REPORT #679

TAX SECTION

New York State Bar Association

NEW YORK STATE BAR ASSOCIATION TAX SECTION
REPORT ON SUGGESTED BANKRUPTCY TAX REVENUE RULINGS
COMMITTEE ON BANKRUPTCY

January 8, 1991

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January 8, 1991

The Honorable Kenneth W. Gideon
Assistant Secretary of the Treasury
for Tax Policy
3120 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Dear Mr. Gideon:

I enclose the New York State Bar Association Tax Section Report on Suggested Bankruptcy Tax Revenue Rulings. The principal author of the report is Robert A. Jacobs.

The law governing tax results in corporate bankruptcy proceedings is complex, inconsistent and unpredictable. The statute -- in many instances - simply does not provide coherent answers to the day-to-day questions that arise in planning and consummating bankruptcy reorganization plans. Although Congress has granted the Treasury Department and the Internal Revenue Service significant authority to provide needed answers, remain large gaps remain in publicly available guidance as to how basic tax law provisions apply to bankruptcy reorganizations. This lack of guidance greatly inhibits the bankruptcy or tax practitioner's ability to devise a bankruptcy plan of reorganization that will satisfy the bankrupt corporation's creditors and restore the bankrupt corporation's financial health. The need for guidance is particularly acute in today's economic environment, where bankruptcies are reaching epidemic proportions.

Our Report provides answers, in revenue; ruling form, to some of the more frequently raised Code S 382(1)(5) questions in Chapter 11 reorganizations. Most of these examples could just as easily be presented as regulations in a “Question and Answer” format. We will address questions relating to the determination of cancellation of indebtedness income and attribute reduction in a forthcoming report.

The Report concludes, among other things, that (1) it will sometimes be necessary to treat related bankrupt corporations as one corporation to achieve the results intended by the Internal Revenue Code of 1986 (the “Code”) S 382(1)(5); (2) there is no continuity of ownership requirement implied in Code § 382(1)(5); (3) neither changes in a creditor's own stock nor a transfer of substantially all of a creditor's own stock nor a transfer of substantially all of a creditor's assets to another corporation should affect the creditor under Code S 382 (1)(5)(E) except where the principal purpose for the change in the creditor's ownership was avoiding the “Old and Cold” creditor rules; (4) a creditor's transfer of its claim to a member of its own commonly controlled group or to a third party as security for a loan should not affect the creditor's status as an “Old, and Cold” creditor, except where the principal purpose for the transfer was the avoidance of the “Old and Cold” creditor rules; (5) debt refinancings and sales of debt participations should be disregarded for purposes of determining whether the ultimate debtholders are “Old and Cold” creditors under S 382(1)(5); (6) a holder of less than 5 percent of the creditor's publicly held debt exchanged for less than 5 percent of the bankrupt corporation's stock in the Chapter 11 reorganization should be treated as having held his debt since the debt's issuance, regardless of the date he acquired the debt; and (7) the minimum quantum of continuing historic business activity required by Prop. Treas. Reg. S 1.269-3(d) is illustrated.

We would be pleased to discuss the Report and its recommendations with your staff at their convenience.

Very truly yours,

Arthur A. Feder
Chair

Enclosure

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NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON SUGGESTED BANKRUPTCY TAX REVENUE RULINGS

COMMITTEE ON BANKRUPTCY[1]

January 8, 1991

I. Introduction.

The tax law governing tax results in corporate bankruptcy proceedings is complex, inconsistent and unpredictable. Its underlying policies are uncertain; its applications erratic. There is no first principle to provide direction. The statute -- in many instances -- simply does not provide coherent answers to the day- to-day questions that arise in planning and consummating bankruptcy reorganization plans.

Congress has granted the Treasury Department and the Internal Revenue Service significant authority to provide needed answers. Notwithstanding the Service's effort over the years, large gaps remain in the publicly available guidance as to how basic tax law provisions apply to bankruptcy reorganizations.

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[1] This report was prepared by Robert A. Jacobs, co-chair of the Committee on Bankruptcy. Significant contributions were made by Arthur A. Feder, Stephen R. Field, co-chair of Bankruptcy Committee, and Simon Friedman, Stuart J. Goldring, Susan J. Halpern, Lewis Kurfist and Timothy C. Sherck. Helpful comments were received from Paul H. Asofsky, Henry M. Cohn, Paul Steinberg, Michael Schler, Ralph O. Winger, Richard L. Reinhold, Peter C. Canellos, John A. Corry, Gordon R. Henderson, William L. Burke, Jr. and Bx-uce Kayle.

The Service should answer these questions soon. The economy is faced with an unprecedented wave of bankruptcy filings and other non-bankruptcy reorganizations. The lack of answers to basic tax questions makes it more difficult to restructure corporations. It is a matter of importance for the national economy that these restructurings be completed quickly so the debtors involved can return to contributing to the economy.

At present we lack a set of workable rules for a host of issues that arise regularly in common bankruptcy and restructuring transactions. The need for these answers is made even more important by the Code §6662(d) penalty on substantial understatements of tax and by the penalty rate of interest imposed on tax deficiencies.

This report seeks to provide, in the form of suggested revenue rulings, many of the missing answers to problems commonly faced.

II. Summary.

The Report provides answers to some of the more frequently raised Code §382(1)(5) questions in Chapter 11 reorganizations.[2] Most of these examples could, just as easily, be presented as regulations in a "Question and Answer" format.

The Report concludes, among other things, that (1) it will sometimes be necessary to treat related bankrupt corporations as one corporation to achieve the results intended by Internal Revenue Code of 1986 (the "Code") §382(1)(5);(2) there is no continuity of ownership requirement implied in Code §382(1)(5); (3) neither changes in a creditor's own stock nor a transfer of substantially all of a creditor's assets to another corporation should affect the creditor's qualification as an "Old and Cold" creditor under Code §382(1)(5)(E), except where the principal purpose for the change in the creditor's ownership was avoiding the "Old and Cold" creditor rules; (4) a creditor's transfer of its claim to a member of its own commonly controlled group or to a third-party as security for a loan should not affect the creditor's status as an "Old and Cold" creditor, except where the principal purpose for the transfer was the avoidance of the "Old and Cold" creditor rules; (5) debt refinancings and sales of debt participations should be disregarded for purposes of determining whether the ultimate debt holders are "Old and Cold" creditors under Code §382(1)(5); (6) a holder of less than 5% of the publicly held debt of the debtor that is exchanged for less than 5% of the bankrupt corporation's stock in the Chapter 11 reorganization should be treated as having held his debt since the debt's issuance, regardless of the date he acquired the debt; and (7) the minimum quantum of

[2] Questions relating to the determination of cancellation of indebtedness income and attribute reduction will follow in a forthcoming report.

continuing historic business activity required by Prop. Treas. Reg. §1.269-3(d) is illustrated.

