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Tax Implications of Distressed Situations

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Agenda

- Introduction
- Proposed § 382(h) Regulations
- Domestic Tax Issues
- International Tax Issues
- Questions

PROPOSED § 382(H) REGULATIONS

Recently proposed Section 382(h) regulations

- Section 382(h) provides special rules for gains and losses that are built-in at the time of a Section 382 ownership change and recognized during the recognition period.
  - If a loss corporation has a **NUBIG**, the Section 382 limitation for any recognition period taxable year is increased by the amount of its **RBIG**, up to the amount of NUBIG (as reduced for RBIG from prior years).
  - If a loss corporation has a **NUBIL**, its **RBIL** for any recognition period taxable year is subject to limitation as if it were a pre-change loss, up to the amount of the NUBIL (as reduced for RBIL from prior years).
- These proposed rules are based on a **neutrality principle**: RBIG and RBIL should be treated in the same manner as if they were recognized before the change date.
- **The proposed regulations make certain significant changes to the current rules especially with respect to the Section 338 RBIG method commonly used by taxpayers.**

Recently proposed Section 382(h) regulations – Key Changes

- Elimination of the 338 method for determining RBIGs. The ability to increase the 382 limitation for deemed RBIG measured by a hypothetical cost recovery of a built-in gain assets provided by the 338 method of Notice 2003-65 (the "Notice") would be eliminated. RBIG for built in gain asset would only be triggered through an actual sale of the asset.
- The treatment of COD as RBIG has also been has been modified from the 1374 approach as provided in the Notice. The proposed rules are quite detailed. Treatment depends on whether debt is recourse or non-recourse, excluded from income under section 108, and if so, what attributes are reduced.
- The treatment of contingent liabilities has also been modified (and may require valuation services). Under the 1374 approach of the Notice, very few deductions were treated as RBIL. This would not be the case under the proposed regulations

Recently proposed Section 382(h) regulations – Key Changes

- The calculations of NUBIG and NUBIL has also been modified largely as a result of the removal of excluded COD from the calculation.
  - Under existing guidance, for purposes of calculating NUBIG or NUBIL, the value of the company's assets could be calculated by assuming that the company's assets were sold to a third party that assumed the company's liabilities, including liabilities that were discharged in the transaction giving rise to the ownership change (See PLR 201051019).

It is expected that this could swing many distressed companies that would currently be in a NUBIG position to being NUBIL companies with more deductions subject to RBIL.

Applicability dates and transition rules

- The IRS and Treasury have proposed to:
  - Delay the applicability date of the proposed regs until 30 days after the date the proposed regs are published as final (the "delayed applicability date"), and
  - Provide transition relief for certain ownership changes.
- To qualify for transition relief, an ownership change must occur immediately after a transaction that:
  - Occurs pursuant to a **binding agreement** in effect on or before the delayed applicability date;
  - Is described in one or more of the following:
    - A **public announcement** made on or before the delayed applicability date,
    - An **SEC filing** submitted on or before the delayed applicability date, or
    - A **PLR request** submitted to the IRS on or before the delayed applicability date; or
  - Occurs by order of a court (or pursuant to a plan confirmed, or a sale approved, by order of a court) in a **Title 11 or similar case**, if the taxpayer was a debtor in a case before that court on or before the delayed applicability date.
- Notice 2003-65 will apply to ownership changes to which the final regs do not apply.

DOMESTIC TAX ISSUES

Domestic Tax Issues

CANCELLATION OF DEBT

Cancellation of debt (COD)

General

- Generally, under § 61(a)(12), a corporation must recognize income upon a “discharge of its indebtedness”
- Amount of COD income is generally the excess of the principal amount (or adjusted issue price) of the debt over the fair market value of any consideration paid in exchange for the debt
- If the debt has original issue discount (OID) (i.e., it was issued for an amount less than its stated redemption price), then the COD amount is measured by the adjusted issue price of the debt
  - Treas. Reg. § 1.61-12(c)(2)(ii)

COD

Debt-for-debt exchange

- Debtor is treated as satisfying the old debt with an amount of money equal to the issue price of the new debt
  - § 108(e)(10)
- If either the new or old debt is publicly traded, the issue price of new debt equals its fair market value
  - Debt is publicly traded if it is traded on an established securities market, appears on a quotation medium, or if price quotations are readily available from dealers, brokers or traders
  - The term "publicly traded" often requires very close examination of the facts
- If neither the new or old debt is publicly traded, the issue price of the new debt equals its stated principal amount, provided the coupon rate is at least equal to the applicable federal rate (AFR)
  - AFR will depend upon the term of the instrument
  - If the coupon rate is less than the AFR, the issue price is determined by discounting the stated principal at the AFR rate

COD

Deemed exchanges

- Debt modifications (Treas. Reg. § 1.1001-3(b))
  - A "significant modification" of the terms of a debt instrument (DI) is treated as an exchange of the old debt for new debt (Treas. Reg. § 1.1001-3(b)) and potentially triggers COD consequences to the debtor
    - A modification is significant if the legal rights or obligations are altered, and the degree to which they are altered is economically significant
    - All modifications are considered collectively, so that a series of modifications may be significant although each modification alone is not significant
  - Two level test
    - An alteration is tested to determine if a modification has occurred
    - If a modification has occurred then it is tested for significance within the extent of Treas. Reg. § 1.1001-1(a)

COD

Common modifications

Maturity Date	Collateral or other security
Interest Rate	Seniority
Principal amount	Guarantee
Obligor	

Whether an exchange has occurred

- Step 1. "Modification" is any alteration of a legal right/obligation of the issuer/holder
  - Timing: Modification generally occurs when the issuer and holder agree to a change in terms, even if the change does not immediately take effect. But a modification conditioned on reasonable closing conditions occurs on the closing date. A modification arising from a bankruptcy plan occurs on the plan's effective date.
  - Exception: "Modification" does not include an alteration that occurs by operation of DI's original terms
    - *E.g.,* a periodic resetting of the interest rate based on an index
    - This exception does **not** apply to:
      - Change in obligor or a change in recourse/non-recourse nature of the DI
      - Change from debt to non-debt (unless a conversion into issuer's stock)
      - Change from exercise of an option, unless option is (a) unilateral or (b) exercisable by holder and such exercise will not defer/reduce a scheduled payment of interest/principal

Whether an exchange has occurred

- Step 1. "Modification"
  - Failure of an issuer to perform its obligations under the debt is not a modification
  - The holder's agreement to stay collection or temporarily waive an acceleration clause or similar default right is not a modification unless and until the forbearance remains in effect for more than two years following the debtor's initial nonperformance
    - The period of nonperformance can continue beyond two years without resulting in a modification if the:
      - Parties are engaged in good faith negotiations or
      - Debtor is in a Title 11 proceeding

Whether an exchange has occurred

- Step 2. Modification is "significant" if legal rights/obligations being altered, and degree to which they are altered, are economically significant
  - General rules/application of economic significance test
    - Contingent modifications
    - Series of modifications
    - Prepayments
  - Change in yield: significant if yield increased by > greater of (a) 25 basis points or (b) 5% of the annual yield
    - Applies both to fixed and variable rate DIs
    - May be implicated when principal amount of the DI is altered

Whether an exchange has occurred

- Step 2. “Significant” modification
  - Change in timing of payments: significant if materially defers any scheduled payment
    - Materiality depends on the facts and circumstances:
      - Original term of the debt and length of the deferral
      - Amount of deferred payments
      - Time period between the modification and actual deferral of payments
    - Safe harbor period: deferral is not material if payment is unconditionally payable during (or by end of) this period
      - Safe harbor period = lesser of 5 years or 50% of DI’s term
      - Begins from original due date of the first deferred payment
      - Safe harbor period is cumulative, i.e. is shortened by any prior deferrals
  - Effect on yield: extension of maturity date that affects the DI’s yield, must also be tested for significance under “change in yield” rules

Whether an exchange has occurred

- Step 2. "Significant" modification
  - Change in obligor or security
    - Substitution of new obligor (recourse DI): generally significant, except if:
      - Old obligor is acquired in § 381 transaction (e.g. tax free reorganization), acquiror replaces old obligor, and transaction does not result in a "change in payment expectations" and is not otherwise a significant alteration
      - Change in payment expectations: modification substantially enhances/impairs obligor's payment capacity
      - Or, new obligor acquired substantially all assets of old obligor (Note: § 338 transaction does not result in "substitution" of obligor)
      - Also, the regulations provide that the filing of a petition in a Title 11 case does not by itself result in the substitution of a new obligor

Whether an exchange has occurred

- Step 2. “Significant” modification
  - Change in obligor or security
    - Substitution of new obligor (non-recourse DI): not significant
    - Addition/deletion of a co-obligor (recourse DI): significant if it changes expectation of payment
    - Change in collateral/guaranty (recourse DI): significant if it changes expectation of payment
  - Change in obligor or security
    - Change in collateral/guaranty (non-recourse DI): significant, regardless of whether it changes payment expectations
      - Exceptions: if (a) collateral is fungible, or (b) particular units of the collateral are irrelevant (e.g. collateral consists of government securities) In addition, improvements to (real property) collateral are not significant

Whether an exchange has occurred

- Step 2. “Significant” modification
  - Change in the nature of the DI: a conversion of DI into non-DI is significant. Change from recourse to non-recourse DI (or vice versa) is generally significant
    - Exception: change from recourse to non-recourse is not significant if DI is still secured by original collateral, and there is no change in payment expectations

COD

Example of COD computation:

D Corp. is a holding company that owns 100% of OPCO. D Corp. proposes to restructure its $270 million 10% subordinated notes effective September 1, 2008, by issuing to the existing note holders in exchange for their existing notes: (a) $28 million in cash, (b) new 7-year notes having a principal amount of $35 million, (c) preferred stock having a fair market value of $25 million, and (d) new D Corp. common stock representing 100% of the D Corp. outstanding common stock. Under the plan, the pre-existing stock of D Corp. will be cancelled and new senior debt of $50 million will replace the existing bank debt of $20 million.
At the time of the restructuring, the “enterprise value” of D Corp. and its subsidiary is $230 million, and its non-interest bearing short-term liabilities are $30 million.

COD

Example of COD computation:

D Corp. should obtain an appraisal or fairness opinion to establish its enterprise value and the value of the new equity to be issued.

- The value of the common stock is generally the enterprise value less long-term liabilities less the value of other equity.

Enterprise value	$230
Bank Debt	-50
New Notes	-35
Preferred Stock	-25
Value of Common	$120

COD

Example of COD computation:

Computation of COD:

Consideration paid to Note Holders	FMV	
Cash	$ 28	
New Debt	35	(New principal balance)
Preferred Stock	25	(Fair market value)
Common Stock	120	(Enterprise value less long-term debt and value of other equity)
Total Consideration	208	
Principal of Old Debt	270	
COD Amount	$ 62	

COD

Income recognition exceptions

- Under § 108(a)(1), there are two common situations in which taxpayers are entitled to relief from the ordinary rules requiring recognition of COD income
  - **Title 11 case** – When there is a discharge of debt in bankruptcy pursuant to the bankruptcy plan of reorganization, the entire amount of such COD is excluded from income
  - **Insolvency** – If the discharge occurs in an out-of-court restructuring or not pursuant to a plan of reorganization in a Title 11 case, the COD amount is excluded from income only to the extent the debtor is insolvent
    - Under § 108(d)(3), insolvency of the debtor is determined immediately prior to the discharge and is measured by the amount of the debtor's liabilities over the fair market value of the debtor's assets
    - See *Merkel v. Comm'r*, 109 T.C. 463 (1997) (contingent liabilities should not be included in determining insolvency unless it can be shown that the taxpayer will likely be called upon to pay the liability)
- § 108(a)(1)(A): There is a general reduction of attributes to defer the COD income recognition
- D Corp. Example:

– Pre-restructuring liabilities	$320
– Less: FMV of assets	260 (Ent. Val. + S.T. Liab.)
– Insolvency	$ 60

COD

General attribute reduction rule

- Under § 108(b), the cost of utilizing the income recognition exceptions is that the debtor's tax attributes are reduced to the extent of the excluded COD in the following order:
  - Net Operating Losses (NOLs) and NOL carryovers, without regard to any limit in use by § 382
  - General Business Credits
  - Minimum Tax Credits
  - Capital Loss and Capital Loss Carryovers
  - Tax Basis in Property (see next page relative to basis reduction ordering rules)
  - Passive Activity Loss and Credit Carryovers
  - Foreign Tax Credit Carryovers
  - NOTE: This list currently does not include §163(j) disallowed interest C/F
- Attributes other than credits are reduced on a dollar for dollar basis by the amount of the COD excluded. Credits are reduced at a rate of 33 1/3¢ for each dollar of excluded COD
- Excluded COD in excess of the debtor's attributes disappears (i.e., it does not reduce future attributes and is not included in income).
  - However, if the debtor is a member of a consolidated group, reduction of consolidated attributes of the other members is as follows beginning with the highest tier debtor having excluded COD income

COD

Basis reduction ordering rules

Treas. Reg. §1.1017-1 provides ordering rules for the reduction of tax basis in property.

