations address this concern by providing a rule that for purposes of this regulation, unless there is a substitution of a new obligor, any deterioration in the financial condition of the issuer is not considered in determining whether the modified instrument is properly characterized as debt.

Regulation Text:

(5) Changes in the nature of a debt instrument -- (i) Property that is not debt. A modification of a debt instrument that results in an instrument or property right that is not debt for federal income tax purposes is a significant modification.

For purposes of this paragraph (e)(5)(i),

any deterioration in the financial condition of the obligor between the issue date of the unmodified instrument and the date of modification (as it relates to the obligor's ability to repay the debt) is not taken into account unless, in connection with the modification, there is a substitution of a new obligor or the addition or deletion of a co-obligor.

DEQUITY

DEEMED EQUITY QUESTIONS

- What portion of an issuer's equity is a lender deemed to receive?
- Is new "equity" of corporate issuers nonqualified preferred stock? Participating preferred stock? Section 305(c) preferred stock?
- Could deconsolidation result, triggering deferred intercompany gains and excess loss accounts and limiting future use of issuer's NOLs against other group members' income?
- Will new "equity" of LLC issuers trigger liability shifts and minimum gain chargebacks under section 752?

MORE DEEMED EQUITY QUESTIONS

- **Is new "equity" (low) fair market value used to measure COD income? Compare (high) stated redemption price at maturity used to calculate COD in case of new privately held debt with adequate interest.**
  - **Corresponding loss to holders receiving deemed equity in a taxable exchange, but *see* Prop. Reg. Section 1.721-1(d)(1).**
- **Will "equity" represent newly issued stock for section 382 purposes that could cause an ownership change?**
- **Could issuers avoid future equity recharacterization by building in equity conversion features contingent on financial covenant defaults at issuance? Could these features cause the debt to be recast as equity upon issuance?**

SECTION 382: STOCK OR NONSTOCK?

Section 382 regs may treat debt as stock under some circumstances if, when it is transferred, it "offers a potential significant participation in the growth of the corporation." *See* Treas. Reg. § 1.382-2T(f)(18)(iii).

- **Debt of troubled companies has always traded at a deep discount – web-based trading has simply lent increased visibility to pricing.**
- **Query whether a debtor corporation could undergo a section 382 ownership change each time enough of its debt changed hands at a low enough price – the better view almost always has to be no.**

WHEN DOES DEBT = STOCK?

PLR 200938010 – Corporate taxpayer's paid-in-kind note not considered "stock" under -2T(f)(18)(ii) even though it was trading at a significant discount.

PLR 200445020 – Creditors' interests not treated as stock where taxpayer in liquidating bankruptcy had liabilities substantially in excess of assets and shareholders were unlikely to receive any value in liquidation.

FSA 199910009 – Agent's broad reading "cannot be correct," because "then possibly every lender to a debtor that subsequently becomes insolvent or bankrupt would be considered as automatically having a potential for significant participation in the growth of the debtor."

WHEN DOES DEBT = STOCK?

IRS officials have recently remarked that the stock-nonstock regulation is limited to circumstance where discounted debt is held by one or more related persons who have some ability to manipulate debtor's future and cause debtor to burn through its losses before ownership change occurred.

- **Note that in *Integrated Resources* the IRS argued that consummation of liquidating plan that did not cancel stock would cause debt to be recharacterized as stock, producing ownership change under section 382.**
- **IRS rulings helpful only by analogy.**

AVOIDING DEEMED DEBT EXCHANGES – FORBEARANCE

FORBEARANCE

Forbearance does not trigger a tax event if:

- **No written or oral agreement to change loan terms.**
- **Limited to two years after default plus period of good faith negotiations or issuer bankruptcy. Treas. Reg. § 1.1001-3.**
    - **Practical Issue: How long can you talk in good faith, especially when talking to an affiliate?**

Generally, issuer continues to deduct unpaid interest, but lenders need not accrue interest income once unlikely to be paid.

- **IRS believes lenders must continue accruing OID even when payment is unlikely.**

INTERCREDITOR FORBEARANCE ISSUES

Few intercreditor issues because all lenders retain original positions.

- **Original terms of debt continue to govern, so debt should not be viewed as participating for purposes of portfolio interest exemption and FIRPTA.**
- **Discussions with issuers permitted, but written or oral agreement must be avoided.**

DEBT EXCHANGE CONSEQUENCES

WHEN IS DEBT PUBLICLY TRADED?

When publicly traded new debt – that qualifies as good debt for tax purposes – is issued to discharge old debt tax, the debtor realizes COD income if market value of new debt is less than adjusted issue price of old debt.

Treas. Reg. section 1.1273-2(f) provides guidance on "public trading."

- Guidance is very old – markets have changed substantially.
- Often difficult to conclude with certainty whether newly issued debt should be treated as publicly traded.

Government panelists have expressed a bias toward the publicly traded rules because they provide a purer economic result.

PUBLIC TRADING TESTS

Public trading tests look to whether, in the 30 days before and after debt is exchanged:

- **The debt is listed on an enumerated exchange;**
- **The debt is traded on a CFTC designated market or interbank market;**
- **The debt is quoted on a medium of general circulation that "provides a reasonable basis to determine fair market value via recent price quotes or actual recent sale transactions"; or**
- **Price quotes are readily available from dealers, traders or brokers.**

PUBLIC TRADING QUESTIONS

Burning questions regarding public trading include:

- **Do price quotes have to be traceable to specific brokers, etc. or simply executable?**
- **Are executable quotes on thinly traded securities sufficient?**
- **Will indicative quotes suffice? Does the answer depend on the number of quotes and/or the spread?**
- **How are quotes on restricted access trading platforms treated? Email blast quotes?**
- **What qualifies as an interbank market?**

ISSUER CONSEQUENCES OF DEEMED EXCHANGES

Issuer realizes COD to extent issue price of new debt is less than issue price of old debt.

> **<u>Publicly Traded Debt</u>. COD income if trading price of new debt is less than adjusted issue price of old debt, including, for example, for a borrower seeking a loan modification despite no change in the amount or timing of principal due, *e.g.*, a yield change.**
>
> **<u>Other Debt</u>. If new debt has adequate stated interest, COD income is only realized if principal is reduced.**

HOLDER CONSEQUENCES OF DEEMED EXCHANGES

If deemed exchange is recapitalization, no gain or loss to holders.

If not a recapitalization, holders recognize taxable gain or loss.

> **<u>Publicly Traded Debt</u>. If either old debt or new debt is "publicly traded," measure gain or loss by FMV of debt over holder's adjusted tax basis. Market discount is transformed into OID.**
>
> **<u>Other Debt</u>. No gain or loss to original holder if new fixed rate debt bears "adequate stated interest," unless principal amount is reduced. If new debt lacks "adequate stated interest," gain or loss measured by FMV of new debt over adjusted tax basis. Secondary purchasers recapture market discount as ordinary income.**

POTENTIALLY ABUSIVE EXCHANGES

Issue price of deemed exchanged private debt is FMV if the situation is "potentially abusive," which may be the case if (i) some or all of the exchanged debt has been acquired recently, and (ii) there is not a deemed or actual exchange of nonrecourse debt for nonrecourse debt.

Contours of the "potentially abusive" exception are not clear, though taxpayers, as well as IRS, can invoke the exception.

- **Issuer's determination binds all holders, unless a holder explicitly discloses an inconsistent position on a statement attached to holder's tax return. Treas. Reg. § 1.1274-3(d).**

COD AND CONTINGENT DEBT

Privately held contingent debt is bifurcated into a fixed component subject to OID rules and a contingent component. Contingent payments are part principal (present value of payment at higher of the AFR or stated rate) and part interest.

- **COD is overstated whenever contingent debt is received in a deemed exchange since rules assign no value to contingent payments, even if they can be estimated.**
- **By contrast, contingent debt issue price under section 1001 includes value of contingent payments in amount realized. Treas. Reg. § 1.1001-1(g)(2)(ii).**
- **Query: Can issuer that pays contingent portion of debt deduct proceeds not allocated to accrued, unpaid interest as a repurchase premium or business expense?**

ALLOCATION OF LOAN PAYMENTS

Each loan payment must first be allocated to accrued and unpaid interest under Treasury Regulation section 1.446-2(e).

- **Not clear whether the IRS intended this rule to apply where debt will not be paid in full.**
- **Bankruptcy disclosure statements routinely treat creditor recoveries as paying principal first.**
- **CCA 200801039 holds that issuers may continue to accrue interest deductions on debt during bankruptcy.**

ALLOCATION OF REDEMPTION PAYMENTS

How does a creditor allocate redemption proceeds between principal and accrued interest? Is a different allocation required between principal and OID?

If issuer retires debt for less than its adjusted issue price, which section applies?

- **Section 166 - ordinary deduction.**
- **Section 1271 - capital loss.**
- **Section 1275 regs - bifurcated treatment.**

TEMPORARY SUSPENSION OF HYDO RULES FOR 2009

2009 Tax Act generally suspended HYDO rules for any debt instrument issued in a deemed or actual debt-for-debt exchange between August 31, 2008 and December 31, 2009, <u>except</u>

- **Debt issued in exchange for existing HYDO.**
- **Contingent debt instruments.**
- **Debt issued to person related to the debtor.**

The 2009 Tax Act grants the IRS the authority to extend suspension of HYDO rules beyond 2009 or use a rate higher than AFR for purposes of applying AHYDO rules.

HYDO RULES SUSPENDED FOR SOME EXCHANGES IN 2010

Notice 2010-11 extends the suspension of the HYDO rules during 2010 only for "qualified obligations."

A qualified obligation is a HYDO that:

- **Is issued to an unrelated party in deemed or actual exchange for a non-HYDO of the same issuer;**
- **Does not pay contingent interest under section 871(h)(4);**
- **Has a fair market value based issue price; and**
- **Would not be a HYDO if its issue price were increased by the amount of any COD income the issuer realizes upon the exchange.**

HOLDER CONSEQUENCES OF DEBT EXCHANGES

HOLDER CONSEQUENCES OF ALL DEEMED EXCHANGES

Whether or not a taxable exchange, deemed issuance of new debt raises holder issues:

- **Market discount becomes OID, requiring current income accruals going forward.**
- **New participating debt may not qualify for the portfolio interest exception and may subject foreign holders to FIRPTA.**
- **New debt may constitute an AHYDO, which would limit the issuer's deductions for substantial OID and raise cash flow issues.**
- **Retest debt/equity; significant issues if new debt is equity.**

HOLDER CONSEQUENCES OF TAX-FREE DEEMED EXCHANGES

Tax-free recapitalization – corporations only.

Must exchange tax securities for tax securities.

- **Most important tax security characteristic is the debt's original term to maturity.**
- **Historically, term of 5 years or less was not a security, 5 to 10 year term was uncertain, and a 10 year term was a security.**
- **Is this still the rule after the IRS tacked the original maturity of exchanged debt, allowing recap treatment for new debt with a short maturity issued in a workout? *See* Rev. Rul. 2004-78.**

Tax-free exchange debt for partnership or LLC interest governed by separate rules. *See* Prop. Reg. §§ 1.108-8; 1.721-1.

HOLDER CONSEQUENCES OF TAXABLE DEEMED EXCHANGES

Gain/loss equals difference between holder's basis in old debt and issue price of new debt.

If either old or new debt is publicly traded, issue price of new debt is the FMV of traded debt.

If neither debt is publicly traded and the new debt bears adequate interest, issue price generally equals the new debt's principal amount.

- **Exchange of non-publicly traded debt can result in significant non-economic gain for distressed debt buyers because issue price equals principal amount and tax basis is low due to recent purchase.**

HOLDER CONSEQUENCES
OF TAXABLE DEEMED EXCHANGES

Unique issues for different groups of holders.

- **Securitization vehicles – REMICs and grantor trusts**
- **U.S. banks**
- **RICs and REITs**
- **U.S. tax-exempts**
- **Foreign holders**

EFFECTS OF EXCHANGES FOR SECURITIZATION VEHICLES

Practical difficulties may arise when securitization vehicles hold troubled loans.

