

WORKOUTS INVOLVING RECOURSE DEBT OF DISREGARDED ENTITIES

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 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.

INTRODUCTION: DISREGARDED ENTITIES

The advent of entities that are disregarded from their owners for U.S. income tax purposes (each, a “DRE”) raises unique issues as relates to analyzing the recourse versus nonrecourse status of debt of a DRE.

- The check-the-box rules generally treat a domestic unincorporated entity with a single owner as a DRE, unless the entity affirmatively elects to be classified as a corporation for U.S. income tax purposes. Reg. §301.7701-3(a), (b)(1).
- DREs are generally treated as branches or divisions of their owners. Accordingly, a DRE’s assets and liabilities generally constitute assets and liabilities of the DRE’s regarded owner for U.S. income tax purposes. Reg. §301.7701-2(a); cf. Reg. §301.7701-3(g)(1)(iii) (effect of conversion).

The following slides explore (i) the significance of recourse versus nonrecourse debt in the context of workouts, and (ii) how this classification should be applied when recourse debt is issued by a DRE without a parent guarantee.

(NON)RECOURSE DRE DEBT

A gating issue is the proper treatment of debt that is fully recourse to a DRE under state law, but not recourse to its regarded shareholder (whether that regarded entity is a corporation or a partnership).

- If state law or a facts and circumstances test controls, such DRE debt will often be treated as recourse.
- On the other hand, the debt could be treated as nonrecourse since the debt is treated for all U.S. federal income tax purposes as incurred by the regarded entity and the lenders do not have recourse to all of that entity's assets.

An IRS conclusion that all DRE debt should be treated as nonrecourse would likely have an adverse impact on many cases involving distressed companies, and could also lead to planning opportunities.

Critical Issues Involving DRE Debt

Three principal areas in which the recourse / nonrecourse distinction arises within the context of workouts are:

- CODI versus Section 1001 gain,
- The application of the insolvency and bankruptcy exceptions under Section 108, and
- The treatment of certain deemed debt modifications under Reg. §1.1001-3, including implications for the rules regarding changes in obligor and recourse versus nonrecourse debt.