- Real property used in a trade or business or held for investment, other than real property described in section 1221(1), that secured the discharged indebtedness immediately before the discharge;
- Personal property used in a trade or business or held for investment, other than inventory, accounts receivable, and notes receivable, that secured the discharged indebtedness immediately before the discharge;
- Remaining property used in a trade or business or held for investment, other than inventory, accounts receivable, notes receivable, and real property described in section 1221(1);
- Inventory, accounts receivable, notes receivable, and real property described in section 1221(1); and
- Property not used in a trade or business nor held for investment.

COD

General attribute reduction rule

- Timing of attribute reduction
  - General rule under §108(b)(4) is that attributes are reduced after the determination of tax for the taxable year of the discharge
  - Under § 1017(a), reduction of tax basis in property occurs on the first day of the taxable year following the year of discharge
- Under § 1017(b)(2), basis in property may not be reduced below the debtor's aggregate liabilities measured immediately after the discharge. This limitation does not apply if the debtor elects to reduce basis before other attributes under § 108(b)(5)

Consolidated return

Attribute reduction

- Debtor first rule:
  - Attributes of the debtor member are first subject to reduction
    - Consolidated attributes attributable to the debtor member, determined under the principles of Treas. Reg. § 1.1502-21(b)(2)(iv)
    - The basis of property of the debtor member: (i) The basis of stock of a subsidiary is not reduce below zero. (ii) The basis reduction limitation of § 1017 is applied by looking only to the basis of property and liabilities of debtor member
    - Reference: Treas. Reg. § 1.1502-28(a)(1),(2)

Consolidated return

Attribute reduction

- "Look-through rule":
  - Applies if the attribute that the debtor member reduced is the basis of stock of a lower tier subsidiary
  - Lower-Tier Sub is treated as having excluded COD income equal to the reduction in basis of its stock
    - To the extent that the amount treated as the lower-tier sub's excluded COD income exceeds its tax attributes, the excess amount is not used to reduce the tax attributes of any other member of the group
    - To the extent that the amount treated as the lower-tier sub's excluded COD income exceeds its tax attributes, the excess amount is not used to reduce the tax attributes of any other member of the group
  - Repeat look-through rule approach for lower tier members if the basis of stock is reduced

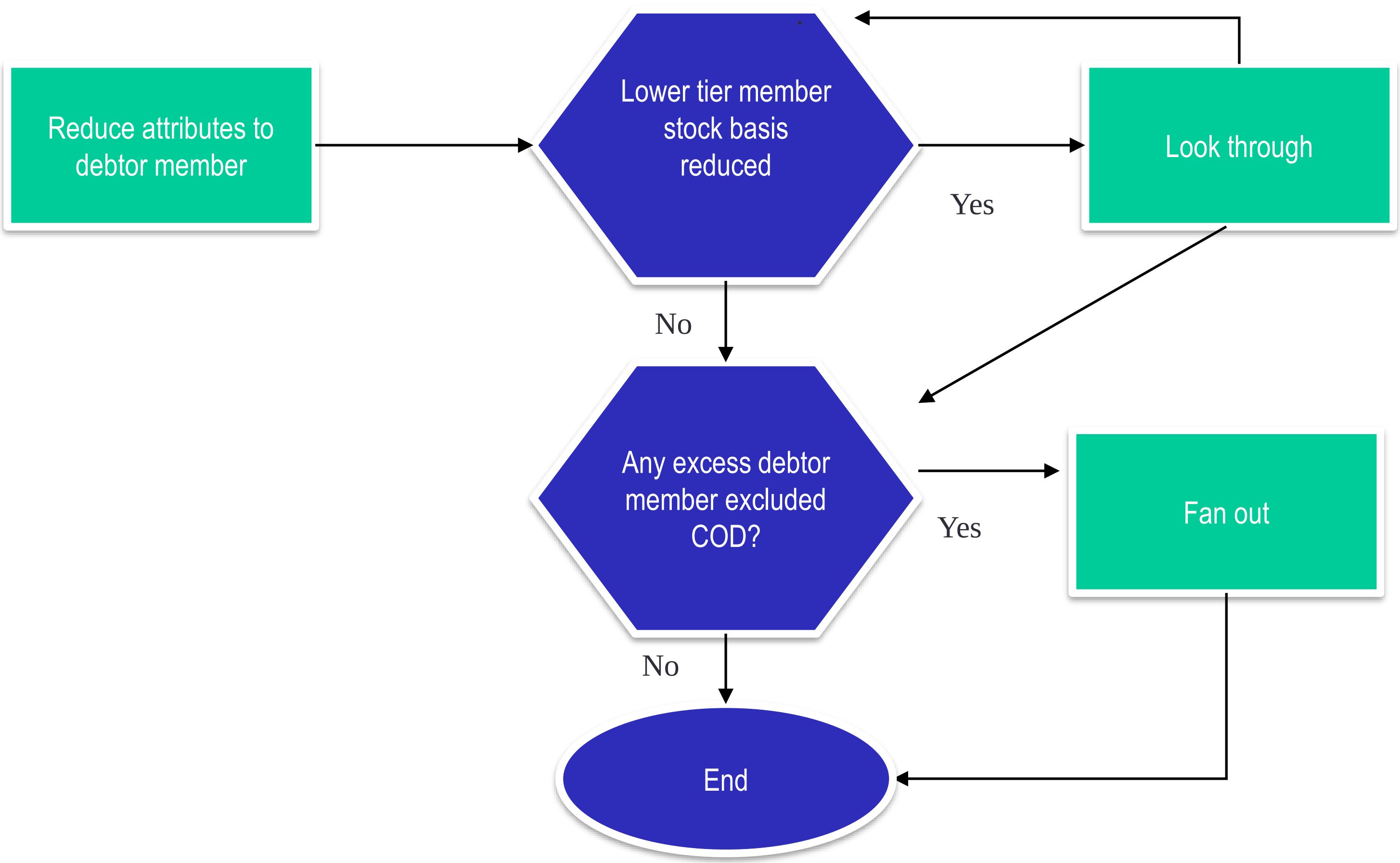
Consolidated return

Attribute reduction

- "Fan-out rule":
  - Consolidated tax attributes
  - After reduction of the debtor member's tax attributes (and application of the look through rule), any remaining excluded COD income is applied to reduce consolidated tax attributes attributable to other members of the group
  - Note: The "Fan-out" rule does not apply to "look-through" COD income

COD

General attribute reduction rule: consolidated return

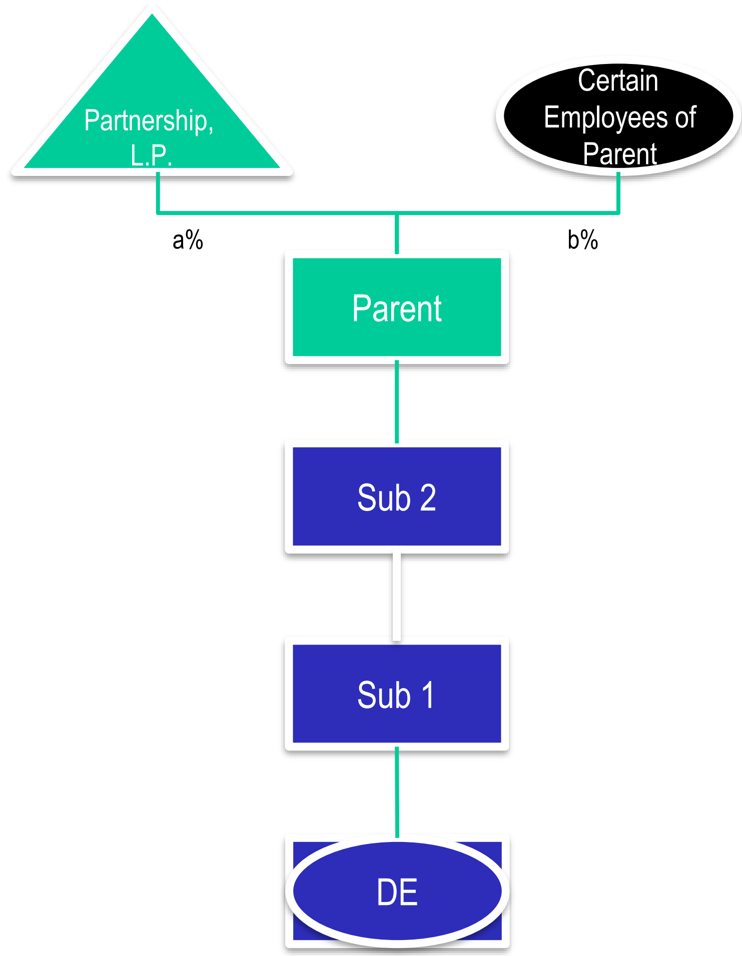


COD

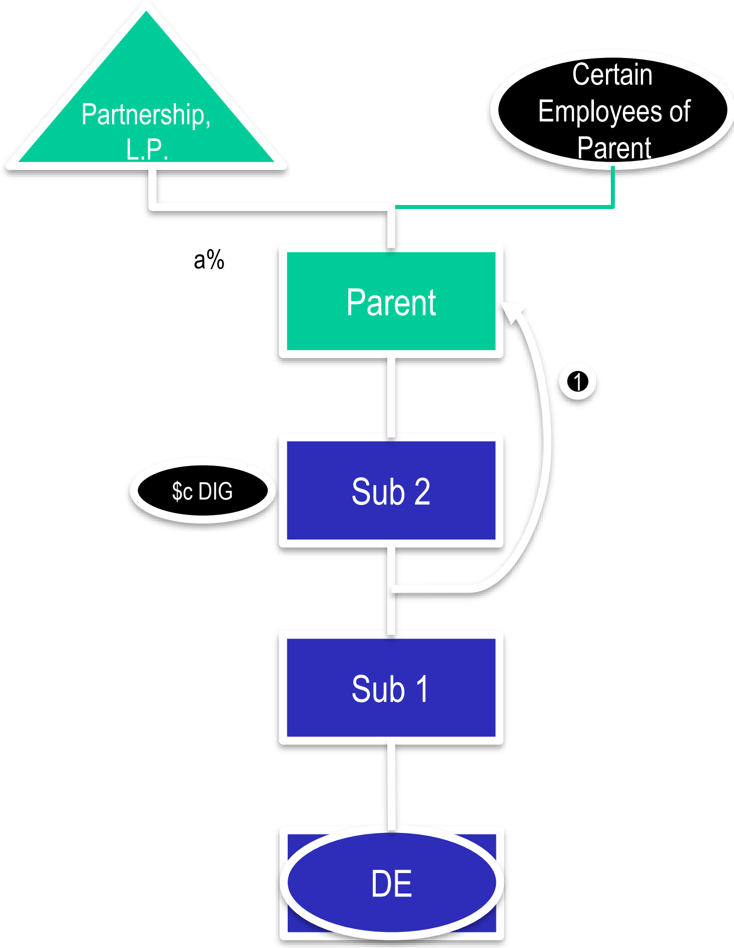
Excess loss accounts

- Excess loss accounts (ELAs) generally result under the consolidated return investment adjustment system when distributions and/or losses of a subsidiary used exceed subsidiary income and amounts invested in or paid for the stock of a subsidiary member of a consolidated group.
- ELAs are triggered and create taxable income under certain circumstances, such as deconsolidation or treatment as worthless. *See* Treas. Reg. 1.1502-19(c)(1)(ii)-(iii)(A).
- If a subsidiary with an ELA has excluded COD that exceeds the amount of the attributes reduced the ELA is triggered to the extent the amount of excluded COD is greater than the amount of attribute reduction. *See* Treas. Reg. 1.1502-19(c)(1)(iii)(B), *see also* Treas. Reg. 1.1502-19(b)(1)(ii) – which provides for the limitation on the amount of the inclusion.
- It is important to note that the entire ELA could be triggered as a result of certain types of restructuring that frequently occur in connection with Chapter 11 proceedings.