- **Pooling and servicing agreements typically require servicer to maximize proceeds for investors, but limit timing and scope of servicer actions in workouts.**
  - **Generally not feasible to obtain certificate holders' consent to take additional actions.**
  - **Servicer actions after workout must also be strictly limited for new debt to be held by "qualified special purpose entity" and kept off balance sheet.**

SATISFYING SECURITIZATION RULES

REMICs and grantor trusts cannot significantly modify loan until it is "reasonably foreseeable" that it will be in default.

- **IRS accepts American Securitization Federation framework for determining when loan default is reasonably foreseeable. Rev. Proc. 2007-72.**
  - **Rev. Proc. 2008-28 permits servicer modifications under "foreclosure mitigation" programs.**
- **Qualifying worked out loans will not be retested for equity characterization following deemed taxable exchange.**

Deemed exchange of loan in workout is neither a potentially REMIC disqualifying prohibited transaction nor modification of REMIC's regular interests.

- **Grantor trust's modification of loans also will not be treated as power to vary investment of certificate holders.**

EFFECTS OF EXCHANGES FOR U.S. BANKS

Banks can take bad debt deductions with or without exchange, so generally indifferent to its occurrence.

- **Conformity election for bad debts.**
- **All gain and loss is ordinary.**
- **Deemed charge off if debt exchange creates phantom gain.**

EFFECTS OF EXCHANGES FOR REITs AND RICs

REITs and RICs

- **Income on taxable exchanges may affect distribution requirements.**
- **RICs may not receive good income if debt is recharacterized as partnership equity.**
- **REITs need to confirm that any rents received will qualify under REIT rules. Same concern for interest when participating debt is issued.**

EFFECTS OF EXCHANGES FOR FOREIGN HOLDERS

Exchange is not taxable unless old debt held in connection with U.S. trade or business, or subject to FIRPTA.

- **Foreign funds that buy and sell distressed debt slated for workouts may be treated as engaged in a U.S. trade or business.**
- **If new debt is participating debt, portfolio interest exception will not be available and FIRPTA may apply.**
- **If new debt is partnership equity, future income on debt, and other lender income, may be ECI. FIRPTA may also apply to sales of deemed equity interests.**

EFFECTS OF EXCHANGES FOR U.S. TAX-EXEMPT HOLDERS

Unless old debt was debt financed, exchange is not taxable.

If new debt is partnership equity, need to consider UBTI.

- **For rents to qualify under section 512(b)(3):**
  - **No non-customary services;**
  - **No participation other than a fixed percentage of receipts or sales; and**
  - **Not too much personal property.**
- **If there is underlying debt, section 514(c)(9) should be investigated.**

CHOICE OF CREDITOR INVESTMENT VEHICLE

FORECLOSURE CONSEQUENCES

Creditor gain/loss on foreclosure equals difference between FMV of asset and tax basis in debt.

Choice of foreclosure vehicle – often creates significant intercreditor friction.

- Using tax partnership to hold asset presents issues for REITs, RICs, tax-exempts, and foreign holders.
- A corporation avoids most of these problems (though it may be a USRPHC for FIRPTA purposes), but subjects U.S. taxables to two levels of taxes.
- Selective use of blockers by creditors.

INDIRECT FORECLOSURE – BALANCING ADVANTAGES WITH TAX UNCERTAINTY

Affiliated entity, *e.g.*, LLC, acquires asset for nominal amount of cash or debt, leaving most or all of the debt outstanding.

- **Allows asset liens to be preserved.**
- **If structure is respected, tax-exempts and foreigners retain advantages of holding debt (portfolio interest; no UBTI, ECI, or FIRPTA) and would only need to hold equity through blocker corporations.**
    - **Cautious investors may also hold debt through blocker corporations due to equity recast risk.**

INDIRECT FORECLOSURE – BALANCING ADVANTAGES WITH TAX UNCERTAINTY

Will indirect foreclosure be respected?

- **Once debt always debt.**
- **Change of obligor should not matter for nonrecourse debt.**
- **Substance over form concerns.**

Stronger arguments for debt treatment if reduce principal amount of loan to collateral FMV?

- **Or reduce loan to 80% of collateral FMV?**
- **And/or subordinate portion of loan?**

INDIRECT FORECLOSURE – PRACTICAL ISSUES OF TAX UNCERTAINTY

Can PTP risk be avoided by restricting trading in equity of LLC holding assets, or must debt trading also be restricted?

Should foreigners and tax-exempts hold only equity positions, or also their debt, through blocker corporations?

Should debt and equity be stapled or can they trade separately?

- **Stapling increases risk that debt will be recast as equity.**
- **LLC debt is initially partner debt because creditors would receive proportionate LLC debt and equity stakes. Trading debt and equity separately may create tax issues, including minimum gain chargebacks and deemed cash distributions in excess of basis.**

POTENTIAL EXIT STRATEGIES

- **Sale of Debt or Equity of Equity LLC.**
- **Third Party Refinancings of Equity LLC.**
- **New Debt Distributions to Equity Holders.**

SALE OF DEBT OR EQUITY

Holder's gain/loss on sale equals amount realized less tax basis in debt.

- **Holder must allocate tax basis between equity and debt and, if relevant, among tranches of debt.**

REMICs must sell foreclosed-upon properties within three years, and grantor trust must sell such properties "expeditiously."

- **Participants in mortgage securitization industry have asked IRS to permit a REMIC to provide seller financing to buyer of foreclosed property. Under current law, such a loan would not be a qualified mortgage for a REMIC.**

SALES OF EQUITY AND SALES OF BLOCKERS

If tax-exempts or foreigners hold equity stakes through blockers, can they sell the blockers?

- **Tax-exempt holders will prefer to sell blockers if assets are subject to debt to avoid UBTI, although pro rata holdings of debt and equity by tax-exempt holders may not create debt financed UBTI.**

- **Foreign holders will prefer to sell blockers unless blocker is a USRPHC.**

Buyers prefer to buy assets to step up asset basis.

Will buyers be willing to buy part assets, part blockers?

THIRD PARTY REFINANCING

Generally requires cancellation of existing debt and release of liens, or increase in collateral value.

If foreclosure vehicle is an LLC, distribution of debt refinancing proceeds is often tax-free under sections 731 and 752.

To avoid partner debt issues, should equity holders be prohibited from participating in the financing or buying third party debt?

- **While a lender actively engaged in the business of lending may own 10% or less of the equity interest in an LLC without creating partner debt, it is unclear whether hedge funds qualify as such lenders.**

DEBT DISTRIBUTIONS

Alternative to third party refinancing to create liquidity and keep upside.

Can LLC create new tradable debt by distributing debt to its members?

- **Tax character of distributed debt is unclear.**
- **Section 704(b) rules suggest that distributed debt is "debt" only if it is readily tradable on an established securities market or once it is transferred in a taxable exchange.**
- **McKee views the debt as an equity-like promise by LLC to make later distributions.**

If distributed debt is equity, PTP, UBTI, ECI, FIRPTA, REIT, and RIC issues discussed earlier may apply.

ISSUER CONSEQUENCES OF DEBT EXCHANGES

SECTION 108(i) - ELECTIVE COD DEFERRAL

SECTION 108(i) – ELECTIVE COD DEFERRAL

2009 Tax Act permits a corporation or other taxpayer that issued debt in connection with an active trade or business to irrevocably elect to defer COD arising from its "reacquisition" of the debt instrument in 2009 or 2010.

- **A reacquisition includes: (i) an acquisition of debt for cash or other property, (ii) a deemed or actual debt-for-debt exchange, (iii) an exchange of debt for common (but not preferred) stock or a partnership interest, (iv) a contribution of debt to capital of issuer, and (v) complete forgiveness of the debt.**
- **Revenue Procedure 2009-37 automatically extends the due date for making section 108(i) deferral election for 12 months.**

SECTION 108(i) – ELECTION MECHANICS

Separate deferral elections may be made for each debt instrument, including instruments that are part of the same issue.

- **Taxpayer electing deferral must forego other COD exclusions, *e.g.*, bankruptcy or insolvency, with respect to the instrument.**

Revenue Procedure 2009-37 authorizes partial elections to defer any portion of COD income realized with respect to a reacquisition.

- **If two or more instruments are reacquired, different portions of COD may be deferred on each instrument.**
- **Portion of COD not deferred can be excluded under section 108(a) if applicable exceptions apply, *e.g.*, insolvency, bankruptcy.**

SECTION 108(i) – ELECTIVE COD DEFERRAL

Deferred COD is included in taxpayer's income ratably over five taxable years beginning in 2014.

Deferred COD generally accelerated if taxpayer

- sells substantially all of its assets,
- liquidates,
- ceases to do business, or experiences "similar circumstances," or
- is a partner or shareholder of a pass-through entity that sells/exchanges/redeems its interest in the debtor.

Open issues on acceleration include whether it is triggered by tax free dispositions under 368, 351, 721, technical partnership terminations, deconsolidations, conversions to/from corporate / LLC / S corporation status.

108(i) – PARTNERSHIP RULES

Revenue Procedure 2009-37 provides special allocation and adjustment rules for partnerships:

- **Section 108(i) requires a pass-through entity (not partners or owners) to make a deferral election with respect to the entity's COD income realized.**
- **Revenue Procedure allows partnerships to tailor each deferral election to meet needs of individual partners, addressing practitioner concerns that pass-through entities would be conflicted by differing desires of partners.**
- **Elaborate, detailed instructions are provided for partnership and S corporation reporting, including tiered structures. Partnerships must make reasonable efforts to obtain outside basis information where needed.**

SECTION 108(i) – CORRESPONDING DEFERRALS

Earnings and profits of CFCs other than RICs and REITs are adjusted for deferred COD income in year income is realized, not year deferred income is includible in gross income. Rev. Proc. 2009-37.

- **General rule under section 312(e): COD increases E&P currently unless excluded from gross income under section 108(a) and applied to reduce asset basis under section 1017.**

Any decrease in a partner's share of liabilities under section 752 as result of deferred COD is also deferred to extent it would cause income recognition under section 731 and is taken into account by the partner at same time, and to same extent, as the deferred COD.

108(i) - MATCHING DEFERRED COD AND OID

Any OID deductions accruing during the first five years on newly issued debt are deferred up to the amount to the extent of deferred COD and are deductible over the five-year COD income recognition period.

- **A deferral election on debt acquired at a discount simply defers tax on COD, but a deferral election when a deemed or actual exchange of debt with the same principal amount that creates COD under the public trading rules may eliminate tax.**
  - **If the new debt has a remaining life of 5 to 10 years, the present value of the constant yield deferred OID deductions (calculated on a constant yield basis) will exceed the present value of the deferred COD income (calculated on a straight line basis) on the exchanged debt if AHYDO relief applies. If the AHYDO rules limit the OID deductions, a net tax liability may result.**

108(i) – PARTIAL ELECTIONS & OID DEDUCTIONS

When a partial election is made in connection with COD realized on more than one debt instrument in an issue, the amount of OID required to be deferred may depend on whether taxpayers make different elections for each instrument in an issue, even if the same amount of aggregate COD is deferred.

- **Electing to defer a portion of COD realized on each instrument will generally cause more OID deductions to be deferred.**
- **Making a deferral election for all of the COD realized on only one instrument (or a limited number of instruments) in an issue will generally reduce the aggregate amount of deferred OID deductions, maximizing the amount of OID deductions allowed.**
- **Guidance needed regarding the application of the OID deferral rule to related party debt acquisitions.**

108(i) - ACQUISITION PREMIUM & OID INCOME

Technically, a debtor's COD deferral election does not alter its lenders' OID income accruals, but the acquisition premium regulations will generally prevent OID income from being accrued before COD income. Treas. Reg. §§ 1.1272-2(a), (b)(4).

- **Where discount and acquisition premium have both been created, OID is reduced by the ratio of acquisition premium to the discount.**
- **If acquisition premium equals the OID on the new debt, as it typically does in a deemed exchange of debt, all OID on the new debt would be eliminated.**

108(i) - PROTECTIVE DEFERRAL ELECTIONS

Revenue Procedure 2009-37 authorizes protective elections to defer additional COD income if the IRS concludes on audit that COD income on return was understated.

