

DEBT MODIFICATION AND 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:

-
- | | |
|-------------------------|---|
| 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 |
-

LINDA Z. SWARTZ



Linda Z. Swartz
Chair, Tax
New York
(212) 504 6062
linda.swartz@cwt.com

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.

DEBT MODIFICATION: OVERVIEW

Changing the terms of a debt instrument generally will only trigger a deemed “exchange” of the debt if the change represents a “significant modification” of the instrument. This test differs for recourse and nonrecourse debt.

- Generally, debt is nonrecourse if a lender may seek recourse only against specific collateral securing debt. See, e.g., FSA 200135002 (debt that the parties classified as a “limited recourse loan” should be treated as nonrecourse debt for purposes of Treasury Regulation §1.1001-2).

Change in Obligor

- **Recourse Debt:** always a “significant modification” (unless pursuant to a §381 or similar transaction). Reg. §1.1001-3(e)(4)(i).
- **Nonrecourse Debt:** not a “significant modification.” Reg. §1.1001-3(e)(4)(ii).

CHANGE IN SECURITY / RECOURSE NATURE

Change in Security

- **Recourse Debt:** An alteration of collateral **is** a significant modification **only if** there is a “change of payment expectations.”
- **Nonrecourse Debt:** An alteration of collateral **is** generally a significant modification **unless** the collateral is fungible.

Change in Recourse Nature of Debt

- A change from nonrecourse (or substantially nonrecourse) to recourse (or substantially recourse) **is** a significant modification.
- A change from recourse to nonrecourse debt **is** a significant modification, **unless** the instrument continues to be secured only by the original collateral **and** there is no “change in payment expectations.”

DRE DEBT: RECOURSE OR NONRECOURSE?

Two approaches to classifying DRE debt for tax purposes.

- **Recourse Debt:**
 - *Reasoning:* Legally, the lender can enforce its rights against all the assets of the DRE including those acquired after the date when the loan was made. A loan that allows the lender to seek recourse against a pool of assets that may change over time should be treated as recourse debt for tax purposes.
- **Nonrecourse Debt:**
 - *Reasoning:* Because a DRE is not a tax “person,” its debt is treated as debt of the owner, and creditors of the DRE can seek recourse only against the DRE’s assets.

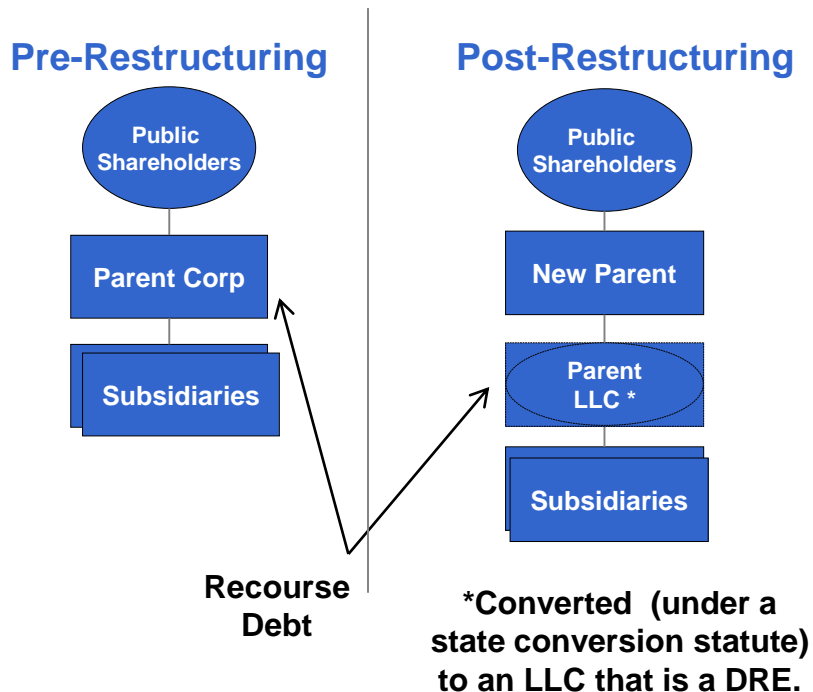
In its earliest rulings, the IRS most clearly ruled that when a corporation is converted into an LLC under state law, outstanding recourse debt of the LLC should not be deemed to have undergone a “significant modification” under Reg. §1.1001-3, strongly implying that the debt remained recourse for this purpose since a change from recourse to nonrecourse would have constituted a *per se* significant modification.