PLR 201326006 – Prior to Date 1



PLR 201326006 – Prior to Date 1



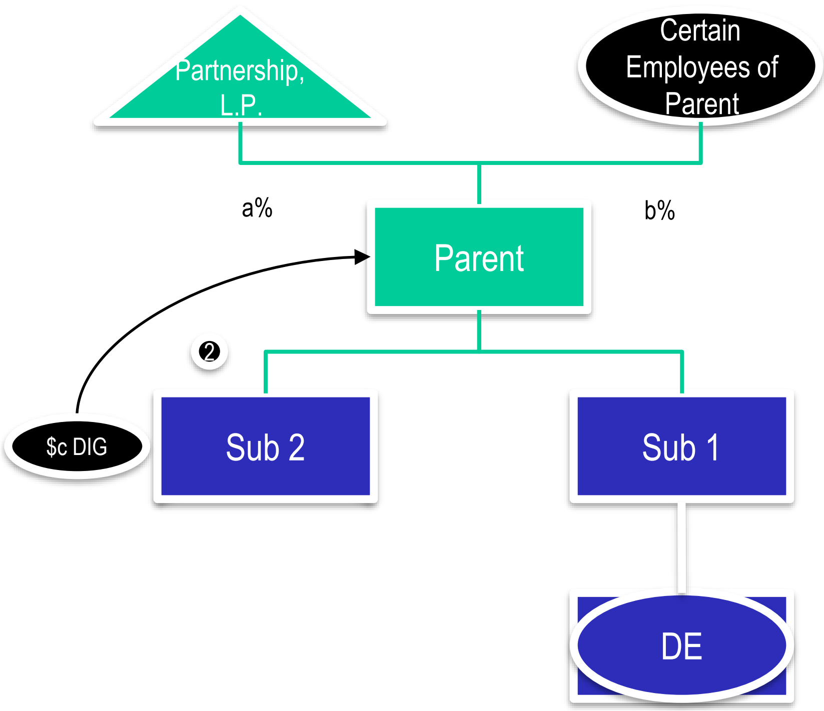
Legal Steps

Date 1: Sub 2 distributed the stock of Sub 1 to Parent as a dividend distribution taxable under Section 301.

Considerations

- Parent excluded the amount of the distribution from its gross income under Treas. Reg. 1.1502-13(f)(2)(ii).
- The Section 311(b) gain recognized by Sub 2 was deferred under Treas. Reg. 1.1502-13(f)(2)(iii), creating a deferred intercompany gain ("DIG") in the amount of $c.
- The Section 311(b) gain was a result of the fact that the fair market value ("FMV") of Sub 1 exceeded Sub 2's tax basis in the stock of Sub 1.

PLR 201326006 – Date 2



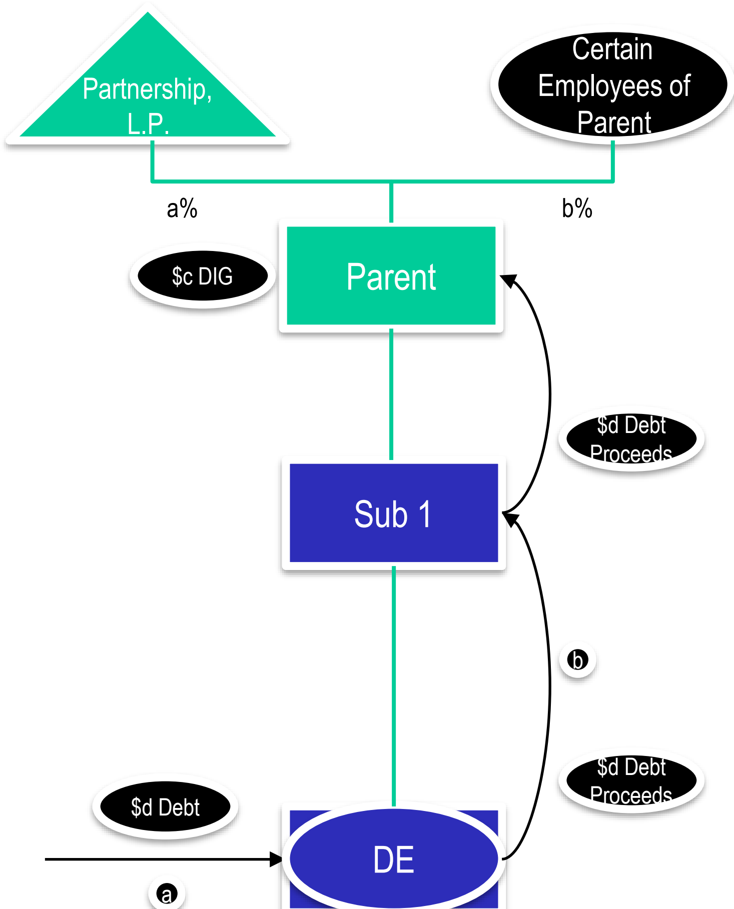
Legal Steps

Date 2: Sub 2 merged upstream into Parent in a transaction intended to qualify as a Section 332 tax-free liquidation.

Considerations

Pursuant to Treas. Reg. 1.1502-13(j)(2), Parent became the successor to Sub 2 and succeeded to its DIG that was created when Sub 2 distributed Sub 1 to Parent.

PLR 201326006 – Year 1



Legal Steps

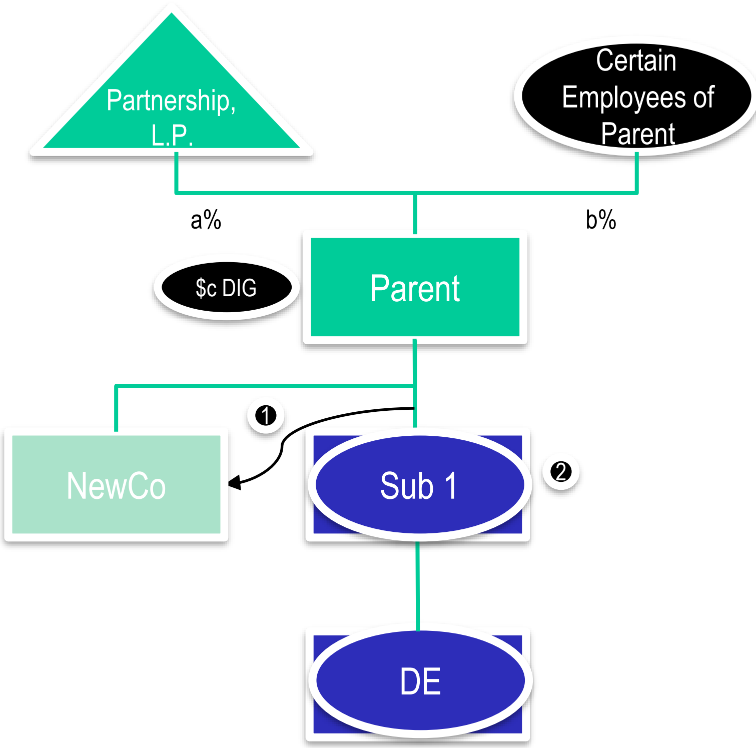
Year 1a: DE incurred debt guaranteed by Sub 1 of $d in connection with the purchase of the Parent Consolidated Group by Parent. Other members of the Parent Consolidated Group also incurred debt for such purpose.

Year 1b: Shortly thereafter, DE distributed the proceeds of the DE Debt to Sub 1. Sub 1 then distributed the proceeds of the debt to Parent.

Considerations

- The DE Debt guaranteed by Sub 1 exceeds the fair market value of the DE membership interests owned by Sub 1.
- The distribution of the proceeds to Parent created an Excess Loss Account ("ELA") in the stock of Sub 1 pursuant to Treas. Reg. 1.1502-19(a)(2).

PLR 201326006 – Reorganization



Legal Steps

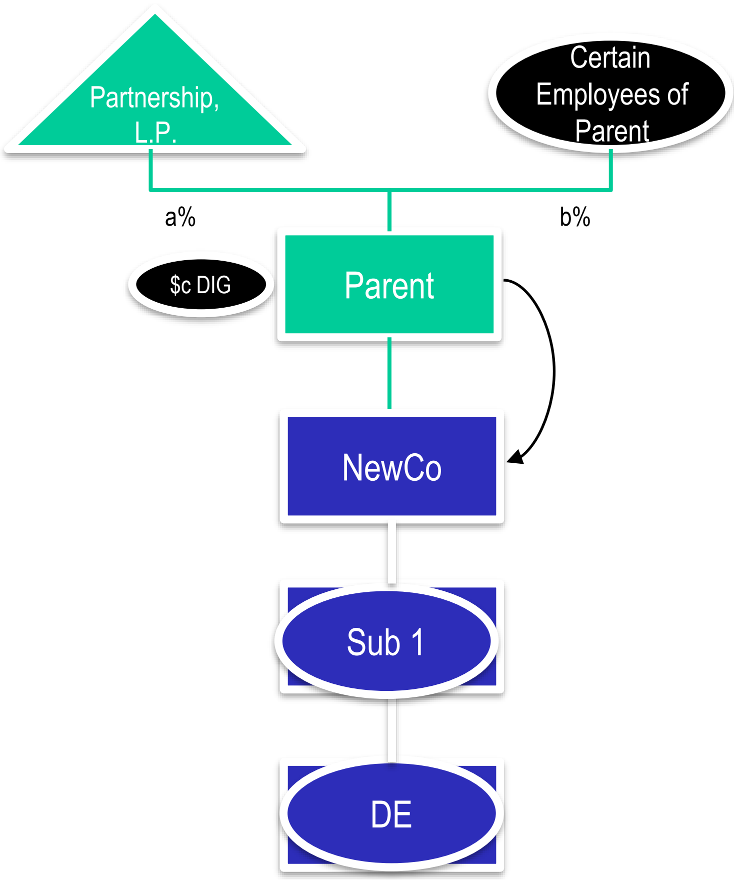
Step 1: Parent will incorporate NewCo and contribute all the stock of Sub 1 to NewCo.

Step 2: Sub 1 will convert into an LLC and immediately thereafter, Sub 1 will be treated as a disregarded entity for US federal income tax purposes.

Considerations

- As a result of the conversion of Sub 1, the DE Debt becomes non-recourse to NewCo under applicable state law.
- The creation of NewCo by Parent is tax free under Section 351.
- The transaction is considered a Type F reorganization under Section 368(a)(1)(F).
- Neither NewCo or Sub 1 recognize gain on the transfer or the conversion of Sub 1 into a disregarded entity.
- Parent's basis in the stock of NewCo will be the same as Parent's basis in the stock of Sub 1. As such, Parent will have an ELA in the stock of NewCo.