- **Partial protective elections are permitted.**
- **Protective elections may be made even if taxpayer's return shows no COD income. However, making such an election extends the statute of limitations and requires an election form to be attached to tax returns for subsequent 8/9 years.**

COD AND GAIN TRIGGERS

Reducing the principal amount of recourse or nonrecourse debt produces COD income. Rev. Rul. 91-31.

Sale of property subject to nonrecourse debt generally produces capital gain; debt balance is part of amount realized.

- **FMV is irrelevant; difference between amount of debt and tax basis produces gain or loss.**

Property subject to recourse debt is treated as sold for its FMV, generating potential for capital gain if FMV exceeds tax basis.

- **Excess of debt over FMV is COD income.
  Treas. Reg. § 1.1001-2(a).**

RECOURSE vs. NONRECOURSE DEBT OF PASS-THROUGH ENTITIES

Whether debt is considered recourse or nonrecourse for purposes of determining COD is not completely clear in the context of a pass-through entity.

- **Section 704 and the 752 regs may treat nonrecourse debt of a partnership as recourse if a partner has personal liability.**
- **Section 465 regs state that recourse debt at the Partnership level may be nonrecourse if partnership only owns real estate.**

ALLOCATION OF COD AMONG PARTNERS

Partnership allocations of COD must have substantial economic effect.

- **An allocation of COD to insolvent partner and tax-exempt income to taxable partner will not pass muster.**
- **An allocation of COD to an insolvent partner that has substantial economic effect will generally increase that partner’s capital account vis á vis the other partners.**
- **COD may be allocated differently than the allocation of the related section 752 liability, even if COD is allocated to one partner and a taxable distribution to another. Rev. Rul. 92-97.**
- **Consider section 704(c) built-in gain.**

ALLOCATION OF COD AMONG PARTNERS - II

- **Disproportionate partnerships must allocate recourse debt to liable partners or via profit shares. In the event of capital account imbalances, consider whether to book-down to lock in loss.**
  - **Minimum gain event on nonrecourse debt?**
- **Shoulder-to-shoulder partnerships must allocate COD *pari passu*.**

CONSEQUENCES OF LIABILITY REDUCTION

Reduction in a partner's share of liability for cancelled debt is a deemed distribution to the partner under section 752(b) that will trigger section 731 gain if the distribution exceeds the partner's basis in its partnership interest.

- **The deemed distribution to a partner resulting from debt cancellation is treated as an advance against a partner's share of income made on the last day of the partnership's taxable year. Rev. Ruls. 92-97 and 94-4.**
- **By contrast, COD increases a partner's basis in its partnership interest, even if the income is excluded under section 108. PLR 9739002.**
- **Thus, if COD and liability shares are allocated consistently, the deemed distribution associated with liability reduction should not trigger section 731 gain.**

COD EXCEPTIONS

Exceptions:

- **Deductible liabilities**
- **Contested liabilities**
- **Capital contribution**
- **Purchase price adjustment**
- **Insolvency and bankruptcy exceptions**
- **Miscellaneous exceptions**

INSOLVENCY EXCEPTION

Realized COD income is excluded to the extent of the taxpayer's insolvency immediately before the cancellation.

- **Excluded amount reduces the tax attributes of the taxpayer, and any excess amount is simply forgiven.**

A taxpayer's "insolvency" is the excess of (i) its liabilities, over (ii) the fair market value of its assets (including intangible assets).

- **Nonrecourse debt is only taken into account up to the value of the underlying property, unless the nonrecourse debt is itself cancelled and the underlying property is retained. Rev. Rul. 92-53.**

- **The Tax Court and Ninth Circuit have held that contingent liabilities are only taken into account if it is more probable than not that the taxpayer will be asked to pay them.**

SECTION 108 – INSOLVENCY EXAMPLE

COD income excluded to the extent of the debtor's insolvency immediately before cancellation of debt.

• Value of stock of debtor	(50)
• Amount of debt cancelled	80
• Post-cancellation value of debtor stock	30
• Amount of COD excluded from Income	50
• Amount of COD included in income	30

INSOLVENCY AND PARTNERSHIPS

COD determined at partnership level.

- **Bankruptcy court discharged partnership debt guaranteed by general partner. *But see* Martinez.**
- **Tax Court allowed general partner to exclude COD since the debt was discharged in a Title 11 case. *Price v. Commissioner*.**

Insolvency and attribute reduction determined on partner-by-partner basis.

BANKRUPTCY EXCEPTION

All realized COD income is excluded from income if:

- **the taxpayer is in bankruptcy and the discharge of debt is granted by the bankruptcy court or is pursuant to a confirmed bankruptcy plan. No insolvency determination is required.**

Excluded amount reduces the tax attributes of the taxpayer and any excess amount issimply forgiven) – same result as under the insolvency exception.

Query: What result if the entity is a single-member LLC? What result if the LLC's shareholder is bankrupt?

- **IRS position: Chapter 11 discharge is at LLC level and, thus, no income is excludible by owner of single member LLC.**

INSOLVENCY / BANKRUPTCY EXAMPLE

Pre-Restructuring Facts:

Value of assets	**$70**
Amount of liabilities	**(110)**
Amount of insolvency	**$40**
Debt to be cancelled	**$50**

Post-Restructuring:

If restructured in bankruptcy:

All $50 is excluded COD income.*

If restructured outside bankruptcy:

Only $40 is excluded,* and $10 is income.

**** All excluded COD would result in attribute reduction.***

RELATED PARTY ACQUISITIONS

RELATED PARTY ACQUISITIONS

Under *Kirby Lumber*, issuer's acquisition of debt at a discount creates COD equal to discount.

Section 108(e)(4) extends COD realization to related party's direct or indirect acquisition of issuer's debt.

<u>Exceptions</u>

- **Short-term debt.**
- **Dealer acquisitions in ordinary course of business.**

DIRECT AND INDIRECT ACQUISITIONS

Direct Acquisition – Related party acquires debt from unrelated holder.

Indirect Acquisition – Holder of debt becomes related to debtor, and acquired debt "in anticipation of" becoming related to debtor.

- **0-6 months – per se COD rule.**
- **6-24 months – presumption unless disclosed on return.**
- **Debt constitutes more than 25% of value of total gross assets of holder group – presumption unless disclosed on return.**

SECTION 108(e)(4) - COD

COD Income

Generally equals adjusted issue price less FMV of debt measured by related holder's tax basis in any debt acquired by purchase within 6 months before direct or indirect acquisition.

Correlative Adjustments

- **Debt is treated as new debt issued on date of direct or indirect acquisition to related holder with an issue price equal to amount used to determine COD, *i.e.*, original debt basis or FMV.**
- **Difference between issue price of new debt and its stated redemption price at maturity creates OID, deductible by debtor and includible by related holder over term of debt under the OID rules.**

ATTRIBUTE REDUCTION

ATTRIBUTE REDUCTION

Tax attributes generally required to be reduced in the following order under section 108(b):

- **Net operating losses (NOLs)**
- **General business credits**
- **Minimum tax credit carryovers**
- **Capital losses**
- **Tax basis**
- **Passive activity loss and credit carryovers**
- **Foreign tax credits**

Exception: A bankrupt or insolvent partner in a partnership may elect to reduce the basis of the taxpayer's depreciable property. Is the reduction partner-specific, or does it reduce common basis? See FSA 200135002.

ATTRIBUTE REDUCTION

General **basis reduction is subject to a liability floor. A taxpayer may elect to reduce depreciable basis first without a liability floor.**

- **May treat stock of a consolidated subsidiary as a depreciable asset if the subsidiary agrees to reduce (and reduces) the basis of its depreciable assets.**
- **May treat a partnership interest as depreciable property if the partnership agrees to reduce (and reduces) the electing partner's share of inside asset basis.**

Reduction of tax attributes occurs only after the tax is determined for the year, and, in the case of basis, occurs the first day of the ***following*** **year.**

- **A debtor can carry back its NOL before reducing attributes. Treas. Reg. section 1.108-7(b).**

ATTRIBUTE REDUCTION – INSOLVENCY EXAMPLE

Restructuring Facts:

- **$50 of COD income, of which**

  $40 is excludable due to insolvency,

  $10 is includable

- **Remaining liabilities: $60**

- **Tax attributes: $25 of current year NOLs**

  $70 of basis (nondepr.)

ATTRIBUTE REDUCTION – INSOLVENCY EXCEPTION

Reduction in Tax Attributes:

- **First, apply tax attributes to offset actual income/tax for the year: $25 NOL offsets $10 COD income**

- **Then, the $40 of excluded COD reduces:**

attributes	reduction	remaining
$15 NOL	$15	zero
$70 tax basis	$10*	$60
	$25	

Due to $60 liability floor

- **Final $15 of excluded COD is forgiven**

PARTNERSHIP EQUITY-FOR-DEBT EXCHANGES

PARTNERSHIP EQUITY-FOR-DEBT EXCHANGES

Until 1993, many taxpayers relied on the judicial stock-for-debt exception in *Capento Securities*, 47 BTA 691 (1942), aff'd, 140 F.2d 382 (1st Cir. 1944), as codified in the Bankruptcy Tax Act of 1980, to conclude that the contribution of debt in exchange for stock does not result in COD.

- **Section 108(e)(8), passed in 1993, requires the realization of COD in corporate context to extent that the FMV of the stock is less than the AIP of the debt.**
- **The 2004 JOBS Act extended section 108(e)(8) to partnerships, providing that the transfer of a partnership interest to satisfy debt will be treated as satisfaction of the debt with cash equal to the FMV of the interest.**

FMV OF AN EQUITY-FOR-DEBT INTEREST

The FMV of a partnership interest received in exchange for debt is its liquidation value if

- **the partnership determines and maintains capital accounts in accordance with Treasury Regulation section 1.704-1(b)(2)(iv),**
- **the parties treat the FMV of the debt as being equal to the liquidation value of the interest for purposes of determining the tax consequences of the equity-for-debt exchange,**
- **the equity-for-debt exchange is an arm's-length transaction, and**
- **after the equity-for-debt exchange, the partnership does not redeem, and no related person purchases, the equity-for-debt interest as part of a plan which has as a principal purpose the avoidance of COD. Prop. Reg. § 1.108-8(b)(1).**

In all other cases, all facts and circumstances will be considered. Prop. Reg. § 1.108-8(b)(2).

CREDITOR/PARTNER'S TREATMENT

Section 721 applies to a contribution of a partnership's indebtedness by a creditor to the partnership in exchange for a partnership interest. Prop. Reg. § 1.721-1(d)(1).

- **Section 721 does not apply, however, to the transfer of a partnership interest to a creditor in satisfaction of a partnership's indebtedness for unpaid rent, royalties, or interest on indebtedness (including accrued OID). Prop. Reg. § 1.721-1(d)(2).**

COD & CONSOLIDATED GROUPS

AFFECTED REGULATIONS

The IRS has issued several sets of final consolidated section 108 and related regulations. *See* T.D. 9192.

- **Treas. Reg. § 1.1502-28 (consolidated 108).**
- **Treas. Reg. § 1.1502-21 (coordination rule for allocating NOLs).**
- **Treas. Reg. § 1.1502-19 (limiting ELA recapture).**
- **Treas. Reg. § 1.1502-32 (COD investment adjustment rules).**
- **Treas. Reg. § 1.1502-13 (coordination of intercompany debt rules).**

CONSOLIDATED 108 REGULATIONS

Final consolidated section 108 regulations apply to discharges of debt that occur after March 21, 2005.

Separate member determination for insolvency and bankruptcy exceptions.

Hybrid approach to consolidated attribute reduction:

- **First, reduce attributes of separate member;**
- **Second, reduce attributes of subsidiary members (to the extent of any stock basis reduction); and**
- **Third, reduce consolidated attributes of all members.**

CONSOLIDATED 108 REGULATIONS

Basis reduction stops at zero, even for subsidiary stock. Treas. Reg. § 1.1502-28(a)(2).

