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Corporate Bankruptcy & Debt Workouts - 2013 Important Developments

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Topics

- Potential 2014 Legislation and Regulation
- 2013 Legislation & Guidance
- 2013 Cases & Rulings

Potential 2014 Legislation and Regulation

Potential 2014 Legislation and Regulations

- Tax Reform Legislation
- Tax Extenders Legislation
- 2013-14 Priority Guidance Plan

Potential 2014 Legislation

Tax Reform Legislation

- Prospects Uncertain
- House Proposal to Change Debt Modification Rules
  - Issue price of new instrument would equal lesser of
    - AIP of old debt instrument
    - Stated (or imputed) principal amount of new debt instrument
  - Would repeal mark-to-market rules for publicly-traded debt
    - Debtors currently can realize COD income (even if principal does not change).
- House Proposal to Change Market Discount Rules
  - Current inclusion of market discount in income
  - Exemption for distressed debt

Potential 2014 Legislation

Tax Extenders Legislation – S. 1859

- Extension of provision to monetize AMT credits (in lieu of bonus depreciation)
  - Extension for property placed in service in 2014
- Bill has not yet been marked up by either tax-writing committee

2013-14 Priority Guidance Plan

Status, as of September 2013

Consolidated Returns

- Finalize 2012 CERT proposed regulations (affecting NOL carrybacks).
- Modify uniform loss rules (affecting losses with respect to subsidiary stock).
- Finalize 2012 proposed regulations relating to the status as agent of a consolidated group.
- Finalize 2011 proposed section 382 NUBIG/NUBIL regulations.

2013-14 Priority Guidance Plan

Corporations and their Shareholders

- Finalize 2005 proposed “no net equity value” regulations relating to corporate reorganizations.
  - Added back to priority guidance plan in 2013.
- Finalize guidance on the method used to determine the section 382 long-term tax-exempt rate.
- Regulations regarding the scope and application of section 597 (affecting bank workouts).

2013-14 Priority Guidance Plan

COD Income

- Finalize 2011 proposed regulations on the application of the bankruptcy and insolvency exceptions to disregarded entities.
- Revenue Ruling regarding the application of COD income exclusion for qualified real property business indebtedness and Revenue Procedure on the definition of "secured by real property."
- Guidance extending recapture of gain rules on COD income to exchanges of debt for partnership interests.
- Revise rules regarding the 36-month rule for information returns reporting COD income by financial institutions.

2013-14 Priority Guidance Plan

Financial Instruments

- Revise rules under section 166 on the conclusive presumption of worthlessness for bad debts.
- Guidance relating to accruals of interest (including discount) on distressed debt.

Other Areas

- Revenue Procedure on the monetization of AMT credits (in lieu of claiming bonus depreciation).

2013 Legislation & Guidance

2013 Legislation and Guidance

- Section 336(e) Elections
- Revised Section 382 Segregation Rules
- Section 382 Long-term Tax-Exempt Rate
- AMT Monetization
- Final Section 108(i) Regulations
- Bad Debt Conformity Rules

Section 336(e) Election

Final Section 336(e) Regulations

- Issued and effective in May, 2013.
- Allow taxpayers to elect to treat certain sales, exchanges, and distributions of the stock of a corporation as taxable asset sale.
- Section 336(e) was enacted in 1986 but implementing regulations were not issued until 2013.
- Similar to the election under section 338(h)(10).
- An additional tool in structuring bankruptcy reorganizations and debt workouts.

Section 336(e) Election

The Section 336(e) regulations differ from Section 338:

- Focus on Seller, rather than Acquirer.
- Uses the term “disposition” rather than “acquisition” or “purchase.”
- Uses the term “sale, exchange, or distribution” rather than “sale.”
- Does not require a corporate Acquirer.
- Can only be used for domestic Targets.

Section 336(e) Election

The Election

- Made by Seller
- Seller and Target must enter into a written, binding agreement to make the election.