PLR 201326006 – Merger



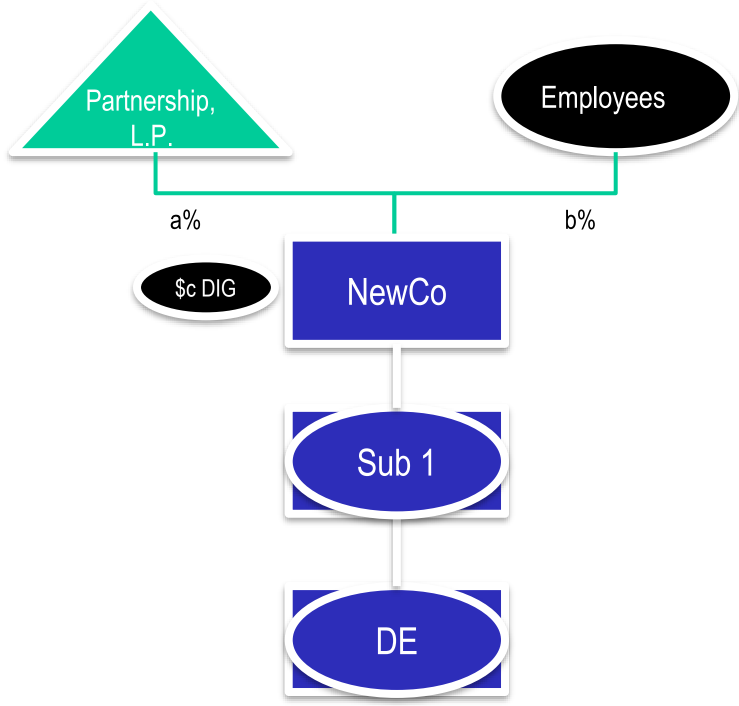
Legal Steps

Step 1: Parent will merge with and into NewCo, with NewCo surviving the statutory merger.

Considerations

- The merger of Parent into NewCo, provided that it qualifies as a statutory merger under state law, will be tax free under Section 368(a)(1)(A).
- NewCo and Parent do not recognize any gain or loss as a result of the merger.
- The ELA that Parent has in the stock of NewCo is eliminated.
- The shareholders of Parent do not recognized any gain or loss as a result of the merger.
- The shareholders' basis in the stock of NewCo received in the merger is equal to their basis in their Parent stock.
- Parent's DIG will be redetermined and excluded from taxable income under Treas. Reg. 1.1502-13(c)(6)(ii)(C).

PLR 201326006 – Post-Merger



Domestic Tax Issues

NET OPERATING LOSS CARRYFORWARDS AND LIMITATIONS

NOLs

General Section 382 limitation

- § 382 limits a corporation's ability to use its NOLs and other tax attribute carryforwards following an "ownership change."
  - An "ownership change" occurs if, immediately after any owner shift (purchase) or an equity structure shift (reorganization), the percentage (based on value) of stock of the loss corporation owned by one or more "5-percent shareholders" has *increased by more than 50 percentage points* over the lowest percentage of stock of the loss corporation owned by such shareholders at any time during the "testing period"
  - In general, the "testing period" is a three-year period ending on the date of any owner shift or equity structure shift involving a 5% shareholder
- The amount of post-change taxable income that a corporation can offset with pre-change NOLs and/or other tax attribute carryforwards cannot exceed an annual limitation prescribed under these rules

NOLs

General Section 382 limitation

- The annual limitation on the future utilization of a loss corporation's NOL carryforwards equals the fair market value of the loss corporation's equity times the long-term tax-exempt rate in effect for the month the ownership change occurs, plus any excess limitation from prior years.
- In cases involving financially distressed corporations, the NOLs may remain unutilized due to the general § 382 limitation. This is a significant factor where the loss corporation is insolvent and it restructures outside of Bankruptcy Court.
- D Corp. example:
  - Pre-change equity value is $0 (D Corp. is insolvent)
  - Therefore, annual § 382 limitation will be $0 after the ownership change

NOLs

Potential impact of shareholder worthless stock deduction

- Section 382(g)(4)(D):
  - 50% shareholder treats stock of L as worthless
  - Causes ownership change at the close of the shareholder's taxable year
  - 50% shareholder: any person owning 50% or more of L at any time during the three year period ending on the last day of the taxable year in which the stock was so treated

NOLs

Built-in gains and losses

- Under § 382(h), a loss corporation must determine its net unrealized built-in-gain (NUBIG) or built-in-loss (NUBIL) on the change date
  - The NUBIG/NUBIL is the amount by which the FMV of the assets of the loss corporation immediately before an ownership change exceeds/is less than the aggregate tax basis of those assets
  - If the amount of the NUBIG/NUBIL does not exceed the lower of: (1) 15% of the FMV of the assets, or (2) $10,000,000, the NUBIG/NUBIL is deemed to be zero
- If the loss corporation has a NUBIG at the time of the ownership change, the annual § 382 limitation is increased by the amount of NUBIG that a loss corporation actually recognizes for tax purposes on pre-change assets sold during the first five years after the ownership change
  - The built-in gain includes only the appreciation in value of the asset over the tax basis inherent in such asset on the date of the ownership change
  - The five-year period is a function of time and not a function of tax years

NOLs

Built-in gains and losses

- If a loss corporation has a NUBIL at the time of the change, the utilization of such losses that are recognized for tax purposes during any of the five years after the ownership change is subject to limitation, just as if such loss were a pre-change NOL
- Income or deductions items recognized during the 5-year recognition period which are attributable to taxable periods before the change date are treated as a recognized built-in gain/loss for the taxable year
  - COD is an example of an income item
  - Depreciation is an example of a deduction item

NOLs

- **Notice 2003-65**
  - The IRS issued tentative safe harbor guidance for calculating NUBIG/NUBIL and recognized BIG/BIL
  - Treasury has Reg. project in process
  - Provides two approaches – "338 approach" and "1374 approach"
- The determination of whether a loss consolidated group has a NUBIL/NUBIG is a complex determination under the consolidated return rules
  - All members of the group are taken into account in determining if there is a NUBIG
  - If any member has joined the group during the five year period prior to the ownership change, depending on the facts, the assets of that member may or may not be included in determining if the group has a consolidated NUBIL (-91(g)(2))

Domestic Tax Issues

EMERGENCE ALTERNATIVES

Recapitalization and asset sale

- Recapitalization – issuing stock or warrants (and/or new debt) in exchange for part of all of the principal and unpaid interest of a company’s debt.
  - Potential CODI and attribute reduction
  - Potential Section 382 ownership change (including NUBIL)
- Asset sale (Bruno’s) – distressed company sells its assets to creditors, utilizing its tax attributes to offset gain and achieving a step-up for the creditors
  - Potential tax due
  - May result in a step-down based upon FMV and asset basis
  - Risk of recharacterization as a G reorganization
  - Worthless stock deduction and the application of Treas. Regs. 1.1502-36, 1.1502-19, and 1.1502-11.

Bruno's

- Bruno's – Bruno's Inc. had 1B in debt and an equity value of 300M. An equity for debt exchange would have resulted in 700M of COD. The Company had NOL of 180M and tax basis in assets of 550M.
  - COD would have reduced the NOL to 0 and reduced the assets basis to 30M.
  - Instead of swapping debt for equity (E recapitalization), the secured creditor's purchased the assets of Bruno's for just over 300M using a newly formed acquisition entity (creditor owned). Bruno's NOLs offset the gain on the sale.

"G" Reorganizations – Defined

- A transfer of assets.
- By a corporation to another corporation in a title 11 or similar case.
- Distribution of stock or securities which qualifies under §§ 354, 355, or 356.

Title 11 or Similar Case

- Includes:
- A case under title 11 of the United States Bankruptcy Code
- Receiverships and foreclosures
- Similar proceedings in a Federal or State court
- Includes Chapter 7 and Chapter 11 bankruptcies
- Out-of-court and foreign reorganizations
  do not qualify.

Transfer of Assets

- Must satisfy the "Substantially All" Test
- Test is more lax than how it would be applied to non-bankruptcy non-related party reorganizations (e.g. "C" reorganizations, forward triangular mergers, and reverse triangular mergers).
- Acquisition of 50% of the gross value of assets and 70% of the value of operating assets qualified as a "G" reorganization.
- Interpreted in light of Congressional intent to facilitate the rehabilitation of corporations in bankruptcy.
- Debtor permitted to pay off creditors or sell assets to increase liquidity.
- Transfer must be made pursuant to a plan of reorganization approved by the court.
- Transfer of stock of the debtor corporation to creditors in satisfaction of their claims will not qualify, however, such transfer may qualify as a recapitalization under § 368(a)(1)(E).

Distribution of Stock or Securities

- Requirements:
- Pursuant to a plan of reorganization.
- To a holder of stock or securities in the acquired corporation in a transaction that qualifies under §§354, 355, or 356.
- Threshold exchange requirement should be satisfied if only one stock or security holder receives either stock or securities pursuant to a plan of reorganization.
- Permits Acquirer to use a relatively small percentage of equity consideration to acquire Target.
- A reorganization involving only short-term creditors (i.e., holders of debt with a maturity of less than 5 years) will not qualify.

Continuity of Interest (COI)

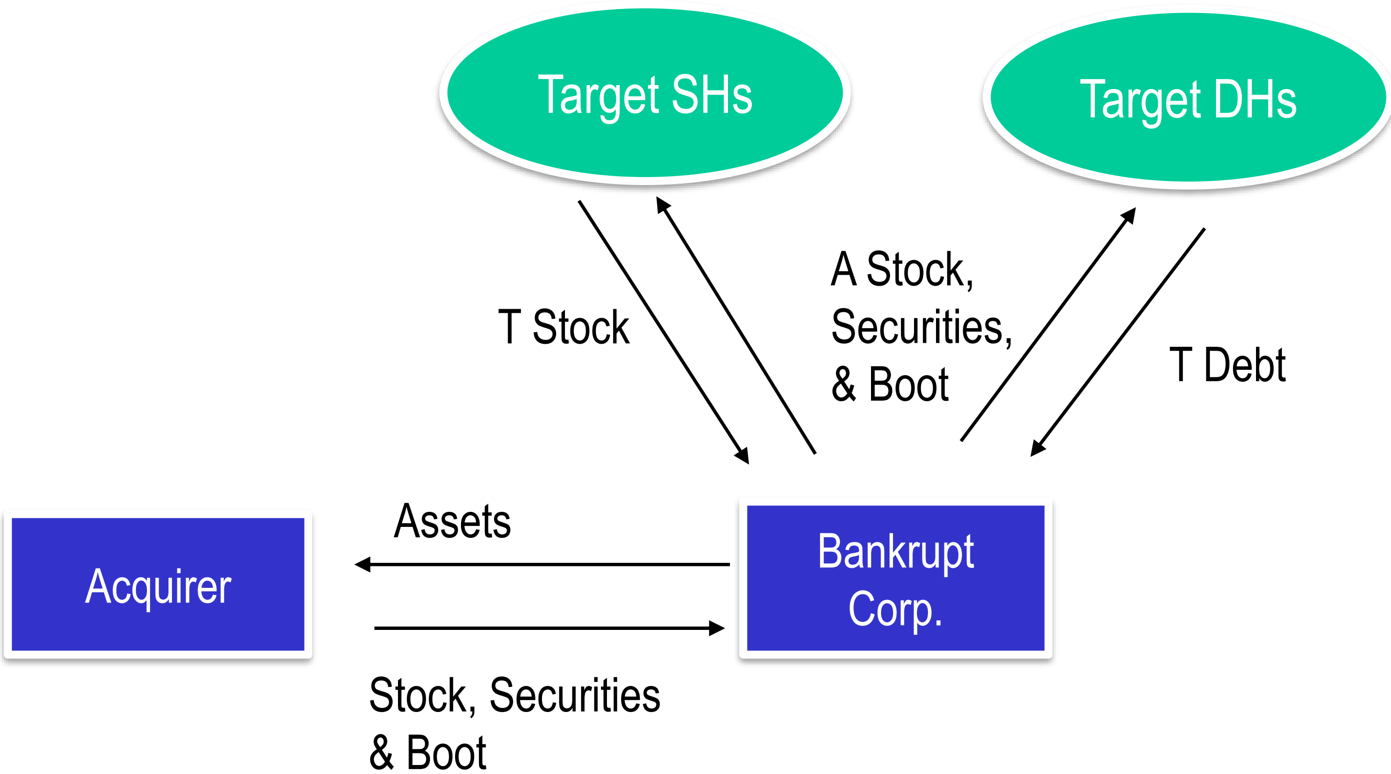
- Issue: Typically, in a “G” reorganization the proprietary interest of the historic shareholders of the bankrupt corporation is eliminated.
- Solution: Creditors deemed to have a proprietary interest in the bankrupt corporation.
- Measuring COI: The most senior class of creditors to receive stock plus all other equal and junior classes (including shareholders who receive any consideration for their stock) are considered the “historic shareholders” of Target.
- Note that for COI purposes, any creditor that receives stock is included in the COI test.
- However, the receipt of stock by short-term creditors may not meet the requirements of §354.