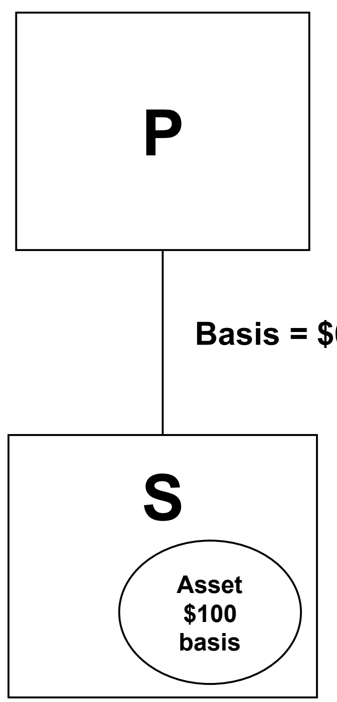
"Liability floor" for basis reduction applies on separate member basis. Treas. Reg. § 1.1502-28(b)(3)(ii).

- **Basis reduction limited to excess of aggregate basis over aggregate liabilities immediately after the discharge.**
- **ELA treated as "zero" for liability floor purposes. Treas. Reg. § 1.1502-28(b)(3)(iii).**

Basis reduction occurs when other attributes are reduced (after tax is determined for taxable year in which excluded COD income is realized), even though only the basis of assets held as of the beginning of the next year are reduced. Treas. Reg. § 1.1502-28(b)(3)(i).

IMPACT OF SECTION 362(e)(2)

P realizes $100 of excluded COD in Yr 2



P borrows $100 from a bank and buys an asset, which declines in value to zero.

P drops asset into S <u>and elects under section 362(e)(2)(C)</u> to take zero basis in S stock, and $100 basis in asset.

P has $100 COD but no attributes to reduce.

Look-through rule does not apply, thereby preserving S's basis in asset, subject to anti-abuse rules.

- **Effect on attributes of other members**

ANTI-ABUSE RULES

Preamble to temporary regulations indicated that IRS and Treasury considered adopting rules under the consolidated return regulations (and possibly other Code sections) to address (i) transitory transactions, and (ii) other transactions designed to avoid application of the consolidated attribute reduction rules.

The final regulations did not adopt any additional rules because of the belief that existing general principles, including step transaction doctrine, can be applied to disregard certain transactions that have the effect of changing the result of the application of the attribute reduction rules. *See* T.D. 9192.

- **The final regulations did add specific rules addressing subsidiaries joining and leaving the consolidated group, and certain intragroup changes.**

INTRAGROUP REORGANIZATIONS

If a debtor member merges or otherwise combines with another member of the group in an acquisitive tax-free reorganization or section 332 liquidation, the successor (rather than the debtor) member is treated as realizing the excluded COD income.

- **Consequently, the <u>combined</u> attributes of the successor are reduced as of the end of the group's taxable year. Treas. Reg. § 1.1502-28(b)(9).**
- **This alters the normal timing rule for attribute reduction. Treas. Reg. § 1.108-7(c).**

THE LOOK-THROUGH RULE – JOINING THE CONSOLIDATED GROUP

The "look-through" rule applies to any subsidiary that joins the consolidated group of the debtor member on the <u>first day of the taxable year following</u> the year COD is realized, if and to the extent that the debtor member <u>previously owned</u> stock in such subsidiary and reduced the subsidiary's stock basis by a portion of its excluded COD income. *See* Treas. Reg. § 1.1502-28(a)(3)(ii).

THE LOOK-THROUGH RULE – DEPARTING THE GROUP

The "look-through" rule applies with respect to any subsidiary of a debtor that is a member of the same consolidated group with the debtor member <u>on the last day of the debtor's year</u>. *See* Treas. Reg. § 1.1502-28(a)(3)(ii); *see also* Treas. Reg. § 1.1502-28(c), Ex. 5.

This rule applies when:

- **The debtor member has a subsidiary at the time it deconsolidates (including a group termination).**
- **The debtor sells or distributes part of the subsidiary stock on the last day of the year, causing a deconsolidation of the subsidiary.**

A non-debtor subsidiary that deconsolidates mid-year (other than by reason of the deconsolidation of the debtor member) generally will <u>not</u> be subject to the look-though rule.

DEPARTING THE GROUP – CONSOLIDATED ATTRIBUTES

If any consolidated group member realizes excluded COD income, the consolidated attributes attributable to any departing subsidiary (whether or not the debtor member) during the year remain available for attribute reduction. *See* Treas. Reg. §§ 1.1502-21(b)(2)(ii)(A); -28(b)(8); -28(c), Ex. 6.

If a debtor member deconsolidates on the same day as it realizes excluded COD income, the COD event and resulting attribute reduction are deemed to occur while the debtor is part of the old group, overriding the "next day" rule of Treasury Regulation section 1.1502-76. Treas. Reg. § 1.1502-28(b)(11).

COD & DEFERRED INTERCOMPANY GAIN

P and its two wholly-owned subsidiaries, S and B, file a consolidated return.

In year 1, S sells Blackacre to B for 100.

- S's basis in Blackacre is 20.
- Sale to B thus creates 80 of deferred intercompany gain.

In year 3, P, B, and S file for bankruptcy – 60 of third party debt will be discharged under the plan of reorganization. B will realize and exclude 60 of COD income.

COD & DEFERRED INTERCOMPANY GAIN - II

IRS believes the excluded COD triggers the following consequences:

- **Under section 1017, B's basis in Blackacre reduced by 60 from 100 to 40.**
- **B's reduction in basis in Blackacre in turn accelerates S's DIG to extent the reduction exceeds S's basis in Blackacre prior to sale.**
- **Since B's basis reduction of 60 exceeds S's pre-sale basis of 20, the excess – 40 – is accelerated into income under the DIG rules and therefore does not qualify for any section 108 exclusion. *See* Treas. Reg. § 1.1502-13(d)(3), Ex. 4.**

COD & DEFERRED INTERCOMPANY GAIN - III

Interaction of section 1017 basis reduction rules and -13(d) DIG acceleration rules effectively causes the excluded COD income to be taxed, notwithstanding section 108(a).

- **Dubroff posits that the correct answer could be that acceleration is not required if B has other tax attributes. *See* Dubroff at 31.06[1][a] n.449.**

The consolidated return regulations similarly create taxable income when a bankrupt subsidiary's COD income exceeds its tax attributes ("black hole income"), because the excess COD creates an ELA that is then recaptured into income.

COD & CREDIT BIDS IN BANKRUPTCY

COD & CREDIT BIDS IN BANKRUPTCY

Asset sales pursuant to Bankruptcy Code ("BC") section 363 are increasingly popular (Chrysler, GM).

- **Much faster than asset sales pursuant to plan of reorganization or liquidation and generally allow buyer to take assets "free and clear" of debtor liabilities.**

Where property being sold is subject to pre-petition liens, BC section 363(k) gives secured creditor right to "credit bid" all or part of its secured claim in the auction.

- **Credit bids permit secured creditor to protect against low bids.**
- **Under bankruptcy law, face amount of debt claim bid in is treated as the economic value of claim, even when collateral is worth less than amount of debt claim. *See* BC section 506(a); *SunMicron* case.**

MORE ON COD & CREDIT BIDS IN BANKRUPTCY

Debtor's acceptance of credit bid should trigger COD income to extent the issue price of the debt used to credit bid exceeds FMV of assets acquired, even though credit bidder gets "credit" for face amount of debt being bid in the 363 auction.

- **Bankruptcy Code rule giving credit bidder face value "credit" does not change tax result because debtor has realized a benefit insofar as it is released from payment.**
- **COD income realized in section 363 credit bid sale should be eligible for section 108(a) exclusion because discharge is granted by the court. *See* section 108(d)(2).**
    - **Order confirming results of auction should include language referencing section 108(d)(2).**

SECTION 382

BANKRUPTCY ELECTIONS

SECTION 382 – A PRIMER

Section 382 limits a corporation's annual use of NOL carryforward after a more than 50% change in its 5% shareholders' stock ownership within a 3-year period.

- **Annual limitation generally equals loss corporation's equity value immediately prior to ownership change multiplied by "long-term, tax-exempt rate" for the month of the ownership change.**
- **NOLs are lost if corporation does not continue business enterprise for at least 2 years after ownership change.**

OWNERSHIP CHANGES UPON EMERGENCE FROM BANKRUPTCY

Most bankruptcy plans of reorganization produce ownership changes for section 382 purposes.

Section 382 provides two special rules for an ownership change effected pursuant to a bankruptcy plan or reorganization.

- **In most cases, a debtor will be subject to annual limitation on future use of tax attributes, calculated by reference to the debtor's equity value immediately AFTER ownership change. Section 382(l)(6).**

- **If old and cold creditors hold a majority of the reorganized debtor's equity upon emergence, the debtor can choose to reduce its NOLs by certain interest deductions and use its remaining NOLs without limitation. Section 382(l)(5).**

SECTION 382L6 – MODIFIED ANNUAL LIMITATION

Basic annual section 382 limitation = long-term tax exempt rate multiplied by loss corporation's stock value immediately before ownership change.

- **For ownership changes pursuant to a bankruptcy plan of reorganization, section 382(l)(6) provides that the stock value generally includes any increase in value from surrender or cancellation of creditors' claims under the plan.**
- **Stock value equals lesser of:**
    - **Loss corporation's stock value immediately after the ownership change; or**
    - **Value of loss corporation's pre-change gross assets.**

EXAMPLE – APPLYING SECTION 382L6

Pre-Restructuring Facts:

Gross assets	$100
Liabilities	(120)
Stock value	-0-

Post-Bankruptcy Restructuring:

	Convert All Debt	Convert $40 of $120 Debt to Equity		
		No New Money	+$80 New Money	$180 New Money
Equity Value	$100	$20	$100	$200
Prechange Gross Assets	$100	$100	$100	$100
L6 value	$100	$20	$100	$100
Basic Annual Limitation @ 5%	$5/year	$1/year	$5/year	$5/year

SECTION 382L5 ALTERNATIVE

Elective alternative if loss corporation's preexisting shareholders and qualified old and cold creditors retain or receive in exchange for their interests 50% in vote and value of reorganized corporation stock (or stock of a controlling corporation also in bankruptcy) pursuant to a bankruptcy plan.

A qualified old and cold creditor is one who receives stock in satisfaction of indebtedness that

- **the creditor had held for at least 18 months on bankruptcy filing date, *i.e.*, was "old and cold," or**
- **arose in the ordinary course of the debtor's business and has not changed hands since incurrence.**

CONSEQUENCES OF SECTION 382L5 ELECTION

Annual section 382 limitation rules (including BIG/BIL rules) do not apply. One time reduction in NOLs/tax credits for interest deducted over last 3+ years on debt exchanged for stock in the bankruptcy (the interest haircut rule).

Second ownership change within 2 years results in automatic section 382 annual limitation for such change of zero – all losses predating the later change are effectively eliminated.

- **Section 382(l)(5) applies for purposes of determining section 382 consequences for taxable period between first and second ownership change. PLR 200751011.**

Under section 269, a strong presumption of tax avoidance exists if loss corporation continues only an insignificant active trade or business.

SECTION 382L5 – INTEREST HAIRCUT RULE

Interest haircut rule reverses interest deductions that increased debtor's tax loss during last 3+ years before change date with respect to debt discharged for stock under plan of reorganization.

Unclear how interest haircut applies where creditor receives stock and other property. Three possibilities:

- **Other property discharges debt dollar-for-dollar, stock discharges balance (old stock-for-debt rule).**
- **Pro rata based on relative value of stock and other property.**
- **FMV of debt discharged for stock is limited to stock FMV.**

SECTION 382L5 –EQUITY SUBSCRIPTION RIGHTS

Debtors may raise cash through a sale of below-market subscription rights to creditors as part of their bankruptcy plan of reorganization.

To guarantee enough cash is raised, backstop purchaser often agrees to buy any unsubscribed rights.

- **Shares received by creditors exercising subscription rights count toward 50% test, but shares received by backstop purchaser do not count, even if purchaser is also a creditor. PLR 200818020.**

See generally **Treas. Reg. § 1.382-9(e)(3), Ex. 3 (similar analysis of options exercised post-emergence).**

SECTION 382L5 – OLD AND COLD PRESUMPTION

Creditors receiving less than 5% of reorganized debtor stock generally treated as qualified creditors for section 382(l)(5) purposes.

