

# **COD AND DISREGARDED ENTITIES**

# INTRODUCTION

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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](mailto:linda.swartz@cwt.com)).

## Upcoming speaking engagements:

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

# CODI VS. SECTION 1001 GAIN

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- Under *Tufts v Comm’r*, 461 U.S. 300 (1983), there is a significant difference between the treatment of the cancellation of recourse debt, on one hand, and nonrecourse debt, on the other hand. See also Reg. §1.1001-2.
  - If assets are transferred in satisfaction of recourse debt, Section 1001 gain is recognized with respect to the difference between tax basis and fair market value, and cancellation of debt income (“CODI”) with respect to the amount by which the adjusted issue price of the debt exceeds fmv (subject to exclusion under certain circumstances under Section 108).
  - If assets are transferred in satisfaction of nonrecourse debt, the asset generally is treated as having been sold for the amount of the nonrecourse liability, producing “Tufts gain” under Section 1001.

# CODI VS. SECTION 1001 GAIN (cont'd)

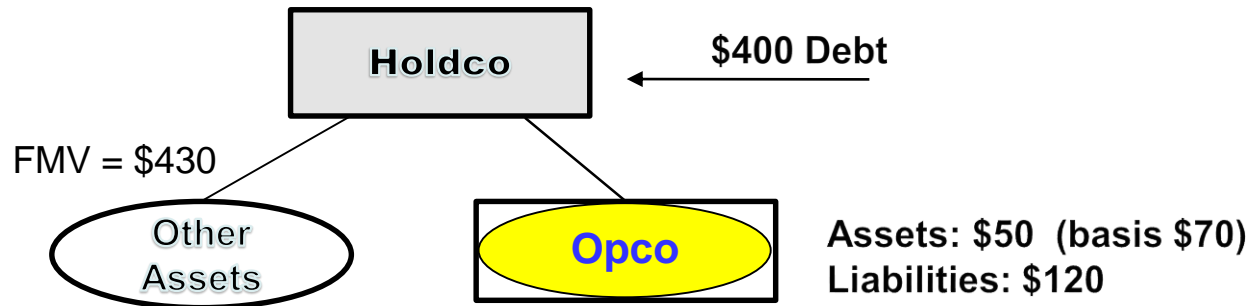
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- *Tufts* gain also results if all the property securing a nonrecourse debt is disposed of to a third party, regardless of whether the creditor receives any of the property or proceeds in connection with the debt cancellation. Reg. §1.1001-2(a)(1), (a)(4)(i), (b).
- Nonrecognition provisions may prevent the recognition of *Tufts* gain, e.g., Section 1032 and 361 for corporations and 721 in the partnership context (both for the partnership and a partner swapping debt for partnership equity).
- In *Tufts*, the Supreme Court generally equated the treatment of nonrecourse debt with recourse debt but deferred to the IRS's long-standing different treatment of nonrecourse debt upon disposition.
- Thus, the distinction between recourse and nonrecourse debt for gain or loss purposes is grounded not in the economic ability to reach an owner's other assets, but rather in the IRS's historic method of tax accounting for nonrecourse debt in a disposition.

# THE *TUFTS*-TYPE SITUATION

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- Facts: Holdco, a corporation, owns *Opco LLC* which is treated as a DRE for U.S. federal income tax purposes. All liabilities are recourse under state law.
- *Opco* will sell all of its assets for \$50 and distribute all of the proceeds in satisfaction and cancellation of its \$120 of liabilities. *Opco* may or may not file bankruptcy.



- Question:
  - What are the tax consequences to Holdco? Is *Opco LLC*'s debt treated as recourse debt of *Opco LLC* or nonrecourse debt of Holdco?

# COMPARATIVE OUTCOMES

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<b>If the Bank Debt is treated as Nonrecourse Debt of Holdco</b>	<b>If the Bank Debt is treated as Recourse Debt of Opco LLC</b>
<p>Holdco would be treated as selling the assets of Opco for \$120 and would recognize \$50 of gain.</p> <p>Holdco would have no CODI.</p>	<p>Holdco would be treated as selling the Opco assets for their \$50 FMV and would recognize a loss of \$20.</p> <p>Holdco would be treated as satisfying the Opco debt for an amount equal to the FMV of the transferred property and would realize CODI of \$70 (the \$120 adjusted issue price of debt less the \$50 FMV of the assets).</p> <p>If Holdco is in bankruptcy, or if not, to the extent of its insolvency, CODI would be excluded from gross income.</p>