We recognize that a number of thoughtful people - within and without the Government - may find some of these proposed rulings troubling. There is no central beacon - no single rationale - directing the various answers provided in these rulings, other than the answers “feel right,” i.e., reach sensible and practical results consistent with understood policy objectives. Publishing these rulings requires eschewing the normal tendency to extend the logic of Ruling 1 to Ruling 2 and reconciling either the result or logic of Ruling 3 with Ruling 4 or Ruling 2. Working with defective provisions in an area where direction is required sooner, rather than later, prompts us to propose a group of solutions to the pending problems that may be “logically” internally inconsistent.

As noted above, we think it important that the issues we raise be answered quickly. We hope that the positions taken in these proposed rulings, which we believe are reasonable and appropriate applications of the Code's bankruptcy tax rules, will assist taxpayers and others in dealing with these issues until definitive administrative or judicial guidance is obtained. The discussion portion of each of the following proposed revenue rulings is our commentary on the problem it addresses. We do not suggest that our discussion be included in the published rulings.

III. Proposed Tax Revenue Rulings.

1. Treatment of Consolidated Groups in Chapter 11 Reorganizations.

BR 1.1

Facts

L-P (Loss Parent Corporation) and L-S (Loss Subsidiary Corporation) are both loss corporations. Each is a debtor in a Chapter 11 proceeding. Pursuant to the confirmed Chapter 11 Plan involving both L-P and L-S, the L-P Old and Cold creditors.[3] receive a majority of the L-P stock and. the L-S Old and Cold creditors receive a majority of the L-S stock.

Held

Code §382(1)(5) governs the effects of the ownership changes of both L-P and L-S.

Discussion

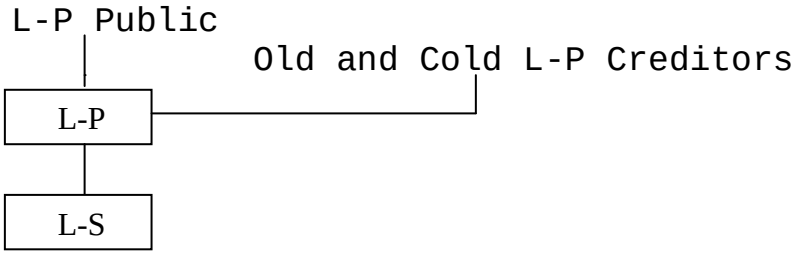
This ruling illustrates a literal and obvious application of the Code §382(1)(5) language. Where the Old and Cold creditors of a debtor receive a majority of the debtor's stock, that change of control qualifies for the bankruptcy exception provided by Code §382(1)(5). Although it will sometimes be necessary to treat L-P and L-S as a single loss corporation to achieve the results intended by Code §382(1)(5), it is not necessary or appropriate to always do so. Where, as here, the literal application of the Code §382(1)(5) language achieves its intended purpose, it should be allowed to effect that purpose.

[3] The term “Old and Cold Creditors”, is used throughout this Report to refer to shareholders and creditors described in Code §§382(1)(5)(A)(ii) and 382(1)(5)(E).

BR 1.2

Facts

L-P and L-S are both debtors in a Chapter 11 proceeding. Pursuant to its Chapter 11 Plan, I>P cancels all its old stock owned by the L-P Public and issues L-P stock solely to L-P Old and Cold creditors.



Held

Code §382(1)(5) governs the effects of the ownership changes of both L-P and L-S.

Discussion

Because the L-P creditors are not L-S creditors, they do not satisfy the literal statutory requirement that to qualify for Code §382(1)(5) treatment, the post-change owners of L-S must be "the shareholders and creditors of the old loss corporation." Here the post-change owners of L-S are the L-P Old and Cold Creditors, not the L-S Old and Cold Creditors. But the purpose of the legislation is best served by a construction that would provide Code §382(1)(5) treatment to the L-S ownership change. It would be bizarre to hold that the ownership change effected by L-P, which qualifies for Code §382(1)(5) treatment, effected an L-S ownership change under Code §382(g) and then proceed to hold that the L-S ownership change did not qualify for Code §382(1)(5) relief. That result can be avoided by treating the L-P—L-S affiliated group as a single loss corporation for purposes of Code §382(1)(5). Cf. Code §384(c)(6).

Code §382(1)(5)(A)(ii) provides that a Code §382(1)(5) ownership change of L-S will be effected where L-S Old and Cold creditors receive L-P stock representing 50% of the vote and value of L-P stock, an indication of Congressional recognition that affiliated bankrupt companies should, in appropriate circumstances, be dealt with on a group, rather than on a company by company, basis. The result should be the same, even where the creditors receiving stock are those of L-P. Also, the result should be the same, even if L-P and L-S do not file consolidated returns or L-P and L-S are not “historic members” of the same consolidated group. Query, should this rule apply only if L-P and L-S are part of a consolidated group. Suppose L-P owns 51% of L-S?

BR 1.3

Facts

After to the L-P and L-S ownership changes effected by the L-P stock issuance described in BR 1.2, L-S emerges from its bankruptcy proceedings. All the L-S stock owned by L-P is canceled. L-S issues 100 shares of its stock to its Old and Cold creditors.

Held

L-S has not undergone a second ownership change within two years of its first ownership change as described in Code §382(1)(5)(D). No bankruptcy or tax policy militates in favor of reducing L-S's Section 382 Limitation to zero merely because the L- S Chapter 11 Plan became effective after, rather than before, the L-P Chapter 11 Plan.

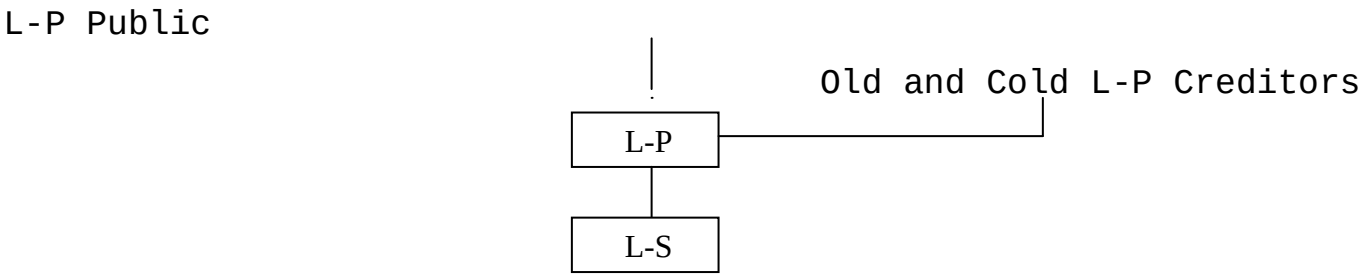
Discussion

Code §382(m) provides the necessary authority to carry out the purposes of Code §382(1)(5). The deemed ownership of L-S by L-P creditors effected by the L-P stock issuance is in any event meaningless as an economic matter, because L-P's stock in L-S is subsequently canceled. This ownership is properly disregarded in measuring the effect of the L-S plan.