- **Presumption reversed if creditor's participation in plan formulation "makes evident" that creditor is not old and cold.** ***See generally*** **Treas. Reg. § 1.382-9(d)(3)(i).**
- **Not clear how or why participation in plan formulation would make evident creditor's unqualified status.**
- **Mere membership on creditors' committee should not constitute such evidence.**
- **Consequences of trading order disclosure.**

SECTION 382L5 – CLAIMS TRADING LIMITATIONS

First generation of orders limiting claims trading resembled first day orders limiting equity trading – investor needed permission to acquire claims that could result in 5% stock ownership in the reorganized debtor.

Recent trend permits free trading in claims, but requires substantial claimholders to sell down below a specified portion of their claims if debtor proposes section 382(l)(5) plan.

- Sell down prevents non-qualified debt holders from receiving 5% or more of the debtor's stock.

SECTION 382 – TOTAL RETURN SWAPS

Public loss companies may rely on 13D and 13G filings in identifying 5% shareholders. Treasury Regulation section 1.382-2T(k)(1)(i).

- **SEC staff believes that holders of total return swaps are not beneficial owners, and therefore need not make 13D or 13G filings.**
  - **Federal District Court in 2008 CSX case disagreed, holding that total return swap was device to evade 13D reporting.**
- **Any implications for section 382 computations if total return swap holders begin making 13D filings?**

BUILT-IN GAIN AND LOSS RULES

SECTION 382 – BUILT-IN GAIN AND LOSS

BIGs and BILs recognized within 5 years after ownership change are subject to special rules if the loss corporation has a NUBIG or NUBIL on an ownership change date.

NUBIG/NUBIL generally equals the difference between aggregate FMV of assets and adjusted basis immediately before an ownership change, with adjustments for pre-change built-in items.

- **Threshold: Lesser of 15% of FMV of corporation's assets or $10,000,000.**
- **Recognized BIGs for 5 years after an ownership change increase annual section 382 limitation of a loss corporation with a NUBIG.**
- **Utilization of a NUBIL loss corporation's built-in losses is subject to section 382 limitation for 5 years after ownership change.**

SECTION 382 – NUBIG RULES

Two primary questions: what constitutes BIG, and how are BIG assets valued in determining whether corporation has a NUBIG.

- **Should built-in income items be included, and if so, at what value in determining whether the loss company satisfies the NUBIG threshold?**
- **How should income be traced to particular assets and accrued for purposes of increasing NOL limit?**
- **Should tax or economic accrual models be used, or should income and cost recovery be matched?**

SECTION 382 – NUBIG QUERIES

Is income with respect to interest rate swaps that is attributable to a pre-change period properly treated as built-in gain, since income would be attributable to fluctuations in interest rates after ownership change date?

Does a loss corporation have built-in income when it consumes a wasting asset, to the extent income produced is (or may be) attributable to BIG asset?

NOTICE 2003-65

Pending the issuance of regulations, Notice 2003-65 provides two safe harbors for identifying recognized built-in items:

- **Section 1374 approach, and**
- **Section 338 approach.**

NUBIG / NUBIL equals:

- **The net amount of income or loss the loss corporation would have realized on a sale, immediately before ownership change, of all of its assets at FMV to a third party subject to all of its liabilities, including contingent liabilities at their estimated amount, <u>minus</u>**
- **The amount of any deductible liabilities.**

NOTICE 2003-65 – SECTION 338 APPROACH

Section 338 Approach: Loss corporations may treat all income and liability items (using estimated values for contingent items) that would trigger gain on a deemed asset sale on ownership change date as built-in items.

- **RBIG in 5-year post-change period is deemed to include depreciation and amortization deductions based on the FMV of the loss corporation's assets on the ownership change date ("wasting" built-in gain assets).**

- **This approach assumes BIG assets on change date generate income equal to cost recovery deductions that would have been allowed if the loss corporation had made a section 338 election on the ownership change date.**

EXAMPLE OF SECTION 338 APPROACH

FMV of intangible asset	**$90**
Tax Basis of intangible asset	**$15**
• **Mark-to-market amortization ($90 FMV /15 years)**	**$6**
• **Actual amortization ($15 basis /15 years)**	**<$1>**
Annual Benefit From Notice	**$5**
Total 5 Year Benefit From Notice	**$25**

NOTE: These results may vary significantly based on a loss corporation's current amortization and depreciation deductions.

NOTICE 2003-65 – SECTION 1374 APPROACH

Section 1374 Approach: Loss corporations may alternatively elect to treat as built-in items only those items that would satisfy the all events test on the ownership change date but for a lack of economic performance.

- **The portion of depreciation and amortization deductions attributable to basis that exceeds an asset's FMV during 5-year post-change period will be treated as RBIL.**

NOTICE 2003-65 – SPECIAL COD RULES

COD realized (and excluded) in connection with ownership change is not taken into account in calculating loss corporation's NUBIL or NUBIG.

- **Any resulting asset basis reduction is not taken into account in calculating NUBIL or NUBIG.**
- **For all other purposes, basis reduction is deemed to occur immediately before ownership change, which increases RBIG (or reduces RBIL) on a subsequent sale of the asset.**

COD income actually recognized within 5 years after ownership change is treated as BIG under section 338 approach to the extent of the excess of the adjusted issue price of cancelled debt over its fair market value on the ownership change date.

COD income actually recognized within 12 months after ownership change is treated as BIG under section 1374 approach.

RECENT IRS GUIDANCE

ELIMINATING 382 LIMITATION ON BANK BUILT-IN LOSSES (NOTICE 2008-83)

Notice 2008-83 held that any deductions properly allowed to a bank after an ownership change with respect to losses on loans or bad debts, including deductions for a reasonable addition to a reserve for bad debts, would not constitute deductions that are attributable to periods before the change date. Accordingly, those losses would not be subject to the normal section 382(h) limits on use if the bank has a NUBIL.

- **After an ownership change, a loss company's section 382 limitation also applies to any deductions claimed with respect to the loss corporation's net unrealized built-in loss (NUBIL) during the first 5 years after the change date, assuming de minimis tests are satisfied. *See* I.R.C. § 382(h).**

The American Recovery and Reinvestment Act of 2009 (the "2009 Act") revoked Notice 2008-83 for ownership changes occurring after January 16, 2009.

ADDITIONAL RECENT IRS GUIDANCE

The takeover of Fannie Mae and Freddie Mac will not be treated as a section 382 ownership change. Notices 2008-76 and 2008-84.

Relying on Internal Revenue Code section "zero," IRS excepted from the AHYDO rules certain debt issued pursuant to a prior financing commitment through 2010.

When a securities loan is terminated because of a borrower's bankruptcy filing, no gain or loss will be recognized if the lender promptly applies the collateral to the purchase of identical securities. Rev. Proc. 2008-63.

- **Generally, no gain or loss is recognized on the exchange of identical securities if certain requirements are met. *See* I.R.C. § 1058.**

SECTION 382 CONSEQUENCES OF TREASURY ACQUISITIONS PURSUANT TO 2008 ACT

Notice 2009-14 provides guidance to the following programs (collectively, the "Programs"):

- **Capital Purchase Program for publicly-traded issuers ("Public CPP")**
- **Capital Purchase Program for private issuers ("Private CPP")**
- **Capital Purchase Program for S corporations ("S Corp CPP")**
- **Targeted Investment Program ("TARP TIP")**
- **Automotive Industry Financing Program ("TARP Auto")**

Section 101(c)(5) of the 2008 Act authorizes the Treasury Secretary to issue "such regulations and other guidance as may be necessary or appropriate to carry out the purposes of the Act."

Section 382(m) provides that "the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of sections 382 and 383."

NOTICE 2009-14

Treasury's stock ownership for section 382 purposes will not increase by reason of stock it acquires pursuant to the Programs, but any stock it holds (other than section 1504(a)(4) stock) will be considered outstanding for purposes of determining the stock ownership of other 5% shareholders on a testing date.

Once any shares acquired and held by Treasury pursuant to the Programs are redeemed, the shares will be treated on all subsequent testing dates as though they had never been outstanding.

NOTICE 2009-14 - II

Stock acquired by Treasury pursuant to the Programs and then transferred is treated as section 1504(a)(4) stock that will be disregarded for section 382 purposes while held by any other party.

Warrants acquired by Treasury pursuant to the Emergency Economic Stabilization Act of 2008 (the “2008 Act”) are treated as:

- **Options, and will not be treated as stock, for all purposes while held by any party that receives the warrants pursuant to the Public CPP, TARP TIP, and TARP Auto.**
- **Section 1504(a)(4) stock that is disregarded if acquired pursuant to the Private CPP.**
- **An ownership interest in the underlying debt if acquired pursuant to the S Corp CPP.**

NOTICE 2009-14 - III

Options, as defined under Treas. Reg. section 1.382-4(d)(9), that Treasury acquires pursuant to the Programs will not be deemed exercised under section 1.382-4(d)(2) while held by Treasury.

- **This regulation generally treats options as exercised if a principal purpose of such option is to avoid application of section 382 and either an ownership, control, or income test is satisfied.**

The section 382(l)(1) anti-stuffing rules will not apply to any Treasury capital contributions made pursuant to the Programs.

- **The government also issued more general section 382 anti-stuffing guidance in Notice 2008-78.**

NOTICE 2010-2

General rule: No instrument issued to Treasury other than pursuant to TARP CAP shall be treated as stock for section 382 purposes while held by Treasury or other holders.

- **Exception: Instruments denominated as stock will be treated as section 1504(a)(4) stock for section 382(e)(1) purposes.**
- **Second Exception: Instruments issued to Treasury pursuant to TARP CAP will be classified by applying general tax principles.**

Notice states: "In exercising its authority under EESA in this notice, Treasury and the Service intend no implication regarding the Federal income tax results that would obtain with respect to instruments that are not specifically described in this notice."

NOTICE 2010-2 - II

Operational Rules:

Warrants issued to Treasury will generally be treated as options, not stock, including after transfers to subsequent holders. The warrants will not be treated as exercised while held by Treasury for purposes of Treasury Regulation section 1.382-4(d)(2).

For all purposes, any amount received by an issuer in exchange for instruments issued to Treasury under a TARP-related program shall be treated as received solely for such instruments.

The applicable sections of Notice 2010-2 also apply to instruments received by Treasury in exchange for instruments issued to Treasury under a TARP-related program.

NOTICE 2010-2 - III

General Rule: Ownership of stock shall not be treated as increasing Treasury's percentage ownership of stock for purposes of section 382, although it is considered outstanding while held by Treasury for purposes of determining the stock ownership of 5% shareholders on any testing date.

- Once stock owned by Treasury is redeemed, it is treated as though it had never been outstanding.
- If a sale of stock by Treasury creates a new public group, the group's ownership of stock will not increase by reason of the Treasury sale, although it will increase (or decrease) as a result of all other transactions.

PLR 200713015

Loss corporation (Loss Co) files for bankruptcy and files motion to impose trading restrictions on equity transfers to protect against section 382 ownership change.

Entity A acquires shares of Loss Co stock on the open market before court enters order imposing trading restrictions, becoming a 5% shareholder and thereby triggering a section 382 ownership change.

At the request of Loss Co and Entity A, the Court orders that Entity A's purchase of Loss Co's stock be treated as "void *ab initio*," that its purchased shares be sold, and any profits above and beyond Entity A's costs be donated to charity.

PLR 200713015 - II

Entities B and C are investment advisors that hold Loss Co common stock for their clients/advisees through a common custodian. B and C had no right to receive dividends or sales proceeds from the stock, but could buy, sell and vote the stock.

B and C each filed an SEC Schedule 13G reporting ownership of more than 5% of Loss Co stock.

- **No client/advisee of B or C's filed a Schedule 13G reporting that it owned more than 5% of Loss Co stock.**
- **Loss Co had no actual knowledge that any of B or C's clients/advisees owned more than 5% of its stock or should be treated as members of a coordinated group.**

PLR 200713015 - III

Individual or entity who has right to dividends and proceeds from the sale of stock is the owner of the stock for purposes of section 382; under this test, neither Entity B nor C is an owner.