Other Requirements

- Continuity of Business Enterprise (COBE) –
- Acquiring corporation must either:
- (1)continue the acquired corporation's historic business; or
- (2)use a significant portion of the acquired corporation's historic assets in a continuing business.
- Business Purpose
- All tax-free reorganizations must be undertaken
- pursuant to a legitimate business purpose.
- The business purpose doctrine should be satisfied in the typical title 11 reorganization.

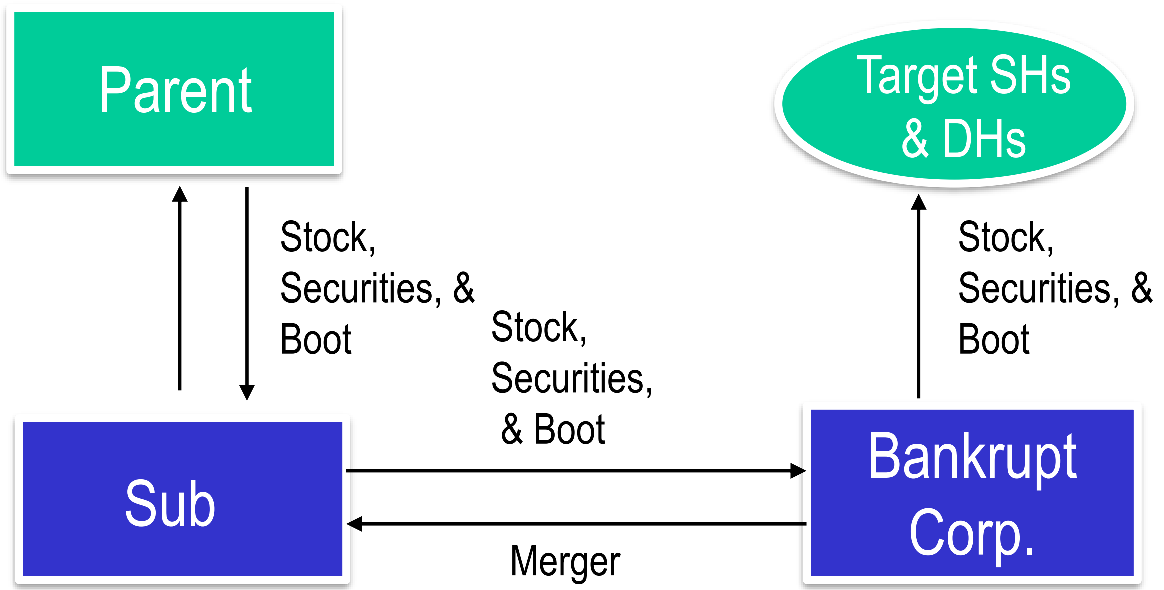
Types of "G" Reorganizations

Acquisitive "G"



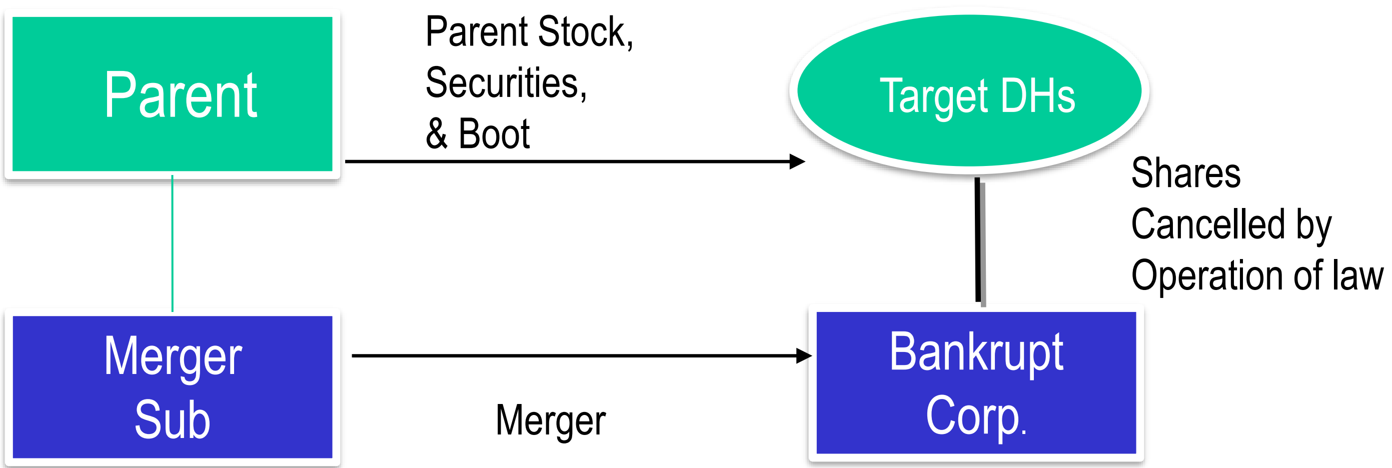
Types of "G" Reorganizations (Cont.)

Forward Triangular "G"



Types of "G" Reorganizations (Cont.)

Reverse Triangular Bankruptcy Merger



Requirements:

– Stockholders of the debtor corporation receive no consideration for their stock.
– Former creditors of the debtor corporation receive voting stock of the acquirer's parent equal to 80% of the total value of the debt.
– The surviving corporation must be in title 11 or similar case.
– Substantially all of the assets requirement applies.
– Acquirer's parent must control target immediately after the transaction.

Other Issues

- Nonexclusive:
- Failing to meet requirements for a “G” reorganization does not preclude other types of reorganizations from applying.
- However, once a transaction qualifies as a “G” reorganization, then the “G” reorganization trumps other reorganization provisions.
- Assumption of Liabilities:
- General Rule: gain recognition rules apply to liabilities that are assumed in excess of the basis of the assets transferred.
- Exception: an exchange in which no former shareholder receives any consideration for his stock.

Domestic Tax Issues

SECTION 382: SPECIAL RULES IN BANKRUPTCY PROCEEDINGS

NOLs

Special bankruptcy limitations under Section 382

- In order to provide additional incentives to restructure a distressed corporation (instead of liquidating it), the law provides two alternative exceptions to the general limitation under § 382. These exceptions described in § 382(l)(5) and § 382(l)(6) are applicable only to loss corporations that restructure in a Title 11 or similar case.
  - § 382(l)(5) is the primary exception to the § 382 annual limitation for loss corporations in bankruptcy court. § 382(l)(5) generally allows the pre-change NOL (after adjustments) to be used without limitation.
  - § 382(l)(6) applies only if the loss corporation does not qualify for the exception provided for in § 382(l)(5) or the loss corporation affirmatively elects not to apply § 382(l)(5). § 382(l)(6) provides an exception to the anti-stuffing rule of § 382(l)(1) in computing the value of the loss corporation for purposes of determining the annual limitation on pre-change NOL.

Section 382(l)(5): requirements

- The loss corporation must be under the jurisdiction of:
  - A court in a case under Title 11 of the United States Code or
  - A receivership, foreclosure or similar proceeding in a federal or state court
- May include certain state court-supervised workouts pursuant to statutes authorizing the corporation, a shareholder or a creditor to bring an equitable action to reorganize the corporation
- Pre-change shareholders and qualified creditors
  - Must own at least 50% of the new loss corporation's stock by vote and by value immediately after the ownership change
  - Such ownership must exist as a result of their being shareholders or creditors immediately before the ownership change
- Qualified creditor
  - Beneficial owner of qualified indebtedness immediately before the ownership change
  - Receives stock in full or partial satisfaction of qualified indebtedness
  - Receipt must be pursuant to a court approved plan
- Owned by same beneficial owner for 18 months before the filing of the Title 11 proceeding
- Arose in ordinary course of trade or business and is owned at all times by the same beneficial owner
- Disallowance of interest deductions:
  - NOL and tax credit carryforwards are redetermined as if no deduction was allowed for interest paid or accrued during the three years preceding the change year and during the pre-change portion of the change year on debt exchanged for stock pursuant to the Title 11 plan
  - Coordination with §108
    - The loss corporation does not take into account any indebtedness for interest related to the disallowed interest deductions for interest accrued but unpaid in determining CODI on a debt-for-stock exchange

NOLs

Section 382(l)(5) exception

- § 382(l)(5) applies if the loss corporation's shareholders and qualified creditors own at least 50% (vote and value) of the loss corporation stock (or stock of a controlling corporation also in bankruptcy) immediately after an ownership change as a result of being shareholders or qualified creditors immediately before the change
- If these conditions are met, then in lieu of the annual § 382 limitation, the loss corporation's pre-change losses and other attributes are reduced for the following two items and the residual tax attributes can be used without any further limitation:
  - The NOL is reduced for interest deducted (1) on or before the change date in the year of the ownership change and (2) in the prior three taxable years, with respect to debt exchanged for stock pursuant to the bankruptcy reorganization (the so-called "interest haircut rule").
  - In addition, the NOL is reduced by the COD excluded by virtue of the attribute reduction rules of § 108(b).
  - Query whether § 163(j) disallowed interest carryforward is subject to reduction under the interest haircut rule.

NOLs

Section 382(l)(5) exception

- Determination of qualified creditors
  - Creditors exchanging their debt for stock are "qualified creditors" only if (1) they held their indebtedness for at least 18 months prior to the filing of the bankruptcy case; or (2) the debt arose in the ordinary course of the debtor's trade or business, and the exchanging creditor has held the beneficial interest in the claim at all times.
  - Treas. Reg. § 1.382-9(d)(3) allows a loss corporation to treat indebtedness not owned by the creditor as still being held by a qualified creditor, if the beneficial owner is not, immediately after the exchange of stock for debt, (1) a 5% shareholder, or (2) an entity through which a 5% shareholder owns an indirect ownership interest in the loss corporation. This rule applies to all qualified indebtedness of the loss corporation and not just publicly held indebtedness. The creditor may not be treated as a qualified creditor under this rule if his participation in the formulation of the plan results in actual knowledge by the company that the creditor does not meet the requirements to be treated as a qualified creditor.

