

SECTIONS 382L5 AND L6

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 |

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.

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 the **lesser** of:
 - loss corporation's stock value immediately **after** the ownership change; or
 - value of loss corporation's **pre-change gross assets**.

SECTION 382L5 ALTERNATIVE

Elective alternative if loss corporation's preexisting shareholders and qualified "old and cold" creditors retain or receive for their claims 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 the 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 and/or 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 two years results in automatic section 382 annual limitation after the second change of zero – all losses predating the second ownership change are effectively eliminated.
 - Section 382(l)(5) applies for purposes of determining section 382 consequences for taxable period between first and second ownership changes. 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 IMPLEMENTATION ISSUES

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.
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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).

Matching Deferred COD and OID

Creditors receiving less than 5% of reorganized debtor stock are generally treated as qualified creditors for section 382(l)(5) purposes unless a 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 what participation in plan formulation could make evident creditor's unqualified status.
 - Mere membership on creditors' committee should not constitute such evidence.
 - Consequences of trading order disclosure.
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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.

Later orders permit free trading in claims, but require substantial claimholders to sell down below a specified portion of their claims if debtor proposes section 382(l)(5) plan.

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