- **Absent actual knowledge to the contrary, Loss Co may rely on absence of or existence of Schedule 13D or 13G to identify direct holders of greater than 5%.**
- **Loss Co can rely on lack of Schedule 13D or 13G from clients/advisees to determine that clients/ advisees are not members of a group that constitutes an entity.**

PLR 200605003

Taxpayer-friendly ruling that three related investment funds will not be treated as a single "entity" for purposes of section 382. Three funds with a common investment advisor and GP wished to acquire stock in loss corporation. If aggregated, the funds would have been a 5% shareholder and the purchase would have been prohibited under trading restrictions. The Funds obtained a PLR holding that they would not be treated as an entity even though the three funds invested in parallel "in virtually every case."

- Owners of stock of a loss corporation will be treated as an "entity" if the owners "have a formal or informal understanding among themselves to make a coordinated acquisition of stock." Treas. Reg. § 1.382-3(a)(1).
- "A principal element in determining if such an understanding exists is whether the investment decision of each member of a group is based upon the investment decision of one or more other members."

PLR 200605003 - II

- **The funds each represented that they did not acquire, or indicate to their investors that they would acquire, equity interests in the loss corporation (or any other issuer) for the purpose of accumulating ownership of any particular minimum percentage of an issuer's equity interests, or changing or influencing control of the issuer.**
- **The IRS ruled that the funds did not have a "formal or informal understanding . . . to make a coordinated acquisition of stock" based solely on the information provided, and would not be treated as a single entity for the purposes of section 382. Thus, no fund would be treated as a 5% shareholder under section 382 as long as no single fund owned 5% of loss corporation.**

PREVENTING OWNERSHIP CHANGES

POISON PILLS AND CHARTER AMENDMENTS

Many corporations with large amounts of NOLs (or built-in loss assets) and depressed stock prices are concerned that they might undergo an inadvertent section 382 ownership change, reducing future value of NOLs and built-in deductions.

Two basic responses:

Section 382 "Poison Pill" – setting triggering percentage at 4.9%, to keep major purchases from taking place.

Examples: Ford, Lear, Ryland Group, USG, Selectica.

Amend charter to void ab initio any unapproved share transfer that would

- increase the holdings of an existing 5% shareholder;
- create a new 5% shareholder; or
- create a new public group treated as a 5% shareholder.

Examples: Hovnanian and EDCI Holdings.

POISON PILLS AND CHARTER AMENDMENTS – II

Methods involve trade-off between effectiveness and ease of implementation.

Poison Pills

- **Can normally be effected by board of directors on its own authority;**
- **Are subject to shareholder challenge; and**
- **Do not actually prevent ownership change from occurring if players are willing to take consequences of share dilution.**

Charter Amendments

- **Implementation and removal generally requires shareholder vote; and**
- **Generally prevents ownership change from taking place under all circumstances.**

FLUCTUATIONS IN VALUE

FLUCTUATIONS IN VALUE – STATUTORY AUTHORITIES

An ownership change occurs if the percentage (by value) of stock of the loss corporation owned by one or more 5-percent shareholders has increased by more than 50 percentage points <u>over</u> the lowest percentage ownership of such shareholders at any time during the testing period. Section 382(g)(1).

- **Except as provided in regulations, any change in proportionate ownership which is attributable solely to fluctuations in the relative fair market values of different classes of stock shall not be taken into account. Section 382(l)(3)(C).**

FLUCTUATIONS IN VALUE – REGULATORY AUTHORITIES

Treas. Reg. § 1.382-2(a)(3):

- **The percentage of stock owned by a person shall be determined based on the fair market value of the stock owned by such person relative to the total fair market value of the corporation's outstanding stock.**

- ***See also* Treasury Regulation § 1.382-2T(c)(1) (computations based on percentage ownership at the close of the testing date over lowest ownership during the testing period).**

FLUCTUATIONS IN VALUE – REGULATORY AUTHORITIES

Preamble to T.D. 8149:

- **The temporary regulations reserve a paragraph under which changes in percentage ownership may be disregarded if they are attributable solely to fluctuations in value. The Internal Revenue Service invites comments on this issue.**
  - **Treas. Reg. § 1.382-2T(l) – "Changes in percentage ownership which are attributable to fluctuations in value. – [Reserved.]"**

Note that although Treasury Regulation section 1.382-2T(l) reserves on section 382(l)(3)(C), the operative rule of Treas. Reg. section 1.382-2(a)(3)(i) could be read to take fluctuations of value into account.

FLUCTUATIONS IN VALUE – PLR 200411012

"On any testing date, in determining the ownership percentage of any 5% shareholder, the value of such shareholder's stock, relative to the value of all other stock of the corporation, shall be considered to remain constant since the date that shareholder acquired the stock; and the value of such shareholder's stock relative to the value of all other stock of the corporation issued subsequent to such acquisition date shall also be considered to remain constant since that subsequent date."

See also **PLR 200511008; PLR 200520011; PLR 200622011; PLR 200901001; PLR 200901003.**

FLUCTUATIONS IN VALUE – QUESTIONS

Questions that any framework for determining when fluctuations in value will be taken into account must consider:

- **What result if one shareholder acquires stock from another shareholder?**
- **What result if a third party acquires stock from a shareholder?**
- **What result if shares are redeemed?**
- **What result if new stock is issued?**
- **What result if different tranches of stock are acquired on different dates?**
- **What if stock is recapitalized in a value for value exchange?**
- **What effect would pre-testing period fluctuations have?**

SECTION 382 – ANTI-STUFFING RULES

Section 382(l)(1)(A) provides that any capital contribution received by an old loss corporation as part of a plan with a principal purpose of avoiding or increasing any section 382 limitation shall be disregarded.

Section 382(l)(1)(B) provides that any capital contribution made during the 2 year period ending on the change date shall – except as provided in regulations not yet promulgated – be treated as part of a plan described in section 382(l)(1)(A).

SECTION 382 – ANTI-STUFFING RULES

The section 382 legislative history provides: "The conferees intend that the regulations will generally except (i) capital contributions received on the formation of a loss corporation . . ., (ii) capital contributions received before the first year from which there is an NOL [or other relevant attribute], and (iii) capital contributions made to continue basic operations of the corporation's business (*e.g.*, to meet the monthly payroll or fund other operating expenses of the loss corporation)."

SECTION 382 – ANTI-STUFFING RULES

- **Although no regulations have been issued, the IRS has issued PLRs concluding that, under certain circumstances, capital contributions within the 2 year period are not subject to section 382(l)(1)(A).** ***See*** **PLR 200814004; PLR 200730003; PLR 9835027; PLR 9706014; PLR 9630038; PLR 9541019; PLR 9508035; TAM 9332004.**
- **Notice 2010-2 provides that any capital contribution made by Treasury pursuant to a TARP-related program is not considered to have a principal purpose of avoiding or increasing any section 382 limitation.**

NOTICE 2008-78

Notice 2008-78 provides rules and safe harbors for determining whether the value of a capital contribution within two years before an ownership change is excluded from the section 382 limitation calculation. Regulations will incorporate this guidance.

- **Whether a capital contribution is part of a Plan is determined based on all the facts and circumstances. A capital contribution is not presumed to be part of a plan with a principal purpose to avoid or increase a section 382 limit (a "Plan") solely as a result of having been made during the two-year period ending on the change date.**

- **If a capital contribution falls within one of four safe harbors, the contribution will not be considered to be part of a Plan.**

- **The fact that a contribution does not fall within safe harbor does not constitute evidence of a Plan.**

NOTICE 2008-78 – SAFE HARBOR 1

<u>**Safe Harbor 1**</u>

Contribution made by a person who is not:

- **a controlling shareholder (determined immediately before the contribution), nor**
- **a party related to the loss corporation;**

No more than 20% of the total value of the loss corporation's outstanding stock is issued in connection with the contribution;

No agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change; and

Ownership change occurs more than 6 months after the contribution.

NOTICE 2008-78 – SAFE HARBOR 2

Safe Harbor 2

Contribution made by:

- **A related person in exchange for no more than 10% of the total value of the loss corporation's outstanding stock, or**

- **An unrelated person;**

No agreement, understanding, arrangement, or substantial negotiations at the time of the contribution regarding a transaction that would result in an ownership change; and

Ownership change occurs more than 1 year after the contribution.

NOTICE 2008-78 – SAFE HARBORS 3 & 4

Safe Harbor 3

Contribution made in exchange for stock issued in connection with the performance of services, or stock acquired by a retirement plan, under the terms and conditions of Treasury Regulation sections 1.355-7(d)(8) or (9), respectively.

Safe Harbor 4

Contribution is received on formation of a loss corporation (not accompanied by the incorporation of assets with a net unrealized built in loss), or before the first year from which there is a carryforward of a net operating loss, capital loss, excess credit, or excess foreign taxes (or in which a built in loss arises).

ACQUISITIONS OF LOSS CORPORATIONS

NO NET VALUE REGULATIONS

NET VALUE REQUIREMENT

The proposed "no net value" regulations require that net value be transferred, and also received, to produce a tax-free reorganization.

Net value is transferred if:

- **FMV of target assets transferred exceeds sum of the liabilities assumed (including liabilities to acquirer treated as assumed) and the FMV of non-stock consideration.**

Net value is received if:

- **FMV of acquirer assets exceeds the amount of acquirer liabilities immediately after the transaction.**

Should value created by reason of the transaction to which the NNV regulations may (otherwise) apply be included to determine net value?

QUESTIONS RAISED BY THE PROPOSED REGULATIONS

Should the section 332 rules be extended to section 368?

What constitutes a liability, how is it valued, and when does net value exist?

- **When do liability transfers facilitate or preclude reorganization treatment?**

Are different liability rules appropriate for stock and asset exchanges?

SECTION 332 NET VALUE RULES

Section 332 clearly requires that a shareholder receive property with respect to stock in order for a liquidation to be tax-free.

- **The preamble to the NNV regulations relies on Revenue Ruling 59-296 to import these section 332 rules to section 368, stating that the ruling "holds that the principles relevant to liquidations under section 332 also apply to section 368."**

SECTION 332 RULES EXTENDED TO SECTION 368

Revenue Ruling 59-296 has a very limited scope – it provides only that, when an insolvent subsidiary that owes its parent an amount which exceeds its asset value merges into its parent, no A reorganization occurs and the parent can therefore recognize a loss on its stock and its debt.

- **The ruling does not address a merger with, for example, another affiliate of parent, a party related to the creditor, or an unrelated third party.**

The preamble to the NNV regulations concedes that case law, including *Norman Scott*, holds that a transaction involving an insolvent target may qualify as A reorganization.

LIABILITY QUESTIONS

The NNV regulations define a liability as an obligation that decreases the obligor's net worth.

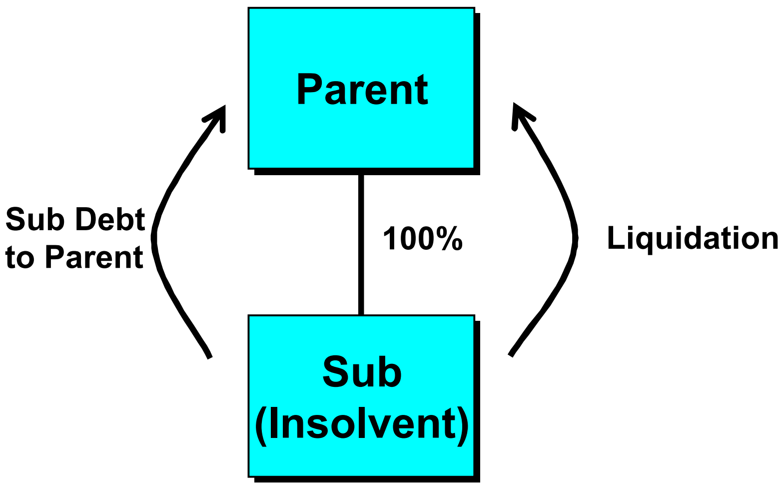
- **Should liabilities be valued according to their face amount, issue price, FMV, or by using another method?**
  - **Should the value of non-recourse debt be capped at FMV of collateral?**
  - **Should section 357(d) apply to multi-obligor debt?**
- **Another crucial question is whether value created by reason of the transaction to which the NNV proposed regulations may (otherwise) apply is included to determine net value.**

CAN ELIMINATING LIABILITIES PRODUCE A TAX-FREE REORGANIZATION?