NOLs

Section 382(l)(5) exception

- Under Treas. Reg. § 1.382-9(d)(2)(iv), debt is “ordinary course” if it is incurred in connection with the normal, usual, or customary conduct of business, regardless of whether the debt funds ordinary or capital expenditures of the debtor. Examples include: trade debt, a tax liability, debt incurred to pay expenses deductible under §162 or as cost of sales, and a liability arising from a past or present business relationship with a supplier, customer, or competitor.
- Treas. Reg. §1.382-9(d)(5) provides a “tacking” rule, whereby a transferee of debt is treated as having owned the debt during the period it was held by the transferor for purposes of determining whether the debt meets the continuous ownership requirement. This rule applies to “qualified transfers,” which include transfers between related parties and transfers in carryover basis transactions.
  - Generally, debt-for-debt exchanges and debt modifications treated as exchanges under § 1001 also result in “tacking” of the old holding period

NOLs

Section 382(l)(5) exception

- Subsequent ownership change
  - Under § 382(l)(5)(D), if there is a subsequent ownership change of the loss corporation within 2 years, the § 382 limitation for the loss corporation following this second ownership change will be zero.
  - The use of NOLs in the intervening period between the first and second ownership changes will not be subject to a zero limitation
    - See PLR 200751011

Sections 269 and 382(l)(5)

- Section 269 – General Rule
- The Secretary may disallow a deduction, credit or other allowance
- If either:
- any person or persons acquire, directly or indirectly, control (at least 50% vote or value) of a corporation, or
- any corporation acquires, directly or indirectly, property
  of another corporation, not controlled by such acquiring corporation or its stockholders in a tax-free transaction; and
- The principal purpose of the acquisition is the evasion or avoidance of tax by claiming a deduction, credit or other allowance that the person or corporation would not otherwise enjoy.

Sections 269 and 382(l)(5) (cont'd)

- Relevance to §382(l)(5)
- A requisite acquisition of property or control of a corporation, in connection with an ownership change to which section 382(l)(5) applies, is considered to be made for the principal purpose of tax evasion, unless:
- The corporation carries on more than an insignificant amount of an active trade or business during and subsequent to the title 11 case.
- Finding by bankruptcy court under 11 U.S.C. 1129(d) that principal purpose of plan is not avoidance of taxes is not controlling.

Example of the Application of the Section 382(l)(5) Interest Haircut Rule

- LossCo owes $100 million in pre-petition debt to Creditor.
- LossCo has $15 million in NOLs after giving effect to attribute reduction under Section 108, consisting of $5 million in accrued interest deductions for each of the past 3 years.
- LossCo discharges the $100M prepetition debt for $25 million worth of stock and $25 million worth of new debt.
- For purposes of the Section 382(l)(5) haircut rule, how much debt is being discharged for stock?
- Residual Approach: any non-stock consideration received by Creditor should be treated as discharging debt dollar for dollar, with the entire remaining amount of debt being treated as discharged for stock.
- This is consistent with the old stock for debt rule under Section 108.
- Under this approach $25 million of the debt would be treated as discharged for new debt and the remaining $75 million would be discharged for stock. This has the result of 75% of the interest deductions ($11.25 million) being subject to the Section 382(l)(5) interest haircut rule, leaving $3.75 million in NOLs available for use post-bankruptcy.

Example of the Application of the Section 382(l)(5) Interest Haircut Rule (cont'd)

- Pro-rata Approach:
- This approach taken in the House report accompanying the Bankruptcy Tax Act of 1980.
- Under this approach ½ of the debt is discharged for stock and ½ for new debt. This has the result of 50% of the interest deductions ($7.5 million) being subject to the Section 382(l)(5) interest haircut rule, leaving $7.5 million in NOLs available for use post-bankruptcy.
- Dollar for Dollar Approach:
- Consistent with current stock for debt rule in section 108(e)(8). This is the inverse of the residual approach.
- Under this approach $25 million of debt is treated as discharged for stock. This has the result of only 25% of the interest deductions ($3.75 million) being subject to the Section 382(l)(5) interest haircut rule, leaving $11.25 million in NOLs available for use post-bankruptcy.
- What if LossCo had no NOLs and instead had a Section 163(j) carryover of $15 million?

NOLs

Section 382(l)(6) exception

- § 382(l)(6) only applies in a title 11 or similar case where the loss corporation does not qualify for § 382(l)(5) treatment or it elects not to apply § 382(l)(5) to its tax attributes (i.e., NOLs, etc.)
- The purpose of § 382(l)(6) is to allow a loss corporation to increase the value of its stock attributable to a conversion of debt into stock.
  - The benefit applies if the stock is issued directly in exchange for debt and indirectly when stock is issued for cash and the cash is used to retire debt.
  - This rule overrides the general antistuffing provisions of § 382(l)(1) (under which capital infusions occurring within the two years prior to the ownership change are disregarded in determining the value of the loss corporation) with respect to the conversion of debt into stock.
  - Treas. Reg. § 1.382-9(n)(2) provides that if there is a subsequent ownership change within 2 years, the antistuffing rule also does not apply to any increase in the value of the loss corporation previously taken into account under § 382(l)(6).

NOLs

Section 382(l)(6) exception

- Treas. Reg. § 1.382-9(j) provides that the value of a loss corporation for purposes of applying § 382(l)(6) will be the lesser of:
  - the value of the loss corporation's stock immediately after the ownership change (the "stock value" test) or
  - the value of the loss corporation's assets (determined without regard to liabilities) immediately before the ownership change (the "asset value" test)

NOLs

Section 382(l)(6) exception

- Limitations
  - Treas. Reg. § 1.382-9(k) contains several limitations applicable to the stock value test.
    - Stock value is reduced by the value of any stock that is issued with the principal purpose of increasing the § 382 annual limitation without subjecting the stock to the risks of business operations (e.g., certain preferred stock).
    - Stock value excludes capital infusions where the proceeds are not used to satisfy debt of the loss corporation
    - Stock issued in connection with the ownership change cannot exceed the amount of cash plus the value of any property (including the corporation's debt) received by the corporation in consideration for the issuance of the stock

NOLs

Trading restrictions

- In bankruptcy, a debtor corporation may seek to limit third parties from trading in the debtor's stock or debt in order to prevent a Section 382 ownership change (often referred to a "stock trading order") or to preserve the ability to qualify for the bankruptcy exception under Section 382(l)(5) (often referred to as a "debt trading order").
- Stock trading order – Intended to prevent a pre-emergence ownership change at a time when the equity value of the Company could be zero by limiting someone from becoming a 5-percent shareholder and/or limiting an existing 5-percent shareholder from trading in the stock
- Debt trading order – Intended to preserve the ability to apply Section 382(l)(5) by limiting the possibility that the creditors that receive stock upon emergence would not be *qualifying creditors*
- *"Prudential Lines" order -* Intended to prevent a 50% shareholder from claiming a worthless stock deduction with respect to the debtor corporation, which would otherwise cause an ownership change under § 382(g)(4)(D)

INTERNATIONAL TAX ISSUES

International Tax Issues

FOREIGN SUBSIDIARY GUARANTEES & STOCK PLEDGES AND OTHER DEVELOPMENTS UNDER SECTION 956

Taxation of CFCs before Tax Reform

- US shareholders constructively taxed on their pro rata share of passive income and other "subpart F" income of a controlled foreign corporation ("CFC")

- US shareholders of a CFC not taxed on active business earnings of the CFC until repatriated (e.g., via cash distributions to US shareholders)
  - US shareholders receive credit against US tax liability for foreign taxes paid in respect of repatriated earnings (subject to highly technical limitations)

- Repatriation is not limited to cash distributions, includes investment by a CFC in US property under Section 956

Investment in US Property

- Generally obligations of a related US person are US property
  - If a CFC loans money to its US parent or US affiliates, it will have an investment in US property (with some exceptions)
  - Amount of the investment in US property is determined by reference to tax basis and the average amount outstanding at the end of each calendar quarter
    - Loans with a term of less than 30 days can avoid investment in US property status, provided loans held for less than 60 days during the year
  - Amount of constructive dividend is the lesser of investment in US property and the CFC's undistributed earnings and profits ("E&P") (as determined for US tax purposes)

- A CFC is treated as holding an obligation of a US person if the CFC is the guarantor or pledgor of the obligation
  - In the statute there is no mention of the pledge of CFC stock by its US parent

Stock Pledge Regulation

- Certain pledges of the stock of a CFC is treated as a guarantee by the CFC:
- "If the assets of a CFC serve at any time, even though indirectly, as security for the performance of an obligation of a United States person, then . . . the CFC will be considered a pledgor or guarantor of that obligation"

- "For this purpose the pledge of stock of a CFC will be considered as the indirect pledge of the assets of the CFC if at least 66 2/3 percent of the total combined voting power of all classes of stock entitled to vote is pledged and if the pledge of stock is accompanied by one or more negative covenants or similar restrictions on the shareholder effectively limiting the CFC's discretion with respect to the disposition of assets and the incurrence of liabilities other than in the ordinary course of business"

- Consistent with existing US corporate law, 2/3rds voting stock threshold considered to be a proxy for the ability of a lender, following foreclosure, to compel liquidation of a CFC under local law, and thereby access the assets of the CFC

Market Standard Exclusions

- Generally in financing transactions a foreign subsidiary is not required to guarantee (or pledge collateral to support) the debt of its US parent (or US affiliates), and stock pledges supporting US debt are limited to 65% of foreign subsidiaries' stock

- Limitations only apply if the foreign subsidiary is a CFC
  - Only entities classified as corporations for US tax purposes (including pursuant to check-the-box elections) can be CFCs
  - More than 50% of stock (either vote or value) is owned by US Shareholders
    - US Shareholder = US person owning 10% or more of the stock (by either vote or value)
  - Tax reform legislation in 2017 ("Tax Reform") expanded the applicable ownership attribution rules causing almost all foreign corporations in a multinational group to become CFCs if there is at least one US corporation in the group

Market Practice for FSHCOs

- A foreign subsidiary holding company or "FSHCO" is a domestic subsidiary, substantially all the assets of which consist of stock of CFCs (and, sometimes, debt of CFCs)
  - A typical formulation is "no material assets other than" stock and[/or] debt of one or more CFCs (or other FSHCOs)

- 100% pledge of FSHCO stock arguably, upon a default, would give lenders access to 100% of the stock of CFCs, facilitating lenders' ability to cause liquidation of CFCs and thereby assets of the CFCs
  - If FSHCO instead had material non-CFC assets, concern goes away since lenders would not have clear access to CFC's assets

- Market practice to treat a FSHCO as a CFC for purposes of pledge and guarantee limitations

Taxation of CFCs after Tax Reform

- US shareholders constructively taxed on their pro rata share of (i) passive income and other “subpart F” income of the CFC and (ii) “GILTI” income of their CFCs
  - GILTI is (very) generally ***all*** income of a CFC other than “subpart F” income and an amount equal to 10% of the basis of its tangible assets
- Non-corporate US shareholders of a CFC taxed on dividends received from the CFC to the extent the earnings were not previously taxed
  - Because of the one-time mandatory repatriation of pre-2018 earnings and the new GILTI regime, the previously taxed earnings exception will apply with great regularity
- Corporate US shareholders of a CFC eligible for a 100% dividends received deduction for dividends received from the CFC (to the extent not already excluded from income under the previously taxed earnings exception), meaning ***dividends paid by CFCs to corporate US shareholders are generally tax-free***
- A potential repeal of section 956 was “left on drafting room floor” and section 956 still applies

New Dividends Received Deduction

- Three principal reasons the new dividends received deduction would not apply:
  - The one-year holding period requirement is not met
    - Corporate US shareholder of a CFC must hold the stock on which the dividend is paid for more than 365 days during the 731-day period beginning on the date that is 365 days before the date on which the stock becomes ex-dividend with respect to such dividend
    - Note that the corporate US shareholder can retrospectively meet the holding period requirement with respect to a dividend paid by a newly acquired CFC so long as the CFC stock is held for a full year after the dividend is paid
  - The dividend is a "hybrid" dividend
    - To extent the dividend paying CFC receives an income tax deduction in a foreign jurisdiction, the dividends received deduction does not apply
    - E.g., the dividend is treated as a deductible interest payment under the tax law of the CFC's country of organization or tax residence
  - The dividend is not attributable to foreign earnings
    - The US-source portion of a dividend paid by a CFC is subject to a deduction under a separate provision of existing law

Section 956 – New Regulations

- New regulations (TD 9859) –
- Calculate “tentative 956 amount” for each CFC.
- Reduce by amount eligible for section 245A had CFC distributed in a “hypothetical distribution”.
- One year holding period requirement is based on last day of year that the foreign corporation is a CFC.
- Treats lower-tier CFC as if they were directly owned.
- Anti-hybrid dividend rule applies to lower-tier CFCs by treating the distribution as if it tiered-up.