Section 336(e) Election

Qualified Stock Disposition (“QSD”) Requirements

- A QSD - a taxable sale, exchange, or distribution (or any combination thereof) of 80% or more of stock of Target (by vote and value) over a 12 month (or less) period.
  - A QSD also includes certain section 355 spin-offs if section 355(d) or (e) applies.
- Two types of transactions qualify.
  - Disposition of stock of a US corporation by a US corporation
  - Disposition of stock of S corporation by shareholders
- Section 338 overrides section 336(e) - If the transaction also qualifies as a QSP, then the transaction is not treated as a QSD.
- Note: Unlike Section 338, the Acquirer need not be a single corporation for the transaction to qualify as a QSD.

Section 336(e) Election

Tax Consequences

- Seller(s) – disregard the actual sale or exchange of Target stock;
- Target - Old Target treated as selling all of its assets to an unrelated person (New Target) in a single transaction at the close of the disposition date (the first date on which a QSD occurs).
- Old Target
  - recognizes gain or loss on the deemed asset disposition while it is owned by the Seller(s).
  - treated as liquidating after the deemed asset disposition.
- New Target – assumes cost basis (with certain adjustments) in assets (acquired from Old Target).

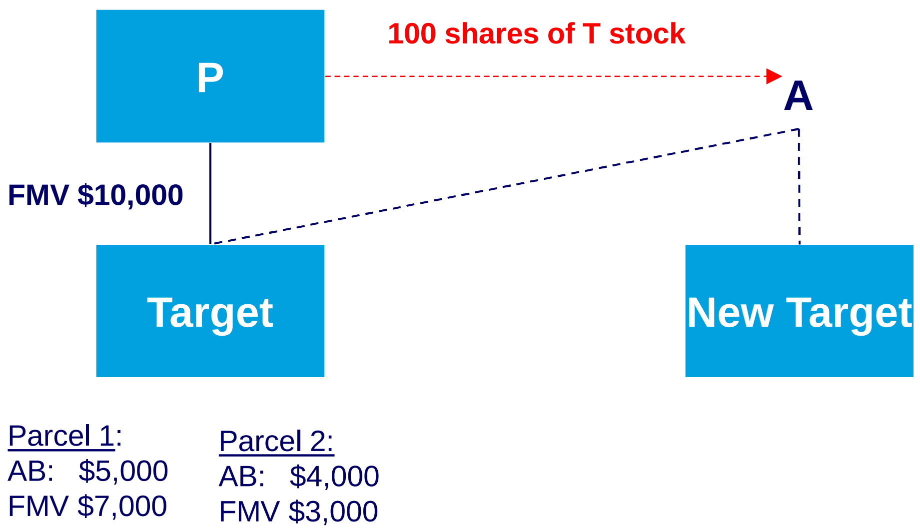
Section 336(e) Election

Cases in which a Section 336(e) election can be made:

- A sale in which there is not a single corporate purchaser
  - Distribution to creditors
  - A sale to a private equity fund
  - A sale to multiple purchasers
  - A sale through a secondary offering
- A non-liquidating distribution to shareholders
- A liquidating taxable distribution
- A distribution to which Section 355(d) or (e) applies

Section 336(e) Election

<u>Example: Sale of Target Stock</u>
Treas. Reg. § 1.336-2(k), Example 1

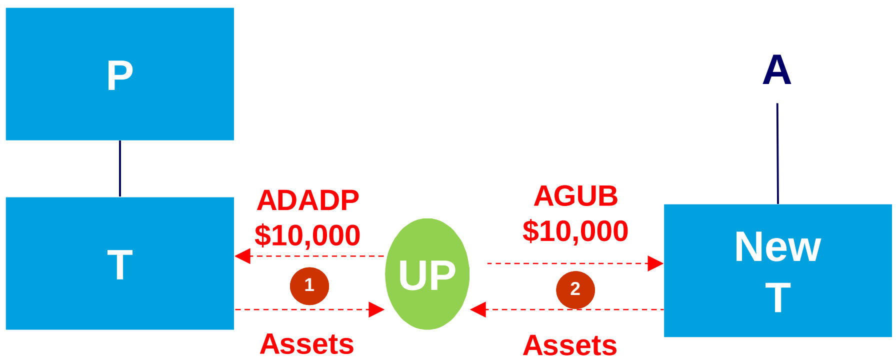


- **Facts:** P owns all 100 shares of Target's only class of stock. Target's only assets are two parcels of land. On July 1, P sells all 100 shares of its Target stock to A for $100 per share and makes a Section 336(e) election.
  - Sale constitutes a QSD; not a QSP since purchaser is an individual.
  - July 1 is the disposition date.