Liabilities assumed pursuant to or in connection with a putative reorganization reduce both the net value of assets surrendered and the amount of net value received in the transaction.

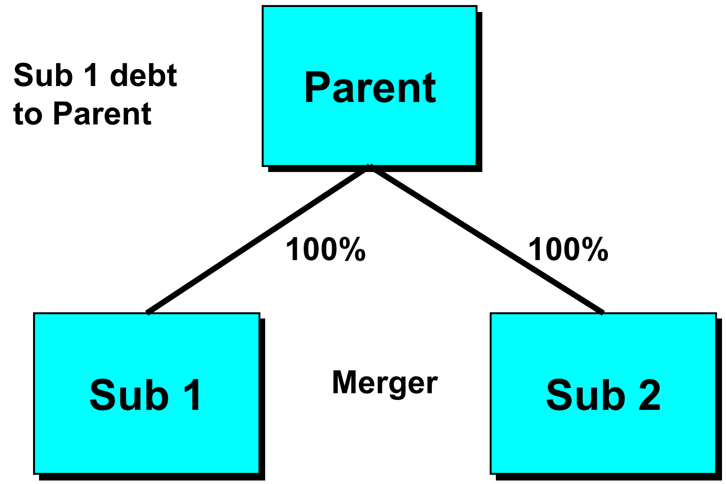
- **The preamble provides that substance over form and step transaction principles will apply to determine whether liabilities are assumed in connection with a reorganization, citing Revenue Ruling 68-602.**

REVENUE RULING 68-602



- Sub's debt to Parent exceeds the fair market value of Sub's assets.
- Parent cancels Sub's debt.
- Sub liquidates, transferring all of its assets, subject to liabilities, to Parent.
- Debt cancellation ignored because it was an integral part of the liquidation and lacked independent significance.
- NNV regs would treat extinguished liabilities as assumed by Parent.

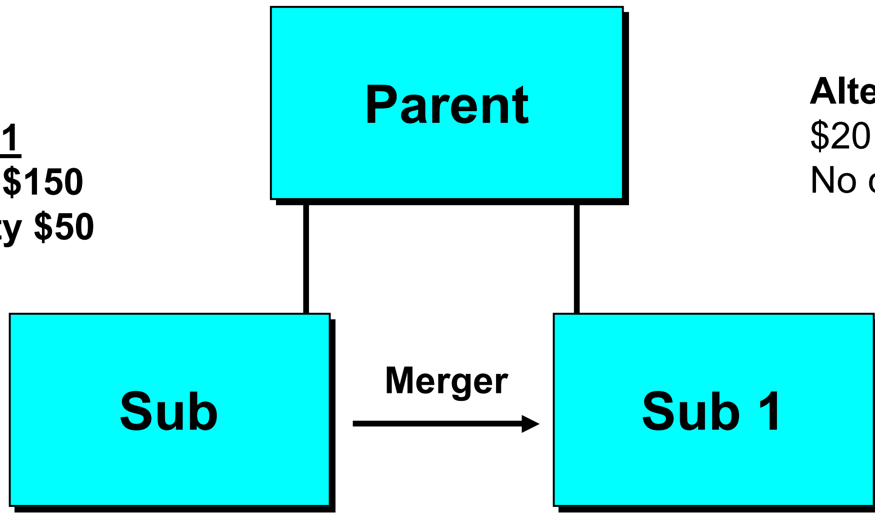
REVENUE RULING 78-330



- Parent cancels Sub 1's debt when Sub 1's liabilities exceed the basis of its assets.
- Basis of Sub 1's assets then exceeds its liabilities.
- Sub 1 merges into Sub 2.
- Cancellation of Sub 1's debt was respected because it altered a bona fide business relationship and so had independent economic significance.

CROSS-CHAIN MERGER – DEBT CANCELLED

<u>Year 1</u>
Debt $150
Equity $50



Alternative Consideration:
$20 of Sub 1 stock to Parent in the merger
No consideration to Parent in the merger

<u>End of Year 2</u>

S Assets	**$ 20**
S Liabilities	**$150**

Year 1: Parent capitalized Sub with $50 of equity and $150 of debt.

Year 2: After Sub incurs an NOL of $180, it merges with and into Sub 1, a solvent subsidiary. Sub-Parent debt is cancelled in the merger.

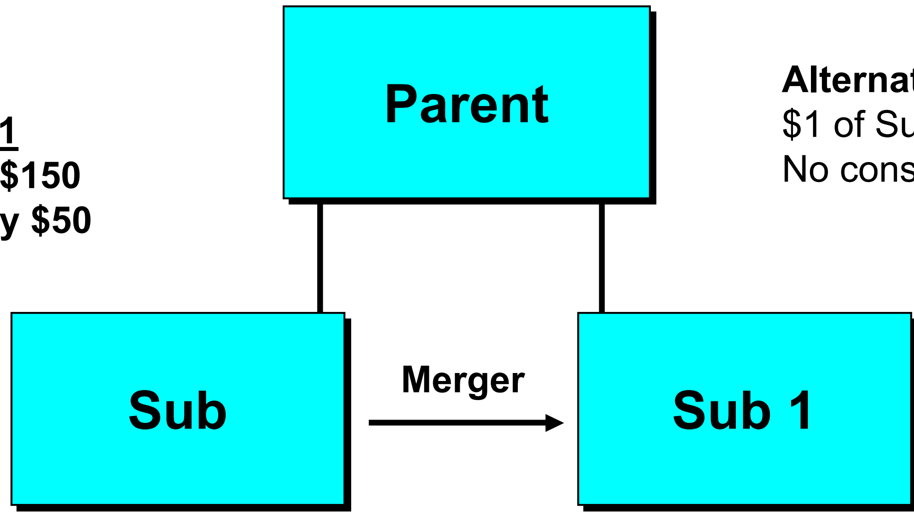
<u>Authorities</u>

Norman Scott, Inc., 48 T.C. 598 (1967).
U.S. v. Adkin-Phelps, Inc., 400 F.2d 737 (8th Cir. 1968).
Western Massachusetts Theatres, Inc. v. Commissioner, 236 F.2d 186 (1st Cir. 1956), *rev'g*, 24 T.C. 331.

CROSS-CHAIN MERGER – NO DEBT CANCELLED

Alternative Consideration:
$1 of Sub 1 stock in the merger
No consideration in the merger

<u>Year 1</u>
Debt $150
Equity $50



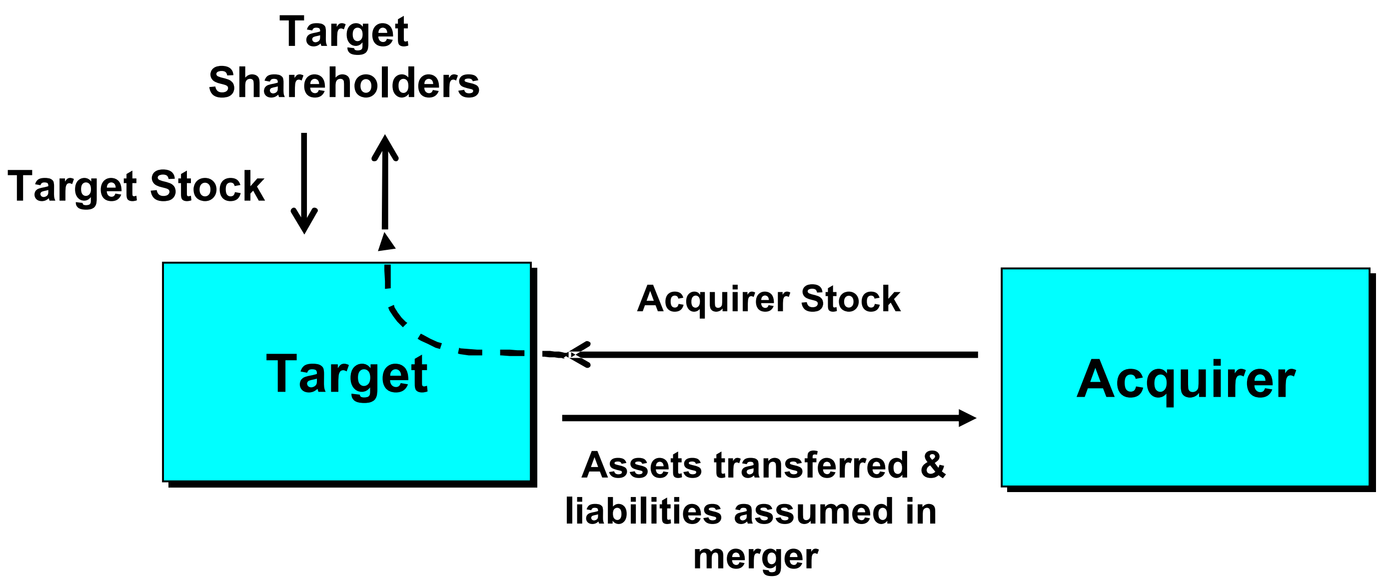
<u>End of Year 2</u>
S Assets $ 20
S Liabilities $150

Year 1:	Parent capitalized Sub with $50 of equity and $150 of debt.
Year 2:	After Sub incurred an NOL of $180, it merges with and into Sub 1 (a solvent subsidiary).

<u>Authorities</u>

Bazley, 331 U.S. 737 (1947).
Rev. Rul. 68-43, 1968-1 C.B. 146.

UNRELATED PARTY MERGER



Target Asset Value: $100 - $130 million

Fixed Liabilities: $90 million

Contingent Liabilities: up to $75 million
56% likelihood paid within 2-10 years

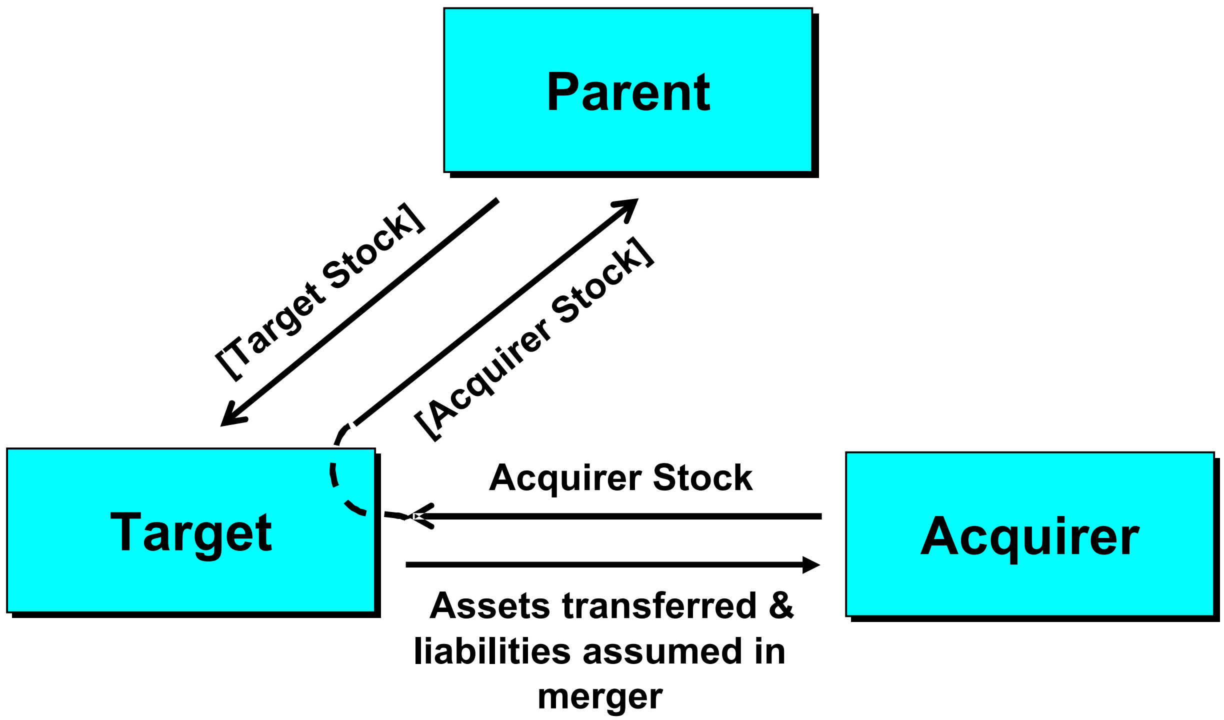
Alternative Consideration:

Acquirer stock = $5 million

Acquirer stock = $1

No consideration

RELATED PARTY MERGER



Target Asset Value: $100 - $130 million

Fixed Liabilities: $90 million

Contingent Liabilities: up to $75 million
56% likelihood paid within 2-10 years

Alternative Consideration:

Acquirer stock = $5 million

Acquirer stock = $1

No consideration

DIFFERENT STOCK AND ASSET TRANSFER RULES

Stock Reorganization Transfers

- **Target obligations owed to an acquirer that are exchanged for <u>stock</u> are generally not treated as assumed in the reorganization, and thus do not reduce net value surrendered or received in the reorganization.**

Asset Reorganization Transfers

- **By contrast, target obligations owed to an acquirer that are exchanged for <u>assets</u> are treated as liabilities assumed by acquirer that reduce net value surrendered in exchange.**
  - **Query why stock, but not assets, may be received in exchange for target liabilities without reducing target's net value.**

SOLUTIONS FOR ASSET REORGANIZATIONS?