BR 1.4

Facts

L-P is a debtor in a Chapter 11 proceeding; L-S is not. Pursuant to its Chapter 11 Plan, L-P cancels all its old stock owned by the L-P Public and issues L-P stock solely to L-P Old and Cold creditors.



Held

Code §382(1)(5) governs the effects of the ownership changes of both L-P and L-S.

Discussion

Code §382(m) should be invoked to provide the appropriate Code §382(1)(5) result for nonbankrupt subsidiaries. The facts here are the same as in BR 1.2, except here L-S is not in a Chapter 11 proceeding. L-S should not be forced into a costly, time consuming proceeding to achieve an obviously correct tax result. For example, if Texaco, with its multitude of solvent subsidiaries, had exited its Chapter 11 proceeding by

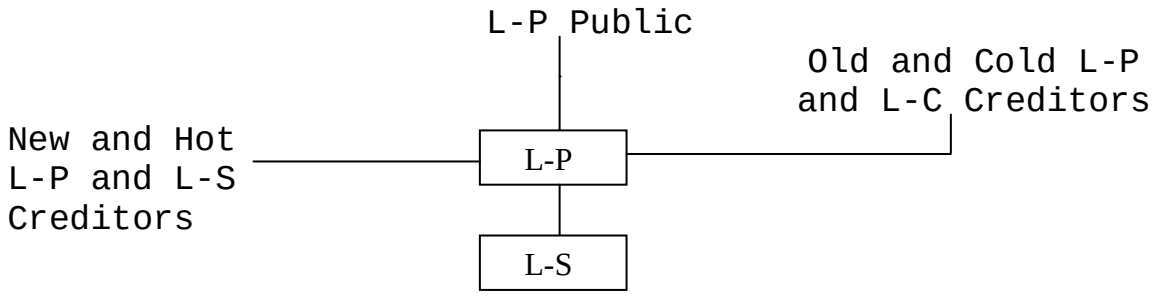
transferring majority control to its Old and Cold creditors, no known policy would dictate the subjecting Texaco's loss subsidiaries not in Chapter 11 to Code §382(b) limitations.

BR 1.5

Facts

L-P and L-S are in Chapter 11 proceedings, which are not substantively consolidated. The bankruptcy plan provides for distribution of L-P stock to:

30% L-P Old and Cold creditors
30% L-S Old and Cold creditors
20% L-P New and Hot creditors
20% L-S New and Hot creditors.



Held

Code §382(1)(5) governs the effects of the ownership changes of both L-P and L-S.

Discussion

Treating all the members of an affiliated group as ore loss corporation is a practical method of meeting the objectives of Code §382(1)(5). Any potential tax abuse engendered by this rule can be avoided by limiting its application to historic groups that, when formed, did not have as one of their principal purposes the exploitation of net operating losses.

The underlying rationale of Code §382(1)(5) is that the exchange by creditors of their debt for stock in the bankrupt corporation under conditions that qualify for Code §382(1)(5)

relief is not trafficking in losses -- the evil Code §382 is designed to prevent. Old and Cold creditors that satisfy the requirements of Code §382(1)(5)(E) are creditors of the debtor, whose transformation into shareholders of the debtor is involuntary. Typically, many of the loss corporation's losses were funded by these very creditors. See S. Rep. 99-313, 99th Cong., 2d Sess. 236 (1986).

These policy considerations are equally applicable to affiliated groups. Assume that insolvent L-P corporation owns all the stock of insolvent L-S corporation. If creditors of both L-P and L-S receive L-P stock, neither creditor has “cashed out” its investment, nor has the L-P -- L-S group garnered a net accession of wealth. The L-P creditors continue their investment in L-P; the L-S creditors continue their indirect investment in L-S through their ownership of L-P stock. Cf. Code §§368(a)(1)(B), 368(a)(1)(C),368(a)(2)(C),368(a)(2)(D),368(a)(2)(E) and Code §382 (1)(5)(A)(ii), which recognize continuing proprietary interests through ownership of stock of a parent corporation where a subsidiary transfers parent stock in a reorganization. Each creditor has diversified its investment — the creditor of L-P has an investment in L-S and the creditor of L-S an investment in L-P. But that involuntary diversification of an involuntary investment does not compel a different treatment of either the creditors or the corporations.

Because it is appropriate for L-P's creditors to benefit from L-P's losses and for L-S's creditors to benefit from L-S's losses, it is equally appropriate for these creditors to share the benefit of their combined losses. That sharing simply replicates the operation of an affiliated group. Before insolvency, the members of the L-P -- L-S group could freely share their post affiliation losses. No new losses are created.

Each creditor's share of the combined loss roughly corresponds to the larger share of the smaller separate loss to which that creditor is entitled. Any SRLY or CRCO limitations affecting the group remain in place and in effect as to the remaining NOLs, although there is serious question as to whether SRLY and CRCO should apply at all in the Post-1986 Code §382 world.

The alternative to allowing creditors of L-P and L-S to jointly own a single reorganized entity is to force the debtors, if they are to preserve their NOLs, to become disaffiliated (and therefore deconsolidated for federal tax purposes). This result may be inappropriate where the businesses of the two loss corporations are so integrally related that splitting the consolidated group for federal tax purposes would adversely affect the loss corporations' ability to rehabilitate themselves. Splitting an integrated business into separate components requires apportioning assets and liabilities and negotiating the terms of any continuing relationships (and may result in collateral tax consequences such as the triggering of excess loss accounts and gain from deferred intercompany transactions). These negotiations will absorb the attention of management at a time when resources are limited and, business crises plentiful. There is no reason to erect tax obstacles to creditors' combining different members of a bankrupt affiliated group in the manner that makes the most business sense.

Additionally, a principle of the Bankruptcy Code is to create viable corporations. The Bankruptcy Court cannot approve a plan of reorganization, even one supported by all the creditors, unless it finds that the resulting reorganized corporation is viable and not likely to require further reorganization. 11 U.S.C. §1129(a)(11). It is likely in the bankruptcy of any

affiliated group that some members of the group will not be viable on their own.