Section 336(e) Election

Example: Sale of Target Stock—Deemed Consequences

Treas. Reg. § 1.336-2(k), Example 1



**UP = unrelated person
ADADP = Aggregate Deemed Asset Disposition Price
AGUB = Adjusted Grossed-up Basis

- Tax Consequences*:
  - T is treated as selling all of its assets to an unrelated person in exchange for $10,000, allocated $7,000 to Parcel 1 and $3,000 to Parcel 2
    - T recognizes gain of $2,000 on Parcel 1 ($7,000 of allocated consideration less $5,000 in basis) and loss of $1,000 on Parcel 2 ($3,000 of allocated consideration less $4,000 in basis).
    - T is generally treated as liquidating into P thereafter and distributing the $10,000 under Section 332
  - New T is treated as having acquired all its assets from an unrelated person at the close of the disposition date (but before the deemed liquidation of T) for $10,000, allocated $7,000 to Parcel 1 and $3,000 to Parcel 2.
  - P recognizes no gain or loss on the liquidation
  - A's aggregate basis in New T stock is $100 per share (the amount paid for the stock)
- If P sells only 80 shares of T stock to A and retains the remaining 20 shares, the tax consequences are the same as above, except that P is also treated as purchasing from New T on July 2 (day after disposition date) and the 20 retained shares of New T stock at their FMV. See Treas. Reg. § 1.336-2(k), Example 2

* Note: ADADP and AGUB principles ignored for illustrative purposes.

Section 336(e) Election

Open Issues under Section 336(e)

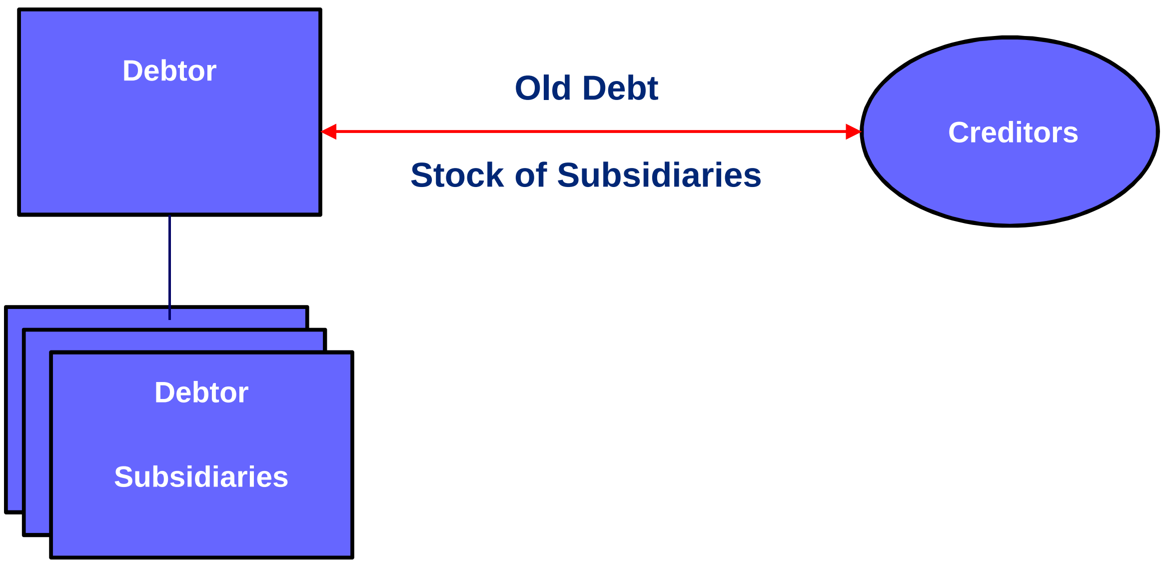
- As the Section 336(e) regime is new, there are a number of instances where the consequences currently are unclear.
  - Scope of the consistency rules?
  - Do redemptions count toward a QSD?
  - In the case of a staggered disposition, does the Target remain a member of the consolidated group? When does Target join a new consolidated group? What are the potential S corporation issues with staggered dispositions?
  - When is the deemed plan of liquidation adopted?
  - Treasury is currently working on fixes for some of these items.

