

CHOICE OF CREDITOR INVESTMENT VEHICLE

INTRODUCTION

With U.S. corporate bankruptcies poised to hit a decade-long high as a result of the economic impact of COVID-19, we have prepared these materials that detail the key bankruptcy tax issues and guidance offered by Linda Swartz, the chair of Cadwalader's Tax Group, in old and new speeches and panels. We hope you find this presentation to be both useful and informative.

For additional information, contact [Linda Swartz](mailto:linda.swartz@cwt.com) (linda.swartz@cwt.com).

Upcoming speaking engagements:

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| October 14, 2020 | <ul style="list-style-type: none">• Linda Swartz will be presenting "Tax Strategies for Financially Troubled Businesses and Other Loss Companies" at PLI's Tax Strategies for Corporate Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings 2020 |
| November 5, 2020 | <ul style="list-style-type: none">• Linda Swartz will be presenting "A Cause for Distress? The Ways the Federal Income Tax Pushes Taxpayers into Bankruptcy" at The University of Chicago Tax Conference |
| January 25, 2021 | <ul style="list-style-type: none">• Linda Swartz will be presenting "Distressed Corporations: Creditor and Shareholder Issues" at the 2021 University of Southern California Federal Tax Institute |
| February 8, 2021 | <ul style="list-style-type: none">• Linda Swartz will be presenting "Workouts and Debt Restructurings" at PLI's 23rd Annual Real Estate Tax Forum |
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LINDA Z. SWARTZ



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Linda Swartz, the longtime chair of Cadwalader's Tax Group and member of the Firm's Management Committee, focuses her practice on structuring complex restructurings, bankruptcies, mergers and acquisitions, spin-offs, joint ventures, and foreign tax planning strategies. She also regularly advises clients on fund structures, financings and derivative transactions.

Linda is consistently recognized as one of the leading tax lawyers in the country. She was recently named one of 14 "Influential Women In Tax Law" by *Law360*, noted for her role as "a key architect on billion-dollar transactions involving major multinational companies" with clients describing her tax structuring expertise as "so strong that we don't even go to the IRS to get a blessing from them. We go to Linda to get a blessing from her." She has been described by *Chambers USA* as "acclaimed for her vast reservoir of practical knowledge of the U.S. tax code" and "an expert on the law of today but cognizant of where the law might go in the future, allowing clients to make decisions which last for the next ten years." Clients quoted by *The Best Lawyers* in America have described Linda as "the foremost U.S. tax advisor on structured acquisition and divestiture deals" and "a professional force of nature" with "extraordinary technical ability, coupled with fiercest and most trenchant deal negotiation skills of any transactional tax lawyer." She was also recognized as "2017 Foreign Tax Planning Lawyer of the Year" by *Finance Monthly*, and *Dow Jones*, reporting on Procter & Gamble's Reverse Morris Trust transaction with Coty, noted that "it isn't often you see a tax adviser credited on a deal, but that's exactly what happened for Cadwalader, Wickersham & Taft in P&G's complicated \$12.5 billion unloading of its beauty business to Coty."

Linda is widely regarded as a thought leader in the industry and is a prolific speaker and writer on a wide range of transactional tax issues, with articles that include "Partnership Bankruptcy Tax issues," "Debt Exchanges," "Bankruptcy Tax Issues," and "Bankruptcy Tax 101." She also authors the chapters on Debt Exchanges in *Collier on Bankruptcy Taxation* (Matthew Bender) and Securities Lending Transactions in *Taxation of Financial Institutions* (Clark Boardman Callaghan). In addition to writing, she speaks on a broad range of topics, including each year on workout and bankruptcy tax issues at the corporate and real estate tax PLI conferences.

Linda is a member of the Executive Committee of the New York State Bar Association Tax Section and has chaired its Tax-Free Reorganizations; Corporations; Bankruptcy; Consolidated Returns; Real Property; and Tax Accounting and Basis Committees.

Linda received her J.D. from University of Pennsylvania Law School, and her B.A. from Bucknell University, where she graduated *magna cum laude* and was elected to Phi Beta Kappa.

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 is common.

INDIRECT FORECLOSURES: CHOICES AND QUESTIONS

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 choose to hold debt through blocker corporations to avoid equity recast risk.

Will indirect foreclosure be respected?

- Once debt always debt.
- Change of obligor should not matter for non-recourse 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 FMV of collateral?
- And/or subordinate a portion of the loan to protect the senior piece?

INDIRECT FORECLOSURES: ADDITIONAL ISSUES

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 if creditors 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 CREDITOR EXIT STRATEGIES

Sale of Debt or Equity of Equity LLC

Holder's gain/loss on sale equals amount realized less its 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."

- During the 2008 downturn, participants in mortgage securitization industry asked IRS to permit a REMIC to provide seller financing to buyer of foreclosed property. Currently, such a loan would not be a qualified mortgage for a REMIC.

Third Party Refinancings of Equity LLC

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 creating partner debt issues, equity holders may be prohibited from directly participating in the financing or buying the 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 so qualify.

New Debt Distributions to Equity Holders

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.

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?