2. Issuing L Stock to Old and Cold Creditors.

BR 2.1

Facts

Upon emerging from its Chapter 11 proceeding, L has NOLs of $300, $100 of assets, and no liabilities. Under its Chapter 11 Plan, L's Old and Cold creditors receive 100% of L's newly issued common stock, while L's New and Hot creditors receive straight preferred stock with a liquidation, redemption and fair market value of $100, paying a market rate dividend.

Held

Code §382(1)(5) governs the effects of L's ownership change.

Discussion

This ruling raises two problems. First, how much “real equity” must be represented by “stock?” Second, how much “coverage” must be provided to straight preferred to avoid its being characterized as “participating in corporate growth to any significant extent?” The L common stock now owned by L's former Old and Cold creditors will benefit from all the upside potential of L's business. In particular, the holders of L common stock will benefit from any advantage L realizes through utilization of its NOLs. Under these circumstances, the L stock issued to the Old and Cold L creditors should qualify under Code §382(1)(5). Had L's Old and Cold creditors received the straight preferred stock and L's New And Hot creditors received the L common stock, Code §382(1)(5) would not govern the effects of L's ownership change.

BR 2.2

Facts

In Chapter 11 proceedings, L's common stock is canceled and new L common stock is issued 51% to Old and Cold creditors, 49% to new investors. Pursuant to the bankruptcy plan, L's New and Hot creditors exchange $1 million of L five year bonds (then trading at 40 cents on the dollar) for L nonvoting nonconvertible preferred stock, redeemable five years from the Effective Date of the Chapter 11 Plan for $1 million, the face amount of the debt exchanged for the preferred. Is the L preferred stock “straight preferred” stock described in Code §1504(a)(4)?

Held

The L preferred stock is not straight preferred stock. L's ownership change does not qualify under Code §382(1)(5). The L preferred stock is disqualified stock defined in Code §108(e)(10)(B)(ii). The exchange of preferred stock for debt is governed by Code §108(a).

Discussion

Stock described in Code §1504(a)(4) (“straight preferred stock”) is excluded from Code §382 ownership change determinations. Code §382(k)(6). Straight preferred stock is stock that is nonvoting, nonconvertible, nonparticipating, and does not have an unreasonable redemption or liquidation premium. If the L preferred stock issued to L's New and Hot creditors has an unreasonable redemption premium, then L's nominal straight preferred stock would not qualify as Code §1504(a)(4) stock and

would be “stock” for purposes of Code §382. If the preferred stock issued to New and Hot creditors is stock, more than 50 percent of L would be owned by persons other than Old and Cold creditors.

No regulations have been issued under Code §1504(a)(4). Treas. Reg. §1.305-5(b)(1), which prescribes dividend treatment for any unreasonable redemption premium on preferred stock that has been issued as a distribution on the issuer's outstanding stock, provides a useful analogy. Preferred stock is deemed to have a redemption premium under the Code §305 regulations where the preferred “may be redeemed after a specified period of time at a price higher than the issue price.”

But what is the “issue price” of L's preferred stock? In Treas. Reg. §1.305-5(d)(Example 7), the issue price of preferred stock distributed on outstanding common stock is defined as “the fair market value of the preferred stock immediately following its distribution as a stock dividend.” If, as would follow from Philadelphia Park Amusement Co. v. U.S., 126 F. Supp. 184 (Ct. Cl. 1954), the fair market value of L's preferred stock approximates the fair market value of the New and Hot debt exchanged (i.e.. 40% of face), L's preferred stock would have a 250% redemption premium (i.e.. a $400,000 issue price and a $1,000,000 redemption price).

The Code §305 rules, designed to prevent taxpayers from converting what would be ordinary dividend income to capital gain through use of an unreasonably high redemption price on preferred stock, do not provide comfortable answers in Code §382 settings. Under Code §305(c), as modified by the Revenue Reconciliation Act of 1990, the Service is directed to promulgate regulations providing that preferred stock that is subject to mandatory redemption or may be put to the issuer by the holder has an

unreasonable redemption premium when its stated redemption price exceeds its issue price by more than the de minimis amount that would apply for purposes of determining OID if the stock were a debt instrument (i.e., $^1/_4$ of 1% for each complete year until the stock is redeemed (or may be put) times the stated redemption (or put) price of the stock). The regulations are to provide that the unreasonable redemption premium "shall be taken into account under principles similar to the principles of Code §1272(a)."

If the Service issues regulations directing the determination of issue price under principles similar to Code §1273, 1274 and 1275, the issue price of the L preferred stock would be its fair market value, its discounted present value, or the fair market value of the debt instrument exchanged there for, depending on whether the preferred stock or the debt instrument is publicly traded. Applying these principles, L's preferred stock possesses an unreasonable redemption premium and is counted in determining whether L's ownership change qualifies under Code §382(1)(5). The value of the preferred stock and the value of the common stock issued to new investors is more than 50% of the value of L. L's ownership change does not qualify under Code §382(1)(5).

L's issuance of its disqualified preferred stock having an issue price of $400,000 for $1 million of debt produces $600,000 cancellation of indebtedness income, governed by Code §§108(a) and 108(b).

If neither the old L debt nor the new L preferred stock exchanged therefor is publicly traded, and the new L preferred pays dividends at or above the "applicable federal rate" set forth in Code §1274(d), the new L preferred stock's issue price presumably would equal its "stated principal amount" under Code §1274 principles and the L preferred stock would not have an

unreasonable redemption premium. But the absence of an unreasonable redemption premium does not provide automatic qualification under Code § 1504(a)(4) requiring the preferred stock not participate in corporate growth to any significant extent.

BR 2.3

Facts

L is in a Chapter 11 proceeding. L's stock is widely held and L has not undergone an ownership change or an equity shift in the past three years. In the Chapter 11 proceeding, Old and Cold creditor B acquires 49% of L's stock, representing effective control of L. The balance of the L shares are retained by L's historic shareholders. Taking into account the control feature, the fair market value of the controlling shares held by B is more than 50% of the total fair market value of all outstanding L stock.

L has not undergone an ownership change pursuant to Code §382(g).

Discussion

Although a case could be made for treating the described Chapter 11 plan as an ownership change, the better administrative position, providing both simplicity and certainty, is to treat

each share of stock of the same class as having a value equal to the value of each other share of that class. In other words, no premiums for control; no discounts for minority interests or blockage; no adjustments, period.

Code §382(k)(6)(C) provides that “[determinations of the percentage of stock held by any person shall be made on the basis of value,” implying that the total value of all of a class of stock would equal the sum of its constituent parts, a conclusion inconsistent with the idea that a control block of shares should be assigned a value premium. (There is no basis for assuming any control premium would necessarily equal minority or blockage discounts).