Section 336(e) Election

Bruno Stores Transaction:

- Frequently, bankruptcy reorganizations and corporate debt workouts are structured as taxable asset sales.
  - The debtors' NOLs (and other tax attributes) may allow for a step-up at a low tax cost.
- Section 336(e) appears to be a useful tool in achieving a step-up.
  - A corporate holding company does not need to be formed to acquire Target's assets (as it would under a section 338 election).

Section 336(e) Election



- Debtor transfers the stock of one or more of its subsidiaries to Creditors in retirement of debt.
- The Debtor and the subsidiaries agree to make a section 336(e) election.

Revised Section 382 Segregation Rules

Section 382

–Limits the ability of a “loss corporation” to utilize its NOLs (and other tax attributes) following an “ownership change.”

–Ownership change – More than 50% increase in ownership by 5% shareholders and shareholder groups over, generally, a three-year period.

- A 5% shareholder is an individual that owned 5% or more of the stock of the loss corporation (directly or indirectly, including by attribution) at any time during the three-year testing period.
- Any person that is not a 5% shareholder is treated as a member of one or more public groups of shareholders.

Revised Section 382 Segregation Rules

The Segregation Rules

– Cause a "split" of certain public groups into multiple public groups for specified transactions
– Portion of the public group is "segregated" into a new separate group
– Application of the segregation rules generally increases the owner shift percentage
– Segregation Transactions include:
    - Share issuances (section 1032 transactions)
    - Redemptions
    - Higher tier entity issuances and redemptions
    - Dispositions by 5% shareholders or entities to less than 5% shareholders (public groups)

Revised Section 382 Segregation Rules

Previous Exceptions to the Segregation Rules

– Small issuance exception – Can reduce the severity of segregation rules
  - Limitation is 10% of beginning of year stock value (corporate-wide measurement) or 10% of number of shares of class of stock being tested (class-by-class measurement)
  - Applies only to extent current issuance and historic issuances in the same year are within limit
  - Eligible shares allocated ratably to pre-existing direct public groups
  - Ineligible shares segregated into new public group

– "Solely for cash" exception - typically reduces the severity of segregation rules
  - Applies to the extent small issuance exception does not apply.
  - Allows loss corporation to allocate some of the shares issued to existing public groups.

Revised Section 382 Segregation Rules

Revised Segregation Rules

- Add additional exceptions to segregation rules.
  - "Small redemption" exception (similar to current small issuance exception).
  - Exception for transfers by 5% shareholders and 5% entities to less than 5% shareholders.
  - Exception for segregation transactions that take place at entities that own 10% or less (directly or indirectly by attribution) of the loss corporation.
- Effective Date
  - Generally, effective for transactions that occur on or after October 22, 2013.
  - Loss corporations can choose to apply the rules retroactively to transactions or afer October 22, 2010, within the same testing period, with exceptions:
    - Applying the rules retroactively cannot change whether a prior ownership change occurred (or the date of such an ownership change).
    - Also can not cause an ownership change that did not occur under the old rules.

Section 382 Long-term Tax-Exempt Rate

- Base Annual Section 382 Limit
  - Limit after an ownership change = Adjusted stock value times long-term tax-exempt rate for the month of the ownership change
  - Long-term tax-exempt rate
    - A rate published monthly by the IRS
    - Recently 2-3%
    - Based on long-term borrowing rates by the U.S. Treasury Department, adjusted for differences between taxable and tax-exempt obligations.