Solution #1: Target retains liabilities (other than liabilities to acquirer), as permitted in C reorganization, and distributes acquirer stock to creditors to satisfy retained liabilities. Retained liabilities would not be treated as assumed.

Solution #2: When the acquirer is solvent, change the direction of the merger so that the acquirer merges into target. Since the acquirer's receivable from target is treated as an acquirer asset, net value is surrendered and received.

Solution #3: Merge into subsidiary of target's creditor. Debt simultaneously contributed to target is not treated as assumed in merger because only exchange between target and subsidiary is tested for net value. Target debt to third parties may also be satisfied with parent stock in connection with such a merger rather than assumed.

WHY RESTRICT LIABILITY ASSUMPTIONS WHILE EXPANDING DEFINITION OF CONTINUITY?

A target that navigates the liability assumption rules and both transfers and retains net value must also ensure that a proposed reorganization satisfies continuity of interest (COI).

- **Historically, relaxed continuity rules treated creditors of a bankrupt target that receive stock as holding continuity- giving proprietary interests in the target, often permitting acquisitions to qualify for G reorganization treatment.**

NOTE: The government has observed that the same purposes underly the net value requirement and the COI requirement. Query, then, why both requirements must be satisfied to obtain tax-free reorganization treatment.

EXPANDED CONTINUITY RULES

The proposed NNV regulations expand the continuity rules for senior creditors of bankrupt targets and extend them to insolvent targets.

- **Regulations bifurcate claims of the most senior class of creditors receiving acquirer (or acquirer parent) stock into claims exchanged for target stock and claims exchanged for other consideration.**
  - **The percentage of stock received by each qualifying senior creditor is determined for COI purposes by reference to the average amount of stock received by all senior creditors.**
- **The aggregate amount of the claims of each junior class of creditors constitutes a proprietary interest in the target; the amount of stock received by each junior creditor is measured as a percentage of total consideration received.**

OBSERVATIONS ON THE CONTINUITY RULES

Under these broader COI rules, tax free treatment would more likely result when creditors receive stock.

- **Acquirer and related party purchases and redemptions of debt before a reorganization, and purchases and redemptions of stock thereafter, would each reduce COI.**

Claims may be continuity-giving, but they do not constitute stock for purposes of the specific target shareholder stock exchanges required for certain reorganizations, which may limit the types of reorganizations available in some cases.

ARE SHAREHOLDER EXCHANGES TAX-FREE UNDER SECTION 354?

Should a claim holder be treated as a shareholder under section 354 to enable its tax-free receipt of stock for securities?

- **The answer may depend on whether the holder is deemed to first exchange its claim for stock of the target and then swap the stock for acquirer stock, as in Revenue Ruling 59-222, unless the holder is otherwise treated as exchanging "securities."**

- **Should the NNV regulations "codify" Revenue Ruling 59-222?**

NET VALUE REQUIREMENT: KEY ISSUES

Cliff effect: $1 of net equity value is sufficient.

Valuation of assets is critical.

- **Subject to challenge if future events suggest valuation was too high (or too low).**

Valuation of liabilities is also critical.

- **Value of nonrecourse liabilities?**
  ***See* section 357(d); *see also* Rev. Rul. 93-53, 1993-2 C.B. 48.**
- **Value of liabilities recourse only to a disregarded entity?**
  ***See* Treas. Reg. § 1.752-2(k).**
- **Value of contingent liabilities? Present value?**
  ***But see Merkel*, 192 F.3d 844 (9th Cir. 1999).**
- **Fair market value of obligation?**
- **Amount a third party would charge to assume the obligation?**

USE OF PREACQUISITION LOSSES – SECTION 384

SECTION 384

Applies to following acquisitions involving a loss corporation and a BIG corporation:

- **Acquisitions of "control," *i.e.*, 80% vote and value, of stock.**
- **Asset reorganizations (other than possibly G reorganizations).**

Prohibits loss corporation from utilizing preacquisition losses to offset RBIG of BIG corporation for 5 years after acquisition.

- **Complete prohibition, rather than limitation as under section 382.**
    - **Section 384 treats consolidated group members as a single company.**

SECTION 384

Recognized Built-in Gain (RBIG)

- **Defined in section 384(c)(1)(A). Almost identical to section 382 definition of RBIG, but with RBIL proof requirements.**
- **Built-in income items defined in section 384(c)(1)(B). Identical to section 382 definition.**

Crossover definitions from section 382:

- **NUBIG**
- **NUBIL**
- **RBIL**
- **Recognition period**
- **Recognition period taxable year**

SECTION 384 – IMPACT OF NOTICE 2003-65

Can Notice safe harbors apply for section 384 purposes where section 382 is <u>not</u> otherwise implicated, *e.g.*, where loss corporation is the acquiror, or there is a creeping acquisition of loss corporation?

If GainCo acquires loss corporation, and an approach under the Notice is selected for loss corporation section 382 purposes, does that approach also automatically apply to GainCo for section 384 purposes?

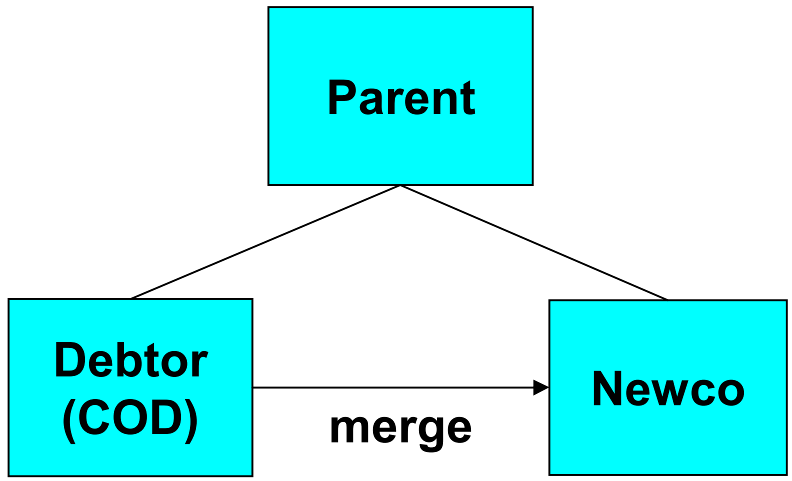
- **Does it matter if the chosen approach is section 1374 or section 338?**
- **What if GainCo is also a loss corporation, such that the issue is applying GainCo's losses against loss corporation's RBIGs, and the section 338 approach is selected for loss corporation section 382 purposes?**

Query: If the Notice does not itself apply, could the IRS's recognition of "wasting" built-in assets apply to section 384 as a matter of law since section 384 limits offset of actual income "attributable" to RBIG?

ACQUISITIONS OF LOSS COMPANIES

- The target group may use a target's NOLs to shelter seller group income (other than gain on the sale of the target stock) for the entire year of sale. Accordingly, NOLs available to the purchaser group will generally not be known until well after the acquisition.
- Buyer of stock assumes accepting joint and several liability for the target group's unpaid taxes; indemnities are often not available from creditworthy parties.
- Purchasing the assets of consolidated subsidiaries with section 338(h)(10) elections transforms target NOLs into additional asset basis.

TAX-FREE REORGANIZATIONS AFTER COD INCOME IS EXCLUDED



Debtor merges into Newco under Chapter 11 plan in a "G" (not "F") reorganization.

Any tax attributes to which the acquiring corporation succeeds and any tax basis carried over in a section 381(a) transaction (such as a "G" reorganization or section 332 liquidation) shall reflect appropriate attribute reduction for any excluded COD income during the year. Treas. Reg. § 1.108-7(c) (overturning FSA 200145009).

MISCELLANEOUS BANKRUPTCY TAX ISSUES

PERSONAL LIABILITY TAXES

Section 6672: 100% penalty imposed on "responsible persons" who willfully fail to collect, account for, or pay over certain "trust fund taxes."

Section 7501: Where any person is required to collect or withhold any tax from any person and pay over such tax to the U.S., the tax so collected or withheld is held to be a special trust fund in trust for the U.S.

TRUST FUND TAXES

Taxes Subject to Personal Liability

- Employee income tax withholding
- Employee share of FICA taxes
- Transportation excise taxes
- Backup withholding taxes
- Many state sales taxes
- State payroll taxes
- Fuel taxes
- Customs duties

Taxes Not Subject to Personal Liability

- Employer portion of FICA taxes
- Corporate income taxes
- Real property taxes

RESPONSIBLE PERSONS

Broadly defined to include officers, directors and employees with sufficient authority to direct payment of the tax, whether or not regularly exercised.

- **Not limited to persons that perform mechanical job of collection and payment but to all persons with power or position to direct payment of tax.**
- **Delegation of duty to another person does not insulate otherwise responsible persons.**
- **Multiple responsible persons may be liable for penalty. Statutory right of contribution.**

BANKRUPTCY RISKS FOR RESPONSIBLE PERSONS

After filing of a bankruptcy petition, the IRS is stayed from collecting pre-petition taxes from debtor corporation.

- **IRS is not stayed from assessing and collecting section 6672 penalty from responsible persons.**
  - **IRS "policy" is to refrain from assessing section 6672 penalty until confirmation of bankruptcy plan, except where delay jeopardizes collection.**
  - **Determination to proceed against responsible persons still left to discretion of revenue agents. Sometimes used as leverage.**
- **Bankrupcty courts are unlikely to enjoin IRS from assessing or collecting the section 6672 penalty against officers.**

PRE-BANKRUPTCY PLANNING

Prepay all trust fund and other personal liability taxes prior to filing bankruptcy petition. If cash is insufficient to do so, segregate collected trust fund taxes in separate account.

- **Supreme Court has held that trust fund taxes held in a segregated account are not property of the debtor's estate and, thus, payment of taxes from such accounts are not preferences.**
- **Specifically designate the tax liability to which each payment is to be applied. Otherwise, the IRS may apply the payment to a non-trust fund liability and seek section 6672 penalty for the trust fund tax.**

Consider also prepaying or segregating funds for controversy issues or contingent trust fund tax liabilities.

2005 BANKRUPTCY ACT TAX PROVISIONS

The tax changes made by the 2005 Bankruptcy Act cover a wide range of topics, but have a pro-government unifying theme.

- **Income tax liabilities of a corporate debtor for the year of the bankruptcy filing are post-petition (and therefore payable immediately), rather than being bifurcated between pre-petition claims (not payable until emergence, or even later) and post-petition claims (payable immediately).**

- **The interest rate on pre-petition and administrative period tax claims is the applicable rate under non-bankruptcy law, which generally exceeds the rates typically imposed by most bankruptcy courts.**

2005 BANKRUPTCY ACT TAX PROVISIONS - II

- The period over which a debtor can pay its unsecured priority taxes was reduced from six years from assessment (normally the emergence date) to five years from the filing date.

- The bankruptcy disclosure statement must contain a discussion of the potential material federal tax consequences to the debtor, any successor to the debtor, and a hypothetical investor typical of the holders of claims or interests in the case.

- Taxing authorities may set off pre-petition refunds owed to a debtor against pre-petition claims against the debtor without court permission.