- Later rulings, while less transparent, appear to treat the “obligor” of the debt as changing but not in a manner that would trigger a significant modification of the debt.

PLR 200315001: CONVERSION TO DRE

PLR 200315001

(simplified steps & description)



- Parent Corp became a subsidiary of newly formed New Parent through a merger of a new corporate subsidiary of New Parent with and into Parent Corp.
 - The merger was intended to be a reorganization under Code §368.
- Following the merger, Parent Corp converted under state law into a limited liability company ("LLC") that became a DRE.
- **The IRS held that, under state law, the rights and obligations under the debt did not change and, thus, that the restructuring did not result in either a change of obligor or a change in the recourse nature of the debt.**

PLR 200630002: CONVERSION TO DRE

On facts similar to PLR 200315001, the IRS held in PLR 200630002 that **there was no significant modification of the debt.**

- The IRS adopted a result oriented approach in this ruling with respect to whether or not a conversion to a DRE resulted in a deemed exchange of the debt for Section 1001 purposes.
 - In setting out the relevant law, the ruling identified the change-in-obligor exception for Section 381 transactions.
 - The transaction in this case was structured as an “F” reorganization (similar to the prior ruling but in this ruling expressly recognized as an “F” reorganization).

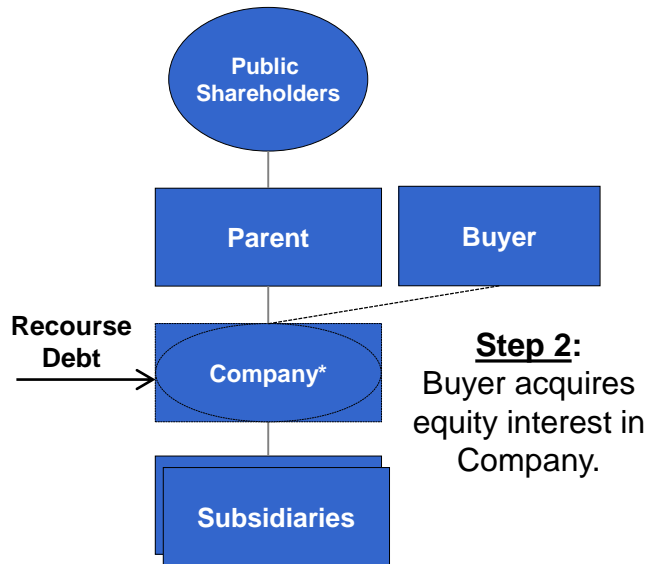
Notably, the ruling concluded **that there was no change in the recourse nature of the debt.**

- Did the IRS rely on the Section 381 exception to find no change in obligor, and therefore no change in the recourse nature of the debt?

PLR 200709013: CONVERSION TO / FROM DRE

PLR 200709013*

(simplified steps & description)



***Step 1:**

Converts from corporation to LLC, which initially elects to be treated as a corporation, and subsequently elects to be treated as a DRE.

Under an agreement with Buyer, the following transactions occurred:

- Company, a corporation, converted into an LLC, which immediately checked the box to be a corporation. The conversion was intended to be an “F” reorganization.
- Company then checked the box to become a DRE, which was held to be a Section 332 liquidation.
- Parent sells equity in Company to Buyer, and Buyer also contributes cash to Company for additional equity, converting Company from a DRE to a partnership for U.S. income tax purposes.