Section 382 Long-term Tax-Exempt Rate

- Old Adjustment Methodology
  - Based on composite yield of highest grade tax-exempt obligations compared to Treasury obligations.
  - Treasury and state bonds are no longer comparable - Since the beginning of the Great Recession, even the highest grade tax-exempt bonds have perceived credit risk.
  - Many tax-exempt bonds now have a yield that is greater than that of a Treasury obligation with the same duration.
- Notice 2013-4
  - Going forward, the long-term tax exempt rate will be limited to a rate based on the composite yield of Treasury obligations.
  - The Treasury Department & IRS have requested comments as to the appropriate methodology for the future.

AMT Monetization

- Provision allows taxpayers to increase credit limitation (in lieu of bonus depreciation).
  - Taxpayer can receive a refund if the increased credit exceeds the amount of tax
  - Only applies to pre-2006 AMT carryforwards
  - American Taxpayer Relief Act of 2012 – extended provision to property placed in service in 2013

AMT Monetization

- Effect of Sequester – Posting to IRS website.
  - Cash refunds –
    - Refund claims processed from August 13 to September 30, 2013 – Reduced by 38%.
    - Refund claims processed from October 1, 2013 to September 30, 2014 – Reduced by 7.2%.
      - The IRS has not announced whether the Bipartisan Budget Act of 2013 affects the calculation.
    - Uncertainty as to whether the credit not paid is lost.
  - Only applies to AMT credit (not research credit).
  - Sequester does not affect the ability to apply credit against tax.

Final Section 108(i) Regulations

- Section 108(i) allowed taxpayers to elect to defer COD income.
  - Income realized in 2009 or 2010 could be deferred
    - Related OID deductions were also deferred.
  - Income taken into account over a five year period from 2014 through 2018.
    - The income is accelerated upon the occurrence of certain events
  - Temporary Regulations were issued in 2010.
- The temporary regulations were finalized in July, 2013.
  - No substantive changes.
  - New rules clarified that the income acceleration rules apply to bankrupt corporations.

Bad Debt Conformity Rules

- Existing Regulations
  - Banks (and other regulated corporations) are permitted to conform their tax bad debt write-offs to the write-offs used for book or regulatory purposes.
- Notice 2013-35
  - The Treasury Department & IRS have requested comments as to whether the existing rules still make sense and, if so, whether they should be modified.

2013 Cases & Rulings

Cases

- In Re: Majestic Star Casino LLC, 716 F.3d 736 (3rd Cir. 2013)– Qsub status not property of bankruptcy estate
- Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund, 724 F.3d 129(1st Cir. 2013) – Private equity fund not liable for unpaid pension liability of portfolio company
- Pilgrim's Pride Corp. v. Commissioner, 141 T.C. No. 17 (12/11/13)– Abandonment loss was capital loss.

Bank Holding Company Tax Refund Cases

- Several cases dealt with a common fact pattern relating to the owner of a consolidated tax refund after an NOL carryback (the common parent corporation (“Holdco”) or the operating subsidiary (“OpCo”) with the NOL).
- In re: Bankunited Fin. Corp., 727 F.3d 1100 (11^{th} Cir. 2013) – OpCo was entitled to refund.
- In re: NetBank, Inc., 729 F.3d 1344(11^{th} Cir. 2013) – OpCo was entitled to refund.
- In re: Downey Fin. Corp., 499 BR 439 (Bankr. D. Del, 2013) – Holdco was entitled to refund.
- On Dec. 18, the Treasury Department issued proposed guidance on tax sharing agreements for banking groups.

Cases

- United States v. Holmes 727 F.3d 1230 (10th Cir. 2013) – Shareholder liable for unpaid corporate taxes
- In re: Enseco Group, Inc., 112 AFTR 2d 2013-5680, (ND Ill. Bankr. Ct.)– tax refund claim dismissed.
- Central Motorplex, Inc. v. Commissioner, TC Memo 2013-286 – dissolved corporation could petition Tax Court for redetermination of employment taxes.

Rulings

- FAA 20131601F (Feb. 19, 2012) – Stock received by shareholders in bankruptcy reorganization results in ordinary income; exchange of stock-for-stock not respected.
- ECC 201315020 (Mar. 12, 2013) – under current law, merger is not disqualified as a corporate reorganization just because one corporation is insolvent.
- ILM 201347019 (Aug. 7, 2013) – Deductibility of QSF Expenses

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