Section 956 – New Regulations

- Can cause an inclusion in certain circumstances, including:
- When the one-year holding period is not met.
- When actual dividend would be a hybrid dividend.
- Is there a change in creditor demand for CFC guarantees as a result of proposed regulations?
- If a guarantee is given, limits flexibility of CFC disposal before one year holding period.
- If guarantee is given, need to guard for foreign law changes that can create hybrid guarantee.

Section 956 – New Regulations

- Under the new section 956 regulations, the tentative section 956 amount is reduced by the amount that is eligible for a section 245A deduction on a hypothetical distribution.
- For these purposes, the hypothetical distribution is sourced from Section 959(c)(2) previously tax earnings and profits (“PTEP”) then section 959(c)(3) non-PTEP earnings.
- Under Treas. Reg. 1.245-5T, a extraordinary distribution account balance is share of extraordinary distribution earnings E&P less prior extraordinary distributions amounts.
- Prior extraordinary distribution amounts appear to require a “real” dividend to “count”.
- Thus, if US corporation has no non-extraordinary distribution E&P and includes an amount under 956 (because tentative inclusion is not reduced), then no credit is given for the Section 956 inclusion and the extraordinary distribution amounts can/will exceed extraordinary distribution E&P.

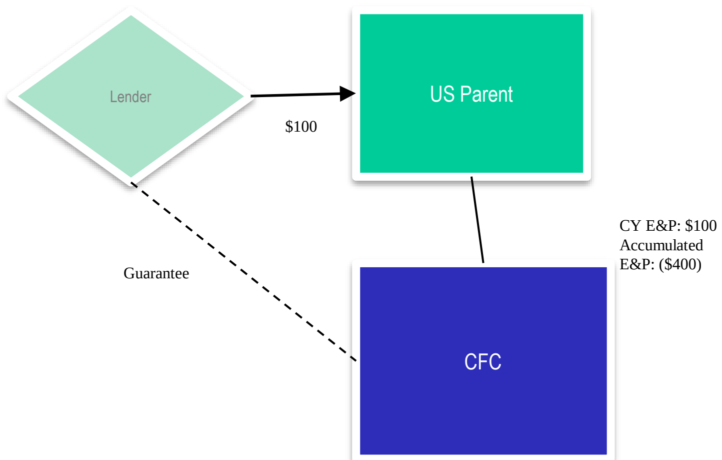
Section 956 and Nimble Dividends

- Under section 956, a US shareholder must generally include in its gross income its pro rata share of the amount of the CFC's US property held by that CFC at the close of each quarter, limited to the CFC's "applicable earnings"
- Under section 956(b)(1), "applicable earnings" means the sum of the (i) amount of (not including a deficit) accumulated E&P from prior years of a (ii) current year E&P as defined in section 316(a)(2)
  - Section 316(a)(2) provides that current year E&P are "earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year)"
  - Accordingly, a section 956 dividend can be included in a US shareholder's income if a CFC has an accumulated E&P deficit but current year E&P (i.e., a "nimble dividend")

Section 956 and Nimble Dividends

- As described above, the new dividends received deduction under 245A only applies to foreign earnings
  - More specifically only "undistributed foreign earnings" are eligible for the 245A deduction
  - Additionally, the amount of such "undistributed foreign earnings" is determined under section 245A(c)(2)(A) "as of the close of the taxable year" of the CFC in which the dividend is distributed
- Some commentators have suggested that if a section 956 dividend results from a nimble dividend (i.e., the CFC has an accumulated E&P deficit but positive current year E&P), that the requirements of section 245A are not met and no dividend received deduction is available for such dividend.
  - More specifically they argue that while *computed* as of the close of the taxable year, current year E&P is not *included* in the E&P of the CFC as of the close of the year.

Nimble Dividends Example



- Facts:
- US parent corporation ("US Parent") borrows $100
- A CFC of the US Parent guarantees the US Parent's debt
- In the year of the borrowing, the CFC has an accumulated E&P deficit ($400) but has a positive current year E&P of $100
- The CFC has no other Subpart F, GILTI, or PTEP
- Analysis:
- US Parent has a section 956 inclusion (deemed dividend) of $100
- Is the dividend eligible for section 245A dividends received deduction?

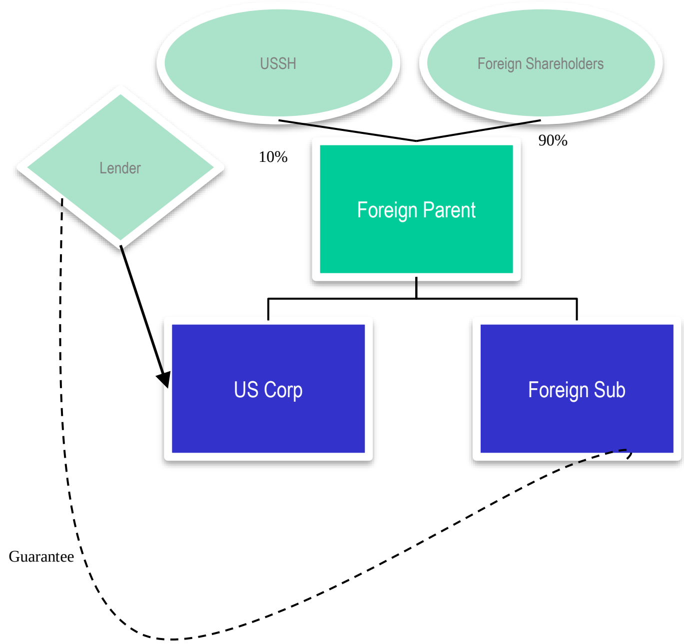
Section 956 and Section 958(b)(4) Repeal

- When determining whether a US shareholder owns 50% or more of the stock of a foreign corporation (and thus whether it is treated as a CFC) certain constructive ownership rules (found in section 958) apply
- The constructive ownership rules generally provide that stock owned by a shareholder or a partner may be attributed “downward” to a corporation or a partnership and also that stock owned by a corporation (or a partnership) may be attributed “upward” to its shareholders (or partners)
- Prior to Tax Reform, section 958(b)(4) prevented the downward attribution of foreign corporate stock from a foreign shareholder, partner or beneficiary to a US corporation, or partnership

Section 956 and Section 958(b)(4) Repeal

- However, section 958(b)(4) was repealed as part of tax reform as part of an attempt to target certain transactions, but such repeal has had far-reaching and unintended consequences
  - For example, if a foreign holding company ("Foreign Parent") wholly owns a US corporation as well as foreign corporations, such foreign corporations are treated as CFCs following the repeal of section 958(b)(4)
    - To the extent Foreign Parent has a US Shareholder, such US Shareholder is generally subject to taxation under Subpart F, GILTI, and section 956 with respect to such CFCs
  - Early versions of the CARES Act in 2020 included an attempt to fix the repeal of section 958(b)(4), but such provisions did not make it into the final legislation

Downward Attribution Example



Facts:

- Foreign Parent wholly owns a US corporation ("US Corp") and a foreign corporation ("Foreign Sub")
- A US person ("USSH") owns 10% of the stock of Foreign Parent with the remaining 90% owned by foreign persons
- US Corp borrows from a lender and Foreign Sub guarantees US Corp's debt. A CFC of the US Corp guarantees the US Parent's debt

Analysis:

- By reason of the attribution rules of section 958, Foreign Sub is treated as a CFC (with more than 50% of its stock being constructively owned by US Corp)
  - Pre-Tax Reform, Foreign Sub would not be treated as a CFC
- USSH is subject to under section 956 with respect to Foreign Sub
- Foreign Sub's guarantee of US Corp's debt is an investment in US property that may result in a section 956 dividend (with USSH taking into account its proportionate share, i.e., 10%, of such dividend)

International Tax Issues

SECTION 7874 – TREATMENT OF CREDITORS AS SHAREHOLDERS

Inversion Transactions Generally

- An "inversion transaction" is a transaction in which a U.S. corporation or partnership (a "Domestic Entity") is expatriated by inserting a foreign corporation above it (the "Foreign Acquiring Corporation").
- The primary benefits of inversion transactions have historically included:
  - "Earnings stripping" through the issuance of debt by the Domestic Entity, taking advantage of the U.S. interest expense deduction;
  - Accessing cash in foreign subsidiaries of the Domestic Entity without repatriating such cash to the U.S.;
  - Reducing tax on future foreign earnings;
  - Avoidance of "subpart F" income and other anti-deferral rules;
  - Avoids subjecting income from non-U.S. operations to U.S. income tax (e.g., by doing "out from under planning" or where there is a foreign target entity involved in the inversion transaction).

Section 7874 – Generally

- Section 7874 applies if, pursuant to a plan (or series of related transactions):
  - A foreign corporation (a "foreign acquiring corporation") completes the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a Domestic Entity;
  - After the acquisition, at least 60% (but less than 80%) of the stock (by vote or value) of the foreign acquiring corporation is held by former shareholders (or former partners) of the Domestic Entity *by reason of* holding stock (or capital or profits interests) in the Domestic Entity; and
  - After the acquisition, the "expanded affiliated group" ("EAG") which includes the foreign acquiring corporation does not meet the "substantial business activities" ("SBA") test.

Section 7874 – 60% Inversion

- Effect of 60% Inversion
  - If the three requirements in the prior slide are met, a "60% Inversion" has occurred.
  - In a 60% Inversion, the Domestic Entity, its owners, and certain other related parties must recognize the full amount of "inversion gain."
    - Whether parties are "related" is determined under sections 267(b) and 707(b)(1).
  - Inversion gain is income or gain recognized from transfers of stock or other properties by the Domestic Entity and any income from licensed property of the Domestic Entity incurred (i) as part of the Domestic Entity acquisition or (ii) after such acquisition if the transfer or license is to a foreign related person.
  - The consequences of a 60% Inversion are generally limited to a 10-year period, and may be managed with additional tax planning.

Section 7874 – 80% Inversion

- Effect of an 80% Inversion
  - If the three requirements on slide 3 are met except that shareholders (or partners) of the Domestic Entity own 80% or more of the foreign acquiring corporation by reason of holding stock in the Domestic Entity, an 80% Inversion has occurred.
  - In an 80% Inversion, the *foreign acquiring corporation* is treated as a U.S. corporation for all U.S. tax purposes.
  - The effect is to deny any potential benefits of the inversion and subjects the foreign acquiring corporation to tax in the U.S. (and also likely in its jurisdiction of incorporation).

Section 7874 – Creditors of a Domestic Entity

- Treas. Reg. 1.7874-2(i)(2) provides that, if immediately prior to a domestic entity acquisition, either (i) the Domestic Entity is in a title 11 or similar case or (ii) the value of the Domestic Entity's assets do not exceed its liabilities, then the claims of a Domestic Entity's creditors are treated as stock (or a partnership interest) in the Domestic Entity and each creditor of the Domestic Entity shall be treated as a shareholder (or partner) of the Domestic Entity.
- Furthermore, a creditor that is treated as a shareholder (or partner) of a Domestic Entity is treated as such *for all purposes of Section 7874* under Treas. Reg. 1.7874-2(i)(2)(iii).
- Accordingly, restructuring transactions involving a Domestic Entity in a bankruptcy plan (or planning in anticipation of bankruptcy) or of an insolvent Domestic Entity may result in unanticipated consequences under Section 7874 and the regulations thereunder without proper awareness and planning.