The prospect of either the Service or the taxpayer asserting that different blocks of shares of the same class have different values is, moreover, not a pleasant one to either administer or plan and would foster significant litigation. Taxpayers would face the prospect of revenue agents asserting that, say, blocks of 48% of a loss corporation's shares really represented a majority of the value of the corporation's stock. Similarly, the Service would face taxpayer arguments that large blocks of stock that otherwise would aggregate enough to constitute an ownership change should be reduced in value to take into account minority or blockage discounts.

BR 2.4

Facts

L is in a Chapter 11 proceeding. Pursuant to its Plan of Reorganization, L's old stock is canceled, 51% of L's stock is issued to Old and Cold Creditors and 49% to I, a third party investor. Three months after its receipt of its L stock and as a

result of a change in circumstances after that receipt, an Old and Cold Creditor sells 6% of L's stock to X.

Held

The sale to X does not vitiate the Plan's qualification under Code §382(1)(5).

Discussion

The Chapter 11 Plan consummation effects an ownership change. The Plan's qualification under Code §382(1)(5) is premised on its constituting an ownership change under Code §382(g). Under Code §382(i)(2), the testing period for determining whether a second ownership change has occurred commences the day after the Chapter 11 ownership change date. Thus, X's acquisition of the 6% of L stock leaves L 44+ percentage points away from a second ownership change. Code §382(1)(5) does not require (expressly or impliedly) that the Old and Cold Creditors that receive L stock “continue” their L stock ownership. To hold otherwise would require all Old and Cold Creditors to retain all their L stock for two or three years, a result not required by the statute or any of its purpose.

BR 2.5

Facts

L is in a Chapter 11 proceeding. Pursuant to its Plan of Reorganization, L's old stock is canceled, 51% of L's stock is issued to Old and Cold Creditors and 49% to I, a third party investor. Two weeks after its receipt of its L stock and as a result of a change in circumstances after that receipt, an Old and Cold Creditor sells 2% of L's stock to I.

Held

The sale to I does not vitiate the Plan's qualification under Code §382(1)(5).

Discussion

The Chapter 11 Plan consummation effects an ownership change. The Plan's qualification under Code §382(1)(5) does not detract from its qualification under Code §382(g). Under Code §382(i)(2), the testing period for determining whether a second ownership change has occurred commences the day after the Chapter 11 ownership change date. Thus, l's acquisition of the 2% of L stock leaves L 48+ percentage points away from a second ownership change. Code §382(1)(5) does not require (expressly or impliedly) that the Old and Cold Creditors that receive L stock “continue” their L stock ownership.

BR 2.6

Facts

L is in a Chapter 11 proceeding. Pursuant to its Plan of Reorganization, L's old stock is canceled, 51% of L's stock is issued to Old and Cold Creditors and 49% to I. Two weeks after its receipt of L stock and pursuant to a binding contract entered into before the effective date, an Old and Cold Creditor sells 2% of L's stock to I.

Held

L has undergone an ownership change not described in Code §382(1)(5).

Discussion

If the selling Old and Cold Creditor never effectively exercised ownership of the L stock, that creditor should not be counted in determining the qualification of the L Plan of Reorganization under Code §382(1)(5). This same result is achieved by applying Prop. Reg. §1.382-2T(h)(4)(x)(J). But if the contract to sell is made after the “ownership change date,” the results outlined in BR 2.5 should obtain here.

BR 2.7

Facts

L is in a Chapter 11 proceeding. Pursuant to its Plan of Reorganization, L's old stock is canceled, 51% of L's stock is issued to Old and Cold Creditors and 49% to I. Two weeks after its receipt of L stock and pursuant to its intention at the confirmation date, but not pursuant to a binding contract entered into prior to its receipt of the stock, an Old and Cold Creditor sells 2% of L's stock to I.

Held

The sale to I does not prevent the L ownership change from qualifying under Code §382(1)(5).

Discussion

The proper test to be applied here is the control test used in Code §351 -- testing whether the transferors are in control of the transferee corporation “immediately after the exchange.” To provide certainty and simplicity, subjective intention not manifested by a binding agreement should be ignored. As a practical matter, many creditors want to liquidate

their claims as quickly as possible. Their intention should not affect L's status under Code §382(1)(5).

3. Who is an Old and Cold Creditor?

BR 3.1

Facts

In a Chapter 11 proceeding, all of L's stock is canceled. Under the bankruptcy plan, Creditor Co., a creditor of L, receives 100% of L's newly issued common stock. Creditor Co.'s claim is described in Code §382(1)(5)(E)(i.e.. Creditor Co.'s claim either arose in the ordinary course of L's business or was held by Creditor Co. at least eighteen months prior to L's Chapter 11 filing). Although Creditor Co. held its L claim at all times since the claim arose, 60% of Creditor Co.'s stock changed hands in a leveraged buyout of Creditor Co. one month before L's Chapter 11 petition was filed.

Held

Creditor Co. qualifies as an Old and Cold L creditor.

Discussion

Code §382(1)(5)(E) defines an “Old and Cold” creditor with reference to that creditor's holding of the indebtedness, i.e.. the creditor must have held the debt for at least 18 months before the date of the filing of the title 11 case or the debt must have arisen in the ordinary course of the trade or business of the debtor and must have been held by the creditor at all times thereafter. Literally, Code §382(1)(5)(E) looks only to the creditor, not the ownership of the creditor. The elaborate attribution rules of Code §382(1)(3)(A) apply only to the ownership of stock in the loss corporation, not to the ownership of the loss corporation's indebtedness. Code §382(1)(5)(E) is

satisfied if a creditor has held the debt for the required periods, even if the ownership of that creditor has changed.

This literal reading of Code §382(1)(5)(E) is consistent with the purpose of that provision. Limitations were placed on the exception for title 11 cases to avoid an abuse, such as a corporation's purchasing a loss corporation's debt immediately before or during a bankruptcy proceeding, exchanging that debt for stock and then using the loss corporation's NOL carryforwards without limitation. See S. Rep. 99-313, 99th Cong., 2d Sess. 236. See also. Jacobs, Tax Treatment of Corporate Net Operating Losses and Other Tax Attribute Carryovers, 5 Va.Tax.Rev. 701, 729-36 (1986). That abuse generally is not possible if, to acquire a corporation's debt, the potential purchaser must acquire the corporation's creditors. Transfers of the ownership of a creditor should be deemed a transfer of the debt only if the ownership is transferred for the principal purpose of avoiding Code §382(1)(5)(E), e.g., if the creditor's sole asset is the debt of one title 11 debtor. See PLR 90-19036 (9 Feb. 90).