Unlike the prior PLRs, this ruling was explicit that **“some” steps in the proposed transaction involved a change in obligor and thus a modification, *albeit* not significant. The ruling was silent as to whether the recourse status of the debt changed.**

* See also PLR 201010015.

PLR 200709013: CONVERSION TO / FROM DRE

The PLR held that any change in obligor was **not** significant either by reason of the exceptions for Section 381 transactions **or** acquisitions of substantially all assets.

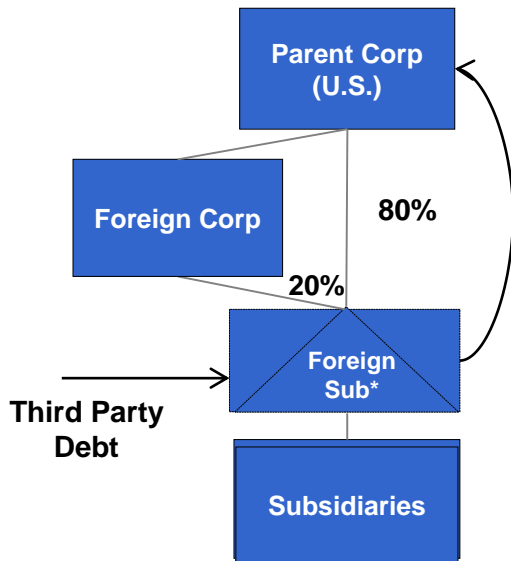
- The PLR did not make clear whether the Section 332 liquidation – the conversion to a DRE – was one of the identified changes in obligor, but it was ignored as an intermediate step in the series of transactions in which Company (the partnership) was substituted for Company (the corporation) as obligor on the debt, triggering a single modification under the “cumulative effect” rule in Reg. §1.1001-3(f)(3).
- If Parent had become a momentary obligor, on a deemed acquisition and recontribution of the assets to the Company, Company (the partnership) would seemingly have had to acquire its, and substantially all of Parent’s, assets in the deemed contribution to satisfy the “substantially all” requirement of Reg. §1.1001-3(e)(4)(i).

Query whether IRS also concluded that there was no change in the recourse status of the debt?

GLAM 2011-003: CONVERSION OF STATUS

General Legal Advice Memorandum (GLAM) 2011-003

(simplified steps & description)



Step: A corporation for U.S. income tax purposes, makes a check-the-box election to be classified as a partnership for U.S. federal income tax purposes.

Foreign Sub checked the box to convert to a partnership.

- In **Situation 1**, Foreign Sub debt was owed to Parent.
- In **Situation 2**, the debt was owed to a third-party.
- For U.S. income tax purposes, Foreign Sub (the corporation) was deemed to distribute its assets and liabilities to its shareholders in liquidation, and Foreign Corp and Parent Corp were deemed to recontribute the assets to Foreign Sub (the partnership).

Under both situations, the IRS concluded that **Foreign Sub's change in entity classification resulted in a change in obligor (*albeit not significant*), but was silent as to whether the restructuring resulted in a change in the recourse status of the debt.**

- The IRS ruling appears to rely on step transaction to disregard Parent's transitory assumption of the debt (which would not have satisfied the substantially all transfer exception in Reg. § 1.1001-3).
- The ruling notes that an actual liquidation and recontribution would produce the same result if no change in the debt results under local law.

THE PATH FORWARD FOR DRE DEBT

The government's analysis of the treatment of DRE debt has grown more opaque over the past 15 years, and clearer guidance is critically important to business transactions.

- Guidance should disregard changes in the tax fiction of a DRE vs Partnership vs Corporation because none of the legal rights of the borrower and lender on DRE debt change with changes in tax status. Accordingly, *Cottage Savings* does not mandate a significant modification.
- More specifically, for state law purposes, neither the recourse nature of DRE debt nor the obligor on the debt changes if the DRE converts to or from a corporation or a partnership, and so no significant modification should result under the Section 1001 regulations.