Section 7874 – Disqualified Stock

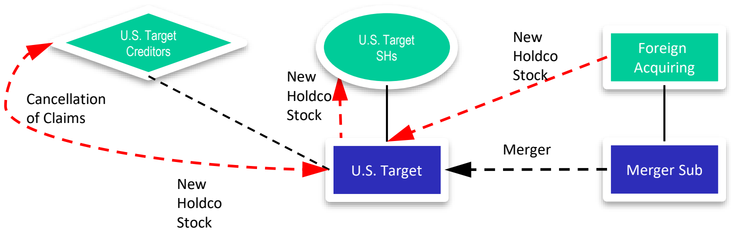
- Treas. Reg. 1.7874-4 generally provides that, stock of foreign acquiring corporation exchanged for (i) cash, (ii) marketable securities, (iii) obligations owed to EAG members and certain former shareholders of the Domestic Entity target, or (iv) property with a principal purpose of avoiding 7874 (collectively "nonqualified property") is "disqualified stock that is excluded from the denominator of the fraction used to determine the ownership percentage of former shareholders of a Domestic Entity for purposes of section 7874 (the "ownership fraction").
- Additionally, if a person (the "acquirer") acquires stock of a foreign acquiring corporation in exchange for property and the acquirer subsequently uses such foreign acquiring corporation stock to satisfy an obligation of such acquirer (or a person related to the transferee), then such foreign acquiring corporation stock is generally treated as "disqualified stock". Treas. Reg. 1.7874-4(c)(1)(ii)(A).
  - Treatment of a portion of the stock received by the acquirer as disqualified stock may be limited to the extent that the foreign acquiring corporation receives property that is not nonqualified property in the exchange with the acquirer. Treas. Reg. 1.7874-4(c)(1)(ii)(B).

Section 7874 – Disqualified Stock (continued)

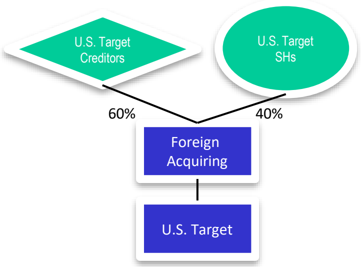
- An "obligation" is defined under Treas. Reg. 1.7874-4(h)(3) as "any fixed or contingent obligation to make a payment or provide value without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code." However, "[a]n obligation does not include any obligation treated as stock for purposes of section 7874 (see, for example, § 1.7874-2(i), which treats certain interests, including certain creditor claims, as stock)."

Example 1 – Creditors as Shareholders

Transaction



Final U.S. Target Structure



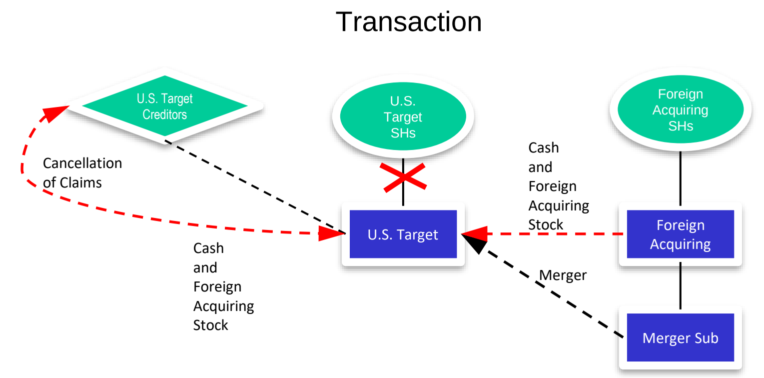
Facts:

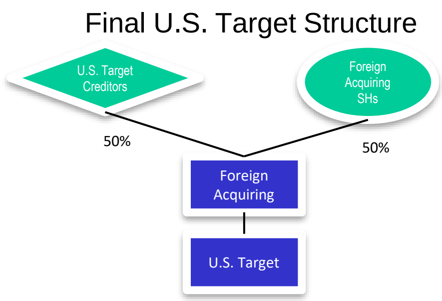
- U.S. Target is a U.S. corporation that is in a title 11 case.
- U.S. Target merges into a merger subsidiary ("Merger Sub") of a newly formed foreign corporation ("Foreign Acquiring") with U.S. Target surviving.
- Pursuant to the merger transaction, 60% of the Foreign Acquiring stock is transferred to U.S. Target's creditors in satisfaction of their claims and the remaining 40% of the Foreign Acquiring stock is transferred to U.S. Target's shareholders in exchange for their U.S. Target Stock.

Analysis:

- The acquisition of the stock of U.S. Target by Foreign acquiring is a domestic entity acquisition (i.e., the indirect acquisition of the assets of U.S. Target).
- Absent the application of Treas. Reg. 1.7874-2(i)(2), the former shareholders of U.S. Target only own 40% of the stock of Foreign Acquiring by reason of their stock in U.S. Target. However, because U.S. Target was in a title 11 case immediately before the transaction, Treas. Reg. 1.7874-2(i)(2) treats U.S. Target's creditors as shareholders of U.S. Target and their claims are treated of stock of U.S. Target for purposes of section 7874.
- Accordingly, the transaction is treated as an 80% Inversion (and Foreign Acquiring being taxed as if it were a U.S. corporation) because former shareholders of U.S. Target and former creditors of U.S. Target collectively own 100% of the stock of Foreign Acquiring by reason of holding their stock or claims of U.S. Target (a 100/100 ownership fraction).

Example 2 – Disqualified Stock





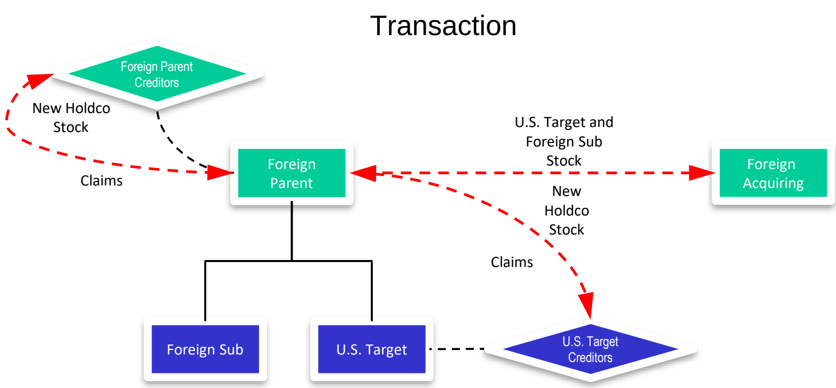
Facts:

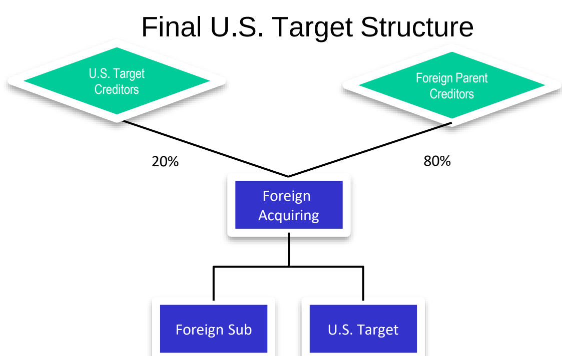
- U.S. Target is a U.S. corporation that is in a title 11 case.
- Foreign Acquiring is formed and capitalized with cash by new shareholders (these may be related or unrelated to U.S. target or its creditors).
- U.S. Target merges into a Merger Sub of Foreign Acquiring with U.S. Target surviving.
- Pursuant to the merger transaction, cash and 50% of the Foreign Acquiring stock is transferred to U.S. Target's creditors in satisfaction of their claims and the stock held by U.S. Target's shareholders is cancelled for no consideration.

Analysis:

- The acquisition of the stock of U.S. Target by Foreign Acquiring is a domestic entity acquisition (i.e., the indirect acquisition of the assets of U.S. Target).
- Because U.S. Target was in a title 11 case immediately before the transaction, each of the U.S. Target's creditors is treated as a shareholder of U.S. Target and their claims are treated of stock of U.S. Target for purposes of section 7874.
- The former creditors of U.S. Target, in form, only own 50% of the stock of Foreign Acquiring by reason of their claims. However, because the other shareholders of Foreign Acquiring ("Foreign Acquiring shareholders") received their Foreign Acquiring stock for nonqualified property (i.e., cash) in an exchange related to the domestic entity acquisition, their stock is disqualified stock.
- Accordingly, the former creditors of U.S. Target are treated as owning 100% of the stock of Foreign Acquiring (a 50/50 ownership fraction) resulting in an 80% Inversion (and Foreign Acquiring being taxed as if it were a U.S. corporation).
- To the extent some or all of the Foreign Acquiring Shareholders do not received their Foreign acquiring stock for nonqualified property, the transaction may result in a 60% Inversion or the inapplicability of section 7874.

Treas. Reg. 1.7874-4 – Example #2





Facts:

- Foreign Parent is a non-U.S. corporation that is in a title 11 or similar case.
- U.S. Target is a U.S. corporation that is in a title 11 case.
- Foreign Parent transfers the stock of U.S. Target and stock of a foreign subsidiary ("Foreign Sub") to Foreign Acquiring in exchange for all of the Foreign Acquiring stock.
- Foreign Parent transfers 80% of the Foreign Acquiring stock received to its creditors and transfers the remaining 20% to U.S. Target's creditors (on behalf of U.S. Target) in cancellation of their claims.

Analysis:

- The acquisition of the stock of U.S. Target by Foreign Acquiring is a domestic entity acquisition (i.e., the indirect acquisition of the assets of U.S. Target).
- Because U.S. Target was in a title 11 case immediately before the transaction, each of the U.S. Target's creditors is treated as a shareholder of U.S. Target and their claims are treated as stock of U.S. Target for purposes of section 7874.
- The former creditors of U.S. Target, in form, only own 20% of the stock of Foreign Acquiring by reason of their claims. However, because Foreign Parent exchanged property for stock of Foreign Acquiring and subsequently transferred such Foreign Acquiring stock received in satisfaction of the claims of the creditors of Foreign Parent, such stock is generally treated as disqualified stock (subject to limitation to the extent the property transferred is not nonqualified property).
- If the stock of Foreign Sub is nonqualified property, the former creditors of U.S. Target are likely treated as owning 100% of the stock of Foreign Acquiring (a 20/20 ownership fraction) resulting in an 80% Inversion (and Foreign Acquiring being taxed as if it were a U.S. corporation). To the extent some or all of assets transferred by Foreign Parent are not nonqualified property, the ownership fraction may be adjusted to a lower ownership percentage under Treas. Reg. 1.7874-4(c)(1)(ii)(B).

Structuring Alternatives

- The stock of an existing foreign parent of a Domestic Entity is acquired, with the Domestic Entity remaining a subsidiary of the existing foreign parent.
  - Such a transaction does not qualify as a domestic entity acquisition and therefore Treas. Reg. 1.7874-2(i)(2) does not apply.
- The creditors of the Domestic Entity receive only cash for their claims, while creditors of an exiting foreign parent receive stock of the foreign acquiring corporation.
  - While creditors of the Domestic Entity would be considered shareholders of the Domestic Entity, such creditors do not receive any stock in the foreign acquiring corporation.
- If a Domestic Entity is insolvent due to intercompany debt (but such Domestic Entity is not in a Title 11 or similar case), a pre-domestic entity acquisition cleaning up of such intercompany debt (e.g., through a contribution of such intercompany debt to the Domestic Entity) could result in the Domestic Entity escaping insolvency.
  - If a Domestic Entity's assets exceed its liabilities (and it is not in a Title 11 or similar case), then Treas. Reg. 1.7874-2(i)(2) does not apply.

QUESTIONS?

THANK YOU