BR 3.2

Facts

In a Chapter 11 proceeding, all of L's stock is canceled. Creditor Co., a creditor of L, files a claim described in Code §382(1)(5)(E)(i.e., Creditor Co.'s claim either arose in the ordinary course of L's business or was held by Creditor Co. at least eighteen months prior to L's Chapter 11 filing). Creditor Co. subsequently assigns its L claim to Creditor Co. Sub, a foreign corporation wholly owned by Creditor Co.

Held

Creditor Co. Sub qualifies as an Old and Cold L creditor.

Discussion

Creditor Co. should be permitted to transfer its claim against L to any member of its commonly controlled group of corporations (not limited to its consolidated group) without adversely affecting its “Old and Cold” creditor status. The “broad” definition of a controlled group should be applied here to permit transfers to banks, insurance companies or foreign corporations. Under this rule, creditors would be permitted to transfer troubled claims to wholly-owned subsidiaries.

BR 3.3

Facts

Under the facts in BR 3.1, Creditor Co.'s stock has not changed hands, but, instead, Creditor Co.'s L debt is transferred to Big Co. in conjunction with the transfer of substantially all the assets of Creditor Co.'s business to Big Co. one month before L's Chapter 11 petition was filed. The transfer by Creditor Co. to Big Co. did not have as its principal purpose the avoidance of Code §382(1)(5)(E).

Held

Big Co. qualifies as an Old and Cold creditor of L.

Discussion

Code §382(1)(5)(E) is literally not satisfied if the loss corporation's debt is transferred by a creditor [Creditor Co.] (1) in conjunction with the transfer of all the assets of a

creditor's business or (2) in an involuntary transfer (as by foreclosure). Because neither described transfer normally will further the abuse Code §382(1),(5)(E) was designed to prevent, these transfers should be disregarded in determining whether a creditor is “Old and Cold.” These facts are an appropriate situation to apply Code §382(1)(8), which provides:

> Except as provided in regulations, any entity and any predecessor or successor entities of such entity shall be treated as 1 entity.

Under this provision, Big Co. and Creditor Co. are treated as a single entity and L's debt transfer is ignored. For these purposes, the transfer of assets need not qualify as a tax-free transfer under Code §368 or otherwise. It would be highly unusual for any Big Co. to acquire a Creditor Co.’s business principally to obtain a debt claim against a loss corporation.

BR 3.4

Facts

L is in a Chapter 11 proceeding. In the Chapter 11 proceeding all of L's stock will be canceled. New L stock will be issued to L's creditors. Creditor Co. has borrowed money from Bank, securing that loan with Creditor Co.'s L claim. Creditor Co. defaults on its loan and Bank forecloses on the collateral.

Neither the loan by Bank, nor the foreclosure on the collateral, had as its principal purpose the avoidance of Code §382(1)(5)(E).

Held

Bank qualifies as an Old and Cold Creditor.

Discussion

A bona fide secured loan made for business reasons and not to avoid the limitations of Code §382(1)(5)(E) should not adversely affect the Old and Cold ordinary course of business status of the claim transferee, the Bank.

BR 3.5

Facts

L is in a Chapter 11 proceeding. In the Chapter 11 proceeding all of L's stock will be canceled. New L stock will be issued to L's creditors. Investor seeks to secure L stock in the Chapter 11 proceeding. To achieve this result, Investor lends Creditor Co. money on a nonrecourse basis, secured by Creditor Co. s L claim. Creditor Co. (as anticipated) defaults on its loan and Investor forecloses on its collateral. The loan by Investor and the foreclosure on the collateral had as its principal purpose the avoidance of Code §382(1)(5)(E).

Held

Investor is not an Old and Cold Creditor within the meaning of Code § 382(1)(5)(E)(ii).

Discussion

While a bona fide secured loan made for business reasons and not to avoid the limitations of Code §382(1)(5)(E) should not adversely affect the Old and Cold ordinary course of business

status of the claim transferee, a loan made as a step to acquire a claim that will be converted into L stock will not qualify the claim transferee as an Old and Cold creditor.

BR 3.6

Facts

L, a clothing retailer, purchases a supply of goods for resale from T, a clothing manufacturer and wholesaler. Six months after the purchase, and before T is paid, L files for reorganization under Chapter 11. T continues to hold its claim on the effective date of L's plan of reorganization.

Held

T is an Old and Cold Creditor within the meaning of Code §382(1)(5)(E)(ii).

Discussion

T, a trade creditor, is the very model of the holder of “a claim that arose in the ordinary course of the trade or business of the old loss corporation and is held by the person who at all times held the beneficial interest in such indebtedness.” Debt incurred in purchasing goods for resale is obviously incurred “in the ordinary course of business,” and T, by virtue of his holding the claim until the effective date, is richly deserving of Old and Cold Creditor status.

BR 3.7

Facts

L refinances a significant block of its outstanding bank debt with new bank lenders. Banks A, B and C, in the ordinary course of their banking business, lend money to L in the

refinancing, the proceeds of which are used to retire existing debt. Less than 18 months after the refinancing takes place, L files for reorganization under Chapter 11. Banks A, B and C continue to hold their claims on the effective date of L's bankruptcy reorganization plan.

Held

Banks A, B and C are Old and Cold Creditors within the meaning of Code §382(1)(5)(E)(ii).

Discussion

The phrase “ordinary course of business of the old loss corporation” should be given a broad construction. The phrase should cover any activity necessary or appropriate to the operation of L's business, provided the debt was not incurred for the purpose of avoiding the Code §382 rules.

As a policy matter, there is no reason to distinguish debt incurred by reason of irregular but ordinary events from debt incurred in pursuing routine business activity (such as trade creditor debt).

L's refinancing, although “unusual” because it happens infrequently, is necessary and appropriate to the operation of L's business. Banks A, B and C did not make loans with the expectation or intention of becoming L shareholders. They qualify as Old and Cold Creditors.

BR 3.8

Facts

L, a financially troubled clothing retailer, attempts to improve its fortunes by acquiring a new line of business. Banks

A, B and C lend money to L to finance L's acquisition of a semiconductor manufacturing business. Unfortunately, L's business reversals continue and it files under Chapter 11 one year after the acquisition.

Held

Banks A, B and C are Old and Cold L Creditors within the meaning of Code §382(1)(5)(E)(ii).

Discussion

Same reasoning as BR 3.7. L's acquisition was not a regular event, but there was no purpose of avoiding any of the Code §382 requirements. That the debt was incurred in L's acquisition of a capital asset does not change the conclusion that the debt was incurred in the “ordinary course” of L's business.

BR 3.9

Facts

Bank D made a loan to L in the ordinary course of L's business. Within 60 days after making the loan, and pursuant to Bank D's intention when it lent the money to L, Bank D issued participations in the loan to Banks E, F and G. One year later, L filed for Chapter 11 protection.