# PARTNERSHIPS: CODI VS. 1001 GAIN

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- The application of *Tufts* is reasonably clear in the context of debt that is secured by a single asset, and there is also guidance with respect to partnerships, but the IRS has not in general addressed the treatment of debt that is recourse to a DRE.
- IRS guidance indicates that state law controls for partnerships; if the debt is recourse to all of a partnership's assets, the debt will be treated as recourse under *Tufts*, even if the debt is nonrecourse under Section 752.
  - But compare IRS Chief Counsel Advice 201525010, with *Great Plains Gasification Associates v. Commissioner, T.C. Memo 2006-76*. The CCA rejects the implication that *Great Plains* (which held that the debt at issue was nonrecourse debt for Section 1001 purposes) was decided by reference to the Code §752 regulations, but supports the facts and circumstances analysis in the decision.
- The IRS is sharpening its focus on the application of these rules to DREs and has added this issue to its priority guidance plan.



# THE INSOLVENCY EXCEPTION TO CODI

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**CODI is generally excluded from a borrower's gross income to the extent the borrower is insolvent immediately before the discharge (at the cost of attribute reduction).**

- Debt for this purpose includes any debt for which the taxpayer is liable or that encumbers property the taxpayer holds.
- A straight reduction in the amount of nonrecourse debt generally results in CODI just like a straight reduction in recourse debt. Rev. Rul. 91-31.

**“Insolvency” is defined as the extent to which the taxpayer's liabilities exceed the fair market value of its assets.**

- Nonrecourse debt is taken into account only to the extent of (i) the FMV of the property securing such debt, and (ii) the amount of any nonrecourse debt discharged. Rev. Rul. 92-53.
- Thus, the “underwater” portion of nonrecourse debt generally does not factor into the insolvency computation.

# THE INSOLVENCY EXCEPTION: IMPACT OF DRES

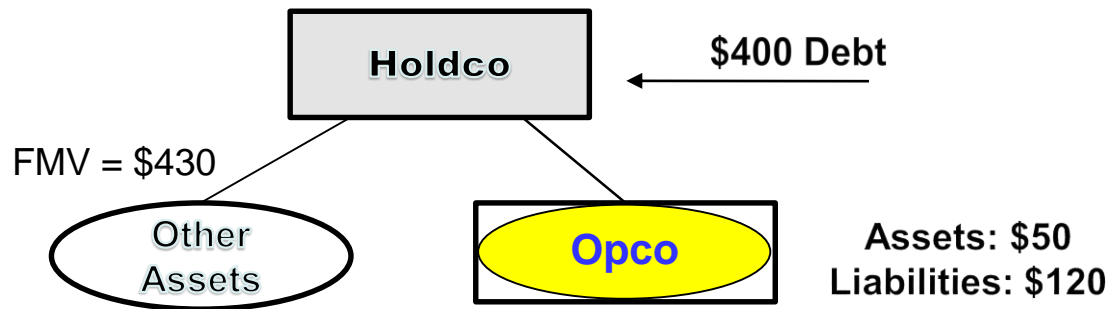
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In June 2016, the IRS finalized Treasury Regulation §1.108-9 addressing certain aspects of the insolvency exception to CODI of a DRE:

- In particular, the regulation makes clear that the insolvency exception is determined by looking to the **insolvency of the tax recognized owner**, not the DRE.
- Similarly, for the bankruptcy exception to CODI to apply, the regulation requires that the tax recognized owner be the party in bankruptcy. The bankruptcy of the DRE alone is irrelevant; the tax recognized owner would have to rely on the insolvency exception.
- The preamble describes the IRS's **current view** as follows:
  - recourse debt of a DRE should generally be treated as nonrecourse debt for purposes of applying the insolvency exception (assuming the owner has not guaranteed the indebtedness and is not otherwise liable for the indebtedness under applicable law), and
  - accordingly, the principles of Rev. Rul. 92-53 should apply to determine the extent to which such debt is taken into account in determining the owner's insolvency.

# THE DETERMINATION OF INSOLVENCY

- Facts: Holdco, a corporation, owns *Opco LLC* which is treated as a DRE for U.S. federal income tax purposes. All liabilities are recourse under state law. Neither is in bankruptcy. Holdco realizes \$50 of CODI.



- Questions:
  - In determining the insolvency of Holdco for Section 108 purposes if **Holdco's direct debt** is the source of the CODI, can Holdco include the Opco liabilities? Is Holdco solvent by \$30 or insolvent by \$40?
  - What if Holdco had guaranteed Opco's liabilities? See *Merkel v. Comr.*, 109 TC 463 (1997).
  - What if Opco's operations are essential to Holdco's business?
  - If Opco's liabilities are cancelled, Rev. Rul. 92-53 should apply.
  - What if Opco's liabilities are discharged in bankruptcy?