Held

The debt of L held by Banks D, E, F and G is held by persons who at all times held the beneficial interest in the debt. Banks D, E, F and G are all Old and Cold Creditors.

Discussion

Banks commonly fund a loan and shortly thereafter sell participations in the loan to other lenders. Where this occurs relatively soon after the original loan is funded and is pursuant to the plan or general intention of the lead lending bank when the loan is made, the participating banks should be viewed as original holders of the L debt. The same treatment should be afforded investors that purchase L's bonds from an underwriter of bond debt, who takes 60 days to place the issue with the investors.

BR 3.10

Facts

L is a debtor in a Chapter 11 proceeding. L has provided full time employees with benefits (“Benefits”) that include, among other things, lifetime medical coverage for eligible retirees (“Retirees”). L has not funded its Benefits obligations. The Retirees' claims for Benefits are unsecured claims in bankruptcy and will be reduced to a fixed and determinable amount on a class basis and satisfied under the Flan by a pro rata share (along with other general unsecured creditors) of stock and cash. The amount of cash and stock will be paid to two Retiree Benefit Trusts, which together will own approximately 38% of the new common stock to be issued by L. L's old common stock will be canceled. Payment of the cash and stock by L to the Retiree Benefits Trusts will, as a matter of law, discharge L from obligations with respect to future Benefits. The two Retiree Benefits Trusts will thereafter provide Benefits to Retirees in accordance with a voluntary benefits plan. The identity of individual benefits claimants will not be known for some time,

and will be determined in accordance with the clams of the benefits plan. However, all cash and stock in the Retiree Benefit Trusts will be used for the exclusive benefit of the Retirees; there can be no reversion to L. Furthermore, the amount of common stock to be issued to the Retiree Benefits Trust will be known (on a class basis) on the effective date of the Plan.

Held

Retirees holding Benefits claims that will be reduced to a fixed and determinable amount on a class basis pursuant to the confirmation of the plan will be “creditors” holding L “indebtedness” within the meaning of Code §382(1)(5)(E)(ii) because their claims to Benefits arose in connection with the ordinary course of L's business. The transfer of L stock to the Retirees Benefit Trust in satisfaction of a claim of a Retiree who at all times held the beneficial interest in the claim will be taken into account in determining whether the test described in §382(1)(5)(A)(ii) is met.

Discussion

The ruling follows the facts and holdings of PLR 8902047 (October 28,1988). “Class” beneficiaries, whose particular identity and extent of ownership is not known as of the effective date, will nonetheless constitute qualified Old and Cold Creditors, provided their claims arose in the ordinary course of L's business and the amount of stock to be received by them as a class is set in the bankruptcy plan.

BR 3.11

Facts

L is a debtor in a Chapter 11 proceeding. L's debt consists of publicly traded debentures issued more than 18 months

before its filing of a Chapter 11 petition. A substantial portion of the debentures were purchased by their owners less than 18 months preceding L's filing its Chapter 11 petition. L exchanges 51% of its stock for the debentures. No debenture holder holds 5% or more of the debentures or receives 5% or more of L's stock in the exchange. The balance of the L stock is issued to a new investor for cash.

Held

Code §382(1)(5) governs the effects of the L ownership change.

Discussion

Transfers between less than 5% shareholders (whether within a public group of shareholders or between members of identified separate public groups) are disregarded under Treas. Reg. §1.382-2T(e)(1)(ii), a rule of administrative convenience. To require L to trace transfers of stock between less than 5% shareholders (especially where L is a public company) would be unfair. What ownership information is available may be inaccurate. Frequently, securities registered in “street name” cannot be traced to their beneficial owners. The burden of proving ownership may be impossible to carry.

Similar considerations should apply to transfers of publicly held debt. While not entirely free from doubt, we believe the difficulties in tracing transfers of publicly held debt are deserving of treatment similar to that accorded publicly held stock. If a holder of less than 5% of the debtor's publicly held debt, which debt has been outstanding more than 18 months prior to the bankruptcy filing, exchanges his L debt for L stock in the Chapter 11 proceeding, he should be treated as having acquired his exchanged L debt on the date of the original debt

issuance I i.e., more than 18 months before the Chapter 11 petition filing) and should qualify as an Old and Cold Creditor for purposes of Code §382(1)(5). Alternatively, instead of testing the debt-for-stock exchange by the percentage of the L publicly held debt exchanged by each debenture holder, the test could be the percentage of L stock received by the debenture holder. Under that rule, debenture holders who received less than 5% of L's stock under the Chapter 11 Plan would be deemed to be Old and Cold Creditors. Or, the Service could determine that Old and Cold Creditor status would be limited to exchanging debenture holders who (i) held less than 5% of L's debt and (ii) received less than 5% of L's stock under the Chapter 11 Plan.

A somewhat less compelling, but on balance sympathetic, case can be made for small holders (i.e.. less than 5%) of that debtor's nonpublic debt. The abuse potential, i.e.. acquiring L debt as a means of gaining control of L and its favorable tax attributes, is equally absent where less than 5% of the L debt is publicly held or privately held but arises in the ordinary course of business, rather than in a lending transaction. Creditors that purchase trade (ordinary course of business) debt that results in the eventual ownership of less than 5% of L's stock should not qualify for this relaxed treatment.

BR 3.12

Facts

In a Chapter 11 proceeding, all of L's stock is canceled. Under the bankruptcy plan, Creditor Co., a creditor of L, receives 100% of L's newly issued common stock. Creditor Co.'s claim is described in Code §382(1)(5)(E) (i.e.. Creditor Co.'s claim either arose in the ordinary course of L's business or was held by Creditor Co. at least eighteen months prior to L's

Chapter 11 filing). Shortly after Creditor Co. acquired its claim against L, Creditor Co. sold that claim “with recourse” to Bank. Upon L's default, Bank reassigned the claim to Creditor Co. Creditor Co., pursuant to its guarantee, paid Bank the amount of the claim, plus interest.

Held

Creditor Co. qualifies as an Old and Cold L Creditor.

Discussion

Code §382(1)(5)(E) defines an Old and Cold creditor with reference to that creditor's holding of the indebtedness, i.e.. the creditor roust have held the debt for at least 18 months before the date of the filing of the title 11 case or the debt must have arisen in the ordinary course of the trade or business of the debtor and must have been held by the creditor at all times thereafter. Here, Creditor Co. at all times was the party at risk with respect to the credit extended to L. Under these circumstances, Creditor Co. qualifies as Old and Cold. See PLR 9019036 (9 Feb. 1990).

4. Chapter 7 Proceedings

BR 4.1

Facts

L is a debtor in a Chapter 7 (liquidating) proceeding. In the liquidation, L creditors receive cash equal to 10% of their claims.

Held

L's payment of its debt at the rate of 10 cents on the dollar does not cause the recognition of cancellation of indebtedness income nor require any reduction in L's tax attributes. L's NOLs are available to shelter income L realized during the Chapter 7 proceedings.

Discussion

L's debt owed to the creditors is not canceled in a Chapter 7 liquidation. 11 U.S.C. §727(a)(1) (1982). Thus, no COD is realized.

5. Transfer Restrictions on Stock Following an Ownership Change.

BR 5.1

Pursuant to its Chapter 11 Plan, L canceled its outstanding stock and issued 50 new shares to Old and Cold creditors, effecting a Code §382(1)(5) ownership change. L issued its remaining 50 shares to new investors. To avoid a second ownership change, L adopted a new article to its certificate of incorporation providing that, in the absence of special Board approval, (i) a purported transfer of L stock in excess of the shares that can be transferred without increasing the transferee's ownership percentage of L above 4.5 percent (the “Prohibited Shares”) is not effective to transfer ownership of the excess shares to the purported acquiror, and (ii) any transfer of an option to acquire L stock between persons who are not 5 percent shareholders is not effective if the transferee would, by virtue of a deemed or actual exercise of the transferred option, become a 5 percent shareholder.

Held

Provided that the transfer restriction is enforceable under applicable state law and L will promptly enforce the restriction, (i) the acquiror of Prohibited Shares will not be treated as having acquired ownership of the Prohibited Shares, and (ii) any transfer of an option to purchase L stock between persons who are not 5 percent shareholders without regard to the deemed exercise of the option will be disregarded if the transferee is prohibited by L's certificate of incorporation from exercising the option (and thereby becoming a 5 percent shareholder).

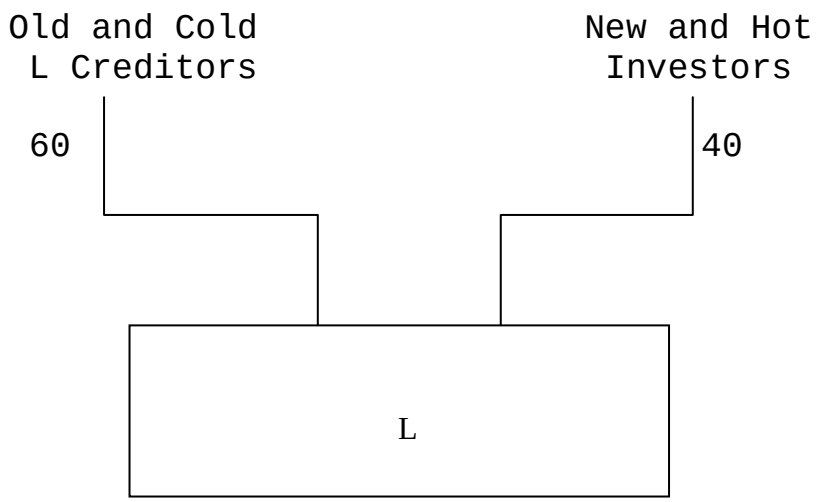
Discussion

If stock transfer restrictions implemented by a corporation's certificate of incorporation are valid under state law, then transfers of stock in violation of these restrictions would be void. Purported stock ownership, void for state law purposes, is disregarded for purposes of Code §382. See PLR 8949040 (December 8, 1989).

6. Deemed Exercise of Options in Code 5382(11(5) Context.

BR 6.1

Facts



In Chapter 11 proceedings, all of L's stock is canceled. Under the bankruptcy plan, L's Old and Cold Creditors receive new L stock representing 60% of L; New and Hot Investors receive new L stock representing 40%. New and Hot Investors also receive options to purchase additional stock from L sufficient to increase their L ownership to 55% on a fully diluted basis. The options cannot be exercised until after two years following the effective date of L's bankruptcy plan.

Held

L's ownership change does not qualify under Code §382(1)(5).

Discussion

Prop. Treas. Reg. §1.382-3(c) provides that options will be deemed selectively exercised or not exercised in determining whether shareholders and Old and Cold creditors satisfy the ownership requirements of Code §382(1)(5). An ownership change will not qualify under Code §382(1)(5), unless under no circumstances would the exercise or nonexercise of options result in a less than 50% ownership of L by its Old and Cold Creditors.

7. Code §269 Application

BR 7.1

Facts

Before filing its Chapter 11 petition, L owned and operated six cruise ships that cost more than $200 million, employed more than 1,000 persons in the various facets of its business and derived revenues in excess of $60 million per year. In connection with its cruise business, L operated two laundry facilities near the Hudson River piers to handle its linen and

other laundry needs. The laundry facilities cost $400,000 to equip and furnish. L's laundry operations employed 100 persons and grossed more than $1 million a year by providing laundry service to restaurants and hospitals in the area. Cruising and L fell on hard times. L filed for Chapter 11 protection. During the course of the Chapter 11 proceedings, L sold all of its cruise ships and terminated all of its employees, except 50 persons employed in the one remaining laundry facility, which continues to gross $1 million per year. In the Chapter 11 proceeding, L canceled all its outstanding stock and issued new common stock to its Old and Cold creditors.

Held

L's reorganization plan qualifies under Code §382(1)(5).L's continuation of the restaurant and hospital segment of its laundry business, with a gross income of $1 million and 50 continuing employees constitutes the carrying on of a more than insignificant amount of an active trade or business during and subsequent to the title 11 case within the contemplation of Prop. Treas. Reg. §1.269-3(d).

Discussion

In a prior report, No. 675, the NYSBA Tax Section recommended the presumption in Prop. Treas. Reg. §1.269-3(d) be deleted. This ruling assumes that action has not yet been taken. The results set forth in the ruling should follow from the proposed regulation. The percentage of L's business income is less than 2% of the former L income and the percentage of L's business assets is less than one tenth of 1% of the former business assets required to conduct L's historic businesses. Nonetheless, L's continuing its historic laundry business

activity is significant, satisfying the requirements of Prop. Treas. Reg. §1.269-3(d).

BR 7.2

Facts

The facts are the same as BR 7.1 except that the laundry business is conducted through a wholly-owned subsidiary, L-S, which is also a debtor in the Chapter 11 proceeding. Following the proceeding, L operates no business and owns no assets except the stock of L-S.

Held

The reorganization plans of L and L-S both qualify under Code §382(1)(5).

Discussion

Although L does not itself continue to carry on a historic business, L's ownership of the L-S stock and L-S's continuation of a significant historic business satisfies the requirements of Prop. Treas. Reg. §1.269-3(d).

January 8, 1991
MDMS 224181